

# UNITED STATES OF AMERICA

October 2014

## DETAILED ASSESSMENT OF IMPLEMENTATION SELF-ASSESSMENT<sup>1</sup>

### IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

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<sup>1</sup> This self-assessment has been prepared by the staff of the U.S. Securities and Exchange Commission for purposes of the IMF's FSAP of the United States and is non-binding, informal, and summary in nature. The responses contained herein express the views of the staff of the Commission and are not rules, regulations, interpretations, or statements of the Commission, which has neither approved nor disapproved the responses.

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## INTRODUCTION

<b>Jurisdiction:</b>	United States of America
<b>Authority:</b>	Securities and Exchange Commission
<b>Date prepared:</b>	August 31, 2014
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1. This self-assessment questionnaire has been prepared in reference to the Methodology to assess the implementation of the IOSCO Objectives and Principles of Securities Regulation approved by IOSCO.
2. Section II provides important guidance that should be taken into account when preparing the responses to the self-assessment questionnaire that is particularly important for the IMF to initiate the assessment of the efficiency of supervision. Please pay particular attention to the fact that the scope of the IOSCO assessment extends beyond the primary securities regulator, if other authorities are responsible for regulating, supervising, and/or enforcing any elements covered by the Principles.
3. As described in the following sections, the authorities are requested to provide (i) brief information on preconditions (section III); (ii) a summary of grades (section IV); and (iii) detailed answers to the self assessment questionnaire (section V).
4. Deadline for providing the fully completed self-assessment to the IMF is [Month, DD, YYYY](#). Questions on this document should be referred to [Assessor Name](#) (IMF-MCM – Phone: +1 (202) 623-XXX, email: [XXX@imf.org](mailto:XXX@imf.org)) and [Assessor Name](#) (Phone: +1 (202) 623-XXXX, email: [XXXX@imf.org](mailto:XXXX@imf.org)).
5. In your answers to the questions, please describe the content of your regulatory, supervisory, and enforcement framework in detail and include precise references to the relevant laws, regulations, and guidelines. Please also provide us with links to/PDF copies of them.

## ADDITIONAL GUIDANCE

### Additional Guidance for the Preparation of the Self-Assessment on the IOSCO Principles and Objectives of Securities Regulation

The self-assessment constitutes a critical input in the assessment process. It provides the authorities' own evaluation of the extent to which the jurisdiction is compliant with the IOSCO Objectives and Principles of Securities Regulation. A recurrent challenge for missions has been the fact that authorities do not always include sufficient information to allow assessors to determine whether the legal and regulatory framework described in the corresponding principle has been implemented in practice. As a result, assessors usually need to request additional information from the authorities under a very tight timetable. The table below lists the most frequent cases where additional information has been requested in the past, so that the authorities can take it into consideration when preparing the self-assessment. The provision of this information should help achieve more effective and efficient meetings during the mission.

Number of the Principle and Question	Useful information to include in the self-assessment, under the response to the corresponding Principle/Question
1, Question 2(a)	<ul style="list-style-type: none"> <li>Please ensure that your description identifies any possible division of responsibilities in the regulation and supervision of securities markets, activities, and participants on the basis of the type of security, market participant (e.g., bank vs. securities dealer/broker) between the various statutory and self-regulatory authorities. Please note that the IOSCO assessment covers also banks' securities activities, and if more than one authority is responsible for the supervision of such activities, the discussion of Principles 1-5 should cover all those authorities. In such case, you are also expected to include information on the responsibilities and activities of all those authorities in all relevant Principles (particularly 10-12 and 29-32).</li> </ul>
1, Question 2(b)	<ul style="list-style-type: none"> <li>Do other types of financial institutions offer securities like products (such as CIS-like insurance products or deposit instruments that mimic CISs/return based on market performance, etc.)?</li> <li>If so, how are these other products regulated with respect to disclosure, suitability for the client, etc.?</li> <li>Is the regulation that is applied equivalent to that which applies to equivalent securities products?</li> </ul>
1, Question 2(d)	<ul style="list-style-type: none"> <li>Reference to any MoUs between the domestic authorities and</li> </ul>

	<p>the areas that they cover. If possible include copies.</p> <ul style="list-style-type: none"> <li>Reference to any committees between the domestic authorities, with indication of frequency of meetings, and types of issues discussed in the past.</li> </ul>
3, Question 2	<ul style="list-style-type: none"> <li>Information on the budget development of the relevant regulatory authorities, including source(s) of funding (for the last three years and any budgets or estimates available for the upcoming years).</li> </ul>
3, Question 3	<ul style="list-style-type: none"> <li>Information on number of staff dedicated to securities markets regulation and supervision, if possible with a break down by main functions (licensing, supervision of intermediaries, market surveillance, enforcement), as well as by profession.</li> <li>Information on average years of experience of staff at different levels of the organization, staff turnover, and competitiveness of the salaries vis-à-vis the private sector.</li> </ul>
5, Question 2(a)	<ul style="list-style-type: none"> <li>Details on the mechanisms in place to oversee that the staff complies with the Code of Conduct or other relevant ethical obligations.</li> </ul>
7, Question 1	<ul style="list-style-type: none"> <li>What information does the regulator have about securities activities in the jurisdiction, including about activities that are not subject to regulation? <ul style="list-style-type: none"> <li>Is this information complete, up-to-date, and accurate?</li> <li>What kind of analysis/review is done on this information?</li> </ul> </li> </ul>
9, Question 3(c)	<ul style="list-style-type: none"> <li>Details on the SRO's supervision of its members, including on- and off-site examinations and enforcement activities over the past 3-5 years (same kind of information as listed under Pr. 12, Questions 1 and 9 below).</li> </ul>
9, Question 4(a)	<ul style="list-style-type: none"> <li>Detailed information on the regulator's oversight program in all entities that qualify as SROs as per Principle 9, including both off-site reporting and on-site inspections. With regards to the latter, include information on the cycle of inspections and their scope/coverage.</li> </ul>
12, Question 1 for issues related to supervision and question 9 for issues related to enforcement	<ul style="list-style-type: none"> <li>For both supervision and enforcement, include the quantitative information listed below for the last three years (the authorities are encouraged to provide a longer set of data, e.g., five years). If supervision and enforcement are (also) carried out by the exchanges or a SRO, please provide the corresponding information also on their activities. <u>For supervision of market intermediaries and fund managers:</u> <ul style="list-style-type: none"> <li>For periodic inspections: number of inspections carried out, with a break down by type of firm, and by type of inspection (due to regular program, and due to complaint/cause). It is important that information be included on the <u>criteria</u> used to select firms, and on the frequency and scope of inspections.</li> <li>Thematic inspections (i.e., inspections focusing on a particular theme across a larger group of supervised entities): number</li> </ul> </li> </ul>

	<p>and themes and how many firms were covered in each thematic inspection. It is important that information be included on the way the themes are selected.</p> <p><u>For administrative/civil enforcement:</u></p> <ul style="list-style-type: none"> <li>• Number of investigations opened on an annual basis and number of investigations finalized on an annual basis, if possible with a break down by type of misconduct.</li> <li>• Number of sanctions imposed on an annual basis, if possible with a break down by type of sanctions, type of participant, and type of misconduct.</li> </ul> <p><u>For criminal enforcement:</u></p> <ul style="list-style-type: none"> <li>• Number of cases referred to the criminal authorities on an annual basis, if possible with a break down by type of criminal offense.</li> <li>• Number of sanctions imposed on an annual basis, if possible with a break down by type of criminal offense.</li> </ul>
14, Questions 5, 6 and 9 and Principle 15, Questions 1 to 7	<ul style="list-style-type: none"> <li>• Number of MoUs with foreign authorities and the areas that they cover.</li> <li>• Information on number of requests for assistance received from foreign regulators in the last three years (per type of request if possible), and average time that it takes to process them.</li> <li>• If requests for information have been refused, how many refusals there have been and what reasons were given for refusal.</li> </ul>
16, Questions 1 and 2	<ul style="list-style-type: none"> <li>• If there are initial offerings that are exempt from public disclosure requirements, describe the types of exemptions available, e.g., by type of transaction, securities, or investor.</li> <li>• If there are any offerings that are required to have initial disclosure documents but thereafter are exempt from continuous disclosure requirements – either immediately or after a period of time, please describe them (e.g., only held by a small number of investors or not listed on an exchange).</li> <li>• If there are special disclosure regimes for particular types of securities (such as asset-backed securities, structured products, ETFs), describe how these rules differ from the general requirements.</li> <li>• What disclosure requirements apply to standardized exchange-traded instruments (e.g., options, futures).</li> </ul>
16, Questions 5, 6, and 9	<ul style="list-style-type: none"> <li>• Information on the system to review prospectuses, e.g., whether all prospectuses are reviewed or just a sample, and if only a sample, what the criteria are to select the prospectuses that will be reviewed. Similar type of information should be provided for the review of periodic reports and material event disclosures. If such review is carried out by the exchanges or a SRO, please provide the corresponding information based on what the exchanges or SRO do.</li> </ul>

	<ul style="list-style-type: none"> <li>• Information on the number of prospectuses and listing documents filed with the regulator (or exchange or a SRO) for the last three years.</li> <li>• Number of sanctions imposed on issuers and others involved in the issuing process during the last three years, if possible with a break down by type of misconduct.</li> <li>• Information on the number of public offerings or listings by foreign issuers within the jurisdiction for the last three years.</li> </ul>
19, Questions 1, 4, 6, and 7 and Principle 20, Question 7	<ul style="list-style-type: none"> <li>• Information on any oversight program in place for auditors, with an indication of whether on-site inspections are carried out on a periodic basis, or only for cause. If on a periodic basis, include information on the criteria used to select the auditors to be inspected, as well as inspection cycles.</li> <li>• Information on sanctions imposed on auditors, if possible for the last three years.</li> </ul>
21, Question 4	<ul style="list-style-type: none"> <li>• Information on the system to review financial statements, e.g., whether all financial statements are reviewed or just a selection of them, and if the latter, include information on the criteria. If such review is carried out by the exchanges or a SRO, please provide the corresponding information based on what the exchanges or SRO do.</li> </ul>
22, Question 2	<ul style="list-style-type: none"> <li>• Number of inspections carried out in CRAs (if applicable), by type of inspection (due to regular program, and due to complaint/cause). It is important that information be included on the criteria used to select firms, frequency, and scope of inspections.</li> </ul>
24, Question 1(a)	<ul style="list-style-type: none"> <li>• Describe the regulation of CIS only sold to sophisticated investors (non-retail or wholesale funds) and how it differs from the regulation of retail funds.</li> </ul>
24, Question 1(b)	<ul style="list-style-type: none"> <li>• Cover in your response all entities involved in the operation of a CIS, including the fund management company, asset manager, fund administrator, custodian, etc.</li> </ul>
24, Questions 8 and 9	<ul style="list-style-type: none"> <li>• For the periodic inspection plan of CIS operators, custodians, and CIS: number of inspections carried out, with a break down by type of firm and by type of inspection (due to regular program, or due to complaint/cause). It is important that information be included on the <u>criteria</u> used to select firms and on the frequency and scope of inspections.</li> <li>• Thematic inspections: number and themes. It is important that information be included on the way the themes are selected.</li> <li>• Number of sanctions imposed on fund managers during the last three years, if possible with a break down by type of misconduct.</li> </ul>
26, Questions 6, 7, and 9	<ul style="list-style-type: none"> <li>• Information on the system, if any, to review the CIS offering documents, e.g., whether all offering documents are reviewed or just a sample, and if only a sample, what the criteria are used</li> </ul>

	<p>to select the documents that will be reviewed. Similar type of information should be provided for the review of periodic reports and other disclosure documents. If such review is carried out by the exchanges or a SRO, please provide the corresponding information based on what the exchanges or SRO do.</p> <ul style="list-style-type: none"> <li>• Information on the number of offering documents filed with the regulator in the last three years.</li> <li>• Number of sanctions imposed on CIS operators and others involved in the preparation of CIS disclosure documents or advertisements, if possible with a break down by type of misconduct.</li> </ul>
28, Question 1	<ul style="list-style-type: none"> <li>• Does the jurisdiction have a definition of hedge fund? If so, please provide it.</li> </ul>
28, Question 8	<ul style="list-style-type: none"> <li>• Number of inspections carried out in hedge fund managers/ advisers and/or hedge funds (if applicable), by type of inspection (due to regular program, and due to complaint/cause). It is important that information be included on the criteria used to select firms and on the frequency and scope of inspections.</li> </ul>
31, Question 19	<ul style="list-style-type: none"> <li>• For the periodic inspection plan of intermediaries: number of inspections carried out, with a break down by type of intermediary, and by type of inspection (due to regular program, and due to complaint/cause). It is important that information be included on the <u>criteria</u> used to select firms and on the frequency and scope of inspections.</li> <li>• Thematic inspections: number and themes. It is important that information be included on the way the themes are selected.</li> <li>• Number of sanctions imposed on market intermediaries during the last three years, if possible with a break down by type of misconduct.</li> </ul>
32, Question 3(d)	<ul style="list-style-type: none"> <li>• Is there a compensation fund for investors or a settlement/default fund at a clearing house? <ul style="list-style-type: none"> <li>• What losses are covered?</li> <li>• Who is covered?</li> </ul> </li> </ul>
32, Question 4	<ul style="list-style-type: none"> <li>• If applicable, concrete examples of how the regulator has dealt with a failure of a market intermediary.</li> </ul>
34, Question 1	<ul style="list-style-type: none"> <li>• Information on the oversight of exchanges and trading platforms, including both off-site reporting and on-site inspections. For the latter, please include information on the frequency and scope of inspections.</li> </ul>
36, Questions 2 and 3	<ul style="list-style-type: none"> <li>• Information on administrative/civil sanctions imposed during the last three years on major misconduct, such as market manipulation and insider trading.</li> <li>• Information on criminal sanctions imposed for major offenses, such as insider trading and market manipulation.</li> </ul>



## PRECONDITIONS FOR EFFECTIVE SECURITIES REGULATION

6. The Annex to the IOSCO Methodology enumerates a set of preconditions necessary for effective securities regulation (company law, commercial/contract law, taxation law, bankruptcy, and insolvency laws, competition law, banking law, and a dispute resolution system). Please provide a brief analysis on whether such preconditions are in place in your jurisdiction, or whether there are particular challenges in regard to one or more of them that might constrain the regulation and/or supervision of the securities market.

## SUMMARY GRADINGS

Grading	Number of Principles
Fully Implemented (FI)	37
Broadly implemented (BI)	
Partly implemented (PI)	
Not Implemented (NI)	
Not applicable (NA)	1
Total	38

Table 1: Summary of IOSCO Objectives and Principles of Securities Regulation		Grade
Principle 1	- The responsibilities of the Regulator should be clear and objectively stated.	FI
Principle 2	The Regulator should be operationally independent and accountable in the exercise of its powers and functions.	FI
Principle 3	The Regulator should have adequate powers, proper resources, and the capacity to perform its functions and exercise its powers.	FI
Principle 4	- The Regulator should adopt clear and consistent regulatory processes.	FI

Table 1: Summary of IOSCO Objectives and Principles of Securities Regulation		Grade
Principle 5	The staff of the Regulator should observe the highest professional standards including appropriate standards of confidentiality.	FI
Principle 6	The Regulator should have or contribute to a process to monitor, mitigate, and manage systemic risk, appropriate to its mandate.	FI
Principle 7	The Regulator should have or contribute to a process to review the perimeter of regulation regularly.	FI
Principle 8	The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed, or otherwise managed.	FI
Principle 9	Where the regulatory system makes use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, such SROs should be subject to the oversight of the Regulator and should observe standards of fairness and confidentiality - when exercising powers and delegated responsibilities.	FI
Principle 10	The Regulator should have comprehensive inspection, investigation, and surveillance powers.	FI
Principle 11	- The Regulator should have comprehensive enforcement powers.	FI
Principle 12	The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance, and enforcement powers and - implementation of an effective compliance program.	FI
Principle 13	Regulator should have the authority to share both public and non-public information with domestic and foreign counterparts.	FI
Principle 14	Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with - their domestic and foreign counterparts.	FI
Principle 15	The regulatory system should allow for assistance to be provided to foreign Regulators who need to make inquiries in the discharge of their functions - and exercise of their powers.	FI
Principle 16	There should be full, accurate and timely disclosure of financial results, risk, and other information which is material to investors' decisions.	FI

Table 1: Summary of IOSCO Objectives and Principles of Securities Regulation		Grade
Principle 17	Holders of securities in a company should be treated in a fair and equitable manner.	FI
Principle 18	Accounting standards used by issuers to prepare financial statements should be of a high and internationally acceptable quality.	FI
Principle 19	- Auditors should be subject to adequate levels of oversight.	FI
Principle 20	- Auditors should be independent of the issuing entity that they audit.	FI
Principle 21	- Audit standards should be of a high and internationally acceptable quality.	FI
Principle 22	Credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision.	FI
Principle 23	Other entities that offer investors analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them.	FI
Principle 24	The regulatory system should set standards for the eligibility, governance, organization and operational conduct of those who wish to market or operate a collective investment scheme.	FI
Principle 25	The regulatory system should provide for rules governing the legal form and structure of CIS and the segregation and protection of client assets.	FI
Principle 26	Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a CIS for a particular investor and the value of the investor's interest in the CIS.	FI
Principle 27	Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units/shares in a CIS.	FI
Principle 28	Regulation should ensure that hedge funds and/or hedge funds managers/advisers are subject to appropriate oversight.	FI
Principle 29	Regulation should provide for minimum entry standards for market intermediaries.	FI

Table 1: Summary of IOSCO Objectives and Principles of Securities Regulation		Grade
Principle 30	There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.	FI
Principle 31	Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters.	FI
Principle 32	There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.	FI
Principle 33	The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.	FI
Principle 34	There should be ongoing regulatory supervision of exchanges and trading systems, which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.	FI
Principle 35	- Regulation should promote transparency of trading.	FI
Principle 36	Regulation should be designed to detect and deter manipulation and other unfair trading practices.	FI
Principle 37	Regulation should aim to ensure the proper management of large exposures, default risk, and market disruption.	FI
Principle 38	Securities settlement systems and central counterparties should be subject to regulatory and supervisory requirements that are designed to ensure that they are fair, effective, and efficient and that they reduce systemic risk.	Not assessed
Aggregate Level: Implemented (FI), Broadly Implemented (BI), Partially Implemented (PI), Non-Implemented (NI), Not applicable (N/A).		

## DETAILED SELF-ASSESSMENT QUESTIONNAIRE

The following questions have been developed by IOSCO as a tool to assess the level of implementation of the IOSCO Objectives and Principles of Securities Regulation. To answer them, the authorities should have as a reference the preamble, scope and explanatory notes included in the IOSCO Methodology, in connection with each Principle.

### Principle 1 The responsibilities of the Regulator should be clear and objectively stated

#### Key Questions

1. Are the regulator's responsibilities, powers and authority:
  - (a) Clearly defined and transparently set out, preferably by law, and in the case of powers and authority, enforceable?

The United States Securities and Exchange Commission (SEC or the Commission) is an independent agency of the U.S. government established pursuant to the Securities Exchange Act of 1934 (Exchange Act).<sup>2</sup> The SEC's responsibilities, powers, and authority are set forth in the following federal statutes: the Securities Act of 1933 (Securities Act),<sup>3</sup> the Exchange Act, the Trust Indenture Act of 1939 (Trust Indenture Act),<sup>4</sup> the Investment Company Act of 1940 (Investment Company Act),<sup>5</sup> and the Investment Advisers Act of 1940 (Advisers Act).<sup>6</sup> The SEC's powers and authority also extend to cases involving public companies arising under Chapters 9 and 11 of the U.S. Bankruptcy Code.<sup>7</sup>

Since 1940, various other laws have been promulgated further defining the SEC's responsibilities, powers, and authority, for example, most recently in the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act),<sup>8</sup> the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act),<sup>9</sup> and the Jumpstart Our Business Startups Act (JOBS Act).<sup>10</sup>

<sup>2</sup> <http://www.sec.gov/about/laws/sea34.pdf>.

<sup>3</sup> <http://www.sec.gov/about/laws/sa33.pdf>.

<sup>4</sup> <http://www.sec.gov/about/laws/tia39.pdf>.

<sup>5</sup> <http://www.sec.gov/about/laws/ica40.pdf>.

<sup>6</sup> <http://www.sec.gov/about/laws/iaa40.pdf>.

<sup>7</sup> 11 U.S.C. §§ 101-12, 301-08, 321-33, 341-51, 361-66, 501-11, 521-28, 541-62, 701-07, 721-27, 741-53, 761-67, 781-84, 901-04, 921-30, 1101-16, 1121-29, 1141-46, 1161-74, 1201-08, 1221-31, 1301-08, 1321-30, 1502-32.

<sup>8</sup> <http://www.sec.gov/about/laws/soa2002.pdf>.

<sup>9</sup> <http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>.

<sup>10</sup> <http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf>.

**SEC Mission, Responsibilities, and Enforceability**

The SEC's mission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. The SEC works with Congress, other executive branch agencies, self-regulatory organizations (SROs) (which comprise securities exchanges, clearing agencies, the Financial Industry Regulatory Authority (FINRA), and the Municipal Securities Rulemaking Board (MSRB)), accounting and auditing standards setters, state securities regulators, law enforcement officials, and many other organizations in support of the agency's mission. Among other things, it is the Commission's responsibility to:

- interpret and enforce the federal securities laws;
- issue new rules and amend existing rules;
- oversee the inspection of brokers, dealers, investment advisers, municipal advisors, transfer agents, clearing agencies, credit rating agencies (CRAs) registered as Nationally Recognized Statistical Rating Organizations (NRSROs), and SROs;
- oversee private regulatory organizations in the securities, accounting, and auditing fields; and
- coordinate U.S. securities regulation with federal, state, and foreign authorities.

The laws administered by the SEC provide for the following: (i) public disclosure of pertinent facts concerning public offerings of securities, securities listed on national exchanges, and certain securities traded in the over-the-counter (OTC) markets; (ii) disclosure requirements in the soliciting of proxies for meetings of security holders by certain companies; (iii) regulation of the trading in securities on national securities exchanges and in OTC markets; (iv) investigation of securities fraud, manipulation, and other federal securities law violations, and the imposition and enforcement of legal sanctions for such violations; (v) registration and the regulation of certain activities of brokers, dealers, investment advisers, CRAs, and municipal advisors; (vi) supervision of the activities of mutual funds and other investment companies; (vii) administration of statutory standards governing protective and other provisions of trust indentures under which debt securities are sold to the public; (viii) protection of the interests of public investors involved in bankruptcy cases involving the adjustment of debts of a municipality; and (ix) administrative sanctions, injunctive remedies, civil money penalties, and criminal prosecution.<sup>11</sup>

The SEC currently oversees more than 25,000 market participants, including more than 11,000

<sup>11</sup> See 17 C.F.R. § 200.1. As discussed in more detail in Principle 11 Question 2(c), the SEC is responsible for non-criminal enforcement of the federal securities laws. The SEC has the authority to refer criminal cases to federal and state criminal law enforcement authorities.

investment advisers, approximately 10,000 mutual funds and exchange-traded funds, 4,450 broker-dealers, approximately 1,200 municipal advisors, 450 transfer agents, 18 securities exchanges, 10 CRAs registered as NRSROs, and 7 clearing agencies as well as the Public Company Accounting Oversight Board (PCAOB), FINRA, MSRB, Securities Investor Protection Corporation (SIPC), and Financial Accounting Standards Board (FASB). The SEC is also responsible for reviewing the disclosures and financial statements of approximately 9,000 reporting companies. The responsibilities for this oversight are set out in the statutes described above and in regulations promulgated by the Commission under those statutes.

### **SEC Structure and Governance**

The SEC consists of five Commissioners appointed by the President and confirmed by the Senate to serve for a term of five years. By law, no more than three of the Commissioners may belong to the same political party. The SEC Chair is designated by the President.<sup>12</sup>

The SEC's functional responsibilities are organized into five Divisions and 23 Offices, each of which is headquartered in Washington, D.C. The SEC also has 11 Regional Offices, which are comprised primarily of staff from the SEC's Enforcement Division (Enforcement) and Office of Compliance, Inspections and Examination (OCIE), the latter of which oversees the SEC's examination programs. As of the end of fiscal year 2013, the SEC had approximately 4,100 employees.

The SEC has rules regarding its organization, program management and the disposition of Commission business.<sup>13</sup> The SEC also has established Rules of Practice that govern proceedings before the Commission under the statutes it administers.<sup>14</sup>

(b) If the regulator can interpret its authority, are the criteria for interpretation clear and transparent?

The SEC can interpret its authority and the criteria for such interpretation are clear and transparent. Rulemaking is the most typical interpretive process by which federal agencies, including the SEC, implement legislation passed by Congress and signed into law by the President. Rulemaking may also be necessary to apply statutory provisions to specific and evolving circumstances in the market. The federal securities laws set forth the Commission's substantive authority to make rules.<sup>15</sup>

<sup>12</sup> Section 1 of Reorganization Plan No. 10 of 1950 (3 C.F.R., 1949-1953 Comp., p. 1006), available at: <http://U.S.C.house.gov/view.xhtml?req=granuleid:U.S.C.-prelim-title5a-node83-leaf113&num=0&edition=prelim>.

<sup>13</sup> 17 C.F.R. PART 200.

<sup>14</sup> 17 C.F.R. PART 201.

<sup>15</sup> See, e.g., Exchange Act Section 23(a)(1), Securities Act Section 19(a), Investment Company Act Section 38(a), Investment Advisors Act Section 211(a), and Trust Indenture Act Section 319(a).

## Interpretation Through Rulemaking

The Commission's rulemaking is governed by the Administrative Procedure Act (APA)<sup>16</sup> and by other statutes that prescribe the manner in which the SEC may undertake to consider or adopt rules of general applicability. The APA generally requires that the Commission, when adopting rules, provide adequate public notice of a proposed rulemaking and seek comment from interested parties.

To promulgate a rule under the APA, a majority of a quorum of the SEC Commissioners must first approve a detailed rule proposal. A Commission vote on whether to propose the rule generally occurs at a meeting open to members of the public, which is also webcast at [www.sec.gov](http://www.sec.gov), but may also occur through *seriatim* vote. *Seriatim* consideration refers to the circulation of matters among SEC Commissioners for individual voting and generally involves rule proposals not requiring deliberation among Commissioners. If the Commissioners approve the proposed rules, the SEC publishes a release in the *Federal Register*, setting forth the text of the proposed new or amended rule, a discussion of the issue or problem the rule is designed to address, and a solicitation of public comment on the proposal. Typically the Commission provides 30 to 60 days for review and comment. The SEC publishes rulemaking releases, comment letters filed with the SEC as well as other data or information that is important to the Commission's consideration of the rulemaking on its website.

Once the analysis of comments is complete, the SEC staff (Staff) considers whether to make a recommendation to the Commissioners, and the Commissioners determine at an open meeting or through a *seriatim* vote whether to adopt the proposed rules, including any appropriate modifications in response to public comments. Adopting releases are published in the *Federal Register* and posted on the SEC's website. Many rules are effective immediately, but some may have a specified future effective date. In either case, the date by which the public must comply with the new or amended rule may be delayed or phased in to ensure a smooth transition.

The SEC generally undertakes rulemakings on its own initiative, in response to requests from the public, or at the direction of Congress. Staff, sometimes at the request of the Chair or other Commissioners, identifies issues to be addressed by rulemaking and formulates proposed rules. Congress may also direct that an agency promulgate rules within certain guidelines.

## Other Interpretations

Staff or the Commission may also occasionally provide guidance to regulated entities and investors by issuing interpretive releases, interpretive letters (including exemptive or no action letters), Staff legal or accounting bulletins, or less formal guidance such as "frequently asked

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<sup>16</sup>

5 U.S.C. Subchapter II.



questions.” Staff or the Commission may publish its views and interpret the federal securities laws and SEC regulations in circumstances where a full rulemaking is not required under the APA or after a full rulemaking has taken place. These interpretations are posted on the SEC’s website and may also be published in the *Federal Register*. In some instances, the SEC may also include a request for public comment, which can result in a revision or reconsideration of the guidance.

(c) Is the interpretative process transparent enough to preclude situations in which an abuse of discretion can occur?

The SEC’s interpretive process – whether through rulemaking or otherwise – is transparent enough to preclude situations in which an abuse of discretion can occur. As noted above, the processes for adopting legally binding rules must adhere to the APA. Moreover, as discussed in response to Principle 2, Question 7(d) below, any person aggrieved by a final order of the SEC may obtain judicial review in a U.S. Court of Appeals in which the person resides or in the District of Columbia Circuit. Parties may request a rehearing of an adverse decision and rehearing *en banc* (i.e., before all the judges of the circuit). An aggrieved party dissatisfied with the ruling of a lower court may also seek judicial review or *certiorari* before the U.S. Supreme Court. The APA generally requires that in order to overturn agency action, a court must conclude that the regulation is “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law.”<sup>17</sup>

The SEC is also subject to the Government in the Sunshine Act (Sunshine Act),<sup>18</sup> which aims to ensure transparent procedures in the discharge of SEC business, including rulemakings. The Sunshine Act generally provides that meetings must be open to the public unless the subject matter falls within one of several exemptions, and requires the SEC to provide advance notice of meetings.

The SEC also makes its Rules of Practice available to the public. These rules govern the proceedings before the SEC under the statutes that it administers. Among other things, they set forth: rules regarding the initiation of proceedings and prehearing rules; rules regarding hearings; appeal to the SEC and SEC review; and rules relating to temporary orders and suspensions.

Finally, as discussed in response to Principle 4 Question 1 below, the SEC is subject to a range of additional procedural rules and regulations, including several that govern the SEC’s rulemaking activities and interpretations. The SEC is also required to conduct its proceedings with due process (see response to Principle 2, Question 7(b) below for a further discussion of these procedural protections).

<sup>17</sup> 5 U.S.C. § 706.

<sup>18</sup> 5 U.S.C. § 552b.

2. When more than one domestic authority is responsible for securities regulation:

- (a) Where responsibility is divided among regulators, is legislation designed to avoid regulatory differences or gaps?

In general, only the SEC has the authority to administer and enforce the federal securities laws discussed above. Where responsibility is divided among the SEC and other regulators, legislation is generally designed to avoid regulatory differences or gaps. Aspects of certain types of products, transactions and functions of financial institutions may also be subject to the authority of more than one regulator. For example:

**SROs**

Congress has vested in the Commission the power to supervise SROs as a matter of public interest and has provided the Commission with several tools to oversee SROs.<sup>19</sup> For example, exchanges, clearing agencies, and national securities associations must register with the Commission, and SROs must file their rule changes with the Commission. In addition, the Commission has the authority to inspect and examine SROs. For more information regarding SROs and the SEC's oversight, see responses to Principle 9 questions below.

**Banks and Bank Holding Companies**

Under applicable federal banking statutes, the Board of Governors of the Federal Reserve (Federal Reserve), Office of the Comptroller of the Currency (OCC), and Federal Deposit Insurance Corporation (FDIC) have regulatory authority over bank holding companies and banks, which can be affiliated with broker-dealers and asset management entities regulated by the SEC. The federal banking statutes generally do not limit the SEC's authority over such affiliates under the federal securities laws, and the SEC and banking regulators coordinate on the regulation of financial institutions that comprise entities subject to different regulations. In addition, some activities conducted by banks that would be regulated by the SEC if conducted by another type of market participant are either excluded or exempt from SEC regulation in lieu of regulation by the banking regulators.<sup>20</sup> Absent an exemption, bank holding companies that issue securities must register the transactions under the Securities Act, become subject to the Exchange Act reporting requirements for at least the fiscal year during which a Securities Act registration statement became effective, and are subject to the liability provisions of the federal securities laws, as discussed in response to Question 16. Banks and bank holding companies that register securities under the Exchange Act are subject to the Exchange Act reporting requirements and the Exchange Act liability provisions discussed in response to Question 16.

<sup>19</sup> See S. Rep. No. 94-75, 94<sup>th</sup> Cong., 1<sup>st</sup> Sess. 7, II (1975).

<sup>20</sup> See Regulation R at: <http://www.sec.gov/rules/final/2007/34-56502fr.pdf>.

### **Enforcement Authority**

The SEC is responsible for non-criminal enforcement of the federal securities laws. The SEC has the authority to refer criminal cases to federal law enforcement authorities and state criminal law enforcement authorities. See response to Principle 11, Question 2(c) below. The SEC also regularly coordinates its efforts with domestic and foreign law enforcement partners, however, including coordination on parallel criminal investigations conducted by Department of Justice (DOJ) and the Federal Bureau of Investigation (FBI), among others. See response to Principle 12, Question 1(c) below.

### **OTC Derivatives**

The 2008 financial crisis highlighted significant issues in the OTC derivatives markets, which had experienced dramatic growth in the years leading up to the crisis and are capable of affecting significant sectors of the U.S. economy. The Dodd-Frank Act was enacted, among other reasons, to promote the financial stability of the U.S. by improving accountability and transparency in the financial system, including in connection with swaps and security-based swaps (SBS).

Title VII of the Dodd-Frank Act provides for a comprehensive new regulatory framework for swaps and SBS. Under this framework, the Commodity Futures Trading Commission (CFTC) regulates swaps, while the SEC regulates SBS, and the SEC and CFTC jointly regulate mixed swaps. The new framework encompasses the registration and comprehensive regulation of dealers and major participants as well as requirements related to clearing, trade execution, regulatory reporting, and public dissemination.<sup>21</sup>

### **Municipal Securities Dealers**

The Securities Acts Amendments of 1975<sup>22</sup> required firms transacting business in municipal securities to register with the SEC as broker-dealers, required banks dealing in municipal

<sup>21</sup> The Commission has proposed a series of rules regarding these matters. See Cross-Border Proposing Release, 78 Fed. Reg. at 30972 nn. 11-18. Most recently, the Commission proposed rules governing recordkeeping, reporting, and notification requirements for dealers and major participants. See Exchange Act Release No. 71958 (Apr. 17, 2014), 79 Fed. Reg. at 2519 (May 2, 2014).

The Dodd-Frank Act further provides that the SEC and CFTC jointly should further define certain terms, including “security-based swap dealer” and “major security-based swap participant.” See Dodd-Frank Act section 712(d). Pursuant to that requirement, the SEC and CFTC jointly adopted rules to further define those terms. See Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” Exchange Act Release, Exchange Act Release No. 66868 (Apr. 27, 2012), 77 Fed. Reg. 30596 (May 23, 2012); see also Cross-Border Proposing Release, 78 Fed. Reg. at 30972 n. 9 (discussing joint rulemaking to further define various Title VII terms). In June 2014, the Commission adopted the critical, initial set of cross-border rules and guidance focusing on the swap dealer and major swap participant definitions. See Release No. 34-72474, Application of “Security-Based Swap Dealer” and “Major Security-Based Swap Participant” Definitions to Cross-Border Security-Based Swap Activities (June 25, 2014).

<sup>22</sup> Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 131 (1975).

securities to register as municipal securities dealers, and gave the SEC broad rulemaking and enforcement authority over such broker-dealers and municipal securities dealers.<sup>23</sup> Therefore, a person who engages in the activities of a broker<sup>24</sup> or dealer<sup>25</sup> in municipal securities, and does not satisfy an exception from the registration provisions of the Exchange Act must register with the SEC as a broker-dealer and must join an SRO such as FINRA.

A bank transacting business in municipal securities, however, is excluded from the general Exchange Act definitions of broker and dealer.<sup>26</sup> A bank can be a municipal securities dealer because the term is defined to include “any person (including a separately identifiable department or division of a bank) engaged in the business of buying and selling municipal securities for his own account, through a broker or otherwise.”<sup>27</sup> A bank that is a municipal securities dealer is required to register with the SEC.<sup>28</sup>

All broker-dealers and municipal securities dealers that engage in municipal securities transactions also must register with the MSRB<sup>29</sup> and may not act in contravention of its rules.<sup>30</sup> The MSRB rules, among other things, establish appropriate standards for broker-dealers and municipal securities dealers and are designed to prevent fraudulent and manipulative acts and practices and promote just and equitable principles of trade.<sup>31</sup>

The current statutory framework clearly establishes the regulatory responsibilities of each regulator and is designed to prevent regulatory difference or gaps. While the MSRB does not have the authority to enforce its rules, the Exchange Act designates the institutions responsible for overseeing compliance with the provisions in the Exchange Act relating to municipal securities and the rules of the MSRB.<sup>32</sup> The SEC has broad inspection and enforcement authority

<sup>23</sup> See, e.g., Exchange Act Sections 15(c)(1), 15(c)(2); 17(a); 17(b), 15B(c)(1), and 21(a)(1). Enforcement activities regarding municipal securities dealers must be coordinated by the SEC, FINRA and the appropriate bank regulatory agency. See Exchange Act Sections 15B(c)(6)(A), 15B(c)(6)(B), and 17(c).

<sup>24</sup> See Exchange Act Section 3(a)(4) (defining “broker” as “any person engaged in the business of effecting transactions in securities for the account of others”).

<sup>25</sup> See Exchange Act Section 3(a)(5) (defining “dealer” as “any person engaged in the business of buying and selling securities ... for such person’s own account through a broker or otherwise”).

<sup>26</sup> Banks are excepted from the definitions of “broker” and “dealer” with respect to transactions in municipal securities. See Exchange Act Sections 3(a)(4)(B) and 3(a)(5)(C).

<sup>27</sup> See Exchange Act Section 3(a)(30).

<sup>28</sup> See Exchange Act Section 15B.

<sup>29</sup> The Securities Act Amendments of 1975 created the MSRB, an SRO subject to SEC oversight, and granted it authority to promulgate rules governing the sale of municipal securities by broker-dealers and municipal securities dealers. See Exchange Act Section 15B(b).

<sup>30</sup> See MSRB Rule A-12.

<sup>31</sup> Exchange Act Section 15B(b)(2)(C).

<sup>32</sup> See Exchange Act Section 15B(c)(5).

over broker-dealers and municipal securities dealers that engage in municipal securities transactions with respect to MSRB rules, SEC rules, and the federal securities laws.<sup>33</sup> In addition, broker-dealers and municipal securities dealers are subject to regulations adopted by the SEC, including those regulations adopted to define and prevent fraud.<sup>34</sup>

FINRA has inspection and enforcement responsibility over its broker-dealer members and federal bank regulators have this responsibility for municipal securities dealers that are banks under their respective jurisdictions.<sup>35</sup> Currently, in addition to the SEC and FINRA, the FDIC, the Federal Reserve, and the OCC all play a role in the enforcement of MSRB rules.<sup>36</sup> The MSRB, in turn, facilitates the enforcement efforts of these agencies through regulatory coordination and enforcement support programs, which provide the agencies with market information and reports of potential violations as they become known and consultation concerning its rules.

### **Federal Versus State Securities Regulation**

The division of responsibility between federal and state regulation of certain securities activities is set forth in the federal securities laws. For example, investment advisers with less than \$100 million in assets under management generally are not required to register with the SEC as investment advisers but are subject to state regulation. As another example, an offering of securities must be registered under both the Securities Act and applicable state securities laws, unless an exemption from registration is available. This dual system of federal-state regulation, which historically preserved the right of each state to regulate the offering of securities in that state, was modified by the National Securities Markets Improvement Act of 1996 (NSMIA).<sup>37</sup> That Act amended Section 18 of the Securities Act to create a class of "covered securities" - the offer and sale of which (through licensed broker-dealers) are no longer subject to state securities law registration requirements.<sup>38</sup> Although NSMIA preempts state securities registration requirements, NSMIA preserves the right of the states to investigate and prosecute fraud.

<sup>33</sup> See generally Exchange Act Sections 15B and 17(b).

<sup>34</sup> See Exchange Act Release No. 33741, "Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others" (Mar. 9, 1994), 59 Fed. Reg. 12748 (Mar. 9, 1994); Exchange Act Sections 15(c)(1) and (2).

<sup>35</sup> Exchange Act Sections 15B(c) and 17(c).

<sup>36</sup> See Exchange Act Section 15B(c)(7), which provides that the periodic examination of regulated entities shall be conducted by (i) a registered securities association in the case of dealers that are members of the registered securities association, (ii) the appropriate regulatory agency (bank regulators) in the case of dealers that are not members of a registered securities association, and (iii) the SEC, or its designee, in the case of municipal advisors.

<sup>37</sup> Pub. L. 104-290, 110 Stat. 3416 (1996).

<sup>38</sup> "Covered securities" include: securities listed (or approved for listing) on the NYSE, AMEX, and the NASDAQ/National Market, and securities of the same issuer which are equal in rank or senior to such listed securities; mutual fund shares; securities sold to certain qualified purchasers; certain securities exempt under Section 3(a) of the Securities Act (including government or municipal securities, bank securities, and commercial paper); and securities exempt from registration under the Securities Act if sold in transactions complying with Rule 506 of Regulation D under the Securities Act.

Offerings of securities that are not “covered securities” continue to be subject to a dual system of federal-state regulation, including registration and review. Securities offerings made solely within a single state and where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such states are not required to be registered pursuant to the provisions of the Securities Act but are subject to state regulation.

### **Other Areas**

In addition to those areas described above, the SEC shares responsibility with other regulators with respect to certain other areas such as variable annuities and government-sponsored enterprises. It also may share responsibility with the Federal Reserve with respect to certain other entities designated by the FSOC as systemically important non-bank financial companies. As discussed in more detail below, various mechanisms also exist to ensure proper coordination in specific contexts.

(b) Is substantially the same type of conduct and product generally subject to consistent regulatory requirements?

In general, substantially similar conduct and products are subject to consistent regulatory requirements.<sup>39</sup> Exceptions and exemptions have been created in some cases, as discussed below.

### **Gramm-Leach-Bliley Act and Bank “Broker” Activity**

In 1999, The Gramm-Leach-Bliley Act (GLBA)<sup>40</sup> amended several federal statutes governing the activities and supervision of banks, bank holding companies, and their affiliates. Among other things, it lowered barriers between the banking and securities industries, which had been erected by the Banking Act of 1933 (Glass-Steagall Act).<sup>41</sup> It also altered the way in which the supervisory responsibilities over the banking, securities, and insurance industries are allocated among financial regulators. Among other things, the GLBA repealed most of the separation of investment and commercial banking imposed by the Glass-Steagall Act.

<sup>39</sup> For example, the Commission, the federal banking agencies (*i.e.*, the Federal Reserve, OCC, and the FDIC), and the CFTC adopted a common rule under Section 13 of the Bank Holding Company Act to restrict banking entities – including banks and their affiliated broker-dealers and investment advisers – from engaging in proprietary trading, sponsoring hedge funds and private equity funds, or investing in such funds. The common rule (also known as the Volcker Rule) includes exemptions for certain permitted activities, including market making-related activities and risk-mitigating hedging. The requirements of the common rule generally apply consistently to similar conduct and products.

<sup>40</sup> Pub. L. 106-102, 113 Stat. 1338 (1999).

<sup>41</sup> Pub. L. 73-66, 48 Stat. 162 (1933).

The GLBA also revised the provisions of the Exchange Act that excluded banks from broker-dealer regulation. Congress instead adopted “functional” regulation for bank securities activities, with certain exceptions from SEC oversight for specified securities activities. Each of these exceptions permits a bank to act as a broker or agent in securities transactions without being subject to SEC oversight if it meets specific statutory conditions. In particular, the Exchange Act provides conditional exceptions from the definition of “broker” for banks that engage in certain securities activities in connection with third-party brokerage arrangements; trust and fiduciary activities; permissible securities transactions; certain stock purchase plans; sweep accounts; affiliate transactions; private securities offerings; safekeeping and custody activities; identified banking products; municipal securities; and a *de minimis* number of other securities transactions.

### **Municipal Securities**

See the discussion in response to Principle 1, Question 2(a) above regarding the regulation of municipal securities dealers.

(c) Are responsible authorities required to cooperate and communicate in areas of shared responsibility?

As discussed in response to Principle 2, Question 2 below, there are specific statutory provisions that require various government agencies to cooperate and coordinate rulemaking efforts. Highlighted below are recent illustrative cooperation efforts imposed by statute. The SEC Chair is also required to serve on several other boards and groups, as described below.

### **Financial Stability Oversight Council**

In 2010, the Dodd-Frank Act established the Financial Stability Oversight Council (FSOC), a formal structure for facilitating coordination among the various financial regulators to monitor systemic risk and to promote financial stability across the U.S. financial system.

The FSOC is composed of 15 members, of whom 10 are voting members and 5 are non-voting. The voting members of the FSOC include the Secretary of the Department of the Treasury (Treasury), who acts as the Chair of the Council, the heads of the primary federal financial regulators – including the SEC, CFTC, the Federal Reserve, FDIC, OCC, Consumer Financial Protection Bureau, Federal Housing Finance Agency (FHFA), and National Credit Union Administration (NCUA) – and an independent insurance expert appointed by the President. The non-voting members include three representatives from state-level regulatory bodies, the Director of the Office of Financial Research (OFR), and the Director of the Federal Insurance Office.

The SEC Chair is a voting member of the FSOC, and certain Staff routinely participates in FSOC committee and working group meetings.

**Financial Stability Oversight Board**

The Financial Stability Oversight Board (FinSOB) was established by Section 104 of the Emergency Economic Stabilization Act of 2008<sup>42</sup> in order to oversee Treasury's implementation of the Troubled Assets Relief Program. The FinSOB is comprised of the heads of five agencies - the Chairman of the Federal Reserve, the Secretary of the Treasury, the Director of the FHFA, the SEC Chair, and the Secretary of the Department of Housing and Urban Development (HUD). The Chairperson is elected by the members of the FinSOB from among the members other than the Secretary of the Treasury. Federal Reserve Chair Janet Yellen currently serves in this capacity.

**Federal Housing Finance Oversight Board**

The Federal Housing Finance Oversight Board (FHFOB) was established to oversee the FHFA. The FHFA regulates government-sponsored enterprises, which are financial services corporations created by Congress. The FHFOB is comprised of the heads of four agencies - the Secretary of the Treasury, the Secretary of HUD, the SEC Chair, and the Director of the FHFA. The Director of the FHFA serves as the Chairperson of the FHFOB. The FHFOB is responsible for advising the Director of the FHFA with respect to overall strategies and policies in carrying out the duties of the Director. The FHFOB must meet at least once every three months<sup>43</sup> and report annually to Congress.<sup>44</sup>

**Financial Fraud Enforcement Task Force**

In November 2009, President Obama established the Financial Fraud Enforcement Task Force to hold accountable those who contributed to the financial crisis. With more than 20 federal agencies, 94 U.S. Attorney's Offices and state and local partners, it is a broad coalition of law enforcement, investigatory and regulatory agencies. The Financial Fraud Enforcement Task Force has established Financial Fraud Coordinators in every U.S. Attorney's Office around the country. The Financial Fraud Enforcement Task Force is composed of senior-level officials from a number of federal departments, agencies and offices, including DOJ, U.S. Attorney's Offices, Treasury, the SEC, and the CFTC.

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<sup>42</sup> Pub. L. No. 110-34 (2008).

<sup>43</sup> 12 U.S.C. § 4513a(a).

<sup>44</sup> 12 U.S.C. § 4513a(d).



### Elder Justice Coordinating Council

The SEC Chair also consults with heads of other federal departments and agencies as a member of the Elder Justice Coordinating Council, a federal entity established under the Elder Justice Act of 2009,<sup>45</sup> to coordinate a federal response to elder abuse, including financial exploitation.

- (d) Are there arrangements for cooperation and communication between responsible authorities through appropriate channels and are cooperation and communication occurring between responsible authorities without significant limitations?

The SEC places great emphasis on building and maintaining close partnerships with other entities across various regulatory and market segments and national boundaries. The SEC works closely with other regulatory and enforcement authorities, through a variety of arrangements, including interagency Memoranda of Understanding (MOUs), through groups such as the FSOC, the International Organization of Securities Commissions (IOSCO), and the Financial Stability Board (FSB). The agency also frequently engages in bilateral action with other international, national, or state jurisdictions on specific rulemaking activities, regulatory initiatives, and enforcement investigations and cases.

In addition to statutory provisions facilitating the sharing of information with other regulators, there are a variety of formal and informal mechanisms by which domestic authorities with responsibility over a particular activity effectively cooperate and communicate information relevant to their respective missions.

SEC Divisions and Offices collaborate with other regulatory entities to oversee the financial markets. For example:

- Staff consults and coordinates routinely with Treasury, the Federal Reserve, other banking regulators, the CFTC, and foreign regulators. These activities include the designation of registered clearing agencies, ongoing supervision of clearing agencies, transition periods in the SBS “push-out” rules in Section 716 of the Dodd-Frank Act, and the implementation of the Volcker Rule,<sup>46</sup> among other initiatives.
- The SEC has been tasked by IOSCO Standing Committee 6 with being the lead regulator to organize or participate in the regulatory colleges for globally active CRAs.
- The SEC and FINRA regularly communicate to discuss strategic initiatives, examination coordination, risk assessment efforts, rule-making issues, and industry risks. This type of

<sup>45</sup> Pub. L. 111-148 (2009).

<sup>46</sup> See footnote 39 for a description of the Volcker Rule.

collaboration is ultimately intended to make oversight of broker-dealers more effective and efficient and to improve compliance within the industry.

- The SEC regularly coordinates its efforts with domestic and foreign law enforcement partners, including coordination on parallel criminal investigations conducted by DOJ and the FBI, among others. For more information, see responses to Principle 11, Question 2(c) and Principle 12, Question 1(c) below. One example is the Southern District of Florida Securities and Investment Fraud Initiative, an initiative designed to combat securities and investment fraud and protect the interests of the investing public, which has resulted in charges against well over 100 individuals and orders for more than \$1.7 billion in restitution. The SEC also promotes the development of broader information-sharing arrangements and efforts to secure the proceeds of fraud in order to successfully prosecute cross-border violations in areas such as offering frauds, market abuse, insider trading, and Foreign Corrupt Practices Act of 1977 (FCPA)<sup>47</sup> cases.
- Staff works with other regulators to issue joint alerts and bulletins, including an SEC-CFTC investor alert on binary options, an SEC-FINRA alert on pump-and-dump stock schemes, and an SEC-FINRA bulletin on pension and settlement income streams. Staff in OCIE collaborates with various federal agencies on Financial Literacy and Education Commission initiatives and partners with interested federal agencies on joint investor alerts and bulletins.
- Staff consults and coordinates with the MSRB, FINRA, the Internal Revenue Service (IRS), and banking regulators with respect to municipal securities issues on an ongoing basis.

In addition, domestic regulators frequently enter into information and regulatory cooperation arrangements for certain products and activities, as described below.

### **Memoranda of Understanding with Other Federal Regulators**

The SEC has entered into several MOUs with various federal regulators that provide for the cooperation and communication of information between and among the relevant authorities on subjects relating to, among other things, credit default swaps (CDSs), novel derivative products and security futures products (SFP).

- The SEC and the Federal Reserve have deepened their information sharing and cooperation by signing an MOU permitting both agencies to better perform their responsibilities. Under the MOU, the SEC and the Federal Reserve share information and cooperate across a number of important areas of common interest including anti-money laundering (AML), bank brokerage activities under the GLBA, clearance and settlement in

<sup>47</sup>

15 U.S.C. § 78dd-1, *et seq.*

the banking and securities industries, and the regulation of transfer agents. This MOU built on and formalized the long-standing cooperative arrangements between the SEC and the Federal Reserve, as well as the more recent cooperation on matters including banking and investment banking capital and liquidity following the Federal Reserve's emergency opening of credit facilities to primary dealers.

- The SEC and the Department of Labor have entered into an MOU formalizing the agencies' longstanding relationship of sharing information on retirement and investments to protect retirement assets of American workers, retirees, and their families held in employee benefit plans. The MOU between the two agencies strengthens cooperation to share information relating to retirement and investments and to provide investors, benefit plan participants, and plan administrators with better access to more understandable information that they can use to make informed investment decisions.
- The SEC, the Federal Reserve, and the CFTC have entered into an MOU establishing a framework for consultation and information sharing on issues related to CDS central counterparties (CCPs).
- The SEC and the CFTC have also entered into an MOU to establish a closer working relationship between the two agencies. The MOU established a permanent regulatory liaison between the agencies, provided for enhanced information sharing, and set forth several key principles guiding the agencies' consideration of novel financial products that may reflect elements of both securities and commodity futures or options.
- The SEC and the CFTC have entered into an MOU regarding the oversight of SFP trading and the sharing of SFP information. The MOU provides that the SEC and CFTC will notify each other of any planned examinations, advise the other of reasons for an intended examination, provide each other with examination-related information, and conduct examinations jointly, if feasible. The MOU also provides that the SEC and CFTC will notify each other of significant issues arising from these markets and share trading data and related information for SFP activity.
- The SEC and the IRS have entered into an MOU in which each acknowledges the other's need for, and interest in, sharing information, and agrees, within the confines of existing law, to communicate with each other regarding, among other things, market risks, practices, and events relating to tax-exempt bonds and municipal securities.

Through these mechanisms and others, the SEC coordinates and communicates with other authorities with respect to areas of shared regulatory responsibilities without significant limitations. See also responses to Principle 1, Questions 2(a) and 2(b) above.

**Principle 2    The Regulator should be operationally independent and accountable in the exercise of its powers and functions**
**Key Questions**
*Independence*

1. Does the securities regulator have the ability to operate on a day-to-day basis without:
  - (a) External political interference?

As discussed in response to Principle 1, Question 1(a), the SEC is an independent federal agency headed by a five-member Commission. By law, no more than three of the Commissioners may belong to the same political party. While subject to oversight by Congress, the SEC has the ability to operate on a day-to-day basis without external political interference. See also a related discussion in response to Principle 2, Question 6 below.

- (b) Interference from commercial or other sectoral interests?

The SEC operates without interference from commercial or other sectoral interests. Although the SEC often solicits the viewpoints of the public – including investors, industry, and other interested market participants – and factors that input into the decisions that are made, it does so as part of a transparent and open process and in a way that does not compromise its independence.

As discussed in more detail in the response to Principle 5, Question 1, Commission members and Staff must comply with federal government-wide ethics laws, rules and regulations, including the criminal law conflict of interest statutes.<sup>48</sup> In addition to these government-wide regulations, Staff is also subject to the SEC's Conduct Regulation<sup>49</sup> and SEC-specific supplemental ethics standards, which are both discussed in more detail in the response to Principle 5, Question 1(b).

In addition, the Exchange Act also expressly prohibits any Commissioner from engaging in any other business, vocation, or employment than that of a Commissioner; and prohibits any Commissioner from participating in any stock-market operations or transactions that are subject to regulation by the SEC under the Exchange Act.

Finally, the Office of Government Ethics (OGE) Standards of Conduct prohibit the misuse of one's official position, including the use of (or allowing others to use) confidential or nonpublic information.<sup>50</sup> The SEC's own regulation also prohibits the misuse of confidential and nonpublic information.<sup>51</sup>

<sup>48</sup> 18 U.S.C. §§ 201-209.

<sup>49</sup> 17 C.F.R. § 200.735.

<sup>50</sup> 5 C.F.R. Part 2635, subpart G.

2. Where particular matters of regulatory policy require consultation with, or even approval by, a government minister or other authority:

(a) Is the consultation process established by law?

As discussed in response to Principle 1, Question 1(a), the SEC is the regulator charged with implementing and enforcing the federal securities laws. As a general matter, the SEC is an independent federal agency and not required to consult with or obtain approval from a government minister or other authority with respect to the discharge of its statutory responsibilities under the federal securities laws.

As discussed above in Principle 1, Question 2(d), however, there are a variety of formal and informal mechanisms – some established by statute – through which the SEC consults and coordinates with other regulators. These mechanisms include, for example, FSOC and the various MOUs established between the SEC and other regulators described in Principle 1, Question 2(d).

Several provisions of the federal securities laws also specifically require consultation or cooperation with other agencies. For example, under the Exchange Act, the SEC also consults and cooperates with the OCC, the Federal Reserve, and the FDIC regarding bank transfer agents and clearing agencies.

In addition, notwithstanding the SEC's primary responsibility as the regulator charged with implementing and enforcing the federal securities laws, the Federal Reserve has authority under the Exchange Act to promulgate rules with respect to the amount of credit (i.e., margin) that may be initially extended and subsequently maintained on a security. The SEC works closely with the Federal Reserve in its development and maintenance of those rules.

In certain instances, Congress has also mandated the SEC to consult with and/or engage in joint rulemaking with respect to a particular matter of regulatory policy. For example, Title VII of the Dodd-Frank Act provides for a framework for the regulation of the OTC swaps markets, including requiring joint rulemaking by the CFTC and the SEC. The CFTC and the SEC are required to act jointly to define key terms (such as swap, SBS, and swap dealer) as well as adopt certain other joint regulations. The SEC is also required to consult with the CFTC and the Federal Reserve on its non-joint rulemakings under Title VII and with the other prudential regulators on capital and margin rules under that provision.

Another example is Title VIII of the Dodd-Frank Act, which authorizes the SEC, in consultation with the Federal Reserve and the FSOC, to prescribe new risk management standards for SEC clearing agencies and financial institutions.

<sup>51</sup>

17 C.F.R. § 200.735-(b)(2).

See also the response to Principle 1, Question 2(b) for a discussion of cooperation among the SEC, CFTC and the federal banking agencies (*i.e.*, the Federal Reserve, OCC, and the FDIC) in adopting the Volcker Rule.

The SEC is also subject to certain general administrative statutes that require it, like a number of other agencies, to undertake additional consultations with respect to its rulemaking or other operations. For example, pursuant to the Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA),<sup>52</sup> all final SEC rules must be submitted to Congress before they can take effect.

Finally, the SEC is also subject to the Paperwork Reduction Act of 1995 (PRA),<sup>53</sup> which requires review and analysis of reporting and recordkeeping issues and burdens with respect to its rulemaking. Under this statute, the Office of Management and Budget (OMB) must approve each SEC collection of information before it can begin.

(b) Do the circumstances, in which consultation is required, exclude decision making on day-to-day technical matters?

While the SEC is subject to certain requirements to consult with other government authorities, the agency has the authority to make day-to-day decisions without the need to consult with other government authorities, even where joint rulemaking or action with another agency is required.

For example, the Commodity Futures Modernization Act of 2000 (CFMA)<sup>54</sup> gives joint authority for the oversight and regulation of SFPs to the SEC and CFTC. Pursuant to this joint authority, the SEC and the CFTC have adopted and amended certain rules under the Exchange Act and the Commodity Exchange Act (CEA)<sup>55</sup> relating to SFPs. Additionally, to implement this joint regulatory authority, the SEC and the CFTC voluntarily entered into an MOU concerning SFPs (see response to Question 1.2(d)). This MOU provides that the SEC and the CFTC will notify each other of any planned examinations, advise the other of reasons for an intended examination, provide each other with examination-related information, and conduct examinations jointly, if feasible. Under the MOU, the SEC and the CFTC will also notify each other of significant issues arising from this market and share trading data and related information for SFP activity. However, neither the MOU nor the statute imposes on the respective agencies an obligation to consult on day-to-day technical matters.

<sup>52</sup> 5 U.S.C. §§ 801-808.

<sup>53</sup> Pub. L. 104-13 (1995).

<sup>54</sup> 7 U.S.C. § 6g.

<sup>55</sup> 7 U.S.C. § 1, *et seq.*

(c)	Are the circumstances in which such consultation or approval is required or permitted clear and the process sufficiently transparent, or the failure to observe procedures and the regulatory decision or outcome subject to sufficient review, to safeguard its integrity?
	<p>The laws requiring the SEC to consult with other government authorities when making regulatory decisions are clear and the process by which regulatory decisions are made is transparent. Among other protections, as described above in Principle 1, Question 1(a), SEC rulemaking is subject to the APA, which establishes a clear and transparent process that must be followed whether or not consultation is required. In addition, any action taken by the SEC, or any other federal regulator, may be subject to judicial review.</p> <p>This transparency can be seen in the context of several examples. First, Title VII of the Dodd-Frank Act clearly requires certain joint rulemaking by the CFTC and the SEC, such as the requirement to act jointly to define key terms relating to jurisdiction, and to adopt certain other joint regulations. These rulemakings, like other SEC rulemakings, were subject to the protections mandated by the APA's rulemaking provisions requiring public notice and comment prior to adopting final rules. Further to the issue of transparency, the SEC is subject to the Sunshine Act, which aims to ensure transparent procedures in the disposition of SEC business, including rulemakings.</p> <p>Second, the GLBA requires that the various financial regulators, including the banking agencies and the SEC, consult with one another regarding rulemaking to implement the GLBA's provisions concerning protection of the security and privacy of customers' nonpublic information. The statute is clear on the scope of the cooperation and the provisions that must be implemented. Similarly, the rulemaking process is transparent; as such, rules are promulgated pursuant to the APA rulemaking provisions.</p> <p>Third, the congressional review process of final SEC rules under the SBREFA, which is clearly and transparently set forth in the statute and which has certain safeguards designed to protect the integrity of the process. Moreover, the Government Accountability Office (GAO) must report to Congress on whether the SEC has complied with the required statutory procedures when the SEC submits a major rule to Congress. For more information on the GAO, see response to Principle 2, Question 6.</p>
3.	Does the securities regulator have a stable and continuous source of funding sufficient to meet its regulatory and operational needs?
	<p>The SEC's budget is part of the federal budget that is prepared by the President and submitted to Congress. Each year, the SEC prepares a budget estimate, which it forwards to OMB. This document outlines the major program areas of the SEC and estimates the resources (including Staff and expenses such as salary, facilities and supplies) needed to operate them. The SEC's budget is part of the budget request that the President typically submits to Congress in February</p>

for the fiscal year that begins the following October.<sup>56</sup> For additional information with regard to funding, see response to Principle 3, Question 2.

Funding for the SEC is made through an annual appropriation from Congress.<sup>57</sup> During the debate on the Dodd-Frank Act, Congress considered making the SEC self-funded. While self-funding did not come to pass, significant changes were made to the SEC's funding structure so that the SEC is now charged with collecting transaction fees from the securities industry to match the SEC's appropriation. The SEC's budget is deficit-neutral because it is offset by those securities transaction fees, as periodically adjusted, assessed on SROs in accordance with Section 31 of the Exchange Act. The current fee rate is approximately \$0.02 per every \$1,000 transacted.

The SEC also has a reserve fund, which can, under certain circumstances, be used for the agency's expenses, and the SEC has dedicated this to technology. The SEC can use up to \$100 million from this fund each year. The funding is provided by deposits of up to \$50 million per year in securities registration fees.

4. Are the regulatory authority, the head and members of the governing body of the regulatory authority, as well as its staff, accorded adequate legal protection for the *bona fide* discharge of their governmental, regulatory and administrative functions and powers?

The SEC, the Chair, the Commissioners, and the Staff have adequate legal protections for the *bona fide* discharge of their governmental, regulatory, and administrative functions and powers. The principle of sovereign immunity, or immunity from civil suit or criminal prosecution, provides significant protection to the SEC as a whole and to individuals (the Chair, Commissioners, and Staff) who comprise the SEC. While there are exceptions to the principle of sovereign immunity, the SEC and its members and Staff are generally sufficiently protected from frivolous or unwarranted litigation or claims.

The SEC is subject to claims for monetary damages based on constitutional or common law claims only in very limited circumstances. When Staff is acting in a prosecutorial fashion, they are entitled to absolute immunity from constitutional torts (civil rights actions), so long as the actions are taken within the scope of their authority. Also, qualified immunity protects government employees from liability for constitutional claims if they have not violated a clearly established

<sup>56</sup> The SEC's fiscal year ends on September 30.

<sup>57</sup> The SEC's current and past budget requests are available on the SEC's website at <http://www.sec.gov/about/secreports.shtml>. See also testimony of Chair Mary Jo White before the United States Senate Committee on Banking, Housing, and Urban Affairs dated September 9, 2014 at <http://www.sec.gov/News/Testimony/Detail/Testimony/1370542893146> and testimony of Chair White before the U.S. Senate Subcommittee on Financial Services and General Government Committee on Appropriations dated May 14, 2014 at <http://www.sec.gov/News/Testimony/Detail/Testimony/1370541815125>.



statutory or constitutional right of which a reasonable government official would have known.

With respect to common law claims, the Federal Tort Claims Act (FTCA) provides the exclusive remedy for torts committed by employees of the federal government in the scope of their employment. Claims based on the performance of a discretionary function or arising out of certain intentional torts, including malicious prosecution, abuse of process, libel, slander, misrepresentation, deceit, or interference with contract rights, cannot be brought under the FTCA.<sup>58</sup> Claims regarding SEC actions rarely fall outside of those protections.

The main claims for damages to which the SEC is subject are claims brought under statutory schemes that specifically contemplate damages against the SEC. These claims include personnel actions brought by employees who allege they have been discriminated against or who have been subjected to significant personnel actions, such as termination of employment. Persons and entities that have contractual relationships with the SEC may also sue for breach of contract.

5. Are the head and governing board of the regulator subject to mechanisms intended to protect independence, such as: procedures for appointment; terms of office; and criteria for removal?

As discussed in response to Principle 1, Question 1(a), the SEC is an independent federal agency headed by a five-member Commission. All Commissioners, including the Chair, are appointed by the President and confirmed by the Senate. The President designates the Chair, and there can be no more than three members who are members of the same political party.

Commissioners are appointed to serve a five-year term. The expiration of these terms is staggered so that one Commissioner's term ends on June 5 of each year. Any Commissioner appointed to fill a vacancy occurring prior to the expiration of the term for which his or her predecessor was appointed is appointed for the remainder of such term. Moreover, the Exchange Act prohibits Commissioners from engaging in any other business, vocation, or employment than that of serving as Commissioner, or participating, directly or indirectly, in any stock-market operations or transactions of a character subject to regulation by the SEC pursuant to the Exchange Act.

<sup>58</sup>

28 U.S.C. §§ 2671-2780.

<i>Accountability</i>	
6.	With reference to the system of accountability for the regulator's use of its powers and resources:
(a)	Is the regulator accountable to the legislature or another government body on an ongoing basis?
<p>The SEC is an independent agency that exercises the authority granted by Congress under the federal securities laws. That said, the SEC is subject to Congressional oversight.</p> <p>The two Congressional committees with primary authorizing and oversight responsibilities over the SEC are the Senate Committee on Banking, Housing and Urban Affairs (Senate Banking Committee) and the House of Representatives Committee on Financial Services (House Financial Services Committee). The Senate Banking Committee oversees, among other things, areas relating to banking, insurance, financial markets, securities, housing, urban development and mass transit, international trade and finance, and economic policy. The House Financial Services Committee oversees all components of the nation's housing and financial services sectors, including banking, insurance, real estate, public and assisted housing, and securities. Each of those committees contains a subcommittee with jurisdiction specific to securities issues: in the Senate Banking Committee, it is the Subcommittee on Securities, Insurance and Investment; and in the House Financial Services Committee, it is the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises.</p> <p>Various other Congressional committees also have oversight or other responsibilities related to the SEC, including the House Oversight and Government Reform Committee, the Senate Homeland Security and Government Affairs Committee, and the House and Senate Appropriations Committees.</p> <p>As discussed above in response to Principle 2, Question 2(c), all final SEC rules must be submitted to Congress for review before they can take effect. See the discussion of SBREFA above in response to Principle 2, Question 2(c).</p> <p>The SEC is also accountable to Congress through its relationship with the GAO, an independent, nonpartisan agency that works for Congress and investigates how the federal government spends taxpayer dollars. The GAO's mission is to support the Congress in meeting its constitutional responsibilities and to help improve the performance and ensure the accountability of the federal government for the benefit of the American people. The GAO's work is done at the request of congressional committees or subcommittees or is mandated by public laws or committee reports. The GAO supports congressional oversight by (i) auditing agency operations to determine whether federal funds are being spent efficiently and effectively; (ii) investigating allegations of illegal and improper activities; (iii) reporting on how government programs and policies are meeting their objectives; (iv) performing policy analyses and outlining options for congressional consideration; and (v) issuing legal decisions and opinions, such as bid</p>	

protest rulings and reports on agency rules.

The SEC also may receive requests for information from Congress. These requests come in various forms (*e.g.*, correspondence from Congressional Members or committees, or phone calls, or emails by Congressional staff to Staff), and may request testimony by SEC witnesses before Congressional committees, technical assistance on potential or pending legislation, or information about SEC rules, actions, programs, or activities.

Additionally, as discussed above in response to Principle 2, Question 3, the SEC reports annually to the President, through the OMB, on the major program areas of the SEC and estimates the resources needed to operate them. The OMB then reviews this information and sets the amount of funding recommended by the President. The SEC's budget is part of the budget request that the President submits to Congress in January for the fiscal year that begins the following October.

Finally, as discussed in response to Principle 2, Question 7(d), any person aggrieved by any final order of the SEC may obtain review in a U.S. Circuit Court of Appeals. Parties may request a rehearing of an adverse decision and rehearing *en banc* (*i.e.*, before all the judges of the circuit). An aggrieved party dissatisfied with the ruling of a lower court may also seek *certiorari* before the U.S. Supreme Court.

- (b) Is the regulator required to be transparent in its way of operating and use of resources and to make public its actions that affect users of the market and regulated entities, excluding confidential or commercially sensitive information?

The SEC is transparent in its operations and decision-making. As noted in response to Principle 1, Question 1(b), the APA prescribes the manner in which the SEC may consider or adopt rules of general applicability. The APA requires that interested parties receive adequate notice of proposed rulemaking. Generally this occurs through notice in the *Federal Register*, which is usually preceded by an open meeting at which the Commissioners vote to approve a rulemaking proposal. After the agency publishes notice, it must give interested persons an opportunity to comment on the proposed rulemaking. The SEC posts its rulemaking releases, public comment letters filed with the SEC, and other data or information that is important to the SEC's consideration of the rulemaking on the SEC's website.

Further to the issue of transparency and as noted in response to Principle 1, Question 1(c) the SEC is subject to the Sunshine Act, which aims to ensure transparent procedures in the disposition of SEC business, including rulemakings. The Sunshine Act generally provides that meetings must be open to the public and requires the SEC to provide advance notice of such meetings. The SEC videocasts all open SEC meetings on the Internet. The Sunshine Act, and SEC rules adopted thereunder, also prescribe certain procedures for closing an SEC meeting from public observation in reliance on an exemption specified by the Sunshine Act. The SEC maintains minutes of its open and closed meetings and retains these records permanently.

The SEC's operations and use of resources are also transparent in other ways. For example, the SEC publishes an Annual Financial Report (AFR), which describes the SEC's accomplishments and financial operations for a given fiscal year. Additionally, the SEC makes publicly available on its website a current copy of its current Rules of Practice and Rules on Fair Fund and Disgorgement Plans. These rules, as well as others concerning conduct, ethics, information requests, and delegations of authority, among other things, are contained in the Code of Federal Regulation, which is widely available in print and on the Internet. In addition, the SEC publishes on its website a wide range of interpretive and other useful materials for investors, regulated entities and their advisers.

SEC enforcement actions are also transparent. Enforcement actions are brought in either federal district court or in administrative proceedings, each of which is public forum.<sup>59</sup> Moreover, the SEC also makes information about its enforcement actions available to the public on its website in the form of "litigation releases" (for civil actions) and "administrative releases" (for administrative proceedings). The SEC also publishes on its website the Staff's Enforcement Manual, a reference document designed for Enforcement staff in connection with the investigation of potential violations of the federal securities laws. In order to promote transparency with entities subject to the Commission's examination authority, OCIE publishes its annual examination priorities, risk alerts, speeches, and letters to the industry about upcoming examination initiatives. See Principle 12 for more information.

In addition, the SEC provides information semiannually about its regulatory activities and priorities to the GSA's Regulatory Information Service Center. The Regulatory Information Service Center, in turn, compiles this information from the SEC (and other agencies) into a Unified Agenda of Federal Regulatory and Deregulatory Actions, which is provided to the President, the Congress, and the public in the Fall and Spring of each year. Each edition of the Unified Agenda includes regulatory agendas from all federal entities that currently have regulations under development or review. Fall editions of the Unified Agenda include agency statements of regulatory priorities and additional information about the most significant regulatory activities planned for the coming 12 months.<sup>60</sup>

(c) Is the regulator's receipt and use of funds subject to review or audit?

The SEC's receipt and use of funds are subject to regular audit by the GAO and the SEC's Office of Inspector General (OIG). Most notably, the SEC undergoes an annual audit of its financial statements and internal controls over financial reporting that is conducted by the GAO. The GAO and OIG also conduct regular audits of SEC programs and operations. The results of these audits

<sup>59</sup> See Principles 10, 11, and 12 for more detailed discussion of Enforcement powers and processes.

<sup>60</sup> The current Unified Agenda of Regulatory and Deregulatory Actions can be found at <http://www.reginfo.gov/public/do/eAgendaMain>.

are reported to agency management, made available to Congress and OMB, and are generally made public on the Internet.

For fiscal year 2013, the GAO issued an unqualified audit opinion on the SEC's financial statements and has affirmed that the agency's financial statements are presented fairly in all material aspects and in conformity with U.S. generally accepted accounting principles (GAAP).

The SEC is also subject to various requirements – including the Inspector General Act of 1978<sup>61</sup> and OMB Circular A-50 – to implement timely and appropriate corrective action on recommendations made by auditors in their audit reports.

In addition to these external audits, the SEC also has a formal program to provide for regular management review of SEC spending and operations. This includes the process set forth in the Federal Managers' Financial Integrity Act of 1982<sup>62</sup> and OMB Circulars A-123 and A-127, which require annual review and reporting on the SEC's internal controls and financial management systems. The SEC has also established a senior management council – the Financial Management Oversight Committee – to assist the SEC's internal controls and financial management functions.

SEC management also provides regular review and oversight of spending that occurs under the agency's annual operating budget. In addition to continually monitoring spending trends during the course of the fiscal year, management also conducts a "mid-year review" at the half-way point of the fiscal year to review spending-to-date, identify emerging resource needs, and shift resources as needed.

In addition, the SEC is required to report to the Senate Banking Committee and the House Financial Services Committee not later than 90 days after the end of each fiscal year on the supervisory controls over the conduct by the SEC of examinations of registered entities, Enforcement investigations, and review of corporate financial securities filings.

7. Are there means for natural or legal persons adversely affected by a regulator's decisions or exercise of administrative authority ultimately to seek review in a court, specifically:

(a) Does the regulator have to provide written reasons for its material decisions?

The APA requires an administrative agency, such as the SEC, to prepare a written decision setting forth the SEC's findings of fact and conclusions of law and the underlying reasons. The federal securities laws themselves also require the SEC to issue orders in its administrative proceedings. A person aggrieved by a final order of the Commission may seek judicial review in a federal court. As discussed in detail in Principle 1, Question 1(b), and Principle 4, Question 2(a), judicial

<sup>61</sup> 5 U.S.C. App. 3.

<sup>62</sup> Pub. L. 97-255.

review also can be sought by those adversely affected by agency rulemaking.

(b) Does the decision-making process for such decisions include sufficient procedural protections to be meaningful?

As discussed in detail in responses to Principle 1, Question 1(b), and Principle 4, Question 2(a), there are means to address those adversely affected by agency rulemaking.

In addition, the U.S. Constitution requires administrative agencies, such as the SEC, to conduct their proceedings with due process. Section 554 of the APA specifically requires the SEC to permit interested parties a hearing to submit facts and argument. Hearings in SEC-instituted administrative proceedings are heard in a trial-type proceeding before an administrative law judge (ALJ). The SEC may not assign duties to ALJs that are incompatible with their duties as ALJs.<sup>63</sup> When conducting a hearing, ALJs cannot be subject to supervision or direction of employees engaged in the performance of investigatory or prosecutorial functions.<sup>64</sup> They may only be removed for cause after a hearing before the Office of Personnel Management,<sup>65</sup> which is also responsible for setting ALJ salaries.<sup>66</sup> Under the APA and SEC Rule of Practice 111, ALJs have a wide-range of powers to oversee proceedings, including the authority to regulate the course of a proceeding and the conduct of parties and their counsel, administer oaths and affirmations, dispose of procedural motions, and issue subpoenas.

Under SEC Rule of Practice 200, the SEC issues an Order Instituting Proceedings, which gives each party to the proceeding notice of the alleged facts and violations. The affected person is entitled to representation by counsel.<sup>67</sup> The affected person may file an answer and/or a motion seeking a more definite statement of specified matters of fact or law to be determined.<sup>68</sup> The ALJ will then conduct a pre-hearing conference, among other things, to set the time to exchange witness and exhibit lists and pre-hearing briefs, identify expert witnesses, determine if any matters can be stipulated to or settled, and set the date for the hearing.<sup>69</sup> Enforcement generally must make its investigatory files available to the affected person for inspection and copying before the hearing and produce any witness statements.<sup>70</sup> The parties may seek subpoenas to require the attendance of witnesses and production of documents.<sup>71</sup>

<sup>63</sup> 5 U.S.C. § 3105.

<sup>64</sup> 5 U.S.C. § 554.

<sup>65</sup> 5 U.S.C. § 7521.

<sup>66</sup> 5 U.S.C. § 5372.

<sup>67</sup> SEC Rule of Practice 102.

<sup>68</sup> SEC Rule of Practice 220.

<sup>69</sup> SEC Rules of Practice 221, 222.

<sup>70</sup> SEC Rules of Practice 230, 231.

<sup>71</sup> SEC Rule of Practice 232.

Under Rule of Practice 300, the hearings before the ALJs are public and the proceedings are recorded.<sup>72</sup> The witnesses testify under oath.<sup>73</sup> At the conclusion of the proceedings, the parties submit proposed findings of fact, conclusions of law, and supporting briefs.<sup>74</sup> Thereafter, under Rule of Practice 360, the ALJ prepares an initial decision, which sets forth findings and conclusions and the reasons therefore as to all material issues of fact, law, or discretion presented on the record and an order with respect to sanctions. If neither party appeals, the SEC issues a finality notice making the initial decision the final decision of the SEC.<sup>75</sup>

Either the affected person or Enforcement may appeal an initial decision by an ALJ to the SEC, and the SEC may take review of all or part of the initial decision on its initiative review.<sup>76</sup>

The SEC will receive briefs from the parties.<sup>77</sup> Upon request of the respondent, the SEC will also hear oral argument.<sup>78</sup> Generally, under Rule of Practice 411, the SEC's review is limited to the issues specified in the petition for review or in the briefing schedule order. However, the SEC may at any time determine any other matter it deems material with a notice to the parties and opportunity for oral or written argument.<sup>79</sup>

The SEC determines the proceeding on the basis of the record before it, which includes the exhibits, transcripts, pleadings before the ALJ, and the pleadings and argument before the SEC.<sup>80</sup> To be effective, the decision must be approved by a majority of a quorum of the sitting Commissioners. Under the applicable law, violations must be proved by a preponderance of the evidence.<sup>81</sup> The written decision resolves the contested findings of fact, makes conclusions of law, rules on procedural matters, and makes a determination whether any sanction is appropriate in the public interest and for the protection of investors.

The SEC also receives appeals from disciplinary decisions by SROs, such as FINRA or an exchange, or the PCAOB. The SRO or the PCAOB previously will have conducted a trial-type

<sup>72</sup> SEC Rule of Practice 320.

<sup>73</sup> SEC Rule of Practice 325.

<sup>74</sup> SEC Rule of Practice 340.

<sup>75</sup> SEC Rule of Practice 360.

<sup>76</sup> SEC Rules of Practice 410, 411.

<sup>77</sup> SEC Rule of Practice 450.

<sup>78</sup> SEC Rule of Practice 451.

<sup>79</sup> SEC Rule of Practice 411(d).

<sup>80</sup> SEC Rules of Practice 460, 350.

<sup>81</sup> Preponderance means the greater weight of the evidence in favor of one side, based on the more convincing evidence and its probable truth or accuracy, and not on the amount of evidence.

hearing before a hearing panel and issued a written decision. The Exchange Act requires the SEC to conduct a *de novo* review<sup>82</sup> of the SRO's or the PCAOB's action. The SEC's review is based on the record certified to the SEC by the SRO or the PCAOB, the application for review, and briefs and pleadings of the parties.<sup>83</sup> Under Section 19(e) of the Exchange Act, the SEC determines whether the violations charged were demonstrated by a preponderance of the evidence, whether the SRO's rules were applied in a manner consistent with the purposes of the Exchange Act (or whether the PCAOB's rules were applied in a manner consistent with the purposes of the Sarbanes-Oxley Act), and whether the sanctions are excessive or oppressive or a burden on competition.

Section 554 of the APA prohibits *ex parte* communications<sup>84</sup> and further provides that no person involved in the performance of investigative or prosecutorial functions in a proceeding may advise the decision maker.

SEC decisions and orders are available in bound volumes, on the SEC's website, and through legal computer databases.

(c) Are affected persons permitted to make representations prior to such a decision being taken by a regulator in appropriate cases?

In administrative proceedings, affected persons may file an answer; testify and require witnesses to testify under oath; file prehearing submissions and motions; subpoena witnesses and documents; offer relevant evidence; seek and make stipulations; request that official notice be taken of certain facts; and file proposed findings of fact, conclusions of law, and briefs before the ALJ.<sup>85</sup> The SROs have similar procedural requirements. See, e.g., FINRA Code of Procedure, Rule 9000, *et seq.*

An affected party in a SEC-instituted proceeding may seek interlocutory review,<sup>86</sup> petition for review, file briefs, and be heard in oral argument.<sup>87</sup> An affected party in an SRO or PCAOB disciplinary proceeding may file briefs and motions.<sup>88</sup> The affected person may also seek to

<sup>82</sup> *De novo* review is a form of appeal in which the tribunal reviews the record without regard to factual findings of the original proceeding.

<sup>83</sup> SEC Rule of Practice 460.

<sup>84</sup> *Ex parte* communication is a material communication relevant to the merits of an adjudicatory proceeding that was neither on the record nor on reasonable prior notice to all parties and takes place between a party and the ALJ.

<sup>85</sup> SEC Rules of Practice 220, 325, 222, 232, 320, 324, 323, and 340.

<sup>86</sup> Interlocutory review is sought by an affected party who files a petition to seek the SEC's review of an ALJ's ruling.

<sup>87</sup> SEC Rules of Practice 400, 410, 450 and 451.

<sup>88</sup> SEC Rule of Practice 450.



adduce additional evidence before the SEC if that evidence is material and there are reasonable grounds for its not being introduced at an earlier stage of the proceedings.<sup>89</sup> A person aggrieved by a final decision of the SEC may seek reconsideration of the order.<sup>90</sup> The SEC has limited ability to reconsider motions to correct manifest errors of law or fact or to introduce newly discovered evidence.

(d) Are all such decisions taken by the regulator subject to a sufficient, independent review process, ultimately including judicial review?

Under the applicable law, any person aggrieved by a final order of the SEC may obtain judicial review of the order in a U.S. Circuit Court of Appeals. Similarly, any person adversely affected by most rules of the SEC promulgated under certain provisions of the federal securities laws may obtain judicial review of such rule in a U.S. Circuit Court of Appeals.

Additionally, as noted above, Chapter 7 of the APA creates the right of judicial review over agency actions. Under Section 702 of the APA, a person suffering legal wrong because of agency action, or adversely affected or aggrieved by agency action, is entitled to judicial review thereof.

8. Where accountability is through the government or some other external agency is confidential and commercially sensitive information subject to appropriate safeguards to prevent inappropriate use or disclosure?

The Exchange Act and Advisers Act both contain statutory provisions that are designed to safeguard the confidentiality of information obtained in the course of examinations or investigations. The SEC also has adopted rules under the Exchange Act to permit requests for confidential treatment of certain information. Rule 24c-1 under the Exchange Act provides that the SEC may provide nonpublic information in its possession to certain entities, including other domestic and foreign governmental entities, but only if it receives appropriate assurances of confidentiality. Moreover, the SEC has procedures in place designed to ensure that assurances of confidentiality are obtained either through an MOU or access request letters, among other processes, and in a manner consistent with applicable statutory and rule requirements. Typically, the terms and conditions of the SEC's MOUs with domestic and/or foreign authorities are designed to satisfy the requirement for confidentiality assurances. Furthermore, Staff has written procedures addressing the manner in which information-sharing is to occur with other regulatory authorities and both foreign and domestic law enforcement. As discussed in the response to Question 14.7, Staff, particularly in Enforcement, shares information with other domestic and criminal authorities such as the OCC, Treasury, DOJ, the FBI, and with foreign authorities.

<sup>89</sup> SEC Rule of Practice 452.

<sup>90</sup> SEC Rule of Practice 470.

Additionally, regulated entities and issuers who are subject to reporting requirements are required to make public filings with the SEC. The Freedom of Information Act (FOIA)<sup>91</sup> governs public access to certain types of documents.<sup>92</sup> FOIA requires that the SEC make certain information available to the public, but also provides certain exceptions for, among other things, commercially sensitive material. A regulated entity or issuer can request that certain information be kept nonpublic, pursuant to one of these exceptions. FOIA and its exceptions are described further below.

FOIA requires all agencies to: (i) publish certain types of information in the *Federal Register*, such as procedural rules and substantive rules of general applicability; (ii) make available for public inspection and copying other types of information such as adjudicative opinions and staff manuals; and (iii) make available to the public other types of information upon specific request for that information. FOIA also enables the public to obtain access to agency records unless the record falls under an exception to the general disclosure requirement. The exceptions protect from disclosure: (i) documents that relate solely to personnel rules and practices; (ii) trade secrets and confidential commercial or financial information; (iii) deliberative or otherwise privileged intra-agency or inter-agency memoranda or letters; (iv) law enforcement records the disclosure of which would interfere with law enforcement proceedings; and (v) matter and records related to examinations. The SEC has also promulgated a confidential treatment regulation that permits persons who have submitted records to the SEC to object to their disclosure in response to a FOIA request.<sup>93</sup>

The SEC's FOIA Office responds to requests for records under FOIA and requests for confidential treatment by submitters of records. These responses may be appealed, pursuant to a delegation of authority from the SEC, to its Office of the General Counsel (OGC), which may grant or deny appeals, or may release records in the exercise of discretion.<sup>94</sup> OGC may also refer appealed matters in appropriate cases to the Commission for its review.

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<sup>91</sup> 5 U.S.C. § 552.

<sup>92</sup> 5 U.S.C. § 552.

<sup>93</sup> 17 C.F.R. § 200.83.

<sup>94</sup> 17 C.F.R. § 200.80(d)(6).

<b>Principle 3      The Regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.</b>
<b>Key Questions</b>
<p>1. Are the powers and authorities of the regulator sufficient, taking into account the nature of a jurisdiction's markets and a full assessment of these Principles to meet the responsibilities of the regulator(s) to which they are assigned?</p>
<p>The SEC's mission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. The legal framework for the SEC generally provides it with adequate powers and authorities to meet these responsibilities. As discussed in greater detail in response to Principle 1, Question 1(a), the SEC's extensive powers and authorities are delineated in the following federal securities statutes and in the rules and regulations that the SEC has adopted thereunder: the Securities Act; Exchange Act; the Trust Indenture Act; the Investment Company Act; and the Advisers Act.</p> <ul style="list-style-type: none"> <li>• The Securities Act requires that investors have access to financial and other significant information concerning securities being offered for public sale (registration); outlines the exemptions under which such registration is not required; and prohibits deceit, misrepresentations, and other fraudulent activities in connection with the offer or sale of securities.</li> <li>• The Exchange Act provides for periodic disclosure to be made by registrants and empowers the SEC with broad authority over all aspects of the securities industry, including the power to register, regulate, and oversee brokers, dealers, transfer agents, CRAs, clearing agencies, securities exchanges, securities associations, municipal advisors, SBSDs, and other entities. It also prohibits deceit, misrepresentations, and other fraudulent activities in connection with the purchase or sale of securities.</li> <li>• The Trust Indenture Act applies to debt securities such as bonds, debentures, and notes that are offered for public sale. These securities may not be offered for sale to the public unless a formal agreement between the issuer of bonds and the bondholder, known as the trust indenture, conforms to the standards of the Trust Indenture Act.</li> <li>• The Investment Company Act empowers the SEC to regulate the organization of companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public.</li> <li>• The Advisers Act empowers the SEC to regulate investment advisers, including advisers to public and private funds.</li> </ul>

2. With regards to funding:
(a) Is the regulator's funding adequate to permit it to fulfil its responsibilities, taking into account the size, complexity and types of functions subject to its regulation, supervision or oversight?
<p>Yes. As described previously in Principle 2, Question 3, the SEC is funded through annual appropriations enacted by Congress and the President.</p> <p>The SEC's appropriation is deficit-neutral, since it is matched by anticipated collections of Section 31 securities transaction fees. Thus, each year, Congress and the President can decide the size of the SEC's appropriation without diverting resources from other priorities or adding to the nation's debt.</p> <p>Prior to preparing its annual budget, the SEC performs an internal self-assessment to evaluate its funding needs for future fiscal years. This self-evaluation is then subject to thorough review by the OMB, and a formal budget request is then submitted to the Congress as part of the President's annual budget request. The budget is then subject to a rigorous review by the House and Senate Appropriations Committees, including appearances by the Chair at formal hearings, and ultimately consideration and approval by the full House and Senate.</p> <p>The annual nature of the budget process ensures that the SEC's priorities, programs, and operations undergo regular internal review as well as external evaluation by OMB and Congress. The current budget process also allows for the evaluation of the SEC's near-term resource needs and the alignment of ongoing spending with the agency's long-term strategic goals.</p> <p>The SEC's current and past budget requests, and accompanying justifications, are available on the SEC's website at <a href="http://www.sec.gov/about/secreports.shtml">http://www.sec.gov/about/secreports.shtml</a>. In addition, at the end of each fiscal year, the SEC publishes the AFR, which discusses the SEC's accomplishments over the past year.<sup>95</sup> Taken together, these annual documents provide a useful overview of the SEC's past performance and future needs.</p>
(b) Can the regulator affect the operational allocation of resources once funded?
<p>Yes. As a general matter, the SEC has the authority to allocate resources where needs are most pressing. In doing so, however, it must operate within the parameters set by the Congress in the annual appropriations law.</p> <p>The SEC's budget, as approved by Congress, sets aside funds in several major categories of spending called "object classes" that describe general categories of spending. The SEC's largest</p>

<sup>95</sup> The SEC's most recent AFR is available at <http://www.sec.gov/about/reports/sec-fy2013-annual-performance-report.pdf>.

budget object class, for instance, is for personnel compensation and benefits, which was approximately \$927 million for fiscal year 2014.

In approving the SEC's budget, Congress also permits funds to be transferred among object classes or programs within certain limits. In recent years, for instance, the SEC has been allowed to reallocate up to \$5 million or 10% of a category, whichever is less. Outside of these limits, the SEC must seek the permission of the House and Senate Appropriations Committees to reallocate funds from one category to another by submitting a formal reprogramming request. A reprogramming request is also required for a number of other agency actions; for instance, to create a new program or to eliminate an existing program, project, or activity.<sup>96</sup> The SEC has in the past obtained permission in this manner to reprogram funds from one object class to another.

3. Does the level of resources recognize the difficulty of attracting and retaining experienced and skilled staff?

Yes. The SEC strives to maintain an organizational climate in which high-performing employees wish to remain with the SEC. Although turnover can fluctuate based on a variety of factors, including the health of the economy and the number of outside job opportunities available for Staff, the agency aims to keep its turnover rate relatively low, below 8% per year. During fiscal years 2010 through 2013, the SEC experienced a turnover rate that averaged less than 6%, which was consistent with the overall federal sector turnover rate.

The SEC has made a concerted effort to recruit and hire employees with the skill sets required to fulfill mission requirements based on the Dodd-Frank Act, JOBS Act, and other key legislation enacted since 2009. Additionally, the SEC continues to implement enhanced employee benefits, market-based pay structure, multiple day telework, flexible work schedules, and pay-for-performance, all of which are designed to encourage skilled Staff to remain. For more information regarding Staff, please see the most recent AFR, available at <http://www.sec.gov/about/reports/sec-fy2013-annual-performance-report.pdf>.

4. Does the regulator ensure that its staff receives adequate ongoing training?

Yes. The SEC created SEC University to provide training and development opportunities to all Staff. The mission of SEC University is to develop SEC employees and managers to ensure high performance and productivity and a collaborative, effective, and engaged workplace. SEC University plans and delivers internally held in-person courses, assists employees who need to take a class offered by an outside organization, and hosts a variety of web based training, including access to the Practising Law Institute, a non-profit continuing legal education organization, and access to the training platforms found on electronic legal databases, *i.e.*,

<sup>96</sup> See Section 608 of Public Law 113-76, Consolidated Appropriations Act, 2014.

LexisNexis and Westlaw. All training offerings are done in consultation with office and division management to identify and deliver training that meets the learning needs of their groups. Additional specialized, operation-specific training is also provided to Staff carrying out the agency's mission. SEC University provides training in the following areas:

- Leadership and management training – to develop leadership effectiveness and create a strong management culture within the SEC.
- Securities and mission-based training – to ensure that SEC employees maintain up-to-date knowledge and skills that allow them to protect investors through the effective oversight of U.S. capital markets.
- General training – to provide employees with training on interpersonal skills, administrative skills, project management, IT applications, and mandatory and ethical requirements.

### **Ethics Training**

In addition to general and specialized operational training, every new and existing employee and Commissioner receives ethics education and training. Regulatory requirements regarding ethics training are set forth in an OGE regulation.<sup>97</sup> In addition to these rules, the SEC's Office of the Ethics Counsel (OEC) has an internal website on the SEC's intranet that provides additional guidance on all of these topics and links to the OGE regulations and disclosure forms. OEC also provides mandatory training annually to all Staff on the SEC's supplemental standards of ethical conduct. For additional information regarding the OEC, see responses to Principle 5 below.

The SEC also has a Personal Trading Compliance System (PTCS), which was designed and developed by the SEC's Office of Information Technology in conjunction with OEC. The purpose of the system is to help SEC employees comply with regulatory requirements regarding reporting and pre-clearing personal financial interests and transactions. PTCS training is also provided to SEC members and Staff.

5. Does the regulator have policies and governance practices to perform its functions and exercise its powers effectively?

Yes. The SEC operates as a Commission with five Commissioners who are appointed by the President and confirmed by the Senate. No more than three Commissioners may belong to the same political party. The President also designates one of the Commissioners as Chair. The Chair's Office oversees the executive and administrative functions of the Commission, including

<sup>97</sup> 5 C.F.R. Part 2638, subpart G.

appointment and supervision of personnel, distribution of business and use and expenditure of funds.<sup>98</sup>

To assist the SEC in effectively performing its functions, the SEC created the Office of Chief Operating Officer in 2010. In addition, see the detailed discussion in Principle 2, Question 6(c), regarding Section 961 of the Dodd-Frank Act and required reports on supervisory control over the conduct by the SEC of examinations of registered entities, enforcement investigations, and review of corporate financial securities filings. The scope of these activities falls principally under the purview of OCIE, the Office of Credit Ratings (OCR), Enforcement and the Division of Corporation Finance (CF).

6. Does the regulator play an active role in promoting education in the interest of protecting investors?

Yes. As part of its investor protection mission, the SEC participates in educational initiatives to help individual investors avoid fraud and make informed investing decisions. The Office of Investor Education and Advocacy (OIEA) leads these efforts by communicating daily with investors, responding to their complaints and inquiries, and providing educational programs and materials.

OIEA handles investment-related complaints and questions from tens of thousands of individual investors and others every year. Investors contact OIEA seeking information about the securities markets, securities laws and regulations, investment products, and financial professionals. Investors also submit complaints involving brokers, investment advisers, transfer agents, mutual funds, and other corporate issuers. OIEA seeks to provide timely and accurately responses to all investor assistance matters.

OIEA also raises awareness about the SEC's online educational resources, including [investor.gov](http://investor.gov), and implements other investor education programs focused on helping individuals to research investments and investment professionals, understand fees, and detect fraud. To maximize its reach, OIEA uses social media technologies and partners with the SEC's Regional Offices, other federal and state agencies, financial industry associations, consumer groups, and educational organizations on investor education programs. In addition, OIEA staff participates in in-person events for investors generally and those targeted to classes of specific investors, such as seniors, service members, and other affinity groups. OIEA also participates in IOSCO's Committee on Retail Investors, whose primary mandate is to conduct IOSCO's policy work on retail investor education and financial literacy.

<sup>98</sup> See Reorganization Plan No. 10 of 1950.

**Principle 4      The Regulator should adopt clear and consistent regulatory processes**
**Key Questions**
*Clear and Equitable Procedures*
**1.      Is the regulator subject to reasonable procedural rules and regulations?**

Yes. The SEC has promulgated formal and informal procedural rules and regulations that govern many of its activities, including, but not limited to:

- A canon of ethics;<sup>99</sup>
- Responses to information requests;<sup>100</sup>
- Privacy of individuals and records maintained by the SEC;<sup>101</sup>
- Conduct of its current and former members and employees;<sup>102</sup>
- Public observation of SEC meetings;<sup>103</sup>
- Emergency operating procedures;<sup>104</sup>
- Administrative hearings;<sup>105</sup>
- Enforcement activities;<sup>106</sup>
- Rulemaking activities;<sup>107</sup>
- Investigations;<sup>108</sup>

<sup>99</sup> 17 C.F.R. § 200.50-72

<sup>100</sup> 17 C.F.R. § 200.80-82.

<sup>101</sup> 17 C.F.R. § 200.301-313.

<sup>102</sup> 17 C.F.R. § 200.735.

<sup>103</sup> 17 C.F.R. § 200.400-410.

<sup>104</sup> 17 C.F.R. § 200.200-205.

<sup>105</sup> 17 C.F.R. § 202.4.

<sup>106</sup> 17 C.F.R. § 202.5.

<sup>107</sup> 17 C.F.R. § 202.6.

<sup>108</sup> 17 C.F.R. § 203.1-8.



- Debt collection;<sup>109</sup> and
- Rules of practice and rules on fair funds and disgorgement plans.<sup>110</sup>

Moreover, as discussed in response to Principle 1, Question 1(b), the SEC's rulemaking is governed by the APA and by other statutes that prescribe the manner in which the SEC may undertake to consider or adopt rules of general applicability. The APA sets forth the basic procedural requirements for agency rulemaking and generally requires the SEC to give notice of the proposed rulemaking in the *Federal Register* when adopting rules and seek comment from interested parties on the proposed rule.

The SEC is also subject to several other procedural requirements with respect to its rulemaking, including:

- The PRA, which requires review and analysis of reporting and recordkeeping issues and burdens with respect to its rulemaking.
- Section 23(a)(2) of the Exchange Act, which requires the SEC to consider the impact that any rule promulgated under the Exchange Act would have on competition. In addition, certain rulemakings pursuant to the Securities Act, Exchange Act or the Investment Company Act require the SEC to consider whether such rules would promote efficiency, competition and capital formation.
- The Regulatory Flexibility Act (RFA)<sup>111</sup> which requires the SEC to consider the special needs of small entities in evaluating proposed rules and rule changes for all rules subject to notice and comment under the APA.
- The Sunshine Act, which, as discussed in response to Question 1.1(c), aims to ensure transparent procedures in the disposition of SEC business, including rulemakings.

Finally, as discussed in response to Principle 2, Question 7(b), the U.S. Constitution requires administrative agencies like the SEC to conduct their proceedings with due process.

<sup>109</sup> 17 C.F.R. § 204.1-77.

<sup>110</sup> 17 C.F.R § 201.

<sup>111</sup> 5 U.S.C. §§ 601-612.

## 2. Does the regulator:

- (a) Have a process for consulting with the public, or a section of the public, including those who may be affected by a rule or policy, for example, by publishing proposed rules for public comment, circulating exposure drafts or using advisory committees or informal contacts?

Yes. As discussed above and in response to Principle 1, Question 1(b), the SEC's rulemaking is governed by the APA, which generally requires the SEC to give notice of proposed rulemaking in the *Federal Register* and to seek public comment. The SEC posts copies of comment letters filed with the SEC on its website as well as other data or information that is important to the SEC's consideration of the rulemaking. After the comment period closes, the SEC completes its analysis of comment letters and considers whether to adopt the rules as proposed or whether provisions should be modified in response to comment letters.

In addition to soliciting public comment on a proposed rule, the SEC may also host a public roundtable. At an SEC roundtable, experts are invited to share their views with the SEC and the public about approaches to certain issues affecting the securities markets. As with a rulemaking, notice of a roundtable is given to the public prior to the meeting, and the discussions are broadcast live via the website with a transcript made available to the public on the SEC website.

The SEC has also created and utilized various federal advisory committees pursuant to the Federal Advisory Committee Act,<sup>112</sup> which regulates the formation and operation of advisory committees by federal agencies. These consultative committees include:

- The Investor Advisory Committee (IAC), which was established by the Dodd-Frank Act to advise the Commission on regulatory priorities, the regulation of securities products, trading strategies, fee structures, the effectiveness of disclosure, and on initiatives to protect investor interests and to promote investor confidence and the integrity of the securities marketplace.
- The Advisory Committee on Small and Emerging Companies, which is intended to provide a formal mechanism through which the Commission can receive advice and recommendations specifically related to privately held small businesses and publicly traded companies with less than \$250 million in public market capitalization.

<sup>112</sup>

Pub. L. No. 92-463 Stat. 86 (1972).

(b) Publicly disclose and explain its rules and regulatory policies, not including enforcement and surveillance policies, in important operational areas, such as through interpretations of regulatory actions, setting of standards, or issuance of decisions stating the reasons for regulatory actions?
<p>Yes. As discussed in response to Principle 1, Question 1(b), all final SEC rules are set forth in a release that is posted on the SEC's website and published in the <i>Federal Register</i>, with an explanation of the reasons for adoption and responses to the more salient issues raised in the comment letters. The SEC also occasionally provides interpretive guidance in which the SEC or Staff publishes its views and interprets the federal securities laws and SEC regulations. As is the case with rulemaking releases, these interpretations are posted on the SEC's website and published in the <i>Federal Register</i> and, in some instances, also include a request for comment.</p> <p>Additionally, the Staff may give interpretative and advisory assistance to members of the general public, prospective registrants, applicants, and declarants.<sup>113</sup> For example, persons having a question regarding the availability of an exemption may secure informal interpretations of the applicable statute or rule as they relate to the particular facts and circumstances presented. Similarly, persons contemplating filings with the SEC may receive advice of a general nature as to the preparation thereof, including information as to the forms to be used and the scope of the items contained in the forms. Staff advisory documents such as no-action letters, responses to frequently asked questions, interpretive guidance, and guidance updates are available on the SEC's public website.</p>
(c) Publicly disclose changes and reasons for changes in rules or policies?
<p>Yes. Generally speaking, as required by the APA, when the SEC proposes amendments to existing rules or adopts new rules that change current regulatory policies, it gives notice of the proposed rulemaking in the <i>Federal Register</i> and seeks comment from interested parties on the proposed rule. Typically, a proposing release will contain an extensive discussion of the reasons underlying a specific rule proposal and will solicit comments on the proposals and on various alternatives. When the SEC approves adoption of final rules or rule amendments, it publishes a release in the <i>Federal Register</i> and posts the release on the SEC's website with an explanation of the reasons for adoption and responses to the more salient issues raised in the comment letters.</p>
(d) Have regard to the costs of compliance with regulation?
<p>Yes. The SEC considers the costs, as well as the benefits, of compliance with its rules during both the proposing and adopting stages.</p>

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<sup>113</sup>

17 C.F.R. § 202.2.

Staff has developed general guidance on economic analysis in rulemaking, which is available on the SEC's website.<sup>114</sup> The Division of Economic and Risk Analysis (DERA) is also involved across the entire range of SEC activities, including policy making, rule-making, enforcement, and examinations.

As discussed above in response to Principle 4, Question 1, the SEC is required to consider the impact that any rule promulgated under the Exchange Act would have on competition. In certain rulemakings pursuant to the Securities Act, Exchange Act, the Advisers Act, or the Investment Company Act, the SEC is also required to consider whether such rules would promote efficiency, competition, and capital formation. Finally, the RFA requires agencies, such as the SEC, to consider the special needs of small entities in evaluating proposed rules and rule changes for all rules subject to notice and comment under the APA.<sup>115</sup>

(e) Make all rules and regulations available to the public?

Yes. The SEC maintains a public website, [www.sec.gov](http://www.sec.gov), with a specific page that provides links to SEC rulemaking releases and policy statements. It also links to announcements concerning SRO rulemaking, PCAOB rulemaking, instructions for Exchange Act exemptive applications, other SEC notices, and public petitions for rulemaking submitted to the SEC. The SEC's rules are also codified in the Code of Federal Regulation, which is available to the public.

(f) Make its rulemaking procedures readily available to the public?

Yes. The SEC's procedures for adoption, revision, and rescission of rules and regulations of general application, including publication of proposed and adopted rules in the *Federal Register*, are codified and are available to the public through the Code of Federal Regulations.<sup>116</sup> There are also instructions on how to submit comment letters set forth in every proposing release as well as on the SEC's website.

<sup>114</sup> See [http://www.sec.gov/divisions/riskfin/rsfi\\_guidance\\_econ\\_analy\\_secrulemaking.pdf](http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf).

<sup>115</sup> See response to Principle 7, Question 2, for further discussion of the RFA.

<sup>116</sup> <http://www.gpo.gov/fdsys/pkg/C.F.R.-2007-title17-vol2/pdf/C.F.R.-2007-title17-vol2-sec202-6.pdf>.

## 3. In assessing procedural fairness:

- (a) Are there rules in place for dealing with the regulator that are intended to ensure procedural fairness?

Yes. The SEC is subject to statutory provisions and its own rules that are intended to ensure the fairness of its processes. For example, the SEC is subject to restrictions relating to *ex parte* contacts and is required to maintain a separation of certain functions under both the APA and its own rules.

In the context of administrative proceedings, Section 554 of the APA and Rule 120 of the SEC's own Rules of Practice prohibit *ex parte* communications. Specifically, persons presiding over evidentiary hearings, such as ALJs, are not permitted to consult any person or party on a fact in issue unless prior notice and an opportunity for all parties to participate have been given. Similarly, Rule 121 of the SEC Rules of Practice prohibits SEC officers, employees or agents engaged in the performance of investigative or prosecutorial functions for the SEC to participate or advise in the decision or in the SEC review of such decision made by an ALJ.

Similarly, in the context of SEC actions in federal court, proceedings are governed by the Federal Rules of Civil Procedure and the Federal Rules of Evidence. Generally, these rules provide the parties and the judge presiding over the matter with instructions on the conduct of the proceeding and the kinds of evidence that can be considered. As in administrative proceedings, for example, *ex parte* communications are prohibited.

With respect to the SEC's statutory review of proposed rule changes submitted by securities exchanges and other SROs, there is a statutory scheme and SEC rules designed to ensure that SROs are afforded adequate process. Among other measures of procedural fairness, Commission determinations must be made within strict timeframes and subject to well-known standards of review under Exchange Act Section 19 and Rule 19b-4.

With respect to rulemaking, as discussed in response to Principle 1, Question 1(b) and to other previous questions under Principle 4, the SEC is subject to the APA's public notice and comment provisions concerning rulemaking.

Finally, Section 4A of the Exchange Act authorizes the Commission to delegate any of its functions to a division, an individual Commissioner, an ALJ, or an employee or employee board, provided that it retains a discretionary right to review any such action taken pursuant to the delegation. Rules 430 and 431 of the SEC's Rules of Practice provide a process by which interested persons may file a petition for review to the SEC of any action made by persons pursuant to a delegation of authority. Generally, any petition for review automatically stays the action made by delegated authority until the SEC orders otherwise.

<p>(b) Is the regulator required to give reasons in writing for its decisions that affect the rights or interests of others?</p>
<p>Yes. The SEC is required to give written reasons for its decisions affecting the rights and interests of others. With respect to adjudications, Section 557 of the APA requires that the record for such adjudications include all decisions, including initial, recommended, and tentative decisions. These decisions must include a statement of findings and conclusions, and the reasons or basis for such, on all material issues of fact, law, or discretion that are presented on the record. Such decisions must all include a statement of the appropriate rule, order, sanction, relief, or denial thereof.</p> <p>With respect to rulemaking, Section 553 of the APA requires the SEC to publish a notice of such proposal. The notice must state the time, place, and nature of the rulemaking, reference the legal authority for the rule proposal, and include the terms or substance of the proposal and a description of the subjects and issues involved. If the SEC determines to adopt a rule after public notice and comment, it is required to incorporate in the rules adopted a concise general statement of their basis and purpose and publish such rule at least 30 days before it becomes effective.</p> <p>See also responses above to Questions 2(b) and 2(c).</p>
<p>(c) Are all material decisions of the regulator in applying its rules subject to review?</p>
<p>Yes. Chapter 7 of the APA creates the right of judicial review over agency actions, including those of the SEC. Under Section 702 of the APA, a person suffering legal wrong because of agency action, or adversely affected or aggrieved by agency action, is entitled to judicial review thereof.</p>
<p>(d) Are such decisions subject to judicial review where they adversely affect legal or natural persons?</p>
<p>Yes. Provisions in the federal securities laws provide that any person aggrieved by a final order of the SEC may obtain judicial review of the order in a U.S. Circuit Court of Appeals. Similarly, any person adversely affected by a rule of the SEC promulgated under certain provisions of the federal securities laws may obtain review of such rule in a U.S. Circuit Court of Appeals.</p> <p>Additionally, as noted above, Chapter 7 of the APA creates the right of judicial review over agency actions, including those of the SEC. Under Section 702 of the APA, a person suffering legal wrong because of agency action, or adversely affected or aggrieved by agency action, is entitled to judicial review thereof.</p>

(e) Are the general criteria for granting, denying, or revoking a licence made public, and are those affected by the licensing process entitled to a hearing with respect to the regulator's decision to grant, deny, or revoke a licence?
<p>Yes. The SEC's criteria and application processes for registration of various entities and products are made public pursuant to SEC rules and regulations promulgated under the statutes the SEC administers, and affected persons are entitled to hearings concerning registration.</p> <p>With respect to registration of entities required to be registered in order to engage in regulated activity, SEC rules generally provide affected persons with an opportunity to be heard by the agency. For example, SROs applying for registration as national securities exchanges, national securities associations, or clearing agencies are entitled to notice of the grounds for denial of such applications under consideration and opportunity for hearing prior to a denial. Similar procedures of notice and an opportunity for hearing are provided to brokers, dealers, CRAs, and investment advisers applying to register as such, or those who are subject to a suspension or de-registration. Transfer agent registration applications may be denied, but only if the SEC makes certain findings on the record after notice and opportunity for a hearing.</p> <p>See also the responses to questions in Principle 9 for additional discussion on licensing.</p>
<i>Transparency and Confidentiality</i>
4. If applicable, are procedures for making reports on investigations public consistent with the rights of individuals, including confidentiality and data protection?
<p>The Exchange Act and Advisers Act both contain statutory provisions that are designed to safeguard the confidentiality of information obtained in the course of examinations or investigations. The SEC also has adopted rules under the Exchange Act to permit confidential treatment of requests for certain information. Rule 24c-1 under the Exchange Act provides that the SEC may provide nonpublic information in its possession to certain entities, including other domestic and foreign governmental entities, but only if it receives appropriate assurances of confidentiality.</p> <p>Additionally, the SEC is also subject to the Privacy Act of 1974 (Privacy Act)<sup>117</sup> and the Right to Financial Privacy Act of 1978 (RFPA),<sup>118</sup> both discussed below.</p>

<sup>117</sup> 5 U.S.C. § 552a.

<sup>118</sup> 12 U.S.C. §§ 3401-3422.

### **The Privacy Act**

The Privacy Act provides procedures for agencies when they obtain, maintain, and disseminate personal information concerning members of the public through a system of records. It requires that the SEC make certain disclosures to any individual from whom the SEC requests or seeks to compel information, and that the SEC maintain a record of information released to persons outside the SEC. The Privacy Act generally forbids disclosure of information concerning an individual, subject to several important exceptions. The Privacy Act also allows individuals to obtain access to certain agency records concerning themselves.

### **Right to Financial Privacy Act**

The RFPA requires government agencies to follow certain procedures when they seek to subpoena records from financial institutions or transfer such records to other government agencies. An agency may obtain financial records of an individual or partnership of five or fewer individuals from a financial institution (such as a bank or savings bank) only if the records are relevant to a legitimate law enforcement inquiry, and the customer has been served with a copy of the subpoena and summons 10 days in advance of the release of the records. If a government agency intends to transfer such records to another government agency, the RFPA requires that (i) the transferring agency certify in writing that there is reason to believe that the records are relevant to a legitimate law enforcement inquiry by the receiving agency; and (ii) the transferring agency notify the customer about the transfer of the records within fourteen days after the transfer.

### *Consistent Application*

5. Are the regulator's exercise of its powers and discharge of its functions consistently applied?

Yes. The SEC's exercise of its powers and discharge of its functions are consistently applied. For more information, please see the response to Principle 3, Question 5.



<b>Principle 5</b> <b>The staff of the Regulator should observe the highest professional standards including appropriate standards of confidentiality.</b>
<b>Key Questions</b>
1.      Are the staff of the regulator required to observe legal requirements or a "Code of Conduct" or other written guidance, pertaining to:
(a)      The avoidance of conflicts of interest?
<p>Yes. Staff must comply with federal government-wide ethics laws, rules, and regulations, including statutes setting forth conflicts of interest that would result in a criminal violation.<sup>119</sup> These legal requirements prohibit Commissioners and Staff from participating personally and substantially in particular matters that would have a direct and predictable effect on their own or imputed financial interests.<sup>120</sup> This prohibition has been implemented and supplemented by regulations issued by OGE, which establishes standards of conduct for the entire executive branch of the federal government, including the SEC. These regulations apply to all SEC employees and are called the Standards of Ethical Conduct for Employees of the Executive Branch (Standards of Ethical Conduct).<sup>121</sup> These standards also regulate non-financial conflicts that could create the appearance that the individual would lack impartiality. Another OGE regulation provides certain exceptions to the restrictions on participation due to financial conflicts of interest and details the procedures for granting waivers from its restrictions, provided certain requirements are met, including consultation with OGE on decisions to grant waivers.<sup>122</sup></p> <p>In addition to these government-wide standards, the SEC has promulgated its own Conduct Regulation,<sup>123</sup> which includes comprehensive rules regarding the securities holdings and transactions of Staff and Commissioners. The SEC, with the concurrence of OGE, has also adopted Supplemental Standards of Ethical Conduct for its Commissioners and employees.<sup>124</sup> Recently, OGE modified the post-employment regulations for many SEC employees. This change has increased the number of SEC employees who are considered to be "senior officials" and thus subject to a one-year post-employment "cooling-off" period during which that person cannot "appear" before the SEC.<sup>125</sup></p>

<sup>119</sup> 18 U.S.C. §§ 201-209.

<sup>120</sup> 18 U.S.C. § 208.

<sup>121</sup> 5 C.F.R. Part 2635.

<sup>122</sup> 5 C.F.R. Part 2640.

<sup>123</sup> 17 C.F.R. Part 200.735.

<sup>124</sup> 5 C.F.R. Part 4401.

<sup>125</sup> 18 U.S.C. § 207 prohibits these employees "from knowingly making, with the intent to influence, any communication to or appearance before, any officer or employee of the SEC on behalf of any other person (except the United States) in connection with any matter on which such person seeks official action by any officer or employee of the SEC, even if the person never worked on the matter."

In addition to the ethical standards issued by OGE, the SEC Conduct Regulation, and the SEC's Supplemental Standards of Ethical Conduct, Enforcement has implemented ethics guidelines to account for the sensitive ethical issues that may arise in connection with enforcement cases and investigations. Under the guidelines, new Enforcement staff must recuse themselves from cases or investigations involving their former employer or clients of their former employer for a period of one year. The one-year period starts on the day the employee begins working at the SEC. This policy is broader than the general ethics standards, which require new staff to recuse themselves if their former employer is involved or if new staff's former client is involved. It also is broader than the Model Rules of Professional Responsibility for attorneys, which would require recusal if a staff member had confidential information about a client.

OCIE has also implemented ethics guidelines specific to Staff in the examination program. Specific requirements include maintaining the confidentiality of information obtained in examinations, the appropriate uses of information obtained during examinations, seeking employment offers, and limitations on the acceptance of food or gifts from registrants. OCIE has also established an "Examination Hotline," which permits securities firms to call with any questions, comments, complaints, or concerns about an examiner's conduct during an examination. Additionally, OCIE's ethics guidelines provide that examination staff must go through an exit interview process with an immediate supervisor after giving notice of an intention to terminate employment with the SEC, in which potential conflicts of interest in post-SEC employment are discussed.<sup>126</sup>

### **SEC Ethics Administration**

The OEC was established in 2011 as an independent office reporting directly to the Chair. The OEC is headed by the Ethics Counsel, who serves as the SEC's Designated Agency Ethics Official. The Ethics Official is assisted by a Deputy Ethics Counsel, who serves as Alternate Deputy Agency Ethics Official. The Ethics counsel is currently assisted by a staff of 13.

The OEC is responsible for administering the Commission's ethics program and for interpreting the SEC's supplemental ethics rules and federal government-wide ethics laws, rules, and regulations. OEC provides independent legal analysis and advice to the Chair, Commissioners, and Staff on ethics issues. OEC is also the SEC's liaison with OGE.

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<sup>126</sup> This requirement is in addition to the requirement for all departing SEC employees to receive an exit interview from the OEC on applicable Federal post-Government employment laws.

(b) Restrictions on the holding or trading in securities subject to the jurisdiction of the regulatory authority and/or requirements to disclose financial affairs or interests?

As described in the response to Principle 5, Question 1(a) above, SEC Commissioners and Staff are subject to provisions for avoiding conflicts of interest, including through their holding and trading of securities.

Specifically, the SEC's Conduct Regulation includes comprehensive rules regarding the securities holdings and transactions of all staff, including Commissioners, as well as any employee's spouse, minor children, or any person the employee serves as legal guardian. The SEC's regulations require the reporting of securities transactions, with certain exceptions, within five days of the receipt of confirmation.

In addition, certain other employees are subject to government-wide financial disclosure rules promulgated by OGE.<sup>127</sup> Commissioners and certain senior employees known as Senior Officers must file a public financial disclosure report when they assume office, on an annual basis thereafter, and upon termination. Employees who have the greatest risk of creating harm by misusing information or having conflicts of interest must file confidential financial disclosure forms. Recent legislation known as the Stop Trading on Congressional Knowledge Act of 2012<sup>128</sup> established several new ethics requirements for Senior Officers and others, increased the frequency of transaction reporting for Senior Officers, and required disclosure of any covered transaction within 30 days of receiving notification of the transaction or within 45 days of the transaction. Covered transactions are generally those that exceed \$1,000 in securities and futures.

The SEC's Supplemental Standards of Ethical Conduct include prohibitions for Commissioners and Staff on transactions involving a security based on material nonpublic information, transactions involving an issuer directly regulated by the Commission, and transactions involving a security of an entity either under investigation by the SEC, a party to a proceeding before the SEC, or party to a proceeding in which the SEC is a party. The Supplemental Standards also require SEC personnel to clear in advance any securities transaction or holding with the Designated Agency Ethics Official.

The SEC has separate, comprehensive written procedures for the administration of the public and confidential financial disclosure systems as required by the Ethics in Government Act of 1978.<sup>129</sup> In addition to covering statutorily required information, the procedures delineate specific

<sup>127</sup> 5 C.F.R. Part 2634.

<sup>128</sup> Pub L. 112-105 (2012).

<sup>129</sup> 5 U.S.C. App. 109.

responsibilities by position and title and specify the types of positions within the agency that are required to file either a public financial disclosure report or a confidential financial disclosure report.

(c) Appropriate use of information obtained in the course of the exercise of powers and the discharge of duties?

The OGE Standards of Conduct prohibit the misuse of one's official position, including the use of (or the allowance of others to use) confidential or nonpublic information.<sup>130</sup> The SEC's own regulation also prohibits the misuse of confidential and nonpublic information.<sup>131</sup>

(d) Observance of confidentiality and secrecy provisions and the protection of personal data?

Yes, the SEC observes confidentiality and secrecy provisions and the protection of personal data as described in the answer to Principle 4, Question 4.

(e) Observance by staff of procedural fairness in performance of their functions?

Yes. The OGE Standards of Ethical Conduct require impartiality in the performance of official duties.<sup>132</sup> These standards establish procedures for Staff to use when participation in a matter does not raise a financial conflict of interest but may raise concerns about impartiality because of other kinds of interests or relationships. The SEC's Rules of Practice<sup>133</sup> also establish standards of procedural fairness, and there is an additional protection of procedural fairness in the SEC's Code of Behavior Governing *Ex Parte* Communications Between Persons Outside the SEC and Decisional Employees.<sup>134</sup>

Generally, under these rules, Commissioners and Staff cannot participate in a "particular matter involving specific parties:" (i) if Staff knows that a person with whom he or she has a "covered relationship" is or represents a party to the matter, or if the matter will have a direct and predictable effect on a financial interest of a member of his or her household; and (ii) if the circumstances would cause a reasonable person with knowledge of the relevant facts to question his or her impartiality in the matter, unless an SEC ethics official issues an authorization to participate.

<sup>130</sup> 5 C.F.R. Part 2635, subpart G

<sup>131</sup> 17 C.F.R. § 200.735-3(b)(1).

<sup>132</sup> 5 C.F.R. § 2635 subpart E.

<sup>133</sup> 17 C.F.R. Part 201.

<sup>134</sup> 17 C.F.R. Part 200, subpart F.

Unless a Commissioner or employee is so authorized, he or she is required to disqualify from participation. Recusal or disqualification is accomplished by not participating in the matter. "Participate" for this purpose includes providing advice, opinions, or recommendations. If a Commissioner or employee becomes aware of the need to disqualify himself or herself from participating in a matter, he or she generally notifies the Commission's Secretary or, in the case of an employee, his or her supervisor.

2. Are there:

(a) Processes to investigate and resolve allegations of violations of the above standards?

Yes. OIG is responsible for monitoring and investigating violations of any of the statutes and regulations described in response to Principle 5, Question 1 above. The OIG is an independent office within the SEC that conducts, supervises, and coordinates audits and investigations of the programs and operations of the SEC. The mission of the OIG is to prevent and detect fraud, waste, and abuse and to promote integrity, economy, efficiency, and effectiveness in the Commission's programs and operations.

The OIG is responsible for concurrent notification to the DOJ and OGE for referrals of potential violations of the federal government-wide criminal conflict of interest statutes. If the OIG finds evidence of non-criminal misconduct under either government-wide or SEC regulations, it forwards a report of investigation to the appropriate management officials for consideration of disciplinary or remedial action. The OIG works closely with OEC and obtains guidance from OEC to ensure that any ethics discussions are accurately conveyed in OIG reports. Finally, the OIG interfaces with OEC on cases and investigations that have an ethics component to gain access to financial disclosure forms and advice rendered.

(b) Legal or administrative sanctions for failing to adhere to these standards?

Yes. Violations of the federal government-wide conflict of interest statutes may be enforced either civilly or criminally.<sup>135</sup> Violations of the SEC's administrative rules can result in disciplinary action. Willful disclosure of nonpublic information under the Exchange Act is also a criminal offense. Depending on the circumstances and the legal authority at issue, an SEC employee may be imprisoned, fined, demoted, or terminated for violating an ethics provision.

<sup>135</sup>

18 U.S.C. § 216.

<b>Principle 6</b>	<b>The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate</b>
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|----|---|
| 1. | Does the regulator have or contribute to a regulatory process (which may be focused on the securities market or be cross-sectoral) to monitor, mitigate, and appropriately manage systemic risk, according to the complexity of the Regulator's market consistent with its mandate and authority? |
|----|---|

The SEC has and contributes to regulatory processes to monitor, mitigate, and appropriately manage risks that could prove to be systemic. The SEC's mission is to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation. Consistent with its mission, the SEC takes steps to identify and address potentially systemic threats to our financial system, including through its own regulatory processes (discussed below); through the development of additional expertise regarding risk measurement and analysis (discussed in Question 2 below); and through collaboration with other domestic and foreign regulators to better understand the interconnections among markets and market participants (discussed in Question 3 below).

The SEC's regulatory processes identify and address possible systemic risks, for example, through vigorous inspection and enforcement programs, extensive disclosure requirements providing investors with greater transparency, and business conduct regulation and resolution regimes for various market intermediaries. For more detailed information regarding these SEC programs, see responses to Principles 10 through 12, Principle 16, and Principles 31-32. Additional examples of systemic risks processes with respect to the securities markets, broker-dealers, financial market utilities (FMUs), and OTC derivatives follow.

### **Operational Integrity of the Securities Markets**

The SEC advances a broad regulatory agenda that, among other things, aims to bolster the operational integrity of the financial markets while monitoring the financial markets to identify potential risks. For example, the SEC has analyzed risks associated with the increasing use of technology in securities markets and has taken numerous steps to address these potential risks. Rule 15c3-5, commonly known as the "market access rule", has been adopted to curb both individual and systemic risks related to market access by broker-dealers, while proposed Regulation Systems Compliance and Integrity (SCI)<sup>136</sup> is designed to enhance market stability by ensuring technological adequacy of market participants. Initiatives such as Limit-Up Limit Down and market-wide circuit breakers have been implemented to reduce extraordinary volatility in the markets, and the SEC has continued to develop its data capabilities to monitor and address risks in a trading environment dominated by algorithms.

<sup>136</sup> Until adopted by the Commission as described in the response to Principle 1 Question 1(b), proposed SEC rules discussed in this Self-Assessment are not final or enforceable. Rules proposed by SROs are neither final nor enforceable until the statutory rule filing process is completed.

For example:

- In November 2010, the SEC adopted Rule 15c3-5 – Risk Management Controls for Brokers or Dealers with Market Access.<sup>137</sup> Rule 15c3-5 applies to broker-dealers with access to trading securities by virtue of being an exchange member, an alternative trading system (ATS) subscriber, or an ATS operator with non-broker-dealer subscribers. Broker-dealers with such market access would be required to establish, document, and maintain a system of risk management controls and supervisory procedures that, among other things, are reasonably designed to: (i) systematically limit the financial exposure of the broker or dealer that could arise as a result of market access, and (ii) ensure compliance with all regulatory requirements that are applicable in connection with market access. Specifically, the risk management controls and supervisory procedures would be required to be reasonably designed to: (i) prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds, or that appear to be erroneous; (ii) prevent the entry of orders unless there has been compliance with all regulatory requirements that must be satisfied on a pre-order entry basis; and (iii) prevent the entry of orders that the broker-dealer or customer is restricted from trading, restrict market access technology and systems to authorized persons, and ensure appropriate surveillance personnel receive immediate post-trade execution reports.
- In May 2012, the SEC approved a National Market System (NMS) plan (known as Limit-Up Limit-Down or “LULD”) proposed by SROs to address extraordinary volatility in individual securities.<sup>138</sup> LULD has been implemented on a pilot basis and applies to all NMS securities. The LULD mechanism prevents trades in individual securities from occurring outside of a specified price band, which varies depending on the security and time of day. Trading pauses occur if the security price moves to and remains outside of the band for a specified period. SROs, ATSs, and broker-dealers executing internally must establish policies and procedures reasonably designed to prevent trades from occurring outside the applicable price band, to honor any trading pause, and to otherwise comply with the NMS Plan. See also Principle 33.
- In May 2012, the SEC also approved SRO rules establishing market-wide circuit breakers. Such circuit breakers at the securities and futures markets provide for brief, coordinated, cross-market trading halts during a securities market decline. Market-wide trading halts are implemented if the market declines below specified levels (currently based on S&P 500). These circuit breakers are applicable to all NMS securities and contain three different “triggers” with associated lengths of trading halts, which may also vary

<sup>137</sup> Exchange Act Release No. 63241 (November 3, 2010), 75 Fed. Reg. 69791 (November 15, 2010).

<sup>138</sup> See Exchange Act Release No. 67091 (May 31, 2012), 77 Fed. Reg. 33498 (June 6, 2012) (File No. 4-631)

depending on time of day. Circuit breaker thresholds will be recalculated at the beginning of each trading session based on the closing value of the S&P 500 index from the previous session.

- In 2012, the SEC adopted new Rule 613 under the Exchange Act to require the national securities exchanges and FINRA to establish a market-wide consolidated audit trail (CAT) to significantly enhance regulators' ability to monitor and analyze trading activity.<sup>139</sup> The CAT must collect and accurately identify every order, cancellation, modification, and trade execution for all exchange-listed equities and equity options across all U.S. markets. The CAT will increase the data available to regulators investigating illegal activities such as insider trading and market manipulation, and it will significantly improve the ability to reconstruct broad-based market events in an accurate and timely manner.
- In March 2013, the SEC proposed Regulation SCI to supersede and replace the SEC's Automation Review Policy (ARP) inspection program and aspects of Regulation ATS.<sup>140</sup> As proposed, Regulation SCI would apply to the systems of exchanges, clearing agencies, securities information processors (SIPs), and certain ATSS. The proposed rule would require these entities to have in place policies and procedures reasonably designed to help ensure that their systems are robust, secure, and compliant and require their key members to participate in business continuity and disaster recovery testing. In addition, as proposed, Regulation SCI would require these entities to notify the SEC of certain events with respect to key systems, including disruptions, intrusions, and systems compliance issues and notify their members or participants of certain systems problems. The proposed rules would also enhance SEC oversight of securities market infrastructure more generally by requiring covered entities to keep the SEC informed about material systems changes and to conduct an annual review of their automated systems.

### **Broker-Dealer Financial Responsibility**

With respect to broker-dealers, the SEC has developed rules and processes designed to monitor, mitigate, and appropriately manage risk (systemic and otherwise). The SEC's Division of Trading and Markets (TM) is responsible for overseeing broker-dealers and administers the SEC's financial responsibility rules governing broker-dealers.<sup>141</sup> These rules are designed to make sure that broker-dealers operate with a level of capital that is sufficient to protect the broker-dealer's

<sup>139</sup> See Press Rel. 2011-154.; see also 77 F.R. 45722.

<sup>140</sup> See Release No. 34-69077, Regulation Systems Compliance and Integrity (March 8, 2013), <http://www.sec.gov/rules/proposed/2013/34-69077.pdf>.

<sup>141</sup> The SEC's "financial responsibility rules" generally refers to not only Rule 15c3-1, but also to the following SEC rules governing broker-dealers: Rule 15c2-1 (hypothecation of customer securities); Rule 15c3-3 (customer protection), Rule 17a-3 (required books and records), Rule 17a-4 (recordkeeping and record retention), Rule 17a-5 (financial reporting), Rule 17a-11 (notices), and 17a-13 (quarterly securities count). See 17 C.F.R. 240.15c2-1; 17 C.F.R. 240.15c3-3; 17 C.F.R. 240.17a-3; 17 C.F.R. 240.17a-4; 17 C.F.R. 240.17a-5; 17 C.F.R. 240.17a-11; 17 C.F.R. 240.17a-13.



counterparties and customers in the event that the broker-dealer fails. In this regard, the SEC's financial responsibility rules are intended to help ensure that customer assets are available for return to customers if a broker-dealer fails. Furthermore, the SEC's financial responsibility rules for broker-dealers that help minimize the impact of the failure of a broker-dealer on counterparties and customers also minimize the systemic risk and follow-on effects to the financial system that may be associated with the failure of any broker-dealer, including any large broker-dealer that may be part of a large financial firm.

TM has a staff of quantitative and analytical experts to evaluate risk measurements used by broker-dealers and other financial regulators. This expert staff also participate in the ongoing prudential supervision of certain large broker-dealers, also known as ANC Broker-Dealers, that may be approved to use value-at-risk (VAR) models to compute deductions for market or credit risk in lieu of standardized "haircuts" as provided in the SEC's net capital rule, or that are owned by a holding company supervised by the SEC pursuant to Section 17(h) of the Exchange Act. Such oversight includes regular meetings with the broker-dealers' senior risk managers as well as those persons at the broker-dealers responsible for, among other things, internal audit, price verification results, and the management of the firm's balance sheet. The SEC's broker-dealer office also has an inspection unit that augments monitoring efforts with testing of broker-dealers' controls. In conducting all of its work, TM's broker-dealer office staff regularly collaborates with staff at other U.S. regulators, such as the Federal Reserve, and international colleagues, such as the U.K. Prudential Regulatory Authority and Germany's *BaFin*. (Please see response to Principle 37, Question 2 for additional detail regarding these interagency working groups.) Such collaboration helps ensure that regulatory efforts are coordinated to the maximum possible extent.

### **Oversight of FMUs**

FMUs<sup>142</sup> provide the essential infrastructure to clear and settle payments and other financial transactions, upon which the financial markets and the broader economy rely to function effectively.

As part of its supervisory activities, Staff closely monitors the operations and financial risk management of each clearing agency, including their respective stress testing programs. In the U.S., the clearance and settlement of securities transactions generally occurs through several registered CCPs and a registered CSD, which operate independently from exchanges or trading systems and are registered with the SEC as clearing agencies under the Exchange Act. See Principles 33.2(c), 37.1(a) and 38 for a fuller description of the operation and oversight of clearing

<sup>142</sup> Section 803(6)(A) of the Dodd-Frank Act defines a "financial market utility" as "any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person." 12 U.S.C. § 5462(6)(A).

agencies, and see Principle 12.1(a) for a discussion of the examination process for FMUs.

In October 2012, the SEC adopted new rules establishing standards for the risk management and operation of all SEC-registered clearing agencies. The new rule requires a review of margin requirements and related risk-based models and parameters (including stress testing) on at least a monthly basis.<sup>143</sup>

Further, in March 2014, the SEC proposed new requirements for clearing agencies that, if adopted, will expand the existing requirements for clearing agencies that are systemically important or are engaged in complex activities, such as clearing SBS, as well as add new requirements for, among other things, liquidity risk management, a comprehensive risk management framework, and general business risk management.<sup>144</sup>

The Dodd-Frank Act provided the SEC with additional authority over FMUs for which it is the supervisory agency and that the FSOC designates as systemically important. In July 2012, FSOC designated eight FMUs as systemically important, including four for which the SEC acts as the supervisory agency.

The Dodd-Frank Act provides a framework for an enhanced supervisory regime for these designated FMUs. It permits the SEC to prescribe regulations for risk management and operations and also directs the SEC to consider relevant international standards and existing prudential requirements for the designated FMUs it supervises. The SEC is also required to examine these FMUs annually.

The Dodd-Frank Act also establishes a process for a designated FMU to submit to the SEC, with a copy to the Federal Reserve, advance notices identifying changes to its rules, procedures, or operations that could materially affect the nature or level of risk presented by the FMU. In June 2012, the SEC adopted rules that establish procedures for how it will address these advance notices. The SEC has considered a significant number of such notices since those rules were adopted.

### **OTC Derivatives**

The Dodd-Frank Act established a new oversight regime for the OTC derivatives marketplace. Title VII of the Dodd-Frank Act requires the SEC to regulate “security-based swaps” and to write rules that address, among other things: mandatory clearing; trade reporting, and trade execution; the operation of clearing agencies, trade data repositories, and trade execution facilities; capital, margin, and segregation requirements and business conduct standards for

<sup>143</sup> See, e.g., 17 C.F.R. 240.17Ad-22(B)(2).

<sup>144</sup> See 79 Fed. Reg. 16866 (March 26, 2014).

dealers and major market participants; and public transparency for transactional information. Such rules are intended to achieve a number of goals, including:

- facilitating the centralized clearing of SBS, whenever possible and appropriate, with the intent of reducing counterparty and systemic risk;
- increasing transparency for market participants and regulators in their efforts to monitor the market and, as appropriate, address risks to financial stability;
- increasing SBS transaction disclosure;
- reducing counterparty and systemic risk through capital, margin and segregation requirements for non-bank dealers and major market participants; and
- addressing potential conflict of interest issues relating to SBS.

The SEC is in the process of implementing this regulatory framework and is actively advancing a number of rules to achieve these goals.

2. Is the regulator developing expertise regarding risk measurements and analysis relevant to systemic risk, or if not, is the regulator able to take into consideration and apply risk measurements and analysis developed by other regulators?

Yes, the SEC has long-standing expertise in measuring and analyzing risk, and has been developing further expertise in this area relevant to systemic risk. Moreover, the SEC can consider and apply risk measurements and analysis developed by other regulators. Some of the SEC's initiatives that contribute to addressing risks that could potentially prove systemic include:

- In 2010, the SEC established in TM an Office of Risk Supervision. Staff in this office participates in a variety of ongoing monitoring reviews focused on clearing agency risk frameworks and processes. As part of this process, the staff reviews a clearing agency's governance framework, which may include: compliance processes; internal audit findings and resolution; board of directors' interaction; and risk management framework, including new products/initiative review and approvals, margin methodology, back-testing and stress-testing procedures, risk monitoring practices, model governance practices, and sizing and allocation of total financial resources.
- In 2012, the SEC established in the Division of Investment Management (IM) a Risk and Examinations Office (REO) to coordinate with OCIE and contribute to the SEC's efforts to monitor risk in the asset management industry and to continue to develop and enhance its methods to better detect emerging risks. REO coordinates its risk monitoring activities closely with other SEC Divisions and Offices to share expertise across the Staff and foster enhanced monitoring of the asset management industry.

- OCIE's Quantitative Analytics Unit (QAU) employs quantitative techniques and modeling to focus on areas that pose substantial risk, such as potential fraud and market abuse. The QAU was formed in 2012 and, during fiscal year 2013, increased its resources, adding a number of experts in quantitative analysis, such as mathematics and computer science. The QAU's expertise provides valuable support to the SEC's examinations of investment advisers and investment companies by creating and deploying customized data-analytic tools.
- The Market Information Data and Analytics System (MIDAS) became available online and now provides the SEC with immediate, new capabilities based on access to all of the real-time data feeds made available to market participants by the exchanges. Using MIDAS, the SEC has developed an initial set of data analysis that directly informs market structure policy questions. A number of investigations, exams, and analyses, based on MIDAS-generated data, also have been launched.
- DERA has developed a tool for corporate issuer risk assessment that creates a consistent methodology for quantifying earnings management and other atypical practices through the use of regression models and statistical analysis. The goal is to apply this modeling framework to other areas of financial markets and to develop custom tools to assist other Offices and Divisions throughout the SEC with their risk-based reviews and investigations. DERA recently announced the creation of a new Office of Risk Assessment that will coordinate efforts to provide data-driven risk assessment tools and models to support a wide range of SEC activities.
- Enforcement's Center for Risk and Quantitative Analytics (CRQA) supports and coordinates the SEC's risk identification, risk assessment, and data analytic activities by identifying risks and threats that could harm investors, and by assisting staff nationwide in conducting risk-based investigations and developing methods of monitoring for possible wrongdoing. CRQA provides strategic guidance on resource allocation (primarily to Enforcement) in light of identified risks, and serves as an analytical hub during searches for patterns indicative of possible fraud or other illegality.
- The SEC continues to increase the number of financial economists on staff with data analysis skills to reconstruct market events. The ability to quickly reconstruct market events allows the SEC to better understand the root cause of the market events and whether they expose a major risk to markets. Market reconstruction requires designing the appropriate metrics to study the event and then manipulating extremely large datasets.

3. Is there communication and information sharing between the regulator and other domestic regulators who have responsibility for systemic stability with respect to efforts to reduce systemic risks?

Yes, there is communication and information sharing between the SEC and other domestic regulators with responsibilities for systemic stability with respect to efforts to reduce systemic risks. As appropriate and in accordance with its authority, the SEC also communicates and shares information with foreign regulators with respect to efforts to reduce risks that may prove to be systemic.

Regulatory collaboration and information sharing are critical elements of processes to monitor, manage, and mitigate systemic risks. The SEC has a long-standing commitment to such collaboration and information sharing, dating back at least to the October 1987 market disruptions and creation of the President's Working Group on Financial Markets. More recently, in 2008, for example, with regard to FMUs designated as "systemically important" (designated FMUs), in 2008, the SEC entered into an MOU with the Federal Reserve that covers "Coordination and Information Sharing in Areas of Common Regulatory and Supervisory Interest."

### **FSOC**

Created by the Dodd-Frank Act, the FSOC is charged with three primary purposes: (i) to identify risks to the financial stability of the U.S. that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace; (ii) to promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the U.S. government will shield them from losses in the event of failure; and (iii) to respond to emerging threats to the stability of the U.S. financial system.

Pursuant to the Dodd-Frank Act, the FSOC consists of 10 voting members and 5 non-voting members. The Chair of the SEC is a voting member of the FSOC. The composition of the FSOC is intended to bring together the federal, state, and insurance regulatory perspectives.

The FSOC's duties include the monitoring of the stability of the U.S. financial system. Moreover, the FSOC provides a centralized venue where the primary U.S. financial regulators can discuss, and coordinate regulatory response with respect to issues of common concern. See Principle 7, Question 1 for additional discussion of FSOC's role in analyzing emerging threats to financial stability.

### **Coordinated Regulation of Designated FMUs**

The Dodd-Frank Act requires that the SEC consult with the Federal Reserve regarding matters that fall within the SEC's supervisory jurisdiction over FMUs designated systemically important,

and grants the Federal Reserve authority to take specific actions in certain circumstances.

- Pursuant to Section 807 of the Dodd-Frank Act, the SEC must consult annually with the Federal Reserve regarding the scope and methodology of any examination of a designated FMU and the Federal Reserve is authorized to participate in any such examination.<sup>145</sup> In fiscal year 2013 and 2014, OCIE conducted examinations of FMUs for which the SEC is the supervisory agency for purposes of Section 807 of the Dodd-Frank Act. See response to Principle 12(a) for more information.
- Section 809 of the Dodd-Frank Act further authorizes the SEC, the Federal Reserve, and the CFTC to disclose to each other copies of examination reports or similar reports regarding any designated FMU.<sup>146</sup>
- Section 812 requires the SEC to consult with the Federal Reserve regarding any proposed changes to rules, procedures, or operations that could materially affect the nature or level of risks of a designated FMU before the SEC completes its review of such proposal.
- Cooperation and information sharing are built into Section 805(a) of the Dodd-Frank Act, which authorizes the Federal Reserve to determine that existing prudential requirements established by the SEC are insufficient to prevent or mitigate significant liquidity, credit, operational, or other risks to the financial markets or to the financial stability of the U.S., which requires a formal SEC response and remedial action.
- The Federal Reserve, pursuant to Section 809 of the Dodd-Frank Act, may prescribe recordkeeping or reporting requirements on designated FMUs. However, before requesting any material information from, or imposing reporting or recordkeeping requirements, coordination with the designated FMU's supervisory agency (such as the SEC) is required to determine if the information is available from or may be obtained by the agency.

### **Coordinated Regulation of Private Funds**

Another example of the SEC's contribution to regulatory collaboration and information sharing is its provision of information relating to private funds to the OFR. Specifically, the SEC adopted Adviser Act Rule 204(b)-1 that requires all SEC-registered advisers with at least \$150 million in private fund assets under management to submit data on the private fund market to the SEC on Form PF. Advisers must file Form PF with the SEC electronically on a confidential basis. While

<sup>145</sup> 12 U.S.C. 5466. This section also allows the Federal Reserve to make a recommendation that the SEC take enforcement action against a designated FMU and, if such recommendation is rejected, provides for a referral of the recommendation to FSOC for a binding decision.

<sup>146</sup> 12 U.S.C. 5468.

the primary goal of adopting Form PF was to create a source of data for use in assessing systemic risk, the SEC is using the information gathered on Form PF to support its own regulatory programs, including examinations, investigations, and investor protection efforts. The information required of different funds includes:

- Once a year, advisers to smaller private funds must report basic information, such as size, leverage, liquidity, fund performance, and counterparty credit risk.
- Advisers to large hedge funds must report quarterly on their funds' exposures by asset class, geographical concentration, and turnover by asset class once a quarter. In addition, if any of their funds' net asset value (NAV) is at least \$500 million, they must report on those funds' exposures, leverage, risk profile, and liquidity.
- Once a quarter, advisers to large liquidity funds must provide information on the types of assets in their fund's portfolio, certain information relevant to their risk profile, and the extent to which the funds have a policy of complying with all or some aspects of the Investment Company Act's principal rule concerning registered money market funds.
- Advisers to large equity funds must report the extent of leverage incurred by their fund's portfolio companies, the use of bridge financing, and their fund's investments in financial institutions annually.

Several SEC Divisions and Offices use this information. In particular, DERA has successfully incorporated Form PF data into its proprietary analytical tool; REO staff is working to develop analytics using Form PF information that will allow it to monitor the risk-taking activities of investment advisers to private funds; and OCIE anticipates using the information collected on Form PF in conducting pre-examination due diligence and in risk identification.

### **Coordinated Regulation of OTC Derivatives**

With respect to the regulation of OTC derivatives, the Dodd-Frank Act calls on the SEC and the CFTC to consult and coordinate for the purposes of assuring regulatory consistency and comparability to the extent possible. The Dodd-Frank Act also calls on the agencies to treat functionally or economically similar products or entities in a similar manner, although it does not require identical rules. Since the enactment of the Dodd-Frank Act in July 2010, the staffs of the SEC and the CFTC have consulted and coordinated regularly in the development and implementation of our respective rules with the objective of establishing consistent and comparable requirements.

Staff has been actively engaged in ongoing bilateral and multilateral discussions with foreign regulators regarding the direction of international derivatives regulation generally, and the SEC's efforts to implement Title VII of the Dodd-Frank Act's requirements for the SBS market. In addition to participating in the FSB, IOSCO, the OTC Derivatives Regulators Group, and other

multilateral groups, since July 2011, Staff has engaged in a series of regulatory dialogues with the European Union, Japan, Hong Kong, Singapore, Canada, and other jurisdictions about regulatory reform efforts. Through these discussions and participation in the various multilateral task forces and working groups, Staff has gathered information about foreign regulatory reform efforts and has discussed the potential for gaps, overlaps, and conflicts between U.S. and foreign regulatory regimes.

### **International Cooperation and Coordination**

The SEC has developed, and continues to develop, arrangements to facilitate communication and cooperation with foreign regulators on supervisory issues, including those that might have systemic implications. MOUs for supervisory cooperation establish clear mechanisms for consultation, cooperation, and exchange of supervisory information, supported by safeguards for confidential or nonpublic information. These MOUs reduce the need to address supervisory information sharing on an *ad hoc* basis.

The SEC's MOUs for supervisory cooperation, which may vary in scope and purpose, can enhance the Staff's ability to share information about regulated entities, such as investment advisers, broker-dealers, CRAs, exchanges, and clearing agencies. Such information may include routine supervisory information and other information regulators need to monitor risk concentrations, identify emerging systemic risks, and better understand a globally active entity's compliance culture. These MOUs also facilitate the ability of the SEC and its counterparts to conduct onsite examinations of SEC-registered entities located outside the U.S.

The SEC has entered into MOUs that cover information sharing and cooperation related to, among other things, the registration of firms with both the SEC and a foreign authority; the affiliates of a financial group with headquarters in either regulator's jurisdiction; the oversight of markets in the U.S. and a foreign jurisdiction affiliated through a common ownership structure; and the sharing of nonpublic issuer-specific information relating to the application of International Financial Reporting Standards (IFRS). These MOUs are consistent with IOSCO's *Principles for Cross-Border Cooperation*, published in May 2010.<sup>147</sup>

<sup>147</sup> For a complete list of the SEC's MOUs for supervisory cooperation, see Cooperative Arrangements with Foreign Regulators, available at [http://www.sec.gov/about/offices/oia/oia\\_cooparrangements.shtml](http://www.sec.gov/about/offices/oia/oia_cooparrangements.shtml).



In addition, Staff also participates in supervisory colleges for certain complex global financial institutions. These colleges create a framework for ongoing dialogue and cooperation among multiple financial authorities with a view to enhancing the risk assessment of internationally active entities and to supporting effective supervision of such entities. The SEC also cooperates with its counterparts on supervisory matters on an *ad hoc* basis and engages in bilateral and multilateral consultations with counterpart regulators to discuss issues of general regulatory concern that exist at a higher, more market-wide level. For more detail, see responses to Principles 13, 14, and 15.

**Principle 7      The Regulator should have or contribute to a process to review the perimeter of regulation regularly.**

1. Does the regulator have or participate in a process, to identify and assess whether its regulatory requirements and framework adequately addresses risks posed by products, markets, market participants and activities to investor protection, fair, efficient and transparent markets and the reduction of systemic risk?

Yes, the SEC has and participates in processes to identify and assess whether its regulatory requirements and framework adequately address risks posed by products, markets, market participants and activities to investor protection, fair, efficient and transparent markets and the reduction of systemic risk. The SEC has broad legal and rulemaking authority, either to create rules pursuant to legislation or to update rules under existing authority, which it uses to review the perimeter of regulation and address risks and concerns related to the securities markets.<sup>148</sup> The staff is continually reviewing and assessing the SEC's regulatory requirements and framework in order to assure the SEC is effectively addressing these risks.

Through both formal and informal processes, the SEC reviews the scope of its regulatory authority. These processes include, for example:

- proactive evaluations of risks identified through examinations and enforcement actions, followed by appropriate revisions of SEC rules or the issuance of guidance;
- implementation review programs to monitor and assess the efficacy of new rules as they are put in place and their impact on the market;
- "post-mortem" identification and implementation of measures to redress risks highlighted by market events, such as the "flash crash" of May 6, 2010, or the financial crisis of 2007-09;
- review of existing regulations retrospectively as part of studies of broad substantive program areas;
- consideration of suggestions to review existing rules through various types of communications, ranging from formal petitions for rulemaking to informal correspondence from investors, investor and industry groups, Congress, fellow

<sup>148</sup> "Rulemaking is the process by which federal agencies implement legislation passed by Congress and signed into law by the President. Major pieces of legislation, such as the Securities Act, the Exchange Act, the Investment Company Act, and the Sarbanes-Oxley Act, provide the framework for the SEC's oversight of the securities markets. These statutes are broadly drafted, establishing basic principles and objectives. To ensure that the intent of Congress is carried out in specific circumstances – and as the securities markets evolve technologically, expand in size, and offer new products and services – the SEC engages in rulemaking." <http://www.sec.gov/answers/rulemaking.htm>.

regulators, the bar, and the public; and

- establishment of standing working groups or programs to assess and recommend measures to identify evolving risks within an industry or market.

For example, TM has for many years dedicated staff in the Office of Market Supervision to the review of exchange proposals to list and trade new exchange-traded products. In 2008, the SEC and the CFTC signed an agreement to enhance coordination and facilitate the review of new derivative products.

TM staff also participates in an SEC cross-border group that reviews the unique issues posed to the markets by potential foreign listings and has worked, among other things, with the exchanges on rule changes to address some of these issues. TM's Office of the Chief Counsel also regularly monitors the perimeter of regulation through its interactions with the public in identifying activity of entities that should fall under the SEC's regulatory umbrella for registered broker-dealers. The Office of the Chief Counsel has also examined the activities of private fund advisers as part of its ongoing efforts to identify activity and entities that should be regulated.

In early 2013, TM completed implementation of MIDAS. This advanced research platform uses commercially available data to provide SEC staff with an unprecedented ability to view and analyze the many billions of quotes, orders, and trades that take place each day on U.S. equity and equity options exchanges. More than 80 employees across the SEC, including the Regional Offices, use MIDAS to help support analyses, research, examinations, and investigations related to the equity and equity options markets, all of which can be relevant to determining whether the SEC's regulatory requirements and framework adequately address risks.

In 2010, the SEC created a new office in CF, which evaluates trends in securities offerings and capital markets to determine whether rules and regulations are keeping pace and working effectively. That office also conducts market research and selectively reviews securities offering documents and coordinates CF's consideration of new products.

Another recent example of the SEC's efforts in this area (and as discussed in the response to Principle 6, Question 2) is a program put into place by IM, which identifies and monitors risks associated with asset management. This effort is centralized in IM's REO, an exam and risk monitoring group that includes examiners and financial analysts, but involves staff throughout IM. IM staff, including staff in REO, monitors risks and trends at the industry and firm levels through industry outreach and data analysis. IM's risk monitoring includes outreach on macroeconomic developments and new market risks. It also involves ongoing monitoring; for example, REO staff performs a monthly review and analysis of money market fund data. This analysis may result in follow-up outreach by REO staff to an asset manager or other action.

As part of its risk monitoring function, IM staff engages in ongoing monitoring of data submitted by asset managers and Collective Investment Schemes (CISs) in regulatory filings and in *ad hoc*

outreach to asset management firms regarding specific emerging risks or market events. In addition, REO performs ongoing monitoring of a select number of the largest asset managers selected for monitoring based on certain risk characteristics.

REO engages senior management of these firms and CISs boards in direct, ongoing discourse about market risks and events, as well as operational risks. The engagements involve in-person meetings and encompass discussions of each firm's business, including: (i) key business risks and general regulatory issues facing the firm; (ii) the firm's growth strategy and any associated risks; (iii) the firm's culture; (iv) the core competence of firm leadership, including the fund board, business leaders, and risk and control function leadership; and (v) the firm's approach to operational and investment risk management and how the fund board and senior management engage in effective risk oversight. REO also seeks feedback from these firms and CISs boards about current and anticipated industry-wide risks.

The goal of IM's risk monitoring program is to develop a comparative view of the risks and risk management practices at different asset management firms and firm types over time, to help inform policy.

2. Does the regulator have a process to review, where it is presented with evidence of changing circumstances, its past regulatory policy decisions on products, markets, entities, market participants or activities, especially decisions to exempt, and take measures as appropriate?

Yes, the SEC has various processes to review, where there is evidence of changing circumstances, its past regulatory policy decisions on products, markets, entities, market participants or activities, and take measures as appropriate, including decisions to exempt. The SEC examines its rules and policy guidance to address changing circumstances, including new market developments and opportunities for regulatory arbitrage.

Every division within the SEC has responsibility for monitoring existing, evolving, and new markets, market processes, market participants, and financial products. Illustrative examples of the SEC and Staff responses to changing circumstances in the securities markets include the following SEC or Staff guidance, alerts, and other actions:

- OCIE launched an initiative to conduct focused, risk-based exams of private fund advisers registered pursuant to the Dodd-Frank Act. These "presence" examinations, designed both to engage with new registrants to inform them of their obligations and to permit the SEC to examine a higher percentage of new registrants, are shorter in duration and more streamlined than typical examinations. The exams focused on five critical areas: marketing, portfolio management, conflicts of interest, safety of client assets and valuation – and identified a number of concerns. In those presence examinations where concerns were identified, OCIE staff responded by issuing a deficiency letter to the adviser, opening follow-up risk priority examinations focusing on specific areas of

concern, and/or referring the matter to another division of the SEC, such as Enforcement or the policy-making divisions, for further review or investigation.

- Staff in TM actively engages in evaluating and assessing the scope of regulatory authority as part of the rule filing and review process in place for SROs, as required by Section 19 of the Exchange Act and Rule 19b-4 thereunder. Specifically, all registered clearing agencies, as SROs, are required to file with the SEC copies of any proposed rule or any proposed change in, addition to, or deletion from the clearing agency's rules. The SEC reviews all proposed rule changes and publishes them for comment.<sup>149</sup> This would include whether the proposed regulatory requirement adequately addresses the targeted risks.
- Enforcement considers changes and developments in the marketplace in its role of pursuing violations of the securities laws. Enforcement deploys and redeploys staff to meet new and evolving challenges, for example, by establishing Specialized Units and Task Forces with expertise and knowledge in programmatically important areas. By redeploying staff in this manner, Enforcement is able to timely respond to emerging areas of risk identified through a number of information sources including: Enforcement's investigative and market surveillance activities; coordination with criminal authorities, other regulators, and SROs; tips and complaints submitted by the public; and referrals from other Divisions and Offices of the SEC.
- CF staff is addressing change through the review of company disclosures. CF staff provides comments on company disclosures to help registrants apply existing disclosure rules to changing circumstances, such as new industry or market developments. In a recent report mandated by the JOBS Act, the Staff undertook a review of Regulation S-K, which provides requirements for public company disclosure, to determine how SEC requirements could be updated and modernized to simplify the registration process.<sup>150</sup>
  - The report offers an overview of Regulation S-K and provides the preliminary conclusions and recommendations about disclosure reform. Following publication of the report, CF staff is reviewing the disclosure requirements in Regulation S-K and Regulation S-X, which provides requirements for financial statements, and is considering ways to improve the disclosure regime for the benefit of both companies and investors.
  - The goal is to comprehensively review the requirements and make recommendations

<sup>149</sup> The SEC must approve many proposed rule changes prior to their going into effect, but certain limited types of proposed changes may be immediately effective upon filing with the SEC. See generally 15 U.S.C. 78s(b) (providing details of the SRO rule filing process).

<sup>150</sup> <http://www.sec.gov/spotlight/disclosure-effectiveness.shtml>.

on how to update the requirements to facilitate timely, material disclosure by companies and to facilitate shareholders' access to that information. Initially, the review will focus on the business and financial disclosures required by periodic and current reports: Forms 10-K, 10-Q, and 8-K. Subsequent phases of the project will include compensation and governance information included in proxy statements.

Regulation reviews may emanate from examination information obtained by Staff, including examinations of market practices. For example, the primary goal of REO's risk monitoring program is to apprise IM and the SEC of potential activities or issues in the industry for which rulemaking, rule amendments, or guidance may be necessary or informative. IM also may identify particular activities that REO staff should evaluate through examinations or risk monitoring to help inform policy decisions. By leveraging IM's risk monitoring efforts, IM staff has identified areas where additional instruction might be useful to the industry and has published interpretive guidance on such issues. As another example, IM staff also recently published guidance related to Rule 206(4)-2 of the Advisers Act (the Custody Rule) for advisers to privately offered funds. In June 2014, staff in CF and IM issued a staff legal bulletin on proxy advisory firms. The staff legal bulletin provides guidance about investment advisers' responsibilities under the Advisers Act in voting client proxies and retaining proxy advisory firms. It also provides guidance on the availability and requirements of two exemptions from the federal proxy rules that are often relied upon by proxy advisory firms.

The SEC also has general exemptive authority under certain of its governing statutes that allows the SEC to exempt a person, security, or transaction from various securities laws and regulations. This broad authority helps the SEC respond to changes in the markets, including advancing technology and internationalization. Due to the nature of this relief, requests for exemptions bring new information to Staff regarding changes in the markets. Thus, in exercising this authority, the SEC evaluates current regulations to determine whether an exemption from those regulations is appropriate for a regulated entity.

In addition to the processes associated with exercising its exemptive authority, the SEC also reviews compliance with previously granted exemptive orders. For example, Staff focuses on compliance with previously granted exemptive orders, such as those related to closed-end funds and managed distribution plans, employees' securities companies,<sup>151</sup> exchange-traded funds and the use of custom baskets, and those granted to fund advisers and their affiliates permitting them to engage in co-investment opportunities with the funds.<sup>152</sup> Staff observations in each of

<sup>151</sup> An employees' securities company (ESC) generally is an investment company all of the outstanding securities of which are held by current and former employees, their immediate family members, and the ESC's manager and its affiliates. See Section 2(a)(13) of the Investment Company Act. An ESC may apply to the SEC for an exemption under Section 6(b) of the Investment Company Act from all or specified provisions of the Investment Company Act. Pending the final determination of such application by the SEC, an ESC will be exempt from all applicable provisions of the Investment Company Act. See Rule 6b-1 under the Investment Company Act.

<sup>152</sup> <http://www.sec.gov/spotlight/disclosure-effectiveness.shtml>.

these areas have helped the SEC to better assess the extent to which the conditions of the applicable exemptive orders are functioning as intended.

The SEC also has more formal processes to review existing regulatory policies. For example, under the RFA, U.S. agencies are required to review regulations that have a significant economic impact upon a substantial number of small entities within 10 years of the publication of such rules. The SEC, however, has chosen to review all regulations, not just those with a significant economic impact, under the RFA.

The purpose of the RFA review is to determine whether such rules should be continued without change, or should be amended or rescinded to minimize any significant economic impact of the rules upon a substantial number of small entities. The RFA sets forth specific considerations that must be addressed in the review of regulations, including: the continued need for the rule; the nature of comments from the public concerning the rule; the complexity of the rule; the extent to which the rule overlaps, duplicates, or conflicts with other rules; the length of time since the rule has been evaluated; and the degree to which technology, economic conditions, or other factors have changed in the area affected by the rule.

The SEC also benefits from having the IAC. Section 911 of the Dodd-Frank Act established the IAC to advise the SEC on regulatory priorities, regulation of securities products, trading strategies, fee structures, effectiveness of disclosure, and initiatives that protect investor interests and promote investor confidence and the integrity of the securities marketplace. The Dodd-Frank Act authorizes the committee to submit findings and recommendations for review and consideration by the SEC. In fiscal year 2013, the IAC submitted its initial recommendations for review and consideration by the SEC. Among the emerging issues the IAC addressed were universal proxy ballots, data tagging, target date mutual funds, and implementation of the JOBS Act rulemaking mandate to remove the ban on general solicitation in private offerings.<sup>153</sup>

At all times, the SEC welcomes and receives comments from the public regarding the operation of its rules. Through these various processes, Staff is continually reviewing existing regulations and working to improve the SEC's regulations.

3. Does the regulator participate in a process (with other financial system supervisors and regulators if appropriate) which reviews unregulated products, markets, market participants and activities, including the potential for regulatory arbitrage, in order to promote investor protection and fair, efficient and transparent markets and reduce systemic risks?

Yes, the SEC participates in a variety of processes, often with other financial system supervisors and regulators, to review unregulated products, markets, market participants, and activities, in

<sup>153</sup>

See <http://www.sec.gov/spotlight/investor-advisory-committee-2012.shtml>

order to promote investor protection and fair, efficient, and transparent markets and reduce systemic risks. This sometimes results in publication of interpretive guidance. For example, CF recently published staff disclosure guidance addressing non-traded real estate investment trusts.

In addition, the SEC prioritizes educating investors on a wide variety of securities-related topics, especially investment fraud. For example, in fiscal year 2013, the OIEA published 26 investor alerts and bulletins. These alerts and bulletins are intended to warn investors of particular fraudulent scams and provide general education on topical investing issues. OIEA's alerts and bulletins have covered a range of topics including *Bitcoin and Other Virtual Currency-Related Investments*<sup>154</sup> and *Advertising for Unregistered Securities Offerings*.<sup>155</sup>

Staff also works with other regulators to issue joint alerts and bulletins, including, the following more recent examples: an SEC-CFTC investor alert on binary options,<sup>156</sup> an SEC-FINRA alert on pump-and-dump stock schemes,<sup>157</sup> and an SEC-FINRA bulletin on pension and settlement income streams.<sup>158</sup>

Staff participates in the work of the FSOC (as described in response to Principle 6, Question 3); however, the Chair is the sole voting member from the SEC. The FSOC is engaged in a regular review of potential threats to financial stability, several of which are cited in the FSOC's Annual Report.<sup>159</sup>

The FSOC's systemic risk committee provides structure for the FSOC's analysis of emerging threats to financial stability. The systemic risk committee—which is comprised of senior staff and reports to a Deputies Committee—is the locus of accountability for systemic risk monitoring and plays a role in prioritizing the review of sources of systemic risk and guiding the work of staff. The committee's work includes identifying and analyzing new, cross-cutting risk-related issues that affect financial institutions in the medium and longer term and attempts to identify structural issues within financial institutions that could threaten financial stability, such as trends in leverage or funding structure, new products, or exposures to particular risks. It is also a forum for agencies to discuss systemic issues of immediate importance as well as share information about institution- and market-related issues that arise in the course of their supervisory or oversight work that could impact financial stability.

<sup>154</sup> <http://investor.gov/news-alerts/investor-alerts/investor-alert-bitcoin-other-virtual-currency-related-investments>

<sup>155</sup> <http://investor.gov/news-alerts/investor-alerts/investor-alert-advertising-unregistered-securities-offerings>

<sup>156</sup> [http://www.sec.gov/investor/alerts/ia\\_binary.pdf](http://www.sec.gov/investor/alerts/ia_binary.pdf)

<sup>157</sup> <http://investor.gov/news-alerts/investor-alerts/investor-alert-don-t-trade-pump-dump-stock-emails>

<sup>158</sup> [http://www.sec.gov/investor/alerts/ib\\_income\\_streams.pdf](http://www.sec.gov/investor/alerts/ib_income_streams.pdf)

<sup>159</sup> See <http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202014%20Annual%20Report.pdf>, pp. 3-6, and 112-124 for a discussion of emerging potential risks.



In addition to efforts undertaken through the FSOC, the Staff also participates in a number of international and multilateral processes to review various types of risks associated with market products and participants. For example, DERA staff plays a leading role in IOSCO's Committee on Emerging Risks. A key objective of the Committee on Emerging Risks is to develop and maintain a detailed research methodology for the identification, monitoring, and mitigation of systemic risk that can be used by securities regulators around the globe. DERA staff is also engaged in the Financial Innovation Network of the FSB's Analytical Group on Vulnerabilities, which examines new financial products and services with view towards spotting emerging risks and regulatory gaps.

4. Does the regulator seek legislative or other changes when it identifies a regulatory weakness or risk to investor protection, market fairness, efficiency and transparency that requires legislative or other changes?

Yes, the SEC seeks legislative changes when it identifies a regulatory weakness or risk to investor protection, market fairness, efficiency, and transparency that requires legislative or other changes.

During the lead-up to enactment of the Dodd-Frank Act in the fall of 2009, in testimony on behalf of the SEC, the SEC's then-Chair recommended that Congress expand the SEC's authority with respect to securities-based OTC derivatives, which previously had not been under a comprehensive regulatory framework. The then-Chair testified to Congress that this lack of oversight authority presented a regulatory gap, and that it was critical to enact legislation to bring transparency and oversight to the OTC derivatives market.<sup>160</sup> During the summer of 2009, the Director of IM testified on behalf of the SEC that the incomplete information regarding advisers to private funds was a "significant regulatory gap in need of closing."<sup>161</sup> Also that summer, the SEC Chair sent Congress a list of other suggested ideas identified by the Staff as possible provisions for securities laws improvements (including, for example, nationwide service of process, authority to impose additional aiding and abetting charges, authority for the PCAOB to inspect auditors of broker-dealers and enhancements to the regulation of stock lending) to help the SEC better protect investors. Many of these proposals also became part of the Dodd-Frank Act.

More recently, in July 2011, the SEC submitted to Congress a study by IM staff that analyzed the

<sup>160</sup> See, e.g., Testimony by SEC Chairman Mary Schapiro before the House Committee on Agriculture (September 22, 2009), available at <http://www.sec.gov/news/testimony/2009/ts092209mls.htm>.

<sup>161</sup> Testimony by Andrew J. Donohue, Director, SEC Division of Investment Management, before the Senate Subcommittee on Securities, Insurance and Investment, Concerning Regulating Hedge Funds and Other Private Investment Pools (July 15, 2009) available at <http://www.sec.gov/news/testimony/2009/ts071509ajd.htm>.

need for enhanced examination and enforcement resources to support the SEC's oversight of investment advisers registered with the SEC.<sup>162</sup> In July 2012, the SEC issued a report that includes legislative and regulatory recommendations to help improve the structure of the municipal securities market and enhance the disclosures provided to investors.<sup>163</sup> In May 2013, the SEC Chair, on behalf of the SEC, submitted 13 legislative proposals for Congressional consideration, including, among other things, measures to help protect brokerage firm customers and enhancements to the SEC's enforcement and examination authorities.

In reports to Congress, the SEC frequently addresses its regulatory framework to determine whether changes should be pursued. For example, several mandated initiatives focus on the regulation of CRAs:

- The Dodd-Frank Act requires the OCR to conduct an examination of each NRSRO at least annually. The examinations include a review of eight areas prescribed in the Dodd-Frank Act, including whether each NRSRO conducts business in accordance with its policies, procedures, and methodologies as well as how an NRSRO manages conflicts of interest and whether it maintains effective internal controls. Under the Dodd-Frank Act, the SEC is required to make available to the public an annual report summarizing the essential findings of the examinations. Staff examination programs, such as the examination program conducted by OCR, generate information and observations that may be used to inform potential rule changes or recommendations to Congress for legislative changes.
- In November 2013, pursuant to Section 939C of the Dodd-Frank Act, OCR staff issued a Report to Congress on the Credit Rating Agency Independence Study concerning the management of conflicts of interest raised by NRSROs providing certain services such as risk management advisory services, ancillary assistance, and consulting services. As part of the report, OCR staff reviewed the SEC's regulatory framework to consider whether to recommend to the SEC changes to the rules on an NRSRO's providing such services to issuers for which it also provides a rating. The report concluded that rule changes were not warranted at the time, given past examination findings, but that the staff would continue to consider and monitor the potential conflicts of interest involved.
- The Credit Rating Agency Reform Act of 2006 (CRA Act)<sup>164</sup> separately requires the SEC to submit an annual report to Congress on NRSROs, including views on the state of competition, transparency, and conflicts of interest among NRSROs. This report also may be used to inform recommendations for future regulatory changes.

<sup>162</sup> Study on Enhancing Investment Adviser Examinations as Required by Section 914 of the Dodd-Frank Act, available at <http://www.sec.gov/news/studies/2011/914studyfinal.pdf>.

<sup>163</sup> Report on the Municipal Securities Market (July 31, 2012), available at <http://www.sec.gov/reportspubs/special-studies/munireport073112.pdf>.

<sup>164</sup> Pub. L. 109 – 291 (2006).

As previously described in the response to Question 7.2, above, the Staff monitors and assesses developments in existing, evolving, and new markets; market processes; market participants; and financial products. Based on information and observations the staff collects through these efforts, the SEC publicly reports to Congress and may make recommendations to, or requests of, Congress regarding the SEC's authority.

**Principle 8 The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed.**

**Key Questions**

1. Does the Regulator have in place a process designed to identify and evaluate potential and actual conflicts of interest regarding regulated entities and misalignment of incentives regarding issuers and regulated entities?

Yes. The SEC administers a regulatory framework based on various statutory provisions and SEC rules designed to address conflicts of interest and misalignment of incentives through requirements that prohibit conflicts, mandate disclosure, or require appropriate steps to manage or mitigate conflicts of interest and misalignment of incentives.<sup>165</sup> For example, with respect to specific prohibitions and requirements to manage or mitigate conflicts, in 2009, the SEC adopted Rule 17g-5, which prohibits an NRSRO from having certain conflicts and requires that the NRSRO manage other conflicts. Examples of required disclosure of conflicts are found in Exchange Act Rules 15c1-5 and 15c1-6, which generally require a broker-dealer to disclose to a customer if it has any control, affiliation, or interest in a security it is offering or in the issuer of the security.

Within this regulatory framework, the SEC has a robust examination and supervisory program designed to identify and evaluate potential and actual conflicts of interest, as well as misalignment of incentives, with respect to regulated entities and issuers. Furthermore, once issues have been identified, the SEC seeks to redress potential violations either through the deficiency citations in the examination program or through enforcement action, as appropriate.

The SEC's regulatory framework includes, but is not limited to, statutes and rules to address general conflicts of interest, such as provisions for the protection of nonpublic information (which, for example, could result in a conflict of interest or misalignment of incentives between a firm or employee and its client),<sup>166</sup> and disclosures of affiliations or other relationships in connection with a securities offering.<sup>167</sup> Various statutory and rule provisions also address more targeted conflicts of interest and misalignment of incentives, such as requirements for investment companies, investment advisers, research analysts, and SBS entities.

<sup>165</sup> These provisions are discussed in more detail below in Question 8.2.

<sup>166</sup> For a discussion of these provisions, see Staff Summary Report on Examinations of Information Barriers: Broker-Dealer Practices under Section 15(g) of the Securities Exchange Act of 1934, available at <http://www.sec.gov/about/offices/ocie/informationbarriers.pdf>.

<sup>167</sup> See, e.g., Rules 15c1-5 and 15c1-6 at 17 C.F.R. 240.15c1-5 and 15c1-6.

## Examination Programs

The SEC's examination programs seek to identify conflicts of interest and misalignment of incentives at entities registered with the SEC. The SROs, which the SEC oversees, also have processes in place to identify and address conflicts of interest.

### OCIE

OCIE administers the SEC's nationwide examination and inspection program and conducts examinations of the SEC-registered entities.<sup>168</sup> Among the priorities in OCIE's examination and inspection program is the identification of conflicts of interest and misalignment of incentives. OCIE's process for identifying conflicts of interest and misalignment of incentives includes, but is not limited to, examining for the following types of conflicts:

#### *Internal Governance, Conflicts of Interest, and Enterprise Risk Management*

- With regard to entities registered with the SEC, including their affiliates, where appropriate, policies and practices by which firms identify and mitigate conflicts of interest in order to: (i) evaluate firms' control environments and "tone at the top," (ii) understand firms' approach to conflict and risk management, and (iii) initiate dialogues on key risks and regulatory requirements.

#### *Conflicts of Interest Inherent in Certain Business Models and Programs*

- Conflicts of interest inherent in the investment adviser business model, including:
  - Compensation arrangements for the adviser, with a particular focus on undisclosed compensation arrangements and their effect on recommendations made to clients;
  - The allocation of investment opportunities;
  - Controls and disclosure associated with side-by-side management of performance-based and purely asset-based fee accounts;
  - Risk controls and disclosure, particularly for illiquid investments and leveraged investment products and strategies; and

<sup>168</sup> In addition to the SEC examination programs described above, SROs also prioritize identifying and addressing conflicts of interest, including, for example, member firms' approaches to identifying and managing conflicts in three critical areas — enterprise-level frameworks to identify and manage conflicts of interest; approaches to handling conflicts of interest in manufacturing and distributing new financial products; and approaches to compensating associated persons, particularly those acting as brokers for private clients. See <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf>.

- Higher risk products or strategies targeted to retail (and especially retired or elderly) investors.
- Conflicts inherent in dually registered broker-dealers and investment advisers, retirement vehicles and rollovers, and wrap fee programs.

#### *Affiliations Between Investment Advisers and Broker-Dealers*

- Incentives associated with the decision to put a client into an investment adviser or broker-dealer account; and
- Incentives of an investment adviser to use an affiliated broker-dealer for executing a client's trade even though the price or other terms of the execution are substandard.

#### *Portfolio Management-Related Conflicts*

- Investment advisers that favor one client over another when managing multiple accounts side-by-side, due to financial incentives or personal relationships.

#### *Compensation-Related Conflicts and Incentives*

- Retail customers' interests versus financial incentives of a broker-dealer or its representatives in recommendations and sales practices for new or high-yield products (e.g., unsuitable recommendations of municipal or corporate bonds);
- Incentives to place investors in accounts with fee structures that are high relative to the services provided, such as certain investment adviser or wrap fee accounts; and
- Undisclosed compensation arrangements.

#### *Valuation*

- Incentives of broker-dealers and investment advisers to provide high valuation in pricing relatively illiquid positions; and
- Incentives to inflate valuations to attract investors and charge more fees.

#### *Exchange conflicts*

- With regard to national securities exchanges that are SROs, potential blurred lines between SRO business and regulatory functions - for example, conflicts when an official with commercial responsibilities is also involved in regulatory oversight and thereby may be in a

position to affect the performance of competitors; and

- The conflict between an exchange's responsibilities as an SRO and its business incentive to attract order flow from particular members.

### *Credit Ratings*

OCR is charged with administering the rules of the SEC with respect to the practices of NRSROs in determining credit ratings, for the protection of users of credit ratings and in the public interest; promoting accuracy in credit ratings issued by NRSROs; ensuring that credit ratings are not unduly influenced by conflicts of interest; and helping to ensure that firms provide greater disclosure to investors.

The Exchange Act requires each NRSRO to “establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of the business of such [NRSRO and affiliated persons thereof], to address and manage any conflicts of interest that can arise from such business.”<sup>169</sup> The Exchange Act requires the SEC to adopt rules to prohibit or require the management of conflicts of interest related to the issuance of credit ratings.<sup>170</sup>

Pursuant to that mandate, the SEC has adopted a rule identifying a series of conflicts of interest arising from the business of determining credit ratings. Rule 17g-5(c) of the Exchange Act prohibits NRSROs from having the following conflicts of interest:

- issuing a credit rating solicited by a person that provided the NRSRO with 10% or more of its total net revenue in its most recently ended fiscal year;
- issuing a credit rating with respect to which the related fee was negotiated, discussed, or arranged by a person within the NRSRO who has responsibility for participating in determining credit ratings or developing or approving the related procedures and methodologies;
- issuing a credit rating for an affiliate of the NRSRO;
- issuing a credit rating with respect to a security where the NRSRO or its affiliate made recommendations “about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security;”
- issuing a credit rating for a person where the NRSRO directly owns securities of the

<sup>169</sup> Exchange Act Section 15E(h)(1).

<sup>170</sup> Exchange Act Section 15E(h)(2).

person that would be subject to the credit rating;

- issuing a credit rating for a person where an employee of the NRSRO that participated in determining, or is responsible for approving, the credit rating directly owns securities of the person that would be subject to the credit rating;
- issuing a credit rating for a person where an employee of the NRSRO that participated in determining, or is responsible for approving, the credit rating is an officer or director of the person that would be subject to the credit rating;
- issuing or maintaining a credit rating where an employee of the NRSRO that participated in determining or monitoring the credit rating or is responsible for approving the credit rating received gifts valued over \$25 from the person being rated; and
- effective June 15, 2015, issuing or maintaining a credit rating where a person within the NRSRO who participates in determining or monitoring the credit rating, or developing or approving procedures or methodologies used for determining the credit rating, including qualitative and quantitative models, also (i) participates in sales or marketing of a product or service of the NRSRO or a product or service of an affiliate of the NRSRO or (ii) is influenced by sales or marketing considerations.<sup>171</sup>

The SEC recognizes that certain other conflicts of interest related to the NRSRO's business may arise and does not prohibit them, but requires that they be managed. Thus, the following conflicts of interest are permissible only if the NRSRO has identified and implemented procedures for managing their impact:

- being paid by obligors, issuers, sponsors of asset-backed securities (ABS), or underwriters to determine credit ratings for such entity or the securities they issue, sponsor, or underwrite or for other services offered by the NRSRO;
- being paid by subscribers to receive access to credit ratings or other services if such subscribers may use the NRSRO's credit ratings to comply with, and obtain benefits or relief under, statutes or regulations using the term "nationally recognized statistical rating organization" or if such subscribers may own investments or have entered into transactions that could be impacted by a credit rating issued by the NRSRO;
- allowing persons within the NRSRO to have an ownership interest in rated obligors or securities or to have business relationships that are more than arm's length, ordinary course relationships with such obligors or the issuers of such securities; and

<sup>171</sup>

Exchange Act Rule 17g-5(c)(8) (as amended, effective June 15, 2015).



- having an affiliate that is a broker or dealer engaged in underwriting activities.

OCR examination staff is required to examine on an annual basis, among other things, the management of conflict of interests by the NRSROs.<sup>172</sup> For further information on how OCR administers the rules of the SEC with respect to the practices of NRSROs in determining credit ratings, see Principle 22.

### Enforcement

Enforcement may receive referrals of matters involving potential and actual conflicts of interest from any source – within and outside of the SEC. Once Enforcement receives a referral, it investigates the matter, and determines whether to recommend an enforcement action to the Commission. If the Commission authorizes an action, Enforcement will bring a proceeding in an administrative forum before an ALJ, or in a civil action in federal district court.

Conflicts of interest issues are a component of many enforcement cases that the SEC brings, including cases against broker-dealers, investment advisers, and hedge funds. For example, in a recent action the SEC instituted proceedings against an investment advisory firm, its chief executive officer, chief compliance officer (CCO), and another employee for allegedly misleading investors and breaching their fiduciary duties to clients. More specifically, in the order instituting proceedings, Enforcement alleges, among other things, that the firm and its CEO entered into revenue sharing arrangements in which they paid themselves kickbacks. They allegedly failed to disclose the conflicts of interest created by these agreements as they recommended investments to clients. The CCO and an investment adviser representative are also alleged to have breached their fiduciary duties and defrauding clients by failing to disclose conflicts of interest and concealing the kickbacks they received from the investments that they recommended.<sup>173</sup>

In addition, Enforcement takes steps to identify and evaluate potential and actual conflicts of interest through its Aberrational Performance Inquiry initiative. This initiative uses proprietary risk analytics to identify hedge funds with suspicious returns and to identify conflicts of interest among private fund registrants. The results of these analytics help to target both examination and enforcement resources.

For more information about Enforcement, see the responses to Principles 10, 11, and 12.

<sup>172</sup> Exchange Act Section 15E(p)(3)(B)(ii).

<sup>173</sup> See *In re Total Wealth Management, Inc. et al.*, Exchange Act Release No. 71948 (April 15, 2014), available at <http://www.sec.gov/litigation/admin/2014/33-9575.pdf>.

2. Where the Regulator identifies significant conflicts of interest among regulated entities or misaligned incentives, does it take steps so that these conflicts of interest or misalignments are avoided, eliminated, disclosed or otherwise managed?

Yes. As discussed in the response to Question 8.1 above, the SEC takes steps pursuant to various statutory and regulatory provisions to address conflicts of interest involving regulated entities or misalignment of incentives. Such steps may be taken via rulemaking efforts, examinations and guidance, or enforcement actions.

### **SEC Rules**

As indicated in the response to Question 8.1, the SEC has adopted and proposed rules in various areas that are designed to manage conflicts of interest or misalignment of incentives. Examples of such rules are set forth below:

#### Final Rules

##### *Investment Advisers and Investment Companies*

Disclosure requirements for CISs and investment advisers are designed to provide investors with material information about any conflicts of interest that exist, and the Investment Company Act, the Advisers Act and the rules thereunder are designed to mitigate and manage those conflicts. One key disclosure requirement for investment advisers is the Form ADV application for registration, which requires, among other things, disclosures of such conflicts of interest as an adviser's fees for its services, financial conditions that are reasonably likely to impair the adviser's ability to meet contractual commitments to clients, and other business activities. A CIS's registration statement also requires disclosure of various conflicts, such as the identities of the directors or trustees that are not independent of the CIS operator and other CIS affiliates; disclosure of the name and address of, and the percentage of voting securities held by, each person who controls the CIS and an explanation of the effect of that control on the voting rights of other shareholders; and disclosures about the various service providers to the CIS, including fee tables describing their compensation. These requirements are discussed more fully in response to Principle 29, Questions 2(a) and (b) as well as Principle 26.

Both CISs and investment advisers also are required to adopt and implement written compliance policies and procedures (CP&P) reasonably designed to prevent a CIS's violation of federal securities laws and an adviser's violation of the Advisers Act, including procedures to address potential conflicts of interest of an adviser with its clients and other compliance factors creating risks for advisory clients and CIS investors. These requirements are discussed more fully in response to Principle 29, Question 2(e); Principle 24, Question 12; and Principle 12, Question 5.

Numerous provisions in both the Investment Company Act and Advisers Act are designed to manage conflicts of interest directly. For example, as discussed in the response to Principle 24, Question 12(a), Section 17(a) of the Investment Company Act addresses conflicts of interests that arise from principal transactions between a CIS and its affiliates by prohibiting these transactions, and Section 206(3) of the Advisers Act similarly prohibits an adviser from engaging in principal transactions. Other statutory and regulatory provisions that address potential conflicts for a CIS are discussed in response to Principle 24, Questions 12(a) and (b), including provisions governing transactions in which a CIS and its affiliates jointly participate, soft dollar arrangements, directed brokerage, lending and borrowing to or from affiliates, use of affiliated brokers, employees transacting for their own accounts, distribution, the adoption of a code of ethics, and the role of the board of directors in approving certain transactions. The responses to Principle 29, Question 7(c); Principle 31, Question 6; and Principle 31, Question 8 discuss additional provisions applicable to investment advisers, including, among other things, agency trading restrictions, codes of ethics requirements, restrictions on performance fees, and pay-to-play issues.

#### *Compensation Committees*

The SEC recently adopted a new rule and amendments to its proxy disclosure rules to implement Section 952 of the Dodd-Frank Act, which added Section 10C to the Exchange Act, and requires the SEC to adopt new disclosure rules concerning compensation consultants and conflicts of interest. Rule 10C-1 requires national securities exchanges to adopt listing standards that require each member of a company's compensation committee to be a member of the board of directors and to be independent.<sup>174</sup> A compensation committee may select a compensation consultant or other adviser, only after considering factors relating to the consultant's independence.<sup>175</sup> Exchange Act registrants subject to the federal proxy rules already are required to disclose information about their use of compensation consultants, including specific information about fees paid to consultants. Under the new amendments to the proxy disclosure rules, with respect to any compensation consultant that has played a role in determining or recommending the amount or form of executive and director compensation and whose work has raised any conflict of interest, companies will be required to disclose the nature of the conflict and how the conflict is being addressed.

#### *Auditor Independence*

As discussed in more detail in the response to Principle 20, the SEC has adopted rules which are intended to prevent relationships or services that create a mutual or conflicting interest

<sup>174</sup> 17 C.F.R. 240.10C-1.

<sup>175</sup> For example, the committee must consider, among other factors, whether the company employing the compensation adviser is providing any other services to the company and what policies and procedures the company employing the compensation adviser has adopted to prevent conflicts of interest.

between the auditor and its client. In addition, these rules set forth a non-exclusive list of circumstances related to financial relationships, employment relationships, business relationships and non-audit services, as well as prohibitions on contingent fees and compensation paid to an audit partner for procuring engagements for non-audit work that could result in an auditor's self-interest being in conflict with the performance of an independent audit.<sup>176</sup>

### *Offerings*

Regulation M proscribes and regulates the activities that participants in a securities offering—such as issuers, selling security holders, underwriters, broker-dealers, and other distribution participants—could use to manipulate the price of the offered security.<sup>177</sup>

### *Brokerage Customer Disclosures*

Exchange Act Rules 15c1-5 and 15c1-6 generally require written disclosure to a customer if a broker-dealer has any control, affiliation, or interest in a security it is offering or in the issuer of the security.<sup>178</sup>

### *New Issue Lending Restriction*

Exchange Act Section 11(d)(1) prohibits a broker-dealer from extending, maintaining or arranging credit on new issue securities if the broker-dealer participated in the distribution of those new issue securities within 30 days preceding the loan. The provision is intended to mitigate the conflict of interest created when a broker-dealer has its own securities to sell but is also expected to give impartial advice about whether its customers should purchase them.<sup>179</sup> The lending restriction prevents a broker-dealer from using special financing arrangements as an incentive to push the new issue securities on its customers.

### *Research Analysts*

Regulation AC requires that brokers, dealers, and certain persons associated with a broker or dealer include in research reports certifications by the research analyst that the views expressed in the report accurately reflect his or her personal views, and disclose whether or

<sup>176</sup> See response to Principle 20.

<sup>177</sup> See Regulation M at 17 C.F.R. 242.100 through 105.

<sup>178</sup> See Rules 15c1-5 and 15c1-6 at 17 C.F.R. 240.15c1-5 and 15c1-6.

<sup>179</sup> See H.R. Rep. No. 1383, 73d Cong., 2d Sess. 15 (1934).

not the analyst received compensation or other payments in connection with his or her specific recommendations or views.<sup>180</sup>

#### *CRA's*

As described above, the SEC adopted Rule 17g-5 under Section 15E of the Exchange Act to require NRSROs to establish, maintain, and enforce policies and procedures designed to address and manage conflicts of interest. As also described above in Question 1 and as discussed in more detail in the response to Principle 22, the SEC addressed two categories of conflicts in Rule 17g-5: those conflicts that are prohibited for an NRSRO and those conflicts that must be disclosed and managed by an NRSRO.

#### *ABS*

The SEC has adopted rules that will give investors the tools they need to more accurately assess risk and better align the interests of the issuer of ABS with those of the investor.<sup>181</sup> In particular, the final rules revised the disclosure, reporting and offering process for ABS to better protect investors in the securitization market.

#### Proposed Rules

##### *SBS Entities*

The SEC has proposed two rule sets under the Dodd-Frank Act to address potential conflicts of interest in the SBS markets. First, the SEC has proposed rules that would limit certain concentrations in the ownership of, and exercise of voting rights with respect to, SBS clearing agencies, security-based swap execution facilities (SB SEFs) and national securities exchanges that post or make available for trading SBS. As proposed, these rules would also require these entities to comply with certain governance requirements.<sup>182</sup> Second, the SEC has proposed rules that would require security-based swap dealers (SBSDs) and major security-based swap participants (MSBSPs) to disclose to the relevant counterparty material information about the SBS, including material incentives and conflicts of interest.<sup>183</sup>

<sup>180</sup> See Regulation AC at 17 C.F.R. 242.500 to 505.

<sup>181</sup> For more information about revised Regulation AB, see SEC Release No. 33-9638 (September 4, 2014), available at <http://www.sec.gov/rules/final/2014/33-9638.pdf>.

<sup>182</sup> See Exchange Act Release No. 63107, available at <http://www.sec.gov/rules/proposed/2010/34-63107.pdf>.

<sup>183</sup> See Exchange Act Release No. 64766, available at <http://www.sec.gov/rules/proposed/2011/34-64766.pdf>.

**ABS**

In addition to the recently adopted revisions to the disclosure, reporting and offering process for ABS discussed above, the SEC has proposed a rule to implement Section 621 of the Dodd-Frank Act<sup>184</sup> to prohibit underwriters, placement agents, initial purchasers, or sponsors of ABS, or any affiliate or subsidiary of such an entity, from engaging in any transaction that would involve or result in a material conflict of interest with respect to any investor in the relevant ABS.

The SEC, in coordination with the other agencies, also proposed and re-proposed a rule to implement new Section 15G of the Exchange Act to require that a securitizer retain an economic interest in the credit risk of the assets that it securitizes.<sup>185</sup>

**SROs**

In addition to the SEC's regulatory framework, SROs, which the SEC oversees, have various rules in place to mitigate or address conflicts of interest. For example, FINRA has numerous rules either requiring broker-dealers to disclose certain conflicts or prohibiting certain activities.

These rules include requirements in the following areas:<sup>186</sup>

*Disclosure and Consent When Trading on a Net Basis with Customers*

FINRA Rule 2124 requires transaction-by-transaction disclosure and written consent for net trades involving non-institutional customers.

*Disclosure of Control Relationship with Issuer*

FINRA Rule 2262 requires disclosure if a firm controls, is controlled by, or under common control with an issuer of a security.

*Disclosure of Participation or Interest in Primary or Secondary Offering*

FINRA Rule 2269 generally requires written disclosure to customers for trades in any security in which the firm is participating in the distribution or is otherwise financially interested.

*Disclosure of Financial Condition upon Customer Request*

FINRA Rule 2261 requires disclosure of the information in its most recent balance sheet.

<sup>184</sup> See SEC Release No. 34-65355 (September 19, 2011).

<sup>185</sup> See SEC Release No. 34-64148 (March 30, 2011) and SEC Release No. 34-70277 (August 28, 2013), available at <http://www.sec.gov/rules/proposed/2011/34-64148.pdf> and <http://www.sec.gov/rules/proposed/2013/34-70277.pdf>.

<sup>186</sup> This non-exhaustive list of FINRA rules is in Appendix I to the FINRA Report on Conflicts of Interest (October 2013), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf>.

*Public Offerings of Securities with Conflicts of Interest*

FINRA Rule 5121 prohibits participation in an offering unless certain conditions are met, including prominent prospectus disclosure of the conflict.

*Restrictions on the Purchase and Sale of Initial Public Offerings (IPOs)*

FINRA Rule 5130 generally prohibits firms and their associated persons from purchasing a new issue for any account in which the firm or an associated person has an interest, except in accordance with the rule's conditions.

*Trading Ahead of Research Reports*

FINRA Rule 5280 prohibits firms from using nonpublic advance knowledge of a research report to change its inventory position in a security or derivative of the security.

*Research Analysts and Research Reports*

Among other things, NASD Rule 2711 and Incorporated NYSE Rule 472 restrict the activities of and the relationships between a firm's research analysts and its investment bankers and personal trading by research analysts in the stocks that they cover.

*Influencing or Rewarding Employees of Others*

FINRA Rule 3220 prohibits firms from giving anything worth more than \$100 annually to employees of other firms where the payment is made because of the employer's business.

*Brokerage Rewarding Fund Sales*

NASD Rule 2830(k) prohibits a firm from favoring the sale of a fund because of brokerage business that has been or may be directed to the firm.

*Borrowing From or Lending to Customers*

FINRA Rule 3240 prohibits these arrangements unless strict conditions are met.

*Trading Ahead of Customers*

FINRA Rule 5320 generally prohibits firms from trading ahead of a customer order for the firm's own account.

**Examinations**

In addition to rulemaking and SRO oversight, and as discussed in the response to Question 1 above, OCIE addresses conflicts of interest and misalignment of incentives through meetings with senior management and boards of entities registered with the SEC, including their affiliates where appropriate, to discuss how each firm identifies and mitigates conflicts of interest and legal, compliance, financial, and operational risks. This initiative is designed to: (i) evaluate firms' control environment and "tone at the top," (ii) understand firms' approach to conflict and risk management, and (iii) initiate a dialogue on key risks and regulatory requirements. The

examination program also alerts industry participants and the general public to conflicts-of-interest related issues through the publication of risk alerts.

### **Enforcement**

As discussed in the response to Question 1 above, conflicts of interest issues are also a component of many enforcement cases that the SEC brings on a routine basis, including cases against broker-dealers, investment advisers, and hedge funds. As described above, one such case is a recent action where the SEC instituted proceedings against an investment advisory firm, its chief executive officer, CCO, and another employee for allegedly misleading investors and breaching their fiduciary duties to clients. More specifically, in the order instituting proceedings, the SEC's Enforcement Division alleges, among other things, that the firm and its CEO entered into revenue sharing arrangements in which they paid themselves kickbacks. They allegedly failed to disclose the conflicts of interest created by these agreements as they recommended investments to clients. The CCO and an investment adviser representative are also alleged to have breached their fiduciary duties and defrauding clients by failing to disclose conflicts of interest and concealing the kickbacks they received from the investments that they recommended.<sup>187</sup>

3. Where the Regulator requires conflicts of interest or misaligned incentives to be disclosed, are the disclosures mandated in such a way that they are accessible by investors and/or the users of the services or products?

Yes. As discussed above in Question 8.2, the SEC addresses conflicts of interest or misaligned incentives by, among other things, mandating disclosures. Such disclosures are generally made directly to the customer or other users of services or are made publicly available. As discussed above in Questions 8.1 and 8.2, the SEC requires disclosures regarding conflicts of interest by regulated entities, such as broker-dealers, investment companies, investment advisers, and NRSROs. For example, broker-dealers are required to disclose certain conflicts of interest, such as affiliations or financial interests to customers; investment companies are required to identify members of their boards of directors that are affiliated with the fund manager or otherwise considered to be interested persons; investment advisers are required to disclose any material facts that might cause the adviser to render advice that is not disinterested; and NRSROs must identify and disclose any conflicts of interest on their registration form.

In order to be registered with the SEC, broker-dealers are required to complete the Form BD and make certain disclosures about their background, controlling persons, principals, and employees. The form is made publicly available online through the Central Registration Depository (CRD), which is operated by FINRA. A registered broker-dealer must keep the disclosures on Form BD

<sup>187</sup> See *In re Total Wealth Management, Inc. et al.*, Exchange Act Release No. 71948 (April 15, 2014), available at <http://www.sec.gov/litigation/admin/2014/33-9575.pdf>.



current and amendments to its registration are also made publicly available through the CRD.

As discussed in the response to Principle 29, the SEC requires a registered adviser to make extensive disclosures in its Form ADV application for registration. Part 1 requires information about the adviser's business, ownership, clients, employees, and business practices (especially those involving potential conflicts with clients); Part 2 requires a narrative providing additional information about potential conflicts and how they are addressed. All of these disclosures are available to the public online.

As discussed in the response to Principle 22, the SEC requires CRAs registered as NRSROs to make disclosures in a way that is accessible by investors or users of services, including disclosures on Form NRSRO to identify conflicts of interest, and the NRSRO's policies and procedures in place to manage such conflicts. These disclosures must be made publicly available on the NRSRO's website or through another comparable, readily accessible means.<sup>188</sup>

The SEC also requires certain disclosures from issuers regarding conflicts of interest. As discussed above, these include, but are not limited to, disclosures about ABS and compensation committees. For example, the SEC's rules for registered offerings of ABS require that robust information be provided about the underlying assets and the structure of the securities.<sup>189</sup> That information must be provided in the prospectus, which is required to be filed with the SEC. In addition, the SEC recently adopted rules that will increase the transparency of ABS by requiring issuers to provide loan-level disclosures about each underlying asset and a minimum period of time for investors to review such information.<sup>190</sup> With respect to the loan-level information, the final rule requires for certain asset classes the filing of tagged, computer-readable, standardized information about the specific assets, or loans, in the pool. This information must be provided at the time of securitization and on an ongoing basis.

The SEC and other agencies have jointly issued proposals requiring that a sponsor retain risk in each offering of ABS.<sup>191</sup> Those proposals are designed to address potential or actual misalignment of incentives in a securitization. The proposals would also require that, in an offering of ABS, certain disclosures relating to the amount of risk retained by a sponsor be provided to investors a reasonable time before sale.

Further, as discussed above, SEC rules require disclosure concerning compensation consultants

<sup>188</sup> See Form NRSRO and the instructions thereto, available at <http://www.sec.gov/about/forms/formnrsro.pdf>.

<sup>189</sup> See also Principle 16 Question 2. "Disclosure Requirements for Asset-Backed Securities."

<sup>190</sup> For more information about revised Regulation AB, see SEC Release No. 33-9638 (September 4, 2014), available at <http://www.sec.gov/rules/final/2014/33-9638.pdf>.

<sup>191</sup> See SEC Release No. 34-64148 (March 30, 2011) and SEC Release No. 34-70277 (August 28, 2013), available at <http://www.sec.gov/rules/proposed/2011/34-64148.pdf> and <http://www.sec.gov/rules/proposed/2013/34-70277.pdf>.

and conflicts of interest. A compensation committee may select a compensation consultant or other adviser, only after considering factors relating to the consultant's independence. With respect to any compensation consultant that has played a role in determining or recommending the amount or form of executive and director compensation and whose work has raised any conflict of interest, companies will be required to disclose the nature of the conflict and how the conflict is being addressed.

**Principle 9** Where the regulatory system makes use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, such SROs should be subject to the oversight of the Regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.

### Key Questions

#### *Performance of Functions of SRO*

1. Are there organizations that:

- (a) Establish rules of eligibility that must be satisfied in order for individuals or firms to participate in any significant securities activity?

Yes. Broker-dealers<sup>192</sup> generally must register with the SEC and become members of at least one SRO, such as a national securities exchange or a registered securities association.<sup>193</sup> FINRA, which was formed in 2007 and consolidated the member firm regulatory functions of the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD), is currently the only registered securities association. FINRA is responsible for regulating all securities firms that do business with the public, including with respect to professional training, testing and licensing of registered persons, and arbitration and mediation.

Broker-dealers that have a public customer business must be members of FINRA unless they limit their transactions to securities traded on an exchange of which they are a member. Broker-dealers that limit their activity to government securities or municipal securities (*i.e.*, sub-sovereign debt) require specialized registration. Broker-dealers may also need to register with individual states within the U.S. under each state's applicable laws.<sup>194</sup>

Section 15(a) of the Exchange Act requires brokers and dealers that effect or solicit transactions

<sup>192</sup> Generally, if an individual or firm is located in the United States and solicits or engages in securities transactions through the mails or in interstate commerce, or otherwise participates in key points in effecting securities transactions for customers, it is required to register as a broker-dealer and become a member of an SRO. In addition, generally, a foreign intermediary would be required to register as a broker-dealer if it (i) has physical operations in the United States, or (ii) effects, induces, or attempts to induce transactions with or for a U.S. person. Under the framework established in the Dodd-Frank Act, SBSDs and MSBSP are not required to be members of SROs, and no SRO has authority to regulate such entities' activities unless they are otherwise a member of that SRO. SBSDs and MSBSP are, however, subject to direct supervision and regulation by the SEC. Further, under this framework, SB SEFs are not SROs, and are not required to be members of SROs.

<sup>193</sup> By definition, national securities exchanges and registered securities associations (like FINRA) are SROs. See Exchange Act Section 3(a)(26), 15 U.S.C. 78c(a)(26). The rules and regulations promulgated by an SRO can be found on its website, see *e.g.*, [www.finra.org](http://www.finra.org) (for FINRA rules). Under the framework established in the Dodd-Frank Act, SBSDs and MSBSP are not required to be members of SROs, and no SRO has authority to regulate such entities' activities unless they are otherwise a member of that SRO. SBSDs and MSBSP are, however, subject to direct supervision and regulation by the SEC. Further, under this framework, SB SEFs are not SROs, and are not required to be members of SROs.

<sup>194</sup> This response does not address the broker-dealer regulation requirements of the states.

by use of a means of interstate commerce to register with the SEC. Section 3(a)(4) of the Exchange Act generally defines the term “broker” as “any person engaged in the business of effecting transactions in securities for the account of others.” Section 3(a)(5) of the Exchange Act generally defines the term “dealer” as “any person engaged in the business of buying and selling securities for such person’s own account through a broker or otherwise.”<sup>195</sup>

Section 15(a) of the Exchange Act requires broker-dealers to register with the SEC if the broker-dealer makes “use of ... any means ... of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security” other than exempted securities. Section 3(a)(17) of the Exchange Act defines the term “interstate commerce” to include “trade, commerce, transportation, or communication among the several States, or between any foreign country and any State.” Therefore, virtually any transaction-related contact between an intermediary meeting the definition of “broker” or “dealer” and the U.S. securities markets or an investor in the U.S. involves interstate commerce and provides the basis for requiring the intermediary to register as a broker-dealer.

Applicants that wish to register as broker-dealers must complete a registration application (also known as Form BD) and comply with applicable minimum net capital requirements. There are clear minimum standards that all applicants must meet in order to register with the SEC, including:

- Each broker-dealer that is a corporation must disclose the identity of all shareholders that beneficially own, have the right to vote, or have the power to sell or direct the sale of 25% or more of any class of a voting security of the broker-dealer on Form BD. Each broker-dealer that is a partnership must disclose the identity of all general partners and any limited or special partners that have the right to receive upon dissolution, or have contributed, 25% or more of the partnership’s capital on its Form BD. Each broker-dealer that is a trust must disclose the identity of the trust and each trustee on its Form BD. Each broker-dealer that is a limited liability company must disclose the identity of those members that have the right to receive upon dissolution, or have contributed, 25% or more of the LLC’s capital and all elected managers on its Form BD.
- Form BD requires additional disclosures of all directors and senior managers. Criminal, regulatory, civil judicial, bankruptcy, and SIPC actions involving each of those individuals or entities generally are required to be disclosed on Form BD. In addition, negative actions by a bonding company, and unsatisfied judgments and liens with respect to the applicant for broker-dealer registration must generally be disclosed on Form BD.

The SEC may deny registration if it finds that the applicant has not filed a complete Form BD in

<sup>195</sup> Discussion of U.S. securities laws generally collapses the terms “broker” and “dealer” into the term “broker-dealer” for simplicity. The term “broker-dealer” is used herein to refer to a broker or a dealer.

accordance with related rules prescribed by the SEC as necessary or appropriate in the public interest or for the protection of investors.<sup>196</sup> The SEC may also deny registration if it finds the applicant, or any person associated with the applicant, has filed false information with the SEC, has been convicted within 10 years preceding the application of a financial-related felony or misdemeanor or substantially equivalent crime by a foreign court. In addition, the SEC may deny registration if it finds the applicant, or any person associated with the applicant, is enjoined by a court from participation in the securities business, has willfully violated, or willfully aided the violation of, the federal securities laws, rules issued by the SEC pursuant to those laws, or the CEA, or has failed to reasonably supervise, with a view to preventing such violations, a person subject to the applicant's, or any person associated with the applicant, supervision.

The SEC may similarly deny registration if it finds the applicant is subject to any final order of a state securities commission (or any agency or officer performing like functions), state authority that supervises or examines banks, savings associations, or credit unions, state insurance commission (or any agency or office performing like functions), an appropriate federal banking agency (as defined in Section 3 of the Federal Deposit Insurance Act<sup>197</sup>), or the NCUA, that—

- bars such person from association with an entity regulated by such commission, authority, agency, or officer, or from engaging in the business of securities, insurance, banking, savings association activities, or credit union activities; or
- constitutes a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative, or deceptive conduct.<sup>198</sup>

The SEC may also deny registration if it determines that similar findings have previously been made by a foreign financial regulatory authority.<sup>199</sup> The SEC may consider criminal, disciplinary, and other regulatory judgments of other entities in determining whether to grant registration, place limitations on a broker-dealer's activities, or suspend or revoke a broker-dealer's registration.<sup>200</sup> Such matters, and information otherwise available to the SEC, may serve as a basis for denial of registration as a broker-dealer.<sup>201</sup> Section 15(b)(1) of the Exchange Act requires the SEC to grant registration, or commence proceedings to determine whether registration should be denied, within 45 days of the date of filing of an application for registration unless the applicant consents to a longer period.

<sup>196</sup> See Exchange Act Section 15(b)(1), 15 U.S.C. 78o(b)(1).

<sup>197</sup> 12 U.S.C. 1813(q).

<sup>198</sup> See Exchange Act Section 15(b)(4)(H), 15 U.S.C. 78o(b)(4)(H).

<sup>199</sup> See Exchange Act Section 15(b)(4)(G), 15 U.S.C. 78o(b)(4)(G).

<sup>200</sup> See Exchange Act Section 15(b)(4)(B), 15 U.S.C. 78o(b)(4)(B).

<sup>201</sup> See Exchange Act Section 15(b)(1)(B), 15 U.S.C. 78o(b)(1)(B).

If the SEC does not issue an order granting the registration application, Section 15(b)(2) of the Exchange Act requires the SEC to institute proceedings within 45 days of the date of filing of the application to determine whether registration should be denied. These proceedings must include notice of the grounds for denial and opportunity for a hearing. The proceedings must be concluded within 120 days of the date of the application. At the conclusion of the proceedings, the SEC must issue an order granting or denying the application.

### **Registration with SROs**

Registration with the SEC is not sufficient to begin operations as a broker-dealer. A registered broker-dealer must also be a member of an SRO. The Exchange Act defines an SRO as “any national securities exchange, registered securities association, or registered clearing agency, or (solely for the purposes of sections 19(b), 19(c) and 23(b) of [the Exchange Act] the Municipal Securities Rulemaking Board established by section 15B of [the Exchange Act].”<sup>202</sup> As noted above, broker-dealers that have a public customer business must be members of FINRA unless they limit their transactions to securities traded on an exchange of which they are a member. In order to trade directly on a particular exchange, a broker-dealer must become a member of that exchange.<sup>203</sup> Firms that engage in transactions in municipal securities must also comply with the rules of the MSRB, an SRO that makes rules governing transactions in municipal securities. In general, broker-dealers must comply with the rules of the SROs of which they are members.

SROs complete a comprehensive assessment of each broker-dealer firm before granting membership. A firm may not engage in any securities business until it has completed the SRO’s membership application process and received the approval of the SRO. During the pre-membership application process, the SRO determines whether the firm is aware of applicable SEC and SRO rules, and determines whether the firm will be capable of complying with those rules once approval is granted. Consistent with the requirements of the Exchange Act, every SRO must have membership rules. Therefore, each exchange or association decides the general conditions of use and membership pursuant to its own rules. Such rules are considered by the SEC pursuant to the SRO rulemaking process as set forth in Section 19(b) of the Exchange Act.<sup>204</sup> Exchange members must satisfy the SRO’s membership rules whether they are doing a proprietary business or a customer business.<sup>205</sup>

Based upon the types of business in which the firm wishes to engage, the SRO will require broker-dealers to maintain different types of books and records that are necessary to conduct

<sup>202</sup> See Exchange Act Section 3(a)(26), 15 U.S.C. 78c(a)(26).

<sup>203</sup> See Exchange Act Sections 6(b)(2) and 6(c), 15 U.S.C. 78f(b)(2) and (c).

<sup>204</sup> The SRO rulemaking process is described in detail in the response to Question 9.2(d) below.

<sup>205</sup> It should be noted, with respect to oversight of SROs and standards of fairness, that Section 6(b)(5) and Section 15A(b)(6) of the Exchange Act prohibit exchanges and associations from adopting rules that would unfairly discriminate against certain members of an exchange or an association, respectively.

and supervise those types of activity. Further, the SRO will obtain the firm's supervisory procedures for review. The SRO will also evaluate whether the firm has an adequate number of experienced supervisory and other personnel, as well as experienced personnel in key areas, to conduct the types of business in which it wants to engage. FINRA also requires a business plan, compliance guide, and an initial interview with the applicable FINRA District Office. An SRO's evaluation typically includes an assessment of, among other things the firm's ability: (i) to meet the SEC's net capital requirements; (ii) meet books and records requirements; (iii) supervise its activities; (iv) implement a reasonable compliance program; and (v) make disclosures relating to beneficial ownership of the firm. SROs also have access to information in a broker-dealer's Form BD, as well as the information and documents required during the application process.

Broker-dealers claiming denial of access may appeal to the SEC for a review.<sup>206</sup>

### **Registration of Associated Persons with FINRA**

Natural persons who are "associated with" a registered broker-dealer do not have to register themselves as broker-dealers.<sup>207</sup> However, unless their activities are strictly clerical and ministerial, these persons must register with the appropriate SRO (generally, FINRA), and must take the appropriate qualifying examinations. This requirement applies to any securities professional associated with a member firm — including partners, officers, directors, branch managers, department supervisors, and salespersons. The registration application requires information about the individual's prior employment and disciplinary history. FINRA prescribes two levels of qualification and registration:

- Registered representatives, generally sales personnel; and
- Principals, generally officers of the firm and other management and supervisory personnel involved in the day-to-day operation of the firm's investment banking or securities business.

A broker-dealer that is a FINRA member is ordinarily required to have at least two general securities principals.<sup>208</sup> If the broker-dealer has fewer than 10 non-clerical employees involved in securities activities, FINRA may waive the "two principal requirement" and require only one registered principal. A broker-dealer that is a FINRA member must have a qualified financial and operations principal responsible for its financial and administrative operations.

<sup>206</sup> See Exchange Act Sections 6(d)(3), 15A(h)(3), and 19(d), 15 U.S.C. 78f(d)(3), 78o-3(h)(3), and 78s(d), respectively.

<sup>207</sup> See Exchange Act Section 15(a), 15 U.S.C. 78o(a).

<sup>208</sup> See NASD Rule 1021(e).

In addition, SROs require that associated persons register with them<sup>209</sup> using Form U4. In order to fulfill SRO requirements, certain individuals must pass qualifications examinations.<sup>210</sup> These examinations test the individuals' knowledge of securities industry laws, regulations, and rules, and are both general and specialized. Any individual seeking to enter the securities industry is required to fill out a Form U4 and submit fingerprints. Generally, the Form U4 contains questions designed to elicit background information about the individual and whether the individual is subject to a statutory disqualification.<sup>211</sup> Under FINRA rules, the member firm is responsible for submitting the Form U4 and fingerprints to FINRA. FINRA reviews the application in light of the information contained in the CRD, which is a comprehensive database used by FINRA, state regulators, and the SEC that contains information about anyone who has ever worked in the securities industry and the disciplinary history for that person. In addition, the fingerprints are submitted to the FBI for a criminal background check.

As part of the registration process, securities professionals must pass an examination administered by FINRA to demonstrate competence in the areas in which they will work. These mandatory qualification examinations cover a broad range of subjects on the markets, as well as the securities industry and its regulatory structure, ensuring a minimum level of understanding and expertise. The areas in which candidates are tested include federal securities laws; SEC and FINRA rules and regulations; securities products; the operation and interrelation of financial markets; economic theory and kinds of risk; corporate financing, accounting, and balance sheet analysis; portfolio theory and analysis; fair sales practices, including solicitation and presentation; types of customer accounts; and tax treatment of various investments.

Prospective principals of securities firms must pass additional examinations that test their knowledge of supervisory rules in the areas of investment banking, trading, and market making; retail sales activities; and financial responsibility rules. Financial and operational principals must further demonstrate a thorough knowledge of the requirements regarding recordkeeping, net capital, customer reserves, financial reporting, and credit.

FINRA also administers examinations for the securities industry regulators and the states to individuals seeking registration with securities firms.

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<sup>209</sup> See, e.g., NYSE Rule 301.

<sup>210</sup> See, e.g., NYSE Rule 304A.

<sup>211</sup> See Exchange Act Section 6(c)(2), 15 U.S.C. 78f(c)(2).



(b) Establish and enforce binding rules of trading, business conduct and qualification for individuals and/or firms engaging in securities activities?
<p>Yes. In the U.S., exchange members and members of an association (such as FINRA) are required to comply with their exchange's or association's trading and business conduct rules. Sections 6(b)(1) and 15A(b)(2) of the Exchange Act provide that a registered national securities exchange or association must be able to enforce compliance by its members with, among other things, the rules of the exchange or association. Sections 6(b)(5) and 15A(b)(6) of the Exchange Act provide that the rules of a national securities exchange or association must be designed:</p> <ul style="list-style-type: none"> <li>• to prevent fraudulent and manipulative acts and practices;</li> <li>• to promote just and equitable principles of trade;</li> <li>• to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities;</li> <li>• to remove impediments to and perfect the mechanism of a free and open market and a national market system; and</li> <li>• in general, to protect investors and the public interest.</li> </ul> <p>The rules must also not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.</p> <p>The SEC also has the authority to enforce compliance with an exchange's or association's rules by its members. Pursuant to Section 21 of the Exchange Act, the SEC may investigate violations and seek sanctions against national securities exchange members that violate an exchange's or association's rules.<sup>212</sup></p>
(c) Establish disciplinary rules and/or conduct disciplinary proceedings, which would enable the SRO to impose appropriate sanctions for non compliance of its rules?
<p><b>SRO Disciplinary Authority</b></p> <p>Yes. Exchanges and associations must have rules that provide that their members shall be appropriately disciplined for violation of the provisions of the Exchange Act, the rules and regulations thereunder, and their own rules by expulsion, suspension, limitation of activities,</p>

<sup>212</sup> Exchange Act Section 21(f) provides that the SEC shall not bring an action against a person for violation of an SRO's rules unless it appears that (i) such SRO is unable or unwilling to take appropriate action or (ii) such action is otherwise necessary or appropriate in the public interest or for the protection of investors.

functions and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction.

Sections 6(b)(7) and 15A(b)(8) of the Exchange Act require that the rules of an exchange or association must provide for a fair procedure for disciplining members and persons associated with members, denying membership, barring persons from being associated with members, and prohibiting or limiting access to services offered by the exchange or its members.<sup>213</sup>

Pursuant to Section 17A of the Exchange Act, a clearing agency must have rules that provide that its participants shall be appropriately disciplined for violation of any provision of the rules of the clearing agency by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, or any other fitting sanction. For example, National Securities Clearing Corporation (NSCC) rulebooks establish a process for the conduct of hearings, dispute of fines, selection of panelists for further hearings, and representation by counsel. Any changes to such clearing agency rules must be submitted for review by the SEC under the process outlined in Section 19(b) of the Exchange Act. Clearing agencies must also provide for fair procedures with respect to disciplining participants, denial of participation, and the prohibition or limitation with respect to the access of services.<sup>214</sup>

### **SEC Authority to Discipline Broker – Dealers and Persons Associated**

The SEC also has authority to take disciplinary actions against a broker-dealer, as well as against persons associated with a broker-dealer. The federal securities laws authorize the SEC, in its discretion, to institute administrative proceedings against broker-dealers and their associated persons or to sue any person in federal court for violations of the federal securities laws, including the Exchange Act.

**Administrative Proceedings:** Sections 15(b)(4) and (6) of the Exchange Act authorize the SEC to sanction a broker-dealer or a person associated with a broker-dealer, respectively, if it finds (after notice and an opportunity for a hearing) that the broker-dealer or an associated person has engaged in certain willful misconduct and if the sanctions are in the public interest. Exchange Act Sections 15B(c)(2) and (4) give the SEC the same authority with respect to municipal securities dealers and persons associated with municipal securities dealers.

<sup>213</sup> See Exchange Act Sections 6(b)(7) and 15A(b)(8), 15 U.S.C. 78f(b)(7) and 78o-3(b)(8), respectively. See also Exchange Act Sections 6(d) and 15A(h), 15 U.S.C. 78f(d) and 78o-3(h), respectively, which contain additional requirements regarding how an exchange or association may discipline its members.

<sup>214</sup> Unlike exchanges and associations, a clearing agency is not charged with disciplining its participants for violations of the Exchange Act and the rules and regulations thereunder.

The SEC may censure, place limitations on, suspend for a period not exceeding 12 months, or revoke the registration of any broker-dealer based upon certain factual findings.<sup>215</sup> Similarly, the SEC may censure, place limitations on the activities or functions of, suspend for not more than 12 months, or bar an associated person of a broker-dealer from further association.<sup>216</sup> The SEC must first find on the record and after notice and opportunity for hearing that (i) such action is in the public interest; and (ii) the broker-dealer (or person associated with such broker-dealer) has willfully made a false or misleading application or report with the SEC, has been convicted of certain financial-related felonies within the last 10 years, has been enjoined from participating in the securities, banking, insurance or futures industries, has willfully violated the U.S. securities laws, or has willfully aided or abetted in the violation of the U.S. securities or futures laws.

The SEC may also censure, place limitations on, or revoke registration based on its finding that the broker-dealer (or person associated with such broker-dealer) is subject to any final order of a State securities commission (or any agency or officer performing like functions); State authority that supervises or examines banks, savings associations, or credit unions; State insurance commission (or any agency or office performing like functions); an appropriate Federal banking agency (as defined in Section 3 of the Federal Deposit Insurance Act<sup>217</sup>); or the NCUA, that--

- bars such person from association with an entity regulated by such commission, authority, agency, or officer, or from engaging in the business of securities, insurance, banking, savings association activities, or credit union activities; or
- constitutes a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative, or deceptive conduct.<sup>218</sup>

The SEC may also censure, place limitations on, or revoke registration on a finding based on equivalent orders imposed outside the U.S.<sup>219</sup>

### **Civil Federal Court Actions Against Broker-Dealers and Persons Associated**

The SEC is authorized to institute an action seeking an injunction or other equitable relief under Section 21(d) of the Exchange Act against any person who has violated, is violating, or is about to

<sup>215</sup> Exchange Act Section 15(b)(4).

<sup>216</sup> Exchange Act Section 15(b)(6).

<sup>217</sup> 12 U.S.C. 1813(q).

<sup>218</sup> Exchange Act Section 15(b)(4)(H).

<sup>219</sup> Exchange Act Section 15(b)(4)(G).

violate, the Exchange Act, the rules thereunder, any SRO's rules, or the rules of a registered clearing agency in which such person is a participant.<sup>220</sup> The SEC similarly may seek an injunction against any person for aiding and abetting a violation of the Exchange Act. Under Section 21(d)(2) of the Exchange Act, a court may prohibit any person who violated the anti-fraud provision, Section 10(b), from serving as an officer or director of any issuer that has securities registered under Section 12 of the Exchange Act or that is required to file reports with the SEC under the Exchange Act. Upon a proper showing, a court may impose monetary penalties of varying amounts, depending upon the nature of the violation, as described in Section 21(d)(3) of the Exchange Act. In addition, Section 21(d)(5) of the Exchange Act authorizes the SEC to seek any equitable relief that may be appropriate or necessary for the benefit of investors. Further, Section 21(d)(6) provides the civil court authority to prohibit persons from participating in an offering of a "penny stock" as defined in that section.

### **Criminal Actions Against Broker-Dealers and Persons Associated**

Any person who willfully violates any provision of the Exchange Act, or any rule or regulation thereunder, or willfully makes a false or misleading statement in an application for membership to an SRO, is subject to criminal penalties under the Exchange Act. Section 32 of the Exchange Act provides for criminal sanctions, upon conviction, not to exceed \$1,000,000 (\$2,500,000 for a corporate entity) and/or imprisonment for not more than 10 years. The SEC does not have the authority to prosecute criminal actions; criminal actions are prosecuted by the DOJ.

An attorney general of a state and/or a state securities regulator may also bring criminal or civil actions against broker-dealers operating in their jurisdiction for violations of state securities laws (also known as "blue sky laws").

### **SEC Authority to Discipline SROs**

As discussed in Principle 10, the SEC may bring an enforcement action against an SRO for failure to act or adequately perform required functions. The SEC has brought actions against SROs for, among other violations, engaging in business practices without having effective exchange rules in place or operating in a manner that does not comply with the exchange's rules or federal securities laws; failing to investigate a member firm and interfering with the SEC's investigation of that firm; improperly distributing market data; failing to detect and halt unlawful proprietary trading by certain independent floor brokers; and weaknesses in its processes and controls which resulted in system outages.<sup>221</sup>

<sup>220</sup> As addressed in Principles 10, 11, 12 and 29, in addition to bringing actions federal court actions pursuant to Exchange Act Section 21(d), the SEC may, as facts warrant, bring federal court actions against any person pursuant to Section 20(b) of the Securities Act; Section 42(d) of the Investment Company Act; and Section 209(d) of the Advisers Act.

<sup>221</sup> See, e.g. *In the Matter of the New York Stock Exchange LLC, NYSE Arca, Inc., NYSE MKT LLC f/k/a NYSE Amex LLC, and Archipelago Securities, L.L.C.*, (settled matter) Exchange Act Release No. 72065, May 1, 2014, available at

(continued)

<i>Authorization or Delegation Subject to Oversight</i>	
2.	As a condition to authorization, does the legislation or the regulator require the SRO to demonstrate that it:
(a)	Has the capacity to carry out the purposes of governing laws, regulations and SRO rules consistent with the responsibility of the SRO, and to enforce compliance by its members and associated persons subject thereto those laws, regulations and rules?
<p>Yes. Pursuant to Sections 5 and 6 of the Exchange Act, national securities exchanges must be registered with and have their rules reviewed by the SEC. Similarly, pursuant to Section 15A of the Exchange Act, national securities associations must be registered with and have their rules reviewed by the SEC. Sections 6(b)(1) and 15A(b)(2) of the Exchange Act provides that an exchange or association shall not be registered unless the exchange or association is so organized and has the capacity to carry out the purposes of the Exchange Act.<sup>222</sup> The exchange or association also must be able to enforce compliance with the Exchange Act, the rules and regulations thereunder, and its own rules by its members and persons associated with its members.<sup>223</sup> In this regard, the SEC evaluates whether applicants for registration as a national securities exchange have adequate computer system capacity, integrity, and security to support the operation of the exchange.<sup>224</sup></p> <p>Where appropriate the SEC also has the ability to permit exceptions to the SRO regulatory requirements in order to provide flexibility with respect to the responsibility of the SRO. Specifically, under Sections 19(g) and Section 17(d)(1) of the Exchange Act, the SEC may provide certain relief from SRO responsibilities. For example, pursuant to this authority, the SEC adopted Rule 17d-2, which permits two or more SROs to file with the SEC a plan for allocating among the SROs the responsibility to receive regulatory reports, from persons who are common members of such SROs, to examine such persons, or to enforce compliance of such persons with the federal securities laws. After appropriate notice and opportunity for comment, the SEC may, by written notice, declare such plan or any part thereof effective, upon finding that such plan or part thereof is consistent with Section 17(d)(1) of the Exchange Act.</p>	

[www.sec.gov/litigation/admin/2014/34-72065.pdf](http://www.sec.gov/litigation/admin/2014/34-72065.pdf); *In the Matter of the Chicago Board of Options Exchange, Inc. and C2 Options Exchange Inc.*, (settled matter) Exchange Act Release No. 69726, June 11, 2013, available at [www.sec.gov/litigation/admin/2013/34-69726.pdf](http://www.sec.gov/litigation/admin/2013/34-69726.pdf); *In the Matter of New York Stock Exchange LLC, and NYSE Euronext*, (settled matter) Exchange Act Release No. 67957, Sept. 14, 2012, available at [www.sec.gov/litigation/admin/2012/34-67857.pdf](http://www.sec.gov/litigation/admin/2012/34-67857.pdf); *In the Matter of EDGX Exchange, Inc. et al.*, (settled matter) Exchange Act Release No. 65556, Oct. 13, 2011, available at [www.sec.gov/litigation/admin/2011/34-65556.pdf](http://www.sec.gov/litigation/admin/2011/34-65556.pdf); *In the Matter of Boston Stock Exchange, Inc. and James B. Crofwell*, (action against the SRO and its President)(settled matter) Exchange Act Release No. 56352, Sept. 5, 2007, available at [www.sec.gov/litigation/admin/2007/34-56352.pdf](http://www.sec.gov/litigation/admin/2007/34-56352.pdf).

<sup>222</sup> Exchange Act Sections 6(b)(1) and 15A(b)(2), 15 U.S.C. 78f(b)(1) and 78o-3(b)(2), respectively.

<sup>223</sup> *Id.*

<sup>224</sup> See Principle 33 for a complete discussion of the exchange registration process and evaluation.

The MSRB is an SRO that makes rules governing transactions in municipal securities; the SEC also reviews the MSRB's rules. However, unlike other SROs, the MSRB does not enforce compliance with its rules. Compliance with MSRB rules is monitored and enforced by FINRA and/or the SEC (in the case of broker-dealers and municipal advisors), and the federal bank regulators and the SEC (in the case of banks).

Similarly, and as discussed in more detail in Principle 33.2(c), clearing agencies are required to be registered with and have their rules reviewed and with limited exceptions approved by the SEC. Pursuant to Section 17A of the Exchange Act and SEC rules, clearing agencies must be able to demonstrate organizational and operational capability that, among other things, will ensure that the clearing agency has the ability to promote the prompt and accurate clearance and settlement of securities transactions and to assure the safeguarding of securities and funds. The SEC also reviews the systems of clearing agencies under the Technology Control Program (TCP) and participates in drafting recommendations for the business continuity plans (BCPs) of clearing agencies so that they would be able to achieve a rapid and timely resumption of critical services following a major disruption to operations.

In part to ensure that an SRO has the capacity to carry out the purposes of governing laws, the provisions of Section 6(b), and their parallel provisions in 15A (for associations), and 17A (for clearing agencies), dictate in specific terms what the rules of an SRO must contain.<sup>225</sup> Most of these provisions are referenced in the responses in paragraphs (b)-(i) below. In addition, Section 6(b) contains the following requirements:

- The rules of an exchange must provide that, subject to the provisions of Section 6(c),<sup>226</sup> any registered broker or dealer or any natural person associated with a registered broker or dealer may become a member of the exchange;<sup>227</sup>
- The rules of an exchange must provide for the equitable allocation of reasonable dues, fees and other charges among its members, issuers and, other persons using the exchange's facilities;<sup>228</sup> and
- The rules of an exchange must prohibit the listing of any security that is issued in a

<sup>225</sup> See Exchange Act Sections 6(b) and 15A(b), 15 U.S.C. 78f(b) and 78o-3(b), respectively.

<sup>226</sup> Generally, Exchange Act Section 6(c), 15 U.S.C. 78f(c), provides that an exchange must deny membership to persons who are not registered broker-dealers (or persons associated with registered broker-dealers) and that it may deny membership to registered broker-dealers and persons associated with registered broker-dealers who: (i) are subject to a statutory disqualification; (ii) who do not meet certain financial responsibility or operational capacity standards; (iii) who do not meet standards of training, experience, and competence; and (iv) who have engaged in and are reasonably likely to engage in acts or practices inconsistent with just and equitable principles of trade.

<sup>227</sup> See Exchange Act Section 6(b)(2).

<sup>228</sup> See Exchange Act Section 6(b)(4).

limited partnership rollup transaction, unless the transaction was conducted in accordance with procedures designed to protect the rights of limited partners.<sup>229</sup>

In addition to satisfying the requirements of Section 6 of the Exchange Act, a prospective exchange must demonstrate its ability to operate as part of the NMS as contemplated in Section 11A of the Exchange Act. In particular, an applicant exchange must satisfy the NMS requirements set forth in Regulation NMS, which contains rules that govern quotations in the NMS, including quotation collection and reporting requirements, firm quotation requirements, and quotation access and trade-through prevention requirements. Specifically, Regulation NMS addresses: (i) trade-throughs; (ii) market access; (iii) sub-penny pricing; and (iv) market data. The Order Protection Rule<sup>230</sup> requires trading centers to establish policies and procedures reasonably designed to prevent the execution of trades at prices inferior to automated quotations that are the best quote of another exchange, subject to applicable exceptions. The Access Rule<sup>231</sup> requires fair and non-discriminatory access to quotations, establishes a limit on access fees to harmonize the pricing of quotations across different trading centers, and requires rules addressing locked and crossed markets. The Sub-Penny Rule<sup>232</sup> prohibits market participants from accepting, ranking, or displaying orders for securities priced \$1.00 or more in increments smaller than a penny. The market data provisions, among other things, modify the way the markets allocate data revenues. In addition, Regulation NMS also sets forth transaction reporting requirements and requires the publication of order execution quality statistics.

(b) Treats all members of the SRO, applicants for membership and similarly situated market participants subject to its rules in a fair and consistent manner?

Yes. Pursuant to Sections 6(b)(2), 15A(b)(3), and 17A(b)(3)(B) of the Exchange Act, a national securities exchange, national securities association, or clearing agency must have rules that permit any registered broker-dealer or natural person associated with a broker-dealer to become a member of the exchange or association.<sup>233</sup> In addition, pursuant to Sections 6(b)(5), 15A(b)(6),

<sup>229</sup> See Exchange Act Section 6(b)(9).

<sup>230</sup> 17 C.F.R. 242.611.

<sup>231</sup> 17 C.F.R. 242.610.

<sup>232</sup> 17 C.F.R. 242.612.

<sup>233</sup> The term "member" is defined with respect to a national securities exchanges as "(i) any natural person permitted to effect transactions on the floor of the exchange without the services of another person acting as broker, (ii) any registered broker or dealer with which such a natural person is associated, (iii) any registered broker or dealer permitted to designate as a representative such a natural person, and (iv) any other registered broker or dealer which agrees to be regulated by such exchange and with respect to which the exchange undertakes to enforce compliance with the provisions of this chapter, the rules and regulations thereunder and its own rules." See Section 3(a)(3)(A) of the Exchange Act, 15 U.S.C. 78c(a)(3)(A).

The term "member" is defined with respect to a registered securities association as "any broker or dealer who agrees to be regulated by such association and with respect to whom the association undertakes to enforce compliance with the provisions of this title, the rules and regulations thereunder, and its own rules." See Section 3(a)(3)(B) of the Exchange Act, 15 U.S.C. 78c(a)(3)(B).

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15B(b)(2)(C), and 17A(b)(3)(F) of the Exchange Act, the rules of an SRO must not be designed to permit unfair discrimination between customers, issuers, broker, or dealers or to regulate by virtue of the Exchange Act matters not related to the purposes of the Exchange Act or the administration of the SRO.<sup>234</sup>

### Membership Access

An exchange's or association's ability to deny membership to a person is limited pursuant to Sections 6(c) and 15A(g) of the Exchange Act, respectively. This statute provides that an exchange or association, generally, must deny membership to any non-registered broker-dealer and may deny membership to any broker-dealer that is subject to a "statutory disqualification."<sup>235</sup> A denial on the grounds of a statutory disqualification must be reported to the SEC. Further, an exchange or association may deny membership to a broker-dealer that does not meet financial responsibility or operational capability standards or that does not have the minimum level of training, experience or competence prescribed by the exchange's rules. In addition, an exchange or association may deny membership to a broker-dealer that has engaged or is likely to engage in acts or practices that are inconsistent with just and equitable principles of trade.

Each national securities exchange or association has rules that prescribe the means by which a registered broker-dealer may apply to become a member. The SEC, pursuant to Section 19(b) of the Exchange Act, reviews rules for admission to a national securities exchange and a registered securities association. While exchanges and associations are free to have reasonable standards for access, such standards should act to prohibit unreasonably discriminatory denials of access. In addition to not permitting an exchange or association to exclude any registered broker-dealer,<sup>236</sup> the exchange's or association's rules may not be designed to permit unfair discrimination between broker-dealers<sup>237</sup> and may not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.<sup>238</sup> Further,

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The term "participant" when used with respect to a clearing agency means any person who uses a clearing agency to clear or settle securities transactions and to transfer, pledge, lend, or hypothecate securities. Such term does not include a person whose only use of a clearing agency is (i) through another person who is a participant or (ii) as a pledgee of securities. See Section 3(a)(24) of the Exchange Act, 15 U.S.C. 78c(a)(3)(24).

<sup>234</sup> As noted in footnote 221, the SEC has brought a number of settled actions against SROs for violations of certain statutory and regulatory requirements. The SEC has also brought actions against national security exchanges for failure to comply with their own rules. See, for example, *In re The NASDAQ Stock Market, LLC and NASDAQ Execution Services, LLC*, (settled matter) Exchange Act Release No. 69655 (May 29, 2013) available at <http://www.sec.gov/litigation/admin/2013/34-69655.pdf>

<sup>235</sup> See Exchange Act Section 3(a)(39).

<sup>236</sup> Other than pursuant to Sections 6(c) and 15A(g) of the Exchange Act, 15 U.S.C. 78f(c) and 78o-3(g), as discussed above.

<sup>237</sup> Sections 6(b)(5) and 15A(b)(6) of the Exchange Act, 15 U.S.C. 78f(b)(5) and 78o-3(b)(6).

<sup>238</sup> Sections 6(b)(8) and 15A(b)(9) of the Exchange Act, 15 U.S.C. 78f(b)(8) and 78o-3(b)(9).



Sections 6(b)(4) and 15A(b)(5) of the Exchange Act require that the rules of an exchange or association provide for an equitable allocation of reasonable dues, fees, and other charges among its members and other persons using its facilities. Pursuant to Section 19 of the Exchange Act, the SEC has plenary authority to review rules that govern the admission of members. Section 6(d)(3), Section 15A(h)(3), and Section 19(d) of the Exchange Act provide that the SEC may review denials of membership in, or access to, an SRO.

If an exchange or association denies membership or participation to an applicant, it must provide the SEC of notice of such action.<sup>239</sup> A denial of membership or participation by an exchange or association is reviewable by the SEC.<sup>240</sup> The SEC will dismiss an appeal if it finds that the SRO's action is based on fact and that the rules were applied in a manner that is consistent with the Exchange Act.<sup>241</sup> If the SEC cannot make such a finding, it will set aside the SRO's action and require it to admit the applicant to membership or participation.<sup>242</sup>

Accordingly, the ability to trade on a national securities exchange is readily attainable by those qualified, registered broker-dealers who seek membership. In recent years, many markets have demutualized and moved away from a floor-based, "membership" structure to a trading permit structure, making the opportunities to access to such exchanges greater; unlike with floor-based exchanges historically, there is typically no limit on the number of trading permits that a fully electronic exchange issues. However, some exchanges that still have trading floors, though demutualized, have retained their limits on access.<sup>243</sup> Generally, exchanges are permitted to increase the number of memberships for their markets, but they are not allowed to decrease market access below membership levels in effect at the time of exchange registration or May 1, 1975.<sup>244</sup> The SEC, however, may increase or remove limitations on the number of memberships for an exchange if it finds that such limitations impose burdens on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.<sup>245</sup>

The requirements for registered clearing agencies are in many ways similar to those for exchanges and national associations. Pursuant to Section 17A(b)(4), a clearing agency may deny participation to any person subject to a statutory disqualification or if any such person does not meet such standards of financial responsibility, operational capability, experience, and competence as are prescribed by the rules of the clearing agency. The clearing agency may

<sup>239</sup> Section 19(d)(1) of the Exchange Act, 15 U.S.C. 78s(d)(1). See Rule 19d-1, 17 C.F.R. 240.19d-1, for the required contents of the notice that an SRO must make to the SEC.

<sup>240</sup> Section 19(d)(2) of the Exchange Act, 15 U.S.C. 78s(d)(2).

<sup>241</sup> Section 19(f) of the Exchange Act, 15 U.S.C. 78s(f).

<sup>242</sup> *Id.*

<sup>243</sup> NYSE is an example of this.

<sup>244</sup> See Section 6(c)(4) of the Exchange Act, 15 U.S.C. 78f(c)(4).

<sup>245</sup> *Id.*

examine and verify the qualifications of a person in accordance with its rules or procedures. In addition, the rules of a clearing agency — including those applicable to membership requirements and access — must not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. For example, the NSCC rulebook establishes initial and ongoing eligibility criteria for membership, such as satisfying operational testing requirements and having adequate personnel, space and data processing capacity.

### **Levels of Access**

The Exchange Act also requires exchanges not to discriminate in the level of access each grants to market participants. Section 11A(c)(1)(C) of the Exchange Act requires that similarly situated market participants have equitable access to trading information by requiring the SEC to assure that all SIPs have equitable access to market information from an exclusive processor of that information (*i.e.*, an exchange or association) on terms that are “fair and reasonable.” In addition, Section 11A(c)(1)(D) of the Exchange Act directs the SEC to assure that all persons may obtain market information on terms that are “not unreasonably discriminatory.” If a registered SIP limits the access of any person to its services, Section 11A(b)(5) provides for SEC review of the limitation.

Rule 610(a) of Regulation NMS prohibits an SRO from imposing unfairly discriminatory terms that prevent or inhibit any person from obtaining efficient access through a member of the SRO to the quotations in an NMS stock displayed in the SRO trading facility. This anti-discrimination provision provides non-members indirect access to quotes by members. This provision would prohibit, for example, different fees or order priority rules based on the identity of a member’s customer.<sup>246</sup>

Paragraph (c) of Rule 610 limits the amount of fees that may be charged by a trading facility to access its best bids and offers. Generally, the rules provide that a trading center may not impose a fee for the execution of an order against a “protected quotation,” as defined, of the trading center that exceed or accumulate to more than \$0.003 per share or for a stock priced less than \$1.00, which exceed or accumulate to more than 0.3 % of the quotation price.

Clearing agencies also may not permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency. Many firms in the U.S. securities industry are not direct participants of a clearing agency but clear their transactions through another broker-dealer that is a direct participant (*i.e.*, a “clearing firm”). The SEC has proposed Rule 17Ad-22(e)(18) to establish objective participation criteria, which permit fair and open access by direct and, where relevant, indirect participants and other FMUs. Also, the rules may

<sup>246</sup> As noted in footnote 221, the SEC has brought a number of actions against SROs for violations of certain statutory and regulatory requirements, including violations of Regulation NMS.

not impose any schedule of prices, or fix rates or other fees, for services rendered by its participants.

- (c) Develops rules that are designed to set standards for its members and to promote investor protection?

### Statutory Requirements

Yes. As discussed in Question 9.1(b), Sections 6(b)(5), 15A(b)(6), and 15B(b)(2)(C) of the Exchange Act require that the rules of an SRO (other than a clearing agency) must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade; to foster cooperation and coordination with persons engaged in regulating, clearing, settling, and processing information with respect to, and facilitating transactions in, securities; to remove impediments to, and perfect the mechanism, of a free and open market and a national market system; and, in general, to protect investors and the public interest. In addition, the rules of an exchange or association, as well as the MSRB, must be designed so as to not permit unfair discrimination between customers, issuers, brokers, or dealers. Moreover, an exchange's or association's rules must provide for the equitable allocation of reasonable dues, fees and, other charges among its members, issuers, and other persons using its facilities.<sup>247</sup>

Section 17A of the Exchange Act recognizes that the operating efficiencies and enhanced risk management that are the core services offered by a clearing agency are necessary for the protection of investors. Section 17A, therefore, directs the SEC to facilitate a national system for the prompt and accurate clearance and settlement of securities transactions and to facilitate the establishment of linked or coordinated facilities for clearance and settlement of transactions in securities. Rule 17Ad-22(b) further specifies that clearing agencies that perform CCP services must establish written policies that provide a person that maintains net capital equal to or greater than \$50 million with the opportunity to obtain membership, with any net capital requirements to be scaled proportionate to the risks posed by the participant's activities to the clearing agency. This rule promotes investor protection by promoting open access to central clearing among participants that have the capacity to participate without posing undue risk to the clearing agency.

The SEC reviews all prospective exchange, association, MSRB, and clearing agency rules to evaluate whether they satisfy these standards. Further, the SEC reviews the prospective rules of the markets to evaluate whether the members of the markets have unfair trading advantages over non-members, or investors generally. For example, the SEC carefully reviews the operations of the SROs' trading systems to evaluate whether investor orders are able to compete freely with

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Exchange Act Sections 6(b)(4) and 15A(b)(5), 15 U.S.C. 78f(b)(4) and 78o-3(b)(5), respectively.

orders of market professionals and are executed on an equitable basis, such as price/time priority.<sup>248</sup> SROs also have specific rules that govern how a broker-dealer may trade for its own account when representing customer orders. Pursuant to these SRO rules, broker-dealers are generally prohibited from trading for their own accounts when they hold an order for the same security that may be executed at the same price.<sup>249</sup> Failure to execute the customer's order first can result in a violation of SRO rules. The SEC carefully reviews any changes to these rules to evaluate whether investor protection are affected.

In addition, the SEC has approved SRO rules that provide transparency and disclosure to investors that support investor protection. For example, FINRA has rules that require its members to make certain disclosures to investors<sup>250</sup> and rules that require its members to report certain transactions to FINRA for dissemination.<sup>251</sup>

Clearing agencies are required to have rules that promote the prompt and accurate clearance and settlement of securities transactions and that assure the safeguarding of securities and funds. As a result, the SEC reviews the proposed rules of clearing agencies with respect to risk margin and collateral requirements to determine whether the clearing agency applies its collateral requirements equally to all participants and whether the clearing agency has sufficient requirements to protect the interests of the clearing agency and its participants in the event of a participant default. Additionally, a clearing agency is required to have written policies to require its participants to have sufficient financial resources and robust operational capacity to meet obligations and to hold and invest assets in a manner that minimizes risks.<sup>252</sup>

In addition, the SEC has adopted its own rule geared at ensuring that public orders are represented in the markets. Specifically, Rule 604 of Regulation NMS provides that exchange specialists and OTC market makers must display public customer limit orders that improve the bid or offer of the specialist or market maker.<sup>253</sup> In addition, specialists and market makers must include the size of public customer limit orders that are priced equal to the specialist's or market maker's bid or offer. This rule helps to ensure that public customer orders are able to compete in the market for quality executions.

<sup>248</sup> It is beneficial for orders in the same securities directed to an exchange to interact with each other as it promotes efficient trading and protects investors by assuring that orders executed pursuant to a single set of priority rules that are consistently and fairly applied. See, e.g., Exchange Act Release No. 53128 (January 13, 2006), 71 Fed. Reg. 3550 (January 23, 2006) (Order approving the application of the NASDAQ Stock Market LLC as a national securities exchange).

<sup>249</sup> See, e.g., NYSE Rule 92.

<sup>250</sup> See, e.g., FINRA Rule 2200 Series and FINRA Rule 2340.

<sup>251</sup> See e.g. FINRA Rule 6380A.

<sup>252</sup> See Principle 33 for a discussion of clearing agency obligations.

<sup>253</sup> 17 C.F.R. 242.604.

As noted above, the SEC carefully considers prospective exchange rules to evaluate whether they provide members with unfair trading advantages. Specifically, the SEC considers carefully the implications of any proposed rule that gives a member a trading advantage against the obligations the member has to the market. For example, exchange specialists and market makers are permitted to trade for their own account ahead of public orders, in certain instances, in order to fulfill their obligations to maintain a fair and orderly market.<sup>254</sup>

The Exchange Act contains several other specific provisions to protect investors that must be complied with by a prospective exchange. An exchange must demonstrate that its members are not permitted to trade for their own accounts, for the accounts of associated person, or for accounts with respect to which an associated person exercises investment discretion, unless such trading is consistent with the exemptions set forth in Section 11(a) of the Exchange Act and the rules thereunder. There are exceptions to these prohibitions, including an exception to allow trading by a dealer acting as a market maker.<sup>255</sup>

The federal securities laws also prohibit fraudulent or deceptive conduct and insider trading. Specifically, the prominent anti-fraud and anti-manipulation provisions are found in Sections 9(a) and 10(b) of the Exchange Act, and Rule 10b-5 thereunder. Section 17(a) of the Securities Act, and Sections 14(e) and 15(c) of the Exchange Act prohibit fraudulent conduct in specific contexts. Section 17(a) of the Securities Act bars fraudulent conduct in the “offer or sale” of securities. With regard to tender offers, Section 14(e) of the Exchange Act prohibits untrue statements of material fact or the misleading omission of material facts, or any fraudulent, deceptive, or manipulative acts or practices. Section 15(c) of the Exchange Act prohibits broker-dealers from effecting any transaction in securities by means of any manipulative, deceptive, or other fraudulent device or contrivance.<sup>256</sup> Under Sections 6(b)(5), 15A(b)(6), and 15B(b)(2)(C) of the Exchange Act, SROs must have rules that are designed, among other things to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and in general to protect investors and the public interest.<sup>257</sup>

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<sup>254</sup> See, e.g., Exchange Act Release No. 53539 (March 22, 2006), 71 Fed. Reg. 16353 (March 31, 2006) (Order approving NYSE Hybrid). See also Section 11(b) of the Exchange Act, 15 U.S.C. 78k(b), and Rule 11b-1 thereunder, 17 C.F.R. 240.11b-1.

<sup>255</sup> See Section 11(a)(1), 15 U.S.C. 78k(a)(1) and the rules thereunder.

<sup>256</sup> See discussion of SEC actions charging insider trading and market manipulation in Principle 12, response to Question 12.3.

<sup>257</sup> As noted in footnote 220, the SEC has brought a number of actions against SROs for violations of certain statutory and regulatory requirements. The SEC has also brought actions against national security exchanges for failure to comply with its own rules. See, for example, *In re The NASDAQ Stock Market, LLC and NASDAQ Execution Services, LLC*, (settled matter) Exchange Act Release No. 69655 (May 29, 2013) available at <http://www.sec.gov/litigation/admin/2013/34-69655.pdf>.

SRO rules generally require members and associated persons of members to arbitrate any eligible dispute upon a customer's request.<sup>258</sup> SROs' arbitration rules are designed to facilitate the resolution of disputes involving members, associated persons of members, and customers. The SEC reviews SRO arbitration rules pursuant to Section 19(b) of the Exchange Act. The SEC's review considers, among other things, whether such rules are consistent with the SRO's obligation to have rules that are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and in general to protect investors and the public interest.

### Best Execution

A broker-dealer has a legal duty to seek to obtain best execution of customer orders.<sup>259</sup> A broker-dealer's duty of best execution derives from common law agency principles and the fiduciary obligations that arise from the agency relationship, and is incorporated in SRO rules and, through judicial and SEC decisions, the anti-fraud provisions of the federal securities laws.<sup>260</sup> The duty of best execution requires broker-dealers to execute customers' trades, in accordance with the conditions of the order, at the most favorable terms available under the circumstances, *i.e.*, at the best reasonably available price.<sup>261</sup> The SEC has viewed the duty of best execution as consistent with the automated routing of orders or requiring automated routing on an order-by-order basis to the market with the best-quoted price at the time. The duty of best execution

<sup>258</sup> See, *e.g.*, FINRA Rule 12200.

<sup>259</sup> See, *e.g.*, *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 269-270 (3d Cir.), *cert. denied*, 525 U.S. 811 (1998) (Newton); *Certain Market Making Activities on NASDAQ*, Exchange Act Release No. 40900 (January 11, 1999)(settled case)(citing *Sinclair v. SEC*, 444 F.2d 399 (2d. Cir. 1971); *Arleen Hughes*, 27 SEC 629, 636 (1948), *aff'd sub nom. Hughes v. SEC*, 174 F.2d 969 (D.C. Cir 1949). See also Order Execution Obligations, Exchange Act Release No. 37619A (Sept. 6, 1996), 61 Fed. Reg. 48290 (Sept. 12, 1996) ("Order Handling Rules Release"). See Regulation NMS, Exchange Act Release No. 51808, 70 Fed. Reg. 37496 (June 29, 2005) (Regulation NMS Release).

<sup>260</sup> See Regulation NMS Release at n.338. See also Order Handling Rules Release, 61 Fed. Reg. at 48322. See also *Newton*, 135 F.3d at 270. Failure to satisfy the duty of best execution can constitute fraud because a broker-dealer, in agreeing to execute a customer's order, makes an implied representation that it will execute it in a manner that maximizes the customer's economic gain in the transaction. See *Newton*, 135 F.3d at 273 ("[T]he basis for the duty of best execution is the mutual understanding that the client is engaging in the trade—and retaining the services of the broker as his agent—solely for the purpose of maximizing his own economic benefit, and that the broker receives her compensation because she assists the client in reaching that goal."); *Marc N. Geman*, Exchange Act Release No. 43963 (Feb. 14, 2001) (citing *Newton*, but concluding that respondent fulfilled his duty of best execution). See also Exchange Act Release No. 34902 (Oct. 27, 1994), 59 Fed. Reg. 55006, 55009 (Nov. 2, 1994) ("Payment for Order Flow Final Rules"). If the broker-dealer intends not to act in a manner that maximizes the customer's benefit when he accepts the order and does not disclose this to the customer, the broker-dealer's implied representation is false. See *Newton*, 135 F.3d at 273-274.

<sup>261</sup> See Regulation NMS Release at n.341, citing *Newton*, 135 F.3d at 270. *Newton* also noted other certain factors relevant to best execution – order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market *Id.* at 270 n. 2 (citing Payment for Order Flow, Exchange Act Release No. 33026 (Oct. 6, 1993), 58 Fed. Reg. 52934, 52937-38 (Oct. 13, 1993) (Proposed Rules)). See *In re E.F. Hutton & Co.* ("Manning"), Exchange Act Release No. 25887 (July 6, 1988). See also Payment for Order Flow Final Rules, 59 Fed. Reg. at 55008-55009.

requires broker-dealers to periodically assess the quality of competing markets to assure that order flow is directed to the markets providing the most beneficial terms for their customer orders. Broker-dealers must examine their procedures for seeking to obtain best execution in light of market and technology changes and modify those practices if necessary to enable their customers to obtain the best reasonably available prices. In doing so, broker-dealers must take into account price improvement opportunities and whether different markets may be more suitable for different types of orders or particular securities.<sup>262</sup>

The duty of best execution is an important protection for investors in the U.S. This duty is generally codified in SRO rules. These rules are disclosed to the regulator and to market participants through the rule filing process under Section 19(b) of the Exchange Act, as described in the response to Question 9.2(d). OCIE conducts examinations of SROs and broker-dealers to evaluate compliance with the federal securities laws and SRO rules, including rules regarding best execution. For example, OCIE reviews order matching and execution systems to evaluate compliance with the applicable statutory standards as stated in Section 6 of the Exchange Act for national securities exchanges, and Section 15A for registered securities associations. OCIE also examines broker-dealers to assess their order matching systems, algorithmic trading platforms, or other order execution systems for compliance with best execution and other obligations.

Under Rule 605 of Regulation NMS, market centers that trade NMS stocks will be required to make available to the public monthly electronic reports that include uniform statistical measures of execution quality. Under Rule 606 of Regulation NMS, broker-dealers that route customer orders in equity and option securities will be required to make publicly available quarterly reports that, among other things, identify the venues to which customer orders are routed for execution. In addition, broker-dealers will be required to disclose to customers, on request, the venues to which their individual orders were routed.

By enhancing disclosure of order routing and execution practices, the disclosure rules are intended to promote fair and vigorous competition among broker-dealers and among market centers. The disclosures required by these rules will reveal if broker-dealers are routing a significant volume of orders to market centers that execute orders at prices substantially inferior to those available at other market centers trading the same security. This improved visibility, in turn, could shift order flow to those market centers that consistently generate the best prices for investors. Finally, by facilitating comparisons among securities traded in different market structures, the disclosures required by the rules may bring competitive forces more directly to bear on broader market structure issues, such as by prompting investors and issuers to choose markets with more efficient structures.

The SEC has adopted its own rules under Regulation NMS to support a broker-dealer's duty of best execution. Rule 611 under Regulation NMS requires a trading center to establish, maintain,

<sup>262</sup> See Regulation NMS Release at 37538.



and enforce policies and procedures that are reasonably designed to prevent executions of trades at prices worse than the best protected quotations, as defined,<sup>263</sup> across the markets. Rule 611 helps to ensure that investors' orders are not executed at inferior prices.

- (d) Submits to the regulator its rules and any amendments thereto, for review and/or approval, as the regulator deems appropriate, and ensures that the rules of the SRO are consistent with the public policy directives established by the regulator?

Yes. Pursuant to Section 19(b)(1) of the Exchange Act, an SRO must file any proposed change in, addition to, or deletion from the rules of the SRO<sup>264</sup> (proposed rule change). Once filed, the SEC must publish a notice of the filing in the *Federal Register*, which notice must include the SRO's description of the terms of substance of the proposed change, the purpose of the proposal, and the statutory basis for the proposal, and give the public an opportunity to submit comments on the proposed rule change. Thereafter, if the proposed rule change was filed pursuant to Section 19(b)(2) of the Exchange Act, within 45 days after the "publication date," the SEC must approve, disapprove, or institute proceedings to determine whether to approve or disapprove, subject to an extension of time from the SRO or on the SEC's own motion up to a maximum of 90 days from the publication date, provided the SEC determines that a longer period is appropriate and publishes the reasons for such determination. If the SEC fails to act by issuing a release that is dated on or before the applicable deadline, Section 19 of the Exchange Act specifies that the filing will be deemed to have been approved by the SEC.

As noted in Section 19(b)(1) of the Exchange Act, "[n]o proposed rule change shall take effect unless approved by the SEC or otherwise permitted in accordance with the provisions of this subsection." The SEC must approve a proposed rule change if it finds that the proposed rule change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to the exchange. If the SEC cannot make such a finding, it must disapprove the proposed rule change. In making this determination, the SEC also must consider whether the proposed rule change will promote efficiency, competition, and capital formation.<sup>265</sup>

There are certain proposed rule changes that may be filed under Section 19(b)(3)(A) of the Exchange Act and take effect upon filing (*i.e.*, without need for SEC approval).<sup>266</sup> The proposed rule changes that may take effect upon filing under this section of the Exchange Act include: (i) those that constitute a stated, policy, practice, or interpretation with respect to the enforcement of an existing rule of the exchange;<sup>267</sup> (ii) those that establish or change a due, fee, or other charge

<sup>263</sup> See Rule 600(a)(58), 17 C.F.R. 242.600(a)(58).

<sup>264</sup> 15 U.S.C. 78s(b)(1).

<sup>265</sup> See Section 3(f) of the Exchange Act, 15 U.S.C. 78c(f).

<sup>266</sup> The SEC has the authority to abrogate any proposed rule change submitted as effective upon filing. See Section 19(b)(3)(A) of the Exchange Act, 15 U.S.C. 78s(b)(3)(A) and further discussion below.

<sup>267</sup> See Rule 19b-4(b), 17 C.F.R. 240.19b-4(b), for a definition of "state policy, practice or interpretation."



imposed by the exchange; (iii) those that are concerned solely with the administration of the exchange, or other matters which the SEC, by rule, consistent with the public interest and the purposes of this subsection, may specify.<sup>268</sup>

Pursuant to its authority under Section 19(b)(3)(A) of the Exchange Act, the SEC adopted Rule 19b-4(f) to expand the types of proposed rule changes that may become effective upon filing. Specifically, an exchange may file a proposed rule change that is effective upon filing if the proposal effects a change to an existing order entry or trading system that: (i) does not significantly affect the protection of investors or the public interest; (ii) does not impose a significant burden on competition; and (iii) does not have the effect of limiting the access or availability of the system.<sup>269</sup> In addition, Rule 19b-4(f)(6) permits SROs to file certain “non-controversial” changes to their rules that may take effect upon filing so long as they: (i) do not significantly affect the protection of investors or the public interest; (ii) do not impose any significant burden on competition; and (iii) do not become operative for 30 days after the date of filing, and the SRO has given written notice of the proposal, including a brief description and rule text, at least five business days prior to filing.<sup>270</sup>

With respect to clearing agencies, the SEC adopted Rule 19b-4(f)(4), which permits a proposed rule change to become effective upon filing if it effects a change in an existing service of a registered clearing agency that: (i) does not adversely affect the safeguarding of securities or funds in the custody or control of the clearing agency or for which it is responsible; and (ii) does not significantly affect the respective rights or obligations of the clearing agency or persons using the service.<sup>271</sup> Although rule changes filed under Section 19(b)(3)(A) are immediately effective, the SEC is required to publish them for notice and comment. The SEC may summarily temporarily suspend such a rule within 60 days of the date of filing if necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act.<sup>272</sup> If the SEC takes such action, it must institute proceedings to determine whether the rule should be approved or disapproved.

Under Section 19(b)(3)(B) of the Exchange Act,<sup>273</sup> the SEC may put into effect summarily a proposed rule change, if it appears to the SEC that such action is necessary for the protection of investors, the maintenance of fair and orderly markets, or the safeguarding of securities or funds. Any proposed rule change summarily put into effect must be filed promptly thereafter in accordance with the provisions of Section 19(b)(1) of the Exchange Act.

<sup>268</sup> See Section 19(b)(3)(A) of the Exchange Act, 15 U.S.C. 78s(b)(3)(A).

<sup>269</sup> Rule 19b-4(f)(5), 17 C.F.R. 240.19b-4(f)(5).

<sup>270</sup> See Rule 19b-4(f)(6), 17 C.F.R. 240.19b-4(f)(6).

<sup>271</sup> See Rule 19b-4(f)(4), 17 C.F.R. 240.19b-4(f)(4).

<sup>272</sup> 15 U.S.C. 78s(b)(3)(C).

<sup>273</sup> 15 U.S.C. 78s(b)(3)(B).

(e) Cooperates with the regulator and other domestic SROs to investigate and enforce applicable laws, regulations and rules?

Yes. Currently, all U.S. exchanges and FINRA are members of the Intermarket Surveillance Group (ISG). The ISG is an industry organization created in 1983 to coordinate intermarket surveillance among the SROs by cooperatively sharing regulatory information pursuant to a written agreement between the parties.<sup>274</sup> The goal of the ISG's information sharing is to coordinate regulatory efforts to address potential intermarket trading abuses and manipulations. Although the ISG Agreement was not established under Section 11A or 17(d) of the Exchange Act, the SEC has required new SROs to become ISG members as a condition of operation.<sup>275</sup> As the members of the ISG are SROs, the SEC has direct oversight of the regulatory procedures that these SROs have developed, individually and jointly, including those developed for preventing insider trading and certain types of market manipulation.

Section 11A(a)(2) of the Exchange Act<sup>276</sup> directs the SEC, having due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets, to use its authority under the Exchange Act to facilitate the establishment of an NMS for securities in accordance with the Congressional findings and objectives set forth in Section 11A(a)(1) of the Exchange Act. Among those findings and objectives is the "linking of all markets for qualified securities through communication and data processing facilities."<sup>277</sup> In this regard, there are several NMS plans that the SEC has approved and oversees, which coordinate the application of the Exchange Act and SEC rules. An example includes the Plan for the Purpose of Creating and Operating an Intermarket Options Linkage, which coordinates the routing of orders among the equity and options markets, pursuant to Exchange Act and the rules thereunder. The Consolidated Tape Association Plan/Consolidated Quotation Plan and Options Price Reporting Authority Plan coordinate the reporting of quotes and transaction information in accordance with the requirements of the Exchange Act and rules thereunder. The options exchanges have also all agreed to the Options Regulatory Surveillance Authority Plan, whereby they share the administration, operation, and cost of a regulatory surveillance program for detecting the misuse of insider information and sharing their regulatory information.

In addition, certain SROs have elected to enter into agreements, pursuant to Exchange Act Section 17(d) and Rule 17d-2 thereunder, to coordinate among themselves the allocation of regulatory responsibility regarding the receipt of regulatory reports from their mutual members

<sup>274</sup> See Concept Release Concerning Self-Regulation, Exchange Act Release No. 50700 (November 18, 2004), 69 Fed. Reg. 71255, 71265 (December 8, 2004).

<sup>275</sup> See, e.g., Exchange Act Release No. 53128 (January 13, 2006), 71 Fed. Reg. 3550 (January 23, 2006) (NASDAQ Exchange Order).

<sup>276</sup> See [http://www.sec.gov/rules/final/34-42212.htm#P25\\_2894#P25\\_2894](http://www.sec.gov/rules/final/34-42212.htm#P25_2894#P25_2894).

<sup>277</sup> See Section 11A(a)(1)(D) of the Exchange Act, 15 U.S.C. 78k-1(a)(1)(D).

or participants, the examination of such persons for compliance, and the enforcement of compliance for such persons. All such agreements must be filed with the SEC and, after public notice and comment, may be declared effective by the SEC.

As previously noted, clearing agencies are not charged with disciplining their participants for violations of the Exchange Act and the rules and regulations thereunder. The Exchange Act requires, however, that a clearing agency have the capability to enforce its own rules with respect to its participants. For example, the NSCC rulebook permits the discipline of members through expulsion, suspension, restrictions on activities, fine, censure, or other fitting sanctions.

As also previously noted, the MSRB, unlike other SROs, does not enforce compliance with its rules. Compliance with MSRB rules is monitored and enforced by FINRA and/or the SEC (in the case of broker-dealers and municipal advisors), and the federal bank regulators and the SEC (in the case of banks). However, the MSRB coordinates with the SEC and other regulators and periodically brings potential enforcement actions to the attention of regulators.

3. Does the SRO:

(a) Have statutory delegation or other formal recognition from the Regulator?

By definition, national securities exchanges, registered securities associations (like FINRA), registered clearing agencies, or the MSRB are defined as SROs under the Exchange Act.<sup>278</sup> Such entities must apply for and be approved for registration by the SEC as set forth in the Exchange Act.

(b) Have MoUs or other arrangements in place in secure cooperation between it and the Regulator?

As discussed in more detail throughout, the Exchange Act sets forth a comprehensive regulatory framework for the SEC's oversight of SROs. Among other things, SROs are required under the Exchange Act to be registered with and have their rules reviewed and, with some limited exceptions, approved by the SEC. The SEC conducts vigorous and ongoing oversight of SROs through its registration requirements and examination authority to evaluate compliance with the federal securities laws and SRO rules. The SEC has authority under the Exchange Act to impose penalties on an SRO for violations of the Exchange Act or the SROs own rules and to cancel, suspend, or revoke an SRO's registration.

<sup>278</sup>

See Section 3(a)(26) of the Exchange Act, 15 U.S.C. 78c(a)(26).

(c) Have its own rules which are enforced and whose non-compliance is appropriately sanctioned?

Yes. As discussed in Question 9.1(c), the Exchange Act provides that an exchange or association or clearing agency must have appropriate disciplinary rules in place.

Once an exchange, association, or clearing agency has imposed a final disciplinary sanction against a member or person associated with a member, the exchange must promptly file notice with the SEC of its action.<sup>279</sup> A final disciplinary sanction imposed by an SRO is reviewable by the SEC.<sup>280</sup> The SEC may, by order, affirm or modify the sanction of the SRO, remand the matter to the SRO for further proceedings, or set aside the sanction.<sup>281</sup>

If the SEC, as the appropriate regulatory agency, finds that an exchange, association, or clearing agency<sup>282</sup> has failed, without reasonable justification or excuse, to enforce compliance with any such provision by a member or person associated with a member, it may impose sanctions against the exchange or association under Section 19(h) of the Exchange Act. Under this statute, the SEC has the authority to suspend for a period not to exceed 12 months, revoke registration, or censure or impose limitations upon the activities, functions, and operations of an SRO, if the SEC finds that the SRO has violated or is unable to comply with the provisions of the Exchange Act, the rules or regulations thereunder, or its own rules.<sup>283</sup>

As discussed in Question 9.1(c), if an SRO fails to take appropriate disciplinary action against a member, the SEC has its own authority to take action against such member.

***[IMF Additional Question: Details on the SRO's supervision of its members, including on-site and off-site examinations and enforcement activities over the past 3-5 years.]***

FINRA is the SRO primarily responsible for examinations of nearly all 4,400 SEC-registered broker-dealers. Therefore, the information below focuses on FINRA's examination processes, which are described briefly here and in more detail in response to Principle 12, Questions 1(a) and (b).

The Trading and Financial Compliance Examinations (TFCE) Group within FINRA conducts cycle,

<sup>279</sup> Section 19(d)(1) of the Exchange Act, 15 U.S.C. 78s(d)(1). The SEC adopted Rule 19d-1 to, among other things, prescribe the contents of the required notice to the Commission. 17 C.F.R. 240.19d-1.

<sup>280</sup> Section 19(d)(2) of the Exchange Act, 15 U.S.C. 78s(d)(2).

<sup>281</sup> Section 19(e) of the Exchange Act, 15 U.S.C. 78s(e).

<sup>282</sup> The DTC is registered with the SEC as a clearing agency but its appropriate regulatory agency is the Federal Reserve.

<sup>283</sup> Section 19(h) of the Exchange Act, 15 U.S.C. 78s(h). The decision to suspend, revoke or censure an SRO must be made by order and based on a finding by the SEC on the record after notice and hearing.

cause, and sweep examinations of broker-dealers in FINRA's capacity as an SRO/Designated Examining Authority (DEA) as well as on behalf of certain stock exchanges (exchange clients) pursuant to Regulatory Service Agreements (RSAs). Member Regulation Sales Practice, a separate group within FINRA, is responsible for examinations of business conduct for all firms and financial and operational areas for the firms not assigned to the Risk Oversight and Operational Regulation (ROOR) group in Member Regulation. The Sales Practice examination program is risk-based, meaning that the scope, content, frequency, and nature of a firm's examination will depend on characteristics inherent to the firm, including the risk, scale, and nature of operations and business lines. Examination frequency is determined by an assessment of each firm's size and risk. All firms are on a 1-, 2-, 3-, or 4-year examination cycle. ROOR conducts routine cycle examinations and cause examinations. The frequency of all ROOR cycle exams is based on the firm's risk and impact level.

See Question 12.1(a) for more detailed information on FINRA examinations and the FINRA groups discussed in this paragraph and Question 12.1(b) for information on FINRA thematic reviews/sweeps and examination statistics.

(d) Where applicable, *e.g.*, a mutual organization, assures a fair representation of members in selection of its board of directors and administration of its affairs?

Yes. Sections 6(b)(3), 15A(b)(4), and 17A(b)(3)(C) of the Exchange Act require that the rules of an exchange, association, or clearing agency must assure a fair representation of its members in the selection of its directors and the administration of the affairs of the exchange, association, or clearing agency. Sections 6(b)(3) and 15A(b)(4) also require that the rules of an exchange provide that one or more directors be representative of issuers and investors and not associated with a member of the exchange, broker or dealer.

To this end, the SEC has generally approved for SROs other than clearing agencies 20% member representation on SRO boards of directors and on SRO committees dealing with trading rules and member discipline, affairs which go directly to member interests. With respect to registered clearing agencies, the SEC evaluates the procedures of each clearing agency for meeting the fair representation requirement on a case-by-case basis. As a general matter, the boards of directors of clearing of agencies for which the SEC is the supervisory agency under Title VIII of the Dodd-Frank Act have a majority of clearing agency participants.

Section 15B(b)(2)(B) of the Exchange Act was amended by the Dodd-Frank Act to require that the number of public representatives on the MSRB at all times exceed the number of regulated representatives. The MSRB (with the approval of the SEC) effectuated the relevant governance provisions of the Dodd-Frank Act by increasing the Board from 15 members to 21 members, 11 of whom must be independent, public representatives and 10 of whom must be regulated representatives. Of the 11 public members, at least 1 must be representative of institutional or retail investors, at least 1 must be representative of municipal entities, and at least 1 must be a member of the public with knowledge of or experience in the municipal industry. Of the 10

regulated representatives, at least 1 must be associated with and representative of broker-dealers, at least 1 must be associated with and representative of bank dealers, and at least 1, and not less than 30% of the total number of regulated representatives, must be associated with and representative of municipal advisors.

(e) Avoid rules that may create anti-competitive situations as defined in the Explanatory Note?

Yes. Sections 6(b)(8), 15A(b)(9), 15B(b)(2)(C, and 17A(b)(3)(I) of the Exchange Act require that the rules of an exchange, association, MSRB, or clearing agency must not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. When reviewing an SRO's proposed rule, the SEC analyzes, among other things, the rule's burden on competition.

(f) Avoid using the oversight role to allow any market participant unfairly to gain an advantage in the market?

Yes. The SEC reviews proposed changes to the ownership and regulatory structure of an exchange or association to evaluate the exchange or association's ability to fulfill its statutory obligations, including competitive concerns. Consistent with the requirements of fair representation under Section 6 of the Exchange Act, equity ownership of an exchange or association has not been concentrated in a limited number of individuals or entities because of the potential conflict of interest that may arise for persons or entities that could be both the regulator and a participant in the same market. To this end, when entities or persons own an exchange or association, the SRO has adopted specific ownership/concentration limits for entities that will be both participants in that particular market and a shareholder-owner. The SEC has also approved exchange rules that separate the regulatory function from the business function and rules that relate to the listing of an exchange or association's shares on its own market. The SEC also has taken steps to ensure that it has effective tools to oversee an exchange that is controlled by an entity not fully subject to its jurisdiction. In this regard, the SEC has approved exchange rules that include commitments in corporate documents by holding companies that own exchanges relating to voting and ownership limits, maintenance of books and records, and consent to personal jurisdiction.

In addition, persons responsible for operating an SRO that is an exchange should not have a disciplinary history and, with respect to founders and/or prospective managers of an applicant, they should not be subject to a "statutory disqualification," as defined in Section 3(a)(39) of the Exchange Act.<sup>284</sup> In general, a person is subject to a statutory disqualification if he or she has been expelled or suspended from membership in an SRO, or is subject to an order by the SEC or other appropriate regulatory agency denying, suspending, or revoking his or her registration as a

<sup>284</sup>

15 U.S.C. 78c(a)(39).

broker or dealer. In addition, proposed directors, officers, or managers of a national securities exchange must not have willfully violated the federal securities laws or have been convicted of a felony or misdemeanor (or substantially equivalent foreign crime) involving misappropriation of funds, or securities fraud, larceny, robbery, extortion, or other related crimes within the past 10 years.<sup>285</sup>

With respect to clearing agencies, Section 17A of the Exchange Act helps to prevent the unfair advantage of any one clearing agency participant by requiring that the clearing agency be so organized and have the capacity to enforce its rules against participants and that the shareholders or participants of the clearing agency have fair representation in the selection of the clearing agency's directors and in the administration of its affairs. In addition, the rules of the clearing agency must provide for the appropriate discipline of participants who violate the clearing agency's rules. The rules of the clearing agency also must not discriminate among participants in the use of the clearing agencies.

#### *Oversight*

4. Does the regulator:

(a) Have in place an effective on-going oversight program of the SRO, which may include:

(i) inspection of the SRO;

Yes. The SEC has an examination and enforcement program to oversee the activities of the SROs, including exchanges, associations, and clearing agencies. As discussed in Principle 10, Section 17(b)(1) of the Exchange Act authorizes the Staff to examine the books and records maintained by the entities enumerated in Section 17(a) of the Exchange Act, including national securities exchanges, registered securities associations, and registered clearing agencies.

Section 19(g) of the Exchange Act provides the standards against which the SEC directly assesses the continuing compliance of an SRO with its self-regulatory obligations. Specifically, Section 19(g)(1) mandates that every SRO comply with and enforce compliance with the provisions of the Exchange Act and the rules and regulations thereunder and the SRO's own rules, "absent reasonable justification or excuse." The SEC assesses an SRO's continuing compliance with these obligations by several means, as described below.

OCIE administers the SEC's nationwide examination and inspection program. OCIE examiners in Washington, DC and in the SEC's 11 Regional Offices conduct examinations of SEC-regulated entities, including the SROs. The purpose of examinations is to detect fraud and other violations

<sup>285</sup> The SEC would apply the same standards to an applicant or applicants seeking approval to operate a registered securities association. In addition, an ATS that chooses to register as a broker-dealer (rather than an exchange), and to comply with Regulation ATS, is subject, as are all broker-dealers, to the SEC's statutory disqualification rules. See Sections 6(c)(2) and 15A(g)(2) of the Exchange Act, 17 U.S.C. 78f(c)(2) and 78o-3(g)(2).



of the securities laws, foster compliance with those laws, and help ensure that the SEC is continually made aware of developments and areas of potential risk in the securities industry. The examination program plays a critical role in encouraging compliance within the securities industry, which in turn also helps to protect investors and the securities markets generally.

Staff may select an entity for examination for any number of reasons including, but not limited to, a statutory mandate that requires the SEC to examine the entity on a particular cycle (see response to Question 12.1(a), below); the entity's risk profile; a review of a particular compliance risk area (see response to Question 12.1 (b), below); or a Tip, Complaint, or Referral (TCR) (see response to Question 12.1 (c), below).

Staff conducts inspections of the SROs to evaluate whether they and their members comply with applicable federal securities laws and SRO rules. During these inspections, OCIE may review, among other things, the SROs' examination and surveillance programs for member financial responsibility and operational compliance, regulatory programs for monitoring trading activity, disciplinary and enforcement programs, exchange listing programs, membership programs, and arbitration programs. With respect to FINRA in particular, Dodd-Frank Act Section 964 requires that, on a regular basis, the GAO submit a report to Congress on the SEC's oversight of FINRA with respect to 10 specified areas. The areas include, but are not limited to, governance (including management of conflicts of interest), examinations, arbitration services, and funding of FINRA's operations. See Question 12.1(b) for more details.

***[Additional IMF Question: Detailed information on the regulator's oversight program in all entities that qualify as SROs as per Principle 9, including both off-site reporting and on-site inspections. With regard to the latter, include information on the cycle of inspections and their scope of coverage.]***

As discussed in Principle 12, examinations are nonpublic. As such, we have provided only the following publicly available information about SRO examinations in response to the question. In 2013, OCIE completed an inspection of FINRA focusing on these 10 specified areas in order to assist in its risk-scoping efforts. For future-risk scoping purposes, OCIE has developed a process to evaluate risks and prioritize areas of focus in inspections of FINRA that include, but are not limited to, the areas identified in Section 964. In addition, OCIE has specific monitoring of FINRA that also assists in the risk-scoping of FINRA examinations conducted by OCIE's dedicated SRO examination office. Lastly, OCIE examiners are instructed to consider FINRA oversight as a factor in all broker-dealer examinations. Such oversight examinations are opened in situations where examiners identify significant deficiencies not identified by FINRA but which occurred during the period of a FINRA examination. Oversight examinations serve the dual purposes of evaluating the quality and effectiveness of an SRO's examination of its member firms as well as detecting violations or compliance risks at broker-dealers.

As discussed in response to Question 12.1(b), OCIE takes a targeted, risk-focused approach to the inspection of SROs, including exchanges that are SROs. Through recent assessment



examinations of each SRO, OCIE has established a baseline for comparing the effectiveness of compliance programs across the SROs. Among recent risk areas identified for examination of exchanges are: the internal controls and governance around their rule making processes; their supervision of RSAs; order types used by the options exchanges and the governance process surrounding them; systems outages, errors and integrity; and exchanges' business continuity planning. In addition, OCIE continues to closely monitor industry developments and specific events to further enhance risk assessments and focus, including coordination with the SROs and collaboration with TM and Enforcement on SRO-related matters.

In the past three fiscal years, OCIE has conducted a total of 140 examinations of SROs. Additional information about the scope of OCIE's examinations of SROs and related enforcement actions taken against those SROs can be found in the response to Questions 10.7(a) and 12.1(b).

(ii) periodic reviews;

Yes. The SEC has implemented an ARP Program, through which the staff conducts reviews of the information technology systems operated by the SROs to evaluate whether the systems have sufficient capacity and resiliency to accommodate conditions of increased volume and disruptions to normal operations. The ARP group, which was historically administered by TM, transitioned to OCIE in February 2014 and was renamed the TCP. TCP is staffed by information technology experts who regularly confer and meet with members of the SROs' information technology staff.

The SEC has issued two ARP statements that set forth the SEC's view that the SROs, on a voluntary basis, should establish comprehensive planning and assessment programs to determine their systems' capacity and vulnerability.<sup>286</sup> In ARP I, published in 1989, the SEC recommended that the SROs' programs should have three objectives: (i) each SRO should establish current and future capacity estimates; (ii) each SRO should conduct capacity stress tests periodically; and (iii) each SRO should obtain an annual assessment of whether the affected systems can perform adequately in light of estimated capacity levels and possible threats to the systems. In ARP II, published in 1991, the SEC set forth its views on: (i) the nature of the reviews that SROs are encouraged to obtain with respect to their automated trading and information dissemination systems; (ii) the contents of SROs' annual reports on major systems changes and a process for provision of notifications of material systems changes; and (iii) notifications of significant systems problems. TCP staff participates actively in industry-wide business continuity planning exercises, the most recent of which was conducted in the summer of 2013.

<sup>286</sup> See Exchange Act Release Nos. 27445 (November 16, 1989) (ARP I) and 29185 (May 9, 1991) (ARP II). The SEC has proposed a rule that, if adopted, would require certain entities, including SROs to comply with requirements with respect to their automated systems that support the performance of their activities. See Exchange Act Release No. 69007 (March 8, 2013).

TCP staff also handles reviews for compliance with the *Interagency White Paper* (April 2003), the SEC's *Policy Statement on Business Continuity Planning for Trading Markets* (September 2003), and other business continuity planning issues.

TCP conducts annual risk assessments and performs routine inspections of SROs to evaluate whether the ARP principles are being adequately addressed. Presently, an examination includes a comprehensive review of the following areas: (i) Business Continuity Planning; (ii) Software Development Methodology, Computer Operations, Application Review; (iii) Networking; and (iv) Information Security: Architecture Review, Web Server Security, Wireless Security, System Security, and Device Security. A general description of the methodology used by the TCP is as follows: First, security engineers review an SRO's security policy and procedures and conduct detailed architecture reviews to gain a thorough understanding of an SRO's business functions and the IT infrastructure that supports those functions. Second, the examiners conduct security testing to identify vulnerabilities in an SRO's systems and to verify whether the SRO is complying with its own policies and procedures. Finally, the examiners compare the test results with the SRO's policies and procedures and industry best practices in order to make findings and recommendations. This methodology enables the TCP to verify the confidentiality, integrity, and availability of SRO data and to ensure that there are fair and efficient markets. In addition to routine examinations, the TCP Staff may perform for-cause or special-focus inspections. The review of Section 31 fees processing and enforcement-related databases has also been incorporated into the ARP inspection process.<sup>287</sup>

(iii) reporting requirements;

Yes. A registered exchange or association is required to submit to the SEC updates and amendments to its initial registration application on an ongoing, periodic basis. For a national securities exchange, Rule 6a-2(a) requires the exchange to submit amendments to its Form 1 registration, including the nature and effective date of the action taken, any new information, and corrections to inaccurate information, within 10 days, for information contained in certain exhibits to the Form 1.<sup>288</sup> In addition, each year a national securities exchange must file amendments to certain other Form 1 exhibits relating to exchange financial information, ownership, membership, and listed securities.<sup>289</sup> Further, an exchange must file every three years

<sup>287</sup> See Section 31 of the Exchange Act, 15 U.S.C. 78ee, which requires SROs to pay transaction fees to the SEC based on the volume of securities that are sold on their markets.

<sup>288</sup> Specifically, Exhibits C (information relating to the operators of exchange trading systems), F (membership forms), G (forms that relate to members financial responsibilities), H (listing applications), J (lists of officers, directors and committee members), K (lists of certain shareholders and partners) and M (member lists) and the Execution Page must be updated within 10 days of the action taken that rendered the Form 1 exhibit outdated or inaccurate.

<sup>289</sup> Specifically, an exchange must submit amendments containing information for Exhibits D (unconsolidated financial statements for each subsidiary and affiliate) and I (audited financial statements for the exchange) as of the end of each fiscal year, and for Exhibits K (lists of certain shareholders and partners), M (member lists), and N (schedule of securities traded on the market) as of the period within three months of the date of the amendment.

completely updated information on the exchange's governing documents, managers, and facility operators.<sup>290</sup> In lieu of making annual or periodic filings, an exchange may make the required information available through several alternatives. For example, it could identify a publication that contains the required information and certify as to the accuracy of such information as of its publication date.<sup>291</sup> An exchange may also keep its information up-to-date and make it available to the SEC and the public upon request so long as the exchange certifies as to its availability and accuracy or keep the information available on a website that the exchange certifies is accurate.<sup>292</sup> Finally, an exchange is permitted to make its information available continuously on an Internet website controlled by the exchange, as long as it indicates the location of the website and certifies that the information is accurate as of its date.<sup>293</sup> Rule 6a-3 requires registered exchanges to submit to the SEC certain supplemental information, including notices, circulars, bulletins, lists, or periodicals that the exchange issues or makes generally available to members, participants or subscribers.

For a national securities association, Rule 15Aj-1 requires the association to submit updates to its Form X-15AA-1 registration promptly after the discovery of any inaccuracy in the registration statement (or any amendment or supplement thereto) and after any change that renders the information in the registration statement (or any amendment or supplement thereto) inaccurate. In addition, each year a national securities association must file an annual consolidated supplement on a Form X-15AJ-2.<sup>294</sup> Further, an association must file every three years a complete Exhibit A.<sup>295</sup> In lieu of submitting the annual or periodic filings, an association may identify a publication that contains the required information and certify as to the accuracy of such information as of its publication date.<sup>296</sup>

With respect to clearing agencies, Rule 17Ab2-1 requires that if certain information on the clearing agency's registration Form CA-1 becomes inaccurate, misleading, or incomplete for any reason, the clearing agency must promptly file an amendment to the Form CA-1. In addition, registered clearing agencies are required to provide quarterly to the SEC a record of financial resources used to withstand a default by a participant family and to provide annual audited financial statements to the public. Clearing agencies are also required to provide the SEC and participants with an annual report on internal controls that is prepared by an independent

<sup>290</sup> Specifically, updated Exhibits A, B, C, and J are required. Exhibit A includes the corporate documents and rules of the exchange. Exhibit B includes any written rulings, practices or interpretations of the exchange. Exhibit C includes information relating to the operators of exchange trading systems. Exhibit J includes the lists of officers, directors and standing committee members.

<sup>291</sup> Rule 6a-2(d)(1), 17 C.F.R. 240.6a-2(d)(1).

<sup>292</sup> Rule 6a-2(d)(2), 17 C.F.R. 240.6a-2(d)(2).

<sup>293</sup> Rule 6a-2(d)(3), 17 C.F.R. 240.6a-2(d)(3).

<sup>294</sup> Rule 15Aj-1(c)(1), 17 C.F.R. 240.15Aj-1(c)(1).

<sup>295</sup> Rule 15Aj-1(c)(1)(ii), 17 C.F.R. 240.15Aj-1(c)(1)(ii).

<sup>296</sup> Rule 15Aj-1(c)(1)(i) and (ii), 17 C.F.R. 240.15Aj-1(c)(i) and (ii).

accountant.

Exchanges and associations also have transaction reporting obligations related to the regulatory fees that the SEC is authorized recover from them under Section 31 of the Exchange Act. Pursuant to Exchange Act Rule 31, each covered SRO must submit to the SEC a monthly Form R1, which provides the aggregate transaction information for covered sales on that market. The clearing agency designated for each SRO must then calculate that SRO's owed regulatory fee, based on the amount and value of their transactions for that month, in accordance with a fee rate established by the SEC and adjusted from time to time. SROs must then pay semi-annually to the SEC the sum of their monthly fees for each year.

In addition to the ongoing supervision that occurs pursuant to the continuing review of the registration statements of registered exchanges, associations, and clearing agencies, the SEC supervises the registered exchanges, associations, and clearing agencies pursuant to the rule filing process, as described in the response to Question 9.2(d) above.

(iv) review and revocation of SRO governing instruments and rules; and

Yes. The SEC has authority to modify an SRO's governing instruments<sup>297</sup> and rules pursuant to Section 19(c) of the Exchange Act, with the exception of the governing instruments of registered clearing agencies.

Section 19(c) provides that the SEC "by rule, may abrogate, add to, and delete from [the] rules of an SRO (other than a registered clearing agency) [as] the SEC deems necessary or appropriate to insure the fair administration of the SRO, to conform its rules to the requirements of [the Exchange Act] and the rules and regulations thereunder applicable to such organization...." The rules of the SRO are filed with the SEC for review pursuant to the Section 19(b) rule filing process, as discussed in the response to Question 9.2(d) above.

As discussed in Question 9.1(c), Section 19(h) of the Exchange Act also generally provides the SEC, as the appropriate regulatory agency, with the authority to impose penalties on SROs and their members for certain violations of the federal securities laws and/or exchange rules.<sup>298</sup> Specifically, the SEC has the authority, as the appropriate regulatory agency to: (i) suspend or revoke the registration of an SRO; (ii) censure or impose limitations on its activities; and (iii) remove from office or censure officers or directors of an SRO for violations of the Exchange Act or the SRO's rules.

<sup>297</sup> The definition of "rules of exchange", "rules of an association", or "rules of a clearing agency" includes the constitution, articles of incorporation, bylaws, and rules, or instruments corresponding to the foregoing. See Section 3(a)(27) of the Exchange Act, 15 U.S.C. 78c.

<sup>298</sup> The term "appropriate regulatory agency" is defined in Section 3(a)(34) of the Exchange Act. See 17 U.S.C. 78c(a)(34). The appropriate regulatory agency for the DTC is the Federal Reserve and not the SEC.

Additionally, the SEC has the authority under Section 19(a)(3) of the Exchange Act to cancel, suspend, or revoke an SRO's registration. Section 19(a)(3) states that "[a] self-regulatory organization may, upon such terms and condition as the SEC, by rule, deems necessary or appropriate in the public interest or for the protection of investors, withdraw from registration by filing a written notice of withdrawal with the SEC. If the SEC finds that any SRO is no longer in existence or has ceased to do business in the capacity specified in its application for registration, the SEC, by order, shall cancel its registration."

- (v) the monitoring of continuing compliance with the conditions of authorization or delegation.

Yes. The substantive criteria for registration as an exchange under Section 6 of the Exchange Act, as an association under Section 15A of the Exchange Act, or as a clearing agency under Section 17A of the Exchange Act, are ongoing mandates; the SEC does not conduct a "one time only" evaluation of the exchange, association, or clearing agency's ability to meet these statutory standards. Section 19(g)(1) of the Exchange provides that "[e]very SRO shall comply with provisions [of the Exchange Act] the rules and regulations thereunder, and its own rules [absent] reasonable justification or excuse...." Each SRO's operations are subject to SEC inspection and oversight and the SRO's rules are subject to SEC oversight through the Section 19(b) rule filing process.

In addition, there are several other statutory provisions that provide the SEC with additional authority to act on an SRO's compliance or non-compliance with applicable regulatory standards. As discussed in Questions 9.1(c) and 9.4(a)(iv), the SEC also has the authority under Section 19(h) of the Exchange Act to suspend for a period not exceeding 12 months or revoke the registration of an SRO, or to censure or impose limitations upon the activities, functions, and operations of such SRO for failure to comply with the federal securities laws, including the rules of the SRO, if such action is "necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the [Exchange Act]."<sup>299</sup> Section 19(a)(3) of the Exchange Act provides the SEC with the authority to cancel the registration of an SRO if the SEC finds that the SRO has ceased to do business in the capacity specified in its application for registration. Section 21(a) of the Exchange Act also states that the SEC may undertake at its own initiative special investigations to determine whether any person is violating or about to violate an SRO rule.

<sup>299</sup> Note, however, that Section 19(g)(2) of the Exchange Act also generally provides that the SEC, by rule, may relieve any SRO of any responsibility under the Exchange Act to enforce compliance with any specified provision of the Exchange Act, or the rules thereunder, by member of an SRO, provided the rule adopted by the SEC is consistent with the public interest, the protection of investors, and the other purposes of the Exchange Act.

(b) Retain full authority to inquire into matters affecting the investors or the market?
<p>Yes. In addition to having direct authority under the federal securities laws,<sup>300</sup> the SEC also has the authority to suspend or expel any member or person associated with a member from an SRO for violations of the federal securities laws or rules.<sup>301</sup> Under Sections 21(d) and (e) of the Exchange Act, the SEC has the authority to enforce an SRO's rules. The SEC also has the authority to inspect both SROs and market participants to evaluate whether the various federal anti-fraud, anti-manipulation, and reporting regulations are being observed. To this end, the SEC can obtain surveillance and/or trading data from SROs.</p>
(c) Take over or support an SRO's responsibilities where the powers of an SRO are inadequate for inquiring into or addressing particular misconduct or allegations of misconduct or where a conflict of interest necessitates it?
<p>Yes. Under Sections 21(d) and (e) of the Exchange Act, the SEC has the authority to enforce an SRO's rules and to compel an SRO to enforce its rules with regard to its members by filing an action in federal court; relief available includes, among other things, monetary penalties, injunctive action, and any form of equitable relief. Section 21(f) of the Exchange Act allows the SEC to bring such actions when it appears that an SRO is unable or unwilling to take appropriate action against a person in the public interest and for the protection of investors or when such action is otherwise necessary or appropriate in the public interest for the protection of investors. The authority could be exercised in the event that an SRO fails to carry out its responsibilities with regard to addressing misconduct or in the event of a conflict of interest, or it can be exercised concomitantly with an SRO's own investigation and enforcement.</p>
<i>Professional Standards Similar to those Expected of a Regulator</i>
5. Does the regulator, the law or other applicable regulation require the SRO to follow similar professional standards of behaviour as would be expected of a regulator:
(a) On matters relating to confidentiality and procedural fairness?
<p>Yes. SROs generally have internal policies or rules regarding ethical conduct on the part of their staff, including the preservation of the confidentiality of material accessible by them and not publicly available, and proscribe the use thereof for personal benefit. In addition, SROs are required to comply with Section 10(b) of the Exchange Act and the rules thereunder, particularly Rules 10b-5 and 10b5-1, which prohibit any person that receives material, nonpublic information in a duty of trust or confidence from breaching that duty, causing the trading of securities on the basis on nonpublic information (insider trading).</p>

<sup>300</sup> See, e.g., Section 10(b) of the Exchange Act, 15 U.S.C. 78j, and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, and Section 17(a) of the Securities Act, 15 U.S.C. 77q(a).

<sup>301</sup> Section 19(h)(2) and (3) of the Exchange Act, 15 U.S.C. 78s(h)(2) and (3).

Regarding procedural fairness, Sections 6(b)(7), 15A(b)(8), and 17A(b)(3)(H) of the Exchange Act require that the rules of an exchange, association, and clearing agency, respectively, must provide for a fair procedure for disciplining members and persons associated with members, denying membership, and prohibiting or limiting access to services, and for exchange and associations barring persons from being associated with members. An exchange, association, or clearing agency must notify the member of the specific charges and give the member an opportunity to defend himself or herself against such charges, and keep a record of the proceeding. If the exchange, association, or clearing agency determines to impose a disciplinary sanction against the member, the sanction must be supported by a statement that sets forth: (i) the act or practice in which such member has been found to be engaged or to have omitted; (ii) the specific provision of the Exchange Act, rule or regulation or exchange rule that the act or omission is deemed to violate; and (iii) the sanction imposed and reasons therefore.

(b) On the appropriate use of information obtained in the course of the SRO's exercise of its powers and discharge of its responsibilities?

Yes. SROs must act in manner consistent with the Exchange Act. Furthermore, as noted in the response to Question 9.5(a) above, SROs entrusted with material, nonpublic information have a duty of trust and confidence and, therefore, are liable for any breaches of that duty and the results thereof, under Section 10(b) of the Exchange Act and the rules thereunder, particularly Rules 10b-5, 10b5-1, and 10b5-2. Finally, as noted in response to Question 8.7(d), SROs have implemented other measures to assure that information obtained during the course of carrying out SRO regulatory functions is not misused.

### *Conflicts of Interest*

6. Does the regulator, the law or other applicable regulation assure that potential conflicts of interest at the SRO are avoided or appropriately managed?

Inherent in a self-regulatory model is concern about conflicts of interest, including conflicts an SRO may have between regulating its members and operating its business. The SEC reviews SRO proposals and examines SRO operations to evaluate any potential harmful impact conflicts of interest may have on the effective oversight of the securities markets.<sup>302</sup> In particular, the SEC's review of proposed changes to an SRO's ownership and regulatory structure, pursuant to the 19(b) process described in the response to Question 9.3 (f) above, is aimed at addressing conflicts of interest at the SRO.

<sup>302</sup> See, e.g., *Exchange Act* Release No. 56145 (July 26, 2007), 72 C.F.R. 42169 (Aug. 1, 2009) (order approving the consolidation of member firm regulatory functions of FINRA and NYSE Regulation).



**Principle 10 The Regulator should have comprehensive inspection, investigation and surveillance powers.**
**Key Questions**

1. Does the regulator have the power to inspect a regulated entity's business operations, including its books and records:
  - (a) Without giving prior notice?

Yes. The SEC has the power to inspect a regulated entity's business operations, including its books and records, without giving prior notice. Specifically, as described below, the SEC and its representatives have statutory authority to conduct, at any time, examinations (also referred to as inspections) of all regulated entities registered with the SEC (Registrants). The SEC's examination authority is derived from the Exchange Act, the Advisers Act and the Investment Company Act, none of which require the Staff to provide prior notice to Registrants before exercising its examination authority. See also the response to Principle 22, which addresses the SEC's authority with respect to registered CRAs.

**Statutory Authority**

Section 17(b)(1) of the Exchange Act authorizes the Staff to examine the books and records maintained by the entities enumerated in Section 17(a) of the Exchange Act. Such entities include: registered brokers or dealers; national securities exchanges; registered securities associations; registered clearing agencies; registered transfer agents; NRSROs (*i.e.*, registered CRAs, which, as set forth above, are addressed in Principle 22); registered municipal securities dealers; municipal securities advisors; registered SIPs; and the MSRB.

Similarly, Section 204(a) of the Advisers Act authorizes Staff to examine the books and records maintained by investment advisers, and Sections 31(a) and 31(b) of the Investment Company Act, together, authorize Staff to examine the books and records of the following entities: registered investment companies; underwriters, brokers, dealers, and investment advisers that are majority-owned subsidiaries of an investment company; and investment advisers (that are not majority-owned subsidiaries of a registered investment company), depositors, and the principal underwriters of investment companies other than closed-end companies, in regard to their transactions with investment companies. The types of books and records required to be maintained by the various regulated entities listed are described in response to Question 10.4.

In addition, Title VII of the Dodd-Frank Act amended the Exchange Act to authorize the Staff to examine the books and records of certain new entities including SBS data repositories,<sup>303</sup> SBSD,<sup>304</sup>

<sup>303</sup> Section 13(n) of the Exchange Act.

<sup>304</sup> Section 15F(f)(1)(C) of the Exchange Act.



and MSBSP.<sup>305</sup> Title VII also subjects SB SEFs to similar requirements, requiring SB SEFs to establish and enforce rules to obtain any necessary information to perform their responsibilities and to provide the information to the Commission on request.<sup>306</sup> Furthermore, pursuant to Title VII of the Dodd-Frank Act and other applicable law, the Commission has proposed rules which, if adopted, would provide Staff with the ability to examine the books and records of SB SEFs and their participants.<sup>307</sup>

As set forth above, the Staff may exercise its authority to conduct examinations at any time, and the statutory grants of authority contained in Section 204 of the Advisers Act and Section 17 of the Exchange Act require only that examinations be reasonable.<sup>308</sup>

### **The SEC's Examination and Inspection Program**

The SEC has a nationwide examination and inspection program, administered by OCIE. Staff in Washington, D.C. and in the SEC's 11 Regional Offices conducts examinations of the nation's registered entities. The mission of the examination program is to protect investors, ensure market integrity, and support responsible capital formation through risk-focused strategies that: (i) improve compliance; (ii) prevent fraud; (iii) monitor risk; and (iv) inform policy. The examination program plays a critical role in encouraging compliance within the securities industry, which in turn helps protect investors and the securities markets generally.

During examinations and inspections, Staff reviews the books and records of regulated entities, interviews management and firm employees, and analyzes the entity's operations. In most cases, examinations include an onsite visit to the Registrant's offices. However, Staff also conducts examinations that do not include onsite visits. In certain circumstances, the Staff may not provide notice to a Registrant in advance of an onsite visit and arrive unannounced. In addition, even when a Registrant is contacted in advance of an examination, notice of the areas on which the Staff intends to focus may not be provided in order to ensure that books, records, and activities are not altered or destroyed in order to prevent the Staff from detecting problems.

(b) On-site?

Yes, as noted in response to Question 10.1(a), the SEC has the authority to examine regulated entities at any time as long as such examination is reasonable. As noted in the response above, this includes onsite visits.

<sup>305</sup> Section 15F(f)(1)(C) of the Exchange Act.

<sup>306</sup> Section 3D(d)(5).

<sup>307</sup> See Exchange Act Release No. 63825 (76 Fed. Reg. 10948, 10959-60 and 10978-79 (Feb. 28, 2011)).

<sup>308</sup> See, e.g., *Recordkeeping and Record Production Obligations of National Securities Exchanges and Registered Securities Ass'ns*, Exchange Act Release No. 16728 (Oct. 12, 1979), 18 SEC Docket 670, 671 ("[Section 17] statutory authorization is unconditional except for the requirement that any such record examination be 'reasonable.'").

2. Does the regulator have the power to obtain books and records and request data or information from regulated entities without judicial action, even in the absence of suspected misconduct:

(a) In response to a particular inquiry?

Yes, the SEC has the power to obtain books and records and request data or information from regulated entities without judicial action, even in the absence of suspected misconduct. In general, neither judicial action nor the presence of suspected misconduct is required for Staff to obtain books and records from entities registered with the SEC. This is true regardless of whether the records are being sought by examination staff in response to a particular inquiry, such as an examination based on a complaint, or as part of a periodic or risk-based examination. Registrants must make available the books and records requested by Staff pursuant to the SEC's examination and inspection authority.

In addition, see the response to Principle 12.1 for information about the types of examinations conducted by the examination program including a description of its risk-based process and recent focus areas.

#### **Failure to Produce Books and Records in Response to Examinations and Inspections**

If a Registrant fails to produce books and records in response to an SEC examination request, the SEC may take further action against the Registrant. With respect to a particular inquiry, the SEC may, without judicial action, issue orders pursuant to Section 21(a)(1) of the Exchange Act to require and promptly obtain written statements under oath from any person as to "all the facts and circumstances" of a matter. In addition, Section 21(b) of the Exchange Act provides authority for any member of the SEC or any officer designated by it, typically Enforcement staff, to direct subpoenas to any person to obtain testimony and documents, even in the absence of suspected misconduct by the recipient or anyone else. The SEC may obtain information under Section 21(b) to assess whether that behavior is consistent with the law and the public interest.

Certain provisions under the Securities Act, Advisers Act, and Investment Company Act parallel the authority to compel the production of testimony and documents provided under Section 21(b). See Section 19(c) of the Securities Act, Section 209(b) of the Advisers Act, and Section 42(b) of the Investment Company Act. Thus, in addition to being able to obtain testimony and documents from any person, the SEC has broad authority to review any and all conduct covered by these titles.

(b) On a routine basis?

Yes, as noted in response to Question 10.2(a), pursuant to the SEC's examination and inspection authority, such as Section 17(b)(1) of the Exchange Act, Registrants are required to make available and promptly produce the books and records requested by Staff. This requirement to make available and promptly produce books and records is unconditional (as discussed in

response to Question 10.1(a)).<sup>309</sup>

Moreover, the SEC may take action to enforce compliance with the statutory requirement for prompt production.<sup>310</sup>

3. Does the regulator have the power to conduct or supervise surveillance of trading activity on its authorized exchanges and regulated trading platforms?

Yes, the SEC has the power to supervise authorized exchanges and regulated trading systems pursuant to its authority to conduct SRO inspections and broker-dealer examinations. Subject to the SEC's oversight, SROs have the frontline responsibility for overseeing daily trading activities and regulatory compliance on the exchanges.

SROs have legislatively mandated market surveillance responsibilities and have primary surveillance authority over their marketplaces. Under Section 19(g)(1) of the Exchange Act, SROs are obligated to comply with the Exchange Act and the rules and regulations thereunder, as well as the SRO's own rules. SROs are also required under Section 19(g)(1) to enforce compliance with the securities laws by member firms and persons associated with those members. The SEC interprets Section 19(g)(1) to obligate the exchanges, as SROs, to "be vigilant in surveilling for, evaluating, and effectively addressing issues that could involve violations" of the securities laws, including trading violations.<sup>311</sup>

The SEC coordinates with the SROs through the Market Surveillance Group (MS) in Enforcement's Office of Market Intelligence (OMI) to detect any anomalous market activity, including suspect trading by particular persons and/or entities. MS has oversight over all domestic equity and securities options markets. Data collected by SROs and MS facilitates timely investigation of potential violations of the securities laws and, as warranted, subsequent enforcement actions.

In addition, OCIE reviews the surveillance activity conducted by SROs, including SRO surveillance of trading that occurs on the exchanges. Staff may also request and obtain copies of SRO surveillance reports as necessary to assess an exchange's market activity on a specified date or in a particular security. The various automated surveillance programs used by SROs are discussed in more detail in response to Question 12.2.

<sup>309</sup> See footnote 308.

<sup>310</sup> See *In re Wells Fargo Advisors, LLC*, Exchange Act Release No. 73175 (Sept. 22, 2014) (In settlement, the firm admitted, among other facts, that it unreasonably delayed the production of certain documents and produced an altered document to the Staff. Among other relief, the firm consented to cease and desist from committing or causing certain violations as charged and to pay a civil money penalty in the amount of \$5,000,000.).

<sup>311</sup> *In re National Ass'n of Securities Dealers, Inc.*, Exchange Act Rel. No. 37538, at 3 (Aug. 8, 1996); *In re American Stock Exchange, LLC*, Exchange Act Rel. No. 55507 (Mar. 22, 2007).

OCIE further reviews trading systems through examinations of broker-dealers that operate as an ATS or as an Electronic Communications Network (ECN). ATS and ECN systems, while not regulated as exchanges, are venues for matching the buy and sell orders of their subscribers. OCIE's examinations of broker-dealers, including those operating as an ATS or ECN, are discussed in more detail the response to Principle 12.1. Additionally, as discussed in the response to Question 9.4(a)(ii), OCIE's TCP group conducts reviews of the information technology systems operated by the exchanges, clearing agencies, and certain high-volume ATSs to ensure that the systems have sufficient capacity and resiliency to accommodate conditions of increased volume and disruptions to normal operations.

4. Does the regulatory system have record-keeping and record retention requirements for regulated entities?

Yes, the statutory recordkeeping and record retention requirements applicable to entities regulated by the SEC are contained in three separate statutes: the Exchange Act, the Investment Company Act and the Advisers Act. These provisions and their implementing rules and regulations are described below.

Exchange Act Rule 17a-1 requires national securities exchanges, national securities associations, registered clearing agencies, and the MSRB to maintain copies of all documents, including all correspondence, memoranda, papers, books, notices, accounts, and other such records they make or receive in the course of their business and self-regulatory activity. They also require brokers and dealers to make and keep extensive records relating to their businesses. Exchange Act Rule 17a-3 sets forth the basic recordkeeping requirements applicable to brokers and dealers. Examples of records required to be made and kept current under Exchange Act Rule 17a-3 include trade blotters itemizing trades, receipts, or deliveries of securities, as well as disbursements of cash and other debits and credits; a stock record of positions held in various securities; trial balances; a record of the firm's computation of net capital and aggregate indebtedness; trade confirmations; complaints regarding associated persons; and compliance records. Exchange Act Rule 17a-4 governs the retention periods for these records, which vary by record type, as well as for other records, such as information supporting a firm's financial reports and communications sent or received by the firm which relate to the firm's business.

Investment companies are required under Section 31(a) of the Investment Company Act to maintain records as the SEC prescribes by rules and regulations, as necessary or appropriate in the public interest or for the protection of investors. The SEC has implemented Section 31(a) by adopting Investment Company Act Rules 31a-1 and 31a-2. Some examples of records that investment companies must maintain and keep current under Investment Company Act Rule 31a-1 include: records of purchases or sales of securities (including redemptions); records of portfolio securities positions and securities positions carried by the investment company for its own account; corporate organizational documents of the investment company; records of brokerage orders; and investment advisory material received from the investment company's investment adviser. The required retention periods for records that investment companies are

required to keep vary depending on record type, as set forth by Investment Company Act Rule 31a-2. For additional discussion of recordkeeping and record retention requirements that are applicable to investment companies, see responses to Questions 11.3(b), 24.11 and 24.12(b).

Investment Advisers are required under Section 204(a) of the Advisers Act to make and keep certain records as prescribed by the SEC, as necessary or appropriate in the public interest or for the protection of investors. The SEC has implemented Section 204(a) by adopting Advisers Act Rule 204-2, which requires registered investment advisers to maintain certain books and records that relate to the adviser's advisory business and sets forth the applicable retention periods for such records. In general, records required to be made under Advisers Act Rule 204-2 must be maintained and preserved in an easily accessible place for at least five years (the first two years in an appropriate office of the investment adviser). In addition, the SEC is in the process of proposing rules which, if adopted, would require certain SBS entities to make and keep certain books and records, among other things, as part of the SEC's establishment of recordkeeping, reporting and notification requirements for such entities, pursuant to Title VII of the Dodd-Frank Act and other applicable federal securities laws.<sup>312</sup> For additional discussion of recordkeeping and record retention requirements that are applicable to investment advisers, see responses to Question 31.13

### **Pursuing Violations of the SEC's Books and Records Rules**

The SEC has authority to pursue violations of the recordkeeping and record retention requirements through enforcement actions. When the SEC brings an enforcement action for such violations, it can seek, among other relief, injunctive, remedial, and other sanctions, including penalties to deter future violations of these requirements. For example, in 2014, the SEC sanctioned a broker-dealer for failing to furnish promptly to the SEC "legible, true, complete, and current copies" of records that it was required to preserve and other records subject to examination under the federal securities laws requested by the SEC. Among other sanctions, the SEC imposed a civil money penalty of \$2.5 million against the broker-dealer. In settling the matter, the broker-dealer admitted the conduct for which it was found liable.<sup>313</sup>

In another example, in 2013, the SEC sanctioned a broker-dealer for violating the federal securities laws in connection with its structuring and marketing of certain CDOs. In this settled matter, among key findings, the SEC found that the broker-dealer violated books and records requirements by improperly delaying the recording of certain trades. As a result of its disclosure and books and records violations, the broker-dealer was ordered to cease and desist from

<sup>312</sup> See Exchange Act Release No. 71958 (Apr. 17, 2014), 79 Fed. Reg. 25194 (May 2, 2014). See also Exchange Act Release No. 63825 (Feb. 2, 2011), 76 Fed. Reg. 10948 (Feb. 28, 2011).

<sup>313</sup> *In the Matter of Scottrade, Inc.*, Exchange Act Release No. 71435, Jan. 29, 2014 available at [www.sec.gov/litigation/admin/2014/34-71435.pdf](http://www.sec.gov/litigation/admin/2014/34-71435.pdf).

committing or causing the violations charged in the SEC order, censured, and ordered to pay disgorgement, prejudgment interest, and civil penalties totaling \$131,800,027.<sup>314</sup>

In November 2008, in an action brought solely based on violations of books and records requirements, the SEC successfully obtained civil monetary penalties of \$100,000 against a broker-dealer and \$30,000 against its CCO for aiding and abetting the violations, among other sanctions.<sup>315</sup>

5. Are regulated entities required:

(a) To maintain records concerning client identity?

Yes. Registrants are required to maintain certain records concerning client identity pursuant to certain regulations promulgated under the Exchange Act, the Advisers Act, the Bank Secrecy Act of 1970 (BSA),<sup>316</sup> and the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (PATRIOT Act).<sup>317</sup>

Exchange Act Rule 17a-3 requires brokers and dealers to make and keep current account records, including the customer's or owner's name, tax identification number, address, telephone number, date of birth, employment status, annual income, net worth, and the account's investment objectives.

Similarly, Advisers Act Rule 204-2 requires investment advisers to make and keep current records that have the effect of maintaining clients' identities, including a list of all accounts over which the adviser has discretionary authority, and copies of all written agreements entered into with clients.

In addition, the BSA, initially adopted in 1970, established the basic framework for AML obligations imposed on financial institutions. Among other things, it authorizes the Secretary of the Treasury to issue regulations requiring financial institutions to keep records and file reports on financial transactions that may be useful in conducting investigations and prosecuting money laundering and other financial crimes. Section 326 of the PATRIOT Act amended the BSA to require financial institutions to establish written customer identification programs (CIPs).

Under 31 C.F.R. § 1023.220, registered broker-dealers must establish, document and maintain a CIP appropriate for the broker-dealer's size and business that includes, among other things:

<sup>314</sup> *In the Matter of Merrill Lynch, Pierce, Fenner & Smith Incorporated*, Exchange Act Release No. 71051, Dec. 12, 2013, available at [www.sec.gov/litigation/admin/2013/33-9493.pdf](http://www.sec.gov/litigation/admin/2013/33-9493.pdf).

<sup>315</sup> *In the Matter of v. Finance Investments, Inc., et al.*, 2008 SEC LEXIS 3159, available at [www.sec.gov/litigation/aljdec/2008/id360rgm.pdf](http://www.sec.gov/litigation/aljdec/2008/id360rgm.pdf).

<sup>316</sup> 12 U.S.C. §§1829b and 1951-59, and 31 U.S.C. §§ 5311-5330; see also 31 C.F.R. §103

<sup>317</sup> Pub. L. 107-56 (2001).

- risk-based procedures for verifying the identity of each customer to the extent reasonable and practicable;
- procedures for opening an account that specify identifying information that will be obtained from each customer, including the customer's name, date of birth (for an individual), address, and identification number (*e.g.*, a tax identification number);
- based on the broker-dealer's risk assessment of a new account opened by a customer that is not an individual, procedures for obtaining information about individuals with authority or control over such account in order to verify the customer's identity;
- procedures for responding to circumstances in which the broker-dealer cannot form a reasonable belief that it knows the true identity of a customer;
- procedures for making and maintaining a record of all information obtained pursuant to prescribed CIP procedures;
- procedures for determining whether a customer appears on any list of known or suspected terrorists or terrorist organizations issued by any federal government agency; and
- procedures for providing customers with adequate notice that the broker-dealer is requesting information to verify their identities.

The Treasury has determined that mutual funds should be considered "financial institutions" for certain purposes and thus specific BSA rules apply to mutual funds.<sup>318</sup> The implementing CIP Rules under the PATRIOT Act are located in Chapter X of Title 31 of the Code of Federal Regulations. Under 31 C.F.R. § 1024.220, a mutual fund (which is defined under 31 C.F.R. § 1010.100(gg) as an investment company that is an "open-end company" under Section 5 of the Investment Company Act that is registered or is required to register with the SEC under Section 8 of the Investment Company Act) is also required to implement a CIP appropriate for the fund's size and type of business that includes, among other things:

- risk-based procedures for verifying the identity of each customer to the extent reasonable and practicable;
- procedures for opening an account that specify identifying information that will be obtained from each customer, including the customer's name, date of birth (for an individual), address, and identification number (*e.g.*, a tax identification number);

<sup>318</sup>

See 31 C.F.R. § 1010.100(t)(10).

- based on the mutual fund's risk assessment of a new account opened by a customer that is not an individual, procedures for obtaining information about individuals with authority or control over such account, including persons authorized to effect transactions in the shareholder of record's account, in order to verify the customer's identity;
- procedures for responding to circumstances in which the mutual fund cannot form a reasonable belief that it knows the true identity of a customer;
- procedures for making and maintaining a record of all information obtained pursuant to certain rules relating to the CIP;
- procedures for determining whether a customer appears on any list of known or suspected terrorists or terrorist organizations issued by any federal government agency; and
- procedures for providing customers with adequate notice that the mutual fund is requesting information to verify their identities.

Moreover, pursuant to Section 17(a) of the Exchange Act and Rule 17a-8 thereunder, the SEC has the authority to bring enforcement actions to address violations of certain reporting, recordkeeping, and record retention requirements applicable to broker-dealers promulgated under the BSA, including those that relate to a broker-dealer's CIP.

In 2010, for example, in an action that focused solely on violations of the CIP rule, the SEC sanctioned a broker-dealer and its president, who was also its CCO, finding that the firm had failed to verify the identities of many of its corporate account holders in contravention of the firm's written customer identification procedures. In this settled matter, the SEC ordered both parties to cease-and-desist from committing or causing the violations charged, censured the firm, and ordered the firm to pay a civil money penalty of \$25,000.<sup>319</sup>

In another example, in 2008, the SEC filed an action against one of the world's largest online broker-dealers and its affiliated clearing firm for failure to comply with the BSA's CIP requirements and the broker-dealer's own documented CIP. In this settled matter, the SEC imposed a censure and cease-and-desist order, ordered payment of civil money penalties

<sup>319</sup> *In the Matter of Pinnacle Capital markets LLC and Michael A. Paciorek*, Exchange Act Release No. 62811, Sep. 1, 2010, available at [www.sec.gov/litigation/admin/2010/34-62811.pdf](http://www.sec.gov/litigation/admin/2010/34-62811.pdf).



totaling \$1 million, and required the firm to engage an independent compliance consultant to review and test the CIP in order to ensure compliance with applicable regulatory requirements.<sup>320</sup>

(b) To maintain records that permit tracing of funds and securities in and out of brokerage and bank accounts related to securities transactions?

Yes, as discussed in the response to Question 10.4, under Exchange Act Rule 17a-3, brokers and dealers are required to keep and maintain records showing cash positions and securities purchased, sold, received, or transferred to or from customer accounts. Additionally, several BSA rules under Chapter X of Title 31 of the Code of Federal Regulations require broker-dealers, mutual funds, and investment advisers to obtain and keep certain records relating to the transfer of funds to or from the entity. Certain key provisions of those requirements are discussed below.

First, the "Joint Rule," 31 C.F.R. § 1010.410(e), requires broker-dealers and mutual funds to obtain and keep certain information concerning the transmitter and the recipient of a transfer or transmittal of funds totaling \$3,000 or more when the broker-dealer or mutual fund is acting as the transmitter's financial institution, an intermediary financial institution or the recipient's financial institution. 31 C.F.R. § 1010.410(e)(6) provides for exemptions from the Joint Rule for certain transactions, including an exemption for transmittals of funds where both the transmitter and the recipient are any of the following: a broker-dealer, bank, domestic subsidiary of a bank chartered in the U.S., domestic subsidiary of a broker-dealer, a mutual fund, a federal agency or instrumentality, or the U.S. or a state or local government.

Second, the "Travel Rule," 31 C.F.R. § 1010.410(f), requires broker-dealers and mutual funds to ensure that certain information "travels with" the transmittal order for all transfers of \$3,000 or more. 31 C.F.R. § 1010.410(f)(4) provides for exemptions from the Travel Rule for certain transactions, including an exemption for transmittals of funds where both the transmitter and the recipient are any of the following: a broker-dealer, bank, domestic subsidiary of a bank chartered in the U.S., domestic subsidiary of a broker-dealer, a mutual fund, a federal agency or instrumentality, or the U.S. or a state or local government.

Under 31 C.F.R §§ 1010.306, 310-315, broker-dealers and mutual funds are generally required to file a report of (and maintain a record of) each deposit, withdrawal, exchange of currency or other payment or transfer, by, through, or to the broker-dealer or mutual fund which involves a transaction in currency of more than \$10,000. There are several limitations and exceptions from this requirement, including an exception with respect to a transaction in currency between a broker-dealer or a mutual fund and a commercial bank.

Broker-dealers and mutual funds are also required under 31 C.F.R. §§ 1010.410(b) and

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*In the Matter of E\*Trade Clearing LLC and E\*Trade Securities LLC*, Exchange Act Release No.58250, July 30, 2008, available at [www.sec.gov/litigation/admin/2008/34-58250.pdf](http://www.sec.gov/litigation/admin/2008/34-58250.pdf).

1010.410(c) to retain a record of each advice, request, or instruction received or given regarding any transaction resulting in, or intended to result in, the transfer of currency or other monetary instruments, funds, checks, investment securities, or credit of more than \$10,000 to or from any person, account, or place outside of the U.S.

Under 31 C.F.R. § 1023.410(b)(3), broker-dealers are required to retain a record of any remittance or transfer of funds, or of currency, checks, other monetary instruments, investment securities, or credit, of more than \$10,000 to a person, account, or place, outside the U.S.

Under 31 C.F.R. § 1010.340, broker-dealers, mutual funds, and investment advisers are generally required to report and keep records regarding transactions where the firm is either importing or exporting currency or monetary instruments in an amount exceeding \$10,000. Specifically, each person (including a broker-dealer, mutual fund, or an investment adviser) who physically transports, mails, or ships currency or monetary instruments in excess of \$10,000 at one time out of or into the U.S. (and each person who causes such transportation, mailing, or shipment), must file a Report of International Transportation of Currency or Monetary Instruments.

Under 31 C.F.R. § 330, investment advisers are required to report on Form 8300 and keep records where, in the course of their business, they receive currency in excess of \$10,000 in one transaction (or two or more related transactions).

Finally, 31 C.F.R. § 1023.410(b)(4) requires broker-dealers to retain a record of any receipt of currency, other monetary instruments, checks, or investment securities and of each transfer of funds or credit of more than \$10,000 received on any one occasion directly and not through a domestic financial institution, from any person, account, or place outside the U.S.

6. Does the regulator have the authority to determine or have access to the identity of all clients of regulated entities?

Yes, the SEC has the authority to determine or access the identity of all customers of Registrants pursuant to SEC rules requiring registered entities to maintain specified books and records and the SEC's statutory authority to examine such books and records.

Specifically, Section 17(a) of the Exchange Act requires that certain Registrants, including brokers and dealers, make and preserve such records as the SEC, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the securities laws.<sup>321</sup>

<sup>321</sup> For more information about this authority, see also *Recordkeeping and Record Production Obligations of National Securities Exchanges and Registered Securities Ass'ns*, Exchange Act Release No. 16728 (Oct. 12, 1979), 44 Fed. Reg. 60281 (Oct. 19, 1979).

Exchange Act Rule 17a-3 requires registered brokers and dealers to make and keep current records for each natural person's account, including the customer's or owner's name, tax identification number, address, telephone number, date of birth, employment status, annual income, net worth, and the account's investment objectives. Additionally, Exchange Act Rule 17a-8 requires registered brokers and dealers to comply with the reporting, recordkeeping, and record retention requirements of the BSA, which includes the previously discussed rules requiring broker-dealers to establish, document and maintain a written CIP.<sup>322</sup> Thus, under Exchange Act Section 17(a) and 17(b), and Exchange Act Rules 17a-3 and 17a-8, the SEC has access to the identities of customers of brokers and dealers.

Similarly, the SEC has access to the identities of investors in registered investment companies. As discussed in more detail in response to Question 24.11, AML rules require an open-end CIS to maintain records of the information that is used to verify each customer's account when the account is opened.<sup>323</sup> This information includes the name, date of birth, address, and identification numbers of the customer. However, many investors typically buy CIS shares through registered broker-dealers that, in turn, hold the shares with the CIS's transfer agent in an account. In such a case, the shareholder that appears on the open-end CIS's shareholder ledger is the broker-dealer who maintains the account. Information about those customers is kept by the entity that maintains the omnibus account, such as a broker-dealer (which also is subject to AML rules). As discussed above, broker-dealers are required to create and maintain records of each customer's ownership of a CIS's shares.

Finally, the SEC has access to the identities of clients of registered investment advisers pursuant to its examination authority under Section 204(a) of the Advisers Act. Although investment advisers are not subject to the CIP requirements under the BSA, under Rule 204-2 of the Advisers Act, an investment adviser must maintain certain records that, as a practical matter, include the identities of its clients. For example, under Rule 204-2, investment advisers are required to maintain records of all accounts in which the investment adviser is vested with any discretionary power with respect to the funds, securities, or transactions of any client; copies of written agreements entered into by the adviser with any client; powers of attorney granting any discretionary authority by any client; and statements sent to any client or prospective client.

We note that Section 210(c) of the Advisers Act, which states that "no provision of this title shall be construed to require, or to authorize the Commission to require an investment adviser engaged in rendering supervisory services to disclose the identity of any client of such adviser...", generally permits investment advisers engaged in rendering investment supervisory services to

<sup>322</sup> 31 C.F.R. Part 103.

<sup>323</sup> See Rule 0-11 under the Investment Company Act which requires compliance with 31 U.S.C. 5318(l) and the implementing regulation at 31 C.F.R. 103.131. 31 C.F.R. 103.131 requires that a CIS have a written customer identification procedure that specifies the identifying information that will be obtained upon account opening, including, at a minimum, information regarding a customer's name, date of birth, address, and identification number.

maintain the confidentiality of the identity of its clients, even during examinations by Staff. However, Section 210(c) also provides for an exception when such disclosure may be necessary or appropriate in an enforcement investigation or proceeding. Pursuant to its authority under Section 210(c), the SEC provided in Rule 204-2(d) of the Advisers Act that any books or records required under Rule 204-2 may be maintained by the investment adviser “in such a manner that the identity of any client to whom such investment adviser renders investment supervisory services is indicated by numerical or alphabetical code or some other designation.” Nevertheless, an investment adviser may not rely on Rule 204-2(d) to avoid disclosure of a client’s identity during an examination unless it has maintained records in a manner that is consistent with the Rule in the ordinary course of its business. Furthermore, based on our experience, investment advisers rarely seek to avoid disclosure of a client’s identity by relying on Section 210(c) of the Advisers Act or Rule 204-2(d) thereunder.

As with all documents that regulated entities are required to keep under Sections 17(a) and (b) of the Exchange Act, Section 204 of the Advisers Act, Section 31 of the Investment Company Act, and the rules thereunder, Enforcement staff is able to, without subpoena, obtain documents relating to the identity of customers and clients of regulated entities. The SEC may seek to enforce its right to inspect or obtain such required documents with the filing of a civil injunctive action. Thereafter, continuance of failures to permit examination or production of required documents may result in civil and/or criminal sanctions for contempt of court.

The SEC also has the authority to determine or access the identity of all customers or clients of regulated entities under its powers of subpoena. Section 21(b) of the Exchange Act provides authority for any member of the Commission or any officer designated by it to direct subpoenas to any person to obtain testimony and documents. As noted in response to Question 10.2, in practice, Section 21(b) authorizes the SEC to designate specific staff as officers of the Commission, empowered to administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, or other records deemed relevant or material to the inquiry.

As discussed in response to Question 10.2, certain provisions under the Securities Act, Advisers Act and Investment Company Act parallel the authority to compel the production of testimony and documents provided under Section 21(b). See Section 19(c) of the Securities Act, Section 209(b) of the Advisers Act, and Section 42(b) of the Investment Company Act.

7. Where a regulator out-sources or otherwise grants inspection or other regulatory enforcement authority to a third party, including a SRO:

(a) Does the regulator supervise the outsourced functions of the third party?

The SEC does not outsource inspection or other regulatory enforcement authority to SROs or third parties. SROs regulate certain types of entities that are also subject to oversight and regulation by the SEC. While broker-dealers are primarily regulated by the SROs of which they are members, they are also regulated by the SEC both directly (through oversight examinations

and enforcement actions) and indirectly (through the SEC's regulation of SROs that regulate broker-dealers).

Under Sections 5, 6, and 15A of the Exchange Act, national securities exchanges and national securities associations are required to be registered with the SEC (except for those which the SEC exempts from registration pursuant to certain provisions under the Exchange Act). Pursuant to Sections 6(b) and 15A, neither an exchange nor a securities association can be registered unless the SEC determines that its rules are designed, among other things, "to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade," and to provide for appropriate discipline of its members for any violation of its own rules or the securities laws. Additionally, Section 19(g)(1) of the Exchange Act requires each SRO to comply with, and enforce compliance with, the provisions of the Exchange Act, the rules and regulations thereunder, and the SRO's own rules.

The SEC oversees an SRO's continuing compliance with these obligations through a variety of means. As noted in response to Question 9.1(a), FINRA is currently the only registered securities association and, as explained in the response to Question 12.1(a), FINRA is the SRO primarily responsible for examinations of nearly all broker-dealers. OCIE examiners consider the effectiveness of FINRA oversight as a factor in their broker-dealer examinations. Oversight examinations are opened in situations where examiners identify significant deficiencies not identified by FINRA that occurred during the period of a FINRA examination. More broadly, oversight examinations serve the dual purposes of evaluating the quality and effectiveness of an SRO's examination of its member firms as well as detecting violations or compliance risks at broker-dealers.

In addition to conducting oversight examinations of broker-dealers, which are designed, in part, to evaluate the quality and effectiveness of an SRO's examination of its member firms, OCIE conducts inspections of the SROs' regulatory programs. During these inspections, OCIE may review, among other things, the SROs' examination and surveillance programs for member financial responsibility and operational compliance, regulatory programs for monitoring trading activity, disciplinary and enforcement programs, exchange listing programs, membership programs, and arbitration programs. OCIE's SRO inspections and broker-dealer oversight examinations are discussed in more detail in response to Question 12.1(a).

In some cases, an SRO may enter into an RSA with a registered third-party SRO whereby the third-party SRO agrees to perform certain regulatory obligations of the procuring SRO. In such cases, the procuring SRO remains responsible for meeting its regulatory obligations under the Exchange Act. OCIE conducts inspections that focus on the procuring SRO to ensure that it is appropriately overseeing compliance for all activities on its exchange, including those activities directly monitored by the third-party SRO pursuant to the RSA as well as inspections that focus on the third-party SRO to ensure that it is appropriately administering its contracted regulatory obligations.

Additionally, under Exchange Act Rule 17d-2, any two or more SROs may file with the SEC a plan to allocate among the SROs the regulatory responsibilities of such SROs specified in the Exchange Act. If declared effective by the SEC, any SRO which is a party to the plan is relieved of its regulatory responsibility to the extent that such responsibility is allocated under the plan to another SRO. Currently, SROs have several Rule 17d-2 agreements in effect, including agreements to allocate examination and regulation of members; agreements relating to the surveillance, investigation and enforcement of insider trading rules; and agreements to allocate surveillance and oversight of firms' options exercise advices on expiration date, as well as to monitor for compliance with the SEC's rules regarding options position limits and exercise limits.

The SEC may bring an enforcement action against an SRO for failure to act or adequately perform required functions. The SEC has brought actions against SROs for, among other violations, engaging in business practices without having effective exchange rules in place or operating in a manner that does not comply with the exchange's rules or federal securities laws; failing to investigate a member firm and interfering with the SEC's investigation of that firm; improperly distributing market data; failing to detect and halt unlawful proprietary trading by certain independent floor brokers; and weaknesses in its processes and controls which resulted in system outages.<sup>324</sup>

Under Section 21(f) of the Exchange Act, the SEC is also authorized to bring enforcement action for violations of, or to require compliance with, SRO rules where it appears to the SEC that the SRO is unable or unwilling to take appropriate action in the public interest and for the protection of investors, or where such action is "necessary or appropriate in the public interest or for the protection of investors."<sup>325</sup>

(b) Does the regulator have full access to information maintained or obtained by the third party?

Yes, the SEC has full access to information maintained or obtained by the SROs, as discussed in response to Question 10.7(a). Exchange Act Rule 17a-1(c) requires that SROs, upon request of any representative of the SEC, promptly furnish to such representative copies of any documents

<sup>324</sup> See *In the Matter of the New York Stock Exchange LLC, NYSE Arca, Inc., NYSE MKT LLC f/k/a NYSE Amex LLC, and Archipelago Securities, L.L.C.*, (settled matter) Exchange Act Release No. 72065, May 1, 2014, available at [www.sec.gov/litigation/admin/2014/34-72065.pdf](http://www.sec.gov/litigation/admin/2014/34-72065.pdf); *In the Matter of the Chicago Board of Options Exchange, Inc. and C2 Options Exchange Inc.*, (settled matter) Exchange Act Release No. 69726, June 11, 2013, available at [www.sec.gov/litigation/admin/2013/34-69726.pdf](http://www.sec.gov/litigation/admin/2013/34-69726.pdf); *In the Matter of New York Stock Exchange LLC, and NYSE Euronext*, (settled matter) Exchange Act Release No. 67957, Sept. 14, 2012, available at [www.sec.gov/litigation/admin/2012/34-67857.pdf](http://www.sec.gov/litigation/admin/2012/34-67857.pdf); *In the Matter of EDGX Exchange, Inc. et al.*, (settled matter) Exchange Act Release No. 65556, Oct. 13, 2011, available at [www.sec.gov/litigation/admin/2011/34-65556.pdf](http://www.sec.gov/litigation/admin/2011/34-65556.pdf); *In the Matter of Boston Stock Exchange, Inc. and James B. Crofwell*, (action against the SRO and its President)(settled matter) Exchange Act Release No. 56352, Sept. 5, 2007, available at [www.sec.gov/litigation/admin/2007/34-56352.pdf](http://www.sec.gov/litigation/admin/2007/34-56352.pdf).

<sup>325</sup> See *SEC v. Credit Suisse First Boston Corp.*, 02 CV 00090 (RWR) (D.D.C.), (settled matter) SEC Litigation Release No. 17327, Jan. 22, 2002 available at [www.sec.gov/litigation/litreleases/lr17327.htm](http://www.sec.gov/litigation/litreleases/lr17327.htm).

the SRO makes or receives in the course of its business as such and in the conduct of its self-regulatory activity. Because there are currently no third parties other than SROs performing regulatory functions, the SEC has full access to information maintained by all third-parties. Also, notably, as discussed in response to Question 10.7(a), the SEC does not outsource inspection or other regulatory enforcement authority to SROs or third parties.

The SEC can also subpoena documents from entities and individuals pursuant to its subpoena powers as described in response to Question 10.2.

(c) Can the regulator cause changes/improvements to be made in the third parties' processes?

Yes, the SEC can cause changes/improvements to be made in the third parties' (*i.e.*, SROs') processes. Regarding the third parties referred to in this question, as discussed in response to Question 10.7(a), the SEC does not outsource inspection or other regulatory enforcement authority to SROs or third parties.

Regarding SROs, OCIE conducts inspections of SROs to assess their compliance with federal securities laws, rules and regulations, and to evaluate SROs' programs for overseeing, enforcing, and disciplining their members for compliance with federal securities laws and rules, and the SROs' own rules. If, during an inspection, OCIE identifies violations of federal securities laws by an SRO, or deficiencies in an SRO's programs for regulating its members, OCIE issues an inspection report to the SRO noting the deficiencies and recommending that the SRO take corrective action. The SRO must submit a written response describing the corrective measures it plans to implement with respect to each deficiency noted in OCIE's inspection report.

### **Referrals to TM**

If OCIE identifies inconsistencies between the SRO's practices and its rules, OCIE may refer the matter to TM for a determination whether the SRO should implement new rules or amend its existing rules. Further, if OCIE identifies significant deficiencies in an SRO's regulatory programs that prevent the SRO from fairly and meaningfully enforcing compliance by its members with federal securities statutes, SEC rules or the SRO's rules, OCIE may refer the matter to Enforcement for further action against the SRO.

Under Section 19(b)(3)(B) of the Exchange Act, the SEC has the authority to put into effect summarily a proposed rule change, if it appears to the SEC that such action is necessary for the protection of investors, the maintenance of fair and orderly markets, or the safeguarding of securities or funds. In addition, pursuant to Section 19(c) of the Exchange Act, the SEC, by rule, may abrogate, add to, and delete from the rules of a registered exchange as the SEC deems necessary or appropriate to insure the fair administration of the registered exchange, to conform its rules to requirements of the Exchange Act and applicable rules and regulations thereunder, or otherwise in furtherance of the purposes of the Exchange Act.



The SEC can also cause changes/improvements to be made in SRO processes by utilizing its authority to review SRO rule-change filings under Section 19(b) of the Exchange Act and Rule 19b-4 thereunder. Under Section 19(b)(1) of the Exchange Act, an exchange must file any proposed change in, addition to, or deletion from the rules of the exchange with the SEC. Once filed, the SEC must publish a notice of the filing for public comment in the *Federal Register*. Thereafter, if the proposed rule change was filed pursuant to Section 19(b)(2) of the Act, the SEC must, within 45 days of publication of the notice, approve the proposed rule change by order or institute proceedings to determine whether the proposed rule change should be disapproved. After publication, if comment letters received by the SEC raise significant issues, the Staff will try to obtain the registered exchange's consent to extend the 45-day period and may request that the exchange respond to comments by submitting a comment letter or amending the proposal. The SEC must approve a proposed rule change if it finds that the proposed rule change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to the exchange. If the SEC cannot make such a finding, it must institute proceedings to determine whether such proposed rule change should be disapproved.

There are also certain proposed rule changes that may be filed under Section 19(b)(3)(A) of the Exchange Act and take effect upon filing (*i.e.*, without need for specific SEC approval). Although rule changes filed under Section 19(b)(3)(A) are immediately effective, the SEC may abrogate the rule within 60 days of the date of filing if necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act.

### **Action by Enforcement**

In an enforcement action, the SEC can obtain in federal district court, or impose in an administrative action, remedies resulting in changes and improvements to SRO processes. For example, in a 2013 settled action, the SEC ordered an SRO to, among other undertakings, provide for the independence of its internal audit department in order to ensure that the department can adequately assess the effectiveness of its controls to review and detect risks.<sup>326</sup>

In another example, in a 2011 action, the SEC sanctioned an SRO that was found to have violated the federal securities laws because of weaknesses in its systems, processes, and controls. These weaknesses were found to have resulted in systems outages that resulted in millions of dollars in trading losses. In settlement, among other sanctions and remedies, the SEC ordered the SRO to implement an enterprise risk management framework and information security program, and hire a CCO.<sup>327</sup>

<sup>326</sup> *In the Matter of the Chicago Board of Options Exchange, Inc. and C2 Options Exchange Inc.*, Exchange Act Release No. 69726, June 11, 2013, available at [www.sec.gov/litigation/admin/2013/34-69726.pdf](http://www.sec.gov/litigation/admin/2013/34-69726.pdf).

<sup>327</sup> *In the Matter of EDGX Exchange, Inc. et al.*, Exchange Act Release No. 65556, Oct. 13, 2011, available at [www.sec.gov/litigation/admin/2011/34-65556.pdf](http://www.sec.gov/litigation/admin/2011/34-65556.pdf).



(d) Is the third party subject to disclosure and confidentiality requirements that are no less stringent than those applicable to the regulator?

Regarding the third parties referred to in this question, as discussed in response to Question 10.7(a), the SEC does not outsource inspection or other regulatory enforcement authority to SROs or third parties.

FINRA and other SROs that are responsible under the federal securities laws for regulating Registrants are subject to confidentiality requirements with respect to records and information that the SEC shares with them pursuant to MOUs or requests to the SEC for access to information (pursuant to access request letters) in accordance with authority provided by Section 24(c) of the Exchange Act and Rule 24c-1 thereunder (see responses to Question 14 for additional discussion regarding the SEC's use of MOUs and access request letters). In general, records and information that the SEC shares with SROs are nonpublic. Pursuant to Section 24(c) of the Exchange Act and Rule 24c-1, SROs are among the limited class of requestors with which the SEC may share such information. The MOUs and the access grants made pursuant to proper access request letters require the SROs to protect the confidentiality of such records and information from further disclosure or dissemination. See responses to Question 14.

While SROs are not subject to specific statutory or rule-based confidentiality or disclosure requirements, SROs generally require their employees to adhere to written confidentiality and disclosure policies and procedures. In cases where an SRO performs regulatory functions for a third-party SRO pursuant to an RSA, the parties to the RSA are generally subject to confidentiality and disclosure requirements contained in the RSA or a separate confidentiality agreement.

**Principle 11 The Regulator should have comprehensive enforcement powers.**
**Key Questions**

1. Does the regulator or other competent authority within the jurisdiction have the investigative and enforcement power to enforce compliance with the laws and regulations relating to securities activities?

Yes, the SEC has authority to investigate potential violations and enforce compliance with the federal securities laws and regulations.

**Overview of Investigative Powers**

Sections 20(a) and 8 of the Securities Act, Section 21(a)(1) of the Exchange Act, Section 209(a) of the Advisers Act, and Section 42(a) of the Investment Company Act grant the SEC broad authority to investigate actual or potential violations of the federal securities laws, including the SEC's statutes and rules, and the rules of SROs. This authority permits the SEC to determine the scope of its investigations, including any facts, conditions, practices, or matters needed to enforce the provisions. For example, under Section 21(b) of the Exchange Act, the SEC has authority to subpoena witnesses to compel their testimony, and require the production of books and records, among other materials. The same section permits the SEC to administer oaths and affirmations, which require witnesses to be truthful in their testimony before the SEC. The SEC can also obtain information through voluntary cooperation by witnesses without issuing subpoenas or requiring or administering oaths or affirmations.

SEC investigations are nonpublic. The SEC's Rules Relating to Investigations provide witnesses who have been compelled to testify or produce documents with certain procedural protections, such as the right to have a lawyer present when testifying and to review the Commission's formal order of investigation.<sup>328</sup> A witness can also assert his or her right to protection against self-incrimination under the Fifth Amendment to the U.S. Constitution.

**Overview of Enforcement Powers**
Power to Bring Enforcement Actions and Make Referrals

Once an investigation is completed, the SEC may file a civil action in federal district court,<sup>329</sup> institute an administrative action,<sup>330</sup> or conclude the investigation without recommending an

<sup>328</sup> See *SEC Rules Relating to Investigations*, available at <http://www.ecfr.gov/cgi-bin/text-idx?node=17:3.0.1.1.4&rgn=div5>.

<sup>329</sup> The SEC may seek injunctive relief pursuant to Section 20(b) of the Securities Act; Section 21(d) of the Exchange Act; and Section 42(d) of the Investment Company Act; and Section 209(d) of the Advisers Act.

<sup>330</sup> The SEC has authority to institute administrative actions pursuant to various statutory provisions.

enforcement proceeding. At any point during an inquiry or investigation, the SEC may also refer a matter to the DOJ for criminal prosecution or to other criminal or regulatory bodies for action.

#### Power to Seek Disgorgement and Civil Money Penalties

In civil actions and administrative actions, the SEC can obtain disgorgement, which is an equitable remedy that requires wrongdoers to return amounts by which they were unjustly enriched as a result of violations of the federal securities laws. The SEC also has the authority to seek civil monetary penalties in civil or administrative actions pursuant to, for example, Exchange Act Section 21(d)(3). In fiscal year 2013, the SEC obtained orders in judicial and administrative proceedings requiring securities laws violators to disgorge ill-gotten gains of approximately \$2.257 billion and to pay civil penalties of approximately \$1.167 billion.

#### Power to Seek Officer and Director Bars

Additionally, the SEC has the authority to seek court orders prohibiting individuals from serving as officers and directors of public companies pursuant to Exchange Act Section 21(d)(2) in civil actions and Exchange Act Section 21C (f) in cease-and-desist proceedings. In fiscal year 2013, the SEC sought orders barring 81 defendants and respondents from serving as officers or directors of public companies.

#### Power to Bring Administrative Actions

The SEC has the authority to institute administrative actions against a person or an entity that the Enforcement alleges has violated the law. Administrative actions are instituted by the SEC and litigated by Enforcement before an SEC ALJ. The ALJ's decision is subject to review by the SEC, and the SEC's decision is in turn subject to appeal before a U.S. Court of Appeals.

#### *Administrative Proceedings and Cease-and-Desist Proceedings*

The SEC can institute Administrative Proceedings against individuals and entities regulated by the SEC. Remedies available in Administrative Proceedings include censures, suspensions, bars, disgorgement, and civil money penalties.

In addition to pre-existing authority to impose certain bars and suspensions, the Dodd-Frank Act broadened the SEC's authority to impose industry-wide collateral suspensions and bars. Such collateral suspensions and bars prohibit securities professionals found to have violated any aspect of securities laws from associating with any regulated entity, including brokers, dealers, investment advisers, municipal securities dealers, municipal advisors, transfer agents, and NRSROs.

The SEC can also institute cease-and-desist proceedings against any person or entity. In addition to the SEC's pre-existing authority to order an accounting, disgorgement, and officer and

director bar, the Dodd-Frank Act authorized the SEC to order payment of civil money penalties in cease-and-desist proceedings. The SEC also has the power to order, in both Administrative Proceedings and cease-and-desist proceedings, certain actions and constraints, termed “undertakings,” in order to effect compliance with the law or place limitations on the entity’s or individual’s activities.<sup>331</sup>

### *Trading Suspensions and Stop Orders*

As discussed in more detail in response to Question 11.2, the SEC can summarily suspend trading in a security for up to 10 business days pursuant to Exchange Act Section 12(k). Also, pursuant to Section 8(d) of the Securities Act, the SEC can issue a stop order suspending the effectiveness of a registration statement that contains incomplete, inaccurate, or false or misleading information.

### Power to Seek Emergency Relief in Civil Actions

As discussed in more detail in response to Question 11.2, the SEC has the power to seek emergency relief in federal district court, such as temporary restraining orders (TROs) to halt ongoing fraud and obtain asset freezes to help prevent dissipation of investor funds. For example, in April 2014, the SEC charged certain businesses claiming to run a multilevel marketing company with operating a large pyramid scheme targeting Dominican and Brazilian immigrants. In an emergency action alleging fraudulent conduct, the SEC was able to obtain an asset freeze to halt the possible dissipation of investor assets.<sup>332</sup>

In another example, in 2013, the SEC alleged in an emergency civil action that defendants were engaging in an apparent multi-million dollar investment scheme to dupe foreign investors and exploit an immigration program in the U.S. Among other relief, the SEC obtained an emergency court order to protect \$145 million in investor assets that were at risk of being misappropriated. The court subsequently granted the SEC’s motion to return to investors the entire amount of the assets that had been frozen pursuant to the SEC’s action. Earlier this year, the court entered a consent judgment ordering the defendants to, among other relief, be enjoined and restrained from offering or selling securities for a period of 20 years, pay civil penalties totaling \$2.45 million, and pay over \$11.5 million in disgorgement and prejudgment interest.<sup>333</sup>

<sup>331</sup> See, for example, *In the Matter of Credit Suisse Group AG*, Exchange Act Release No. 71593, February 21, 2014 (settled), available at <http://www.sec.gov/litigation/admin/2014/34-71593.pdf>.

<sup>332</sup> *SEC v. Telexfree, Inc. et al.*, Civil Action No. 1:14-cv-11858-DJC (D. Mass.) SEC Litigation Releases available at <http://www.sec.gov/litigation/litreleases/2014/lr22974.htm> and <http://www.sec.gov/litigation/litreleases/2014/lr22992.htm>.

<sup>333</sup> *SEC v. A Chicago Convention Center, LLC, Anshoo Sethi, and Intercontinental Regional Center Trust of Chicago, LLC*, Civil Action No. 13-cv-982 (N.D. Ill.), SEC Litigation Releases available at <http://www.sec.gov/litigation/litreleases/2013/lr22615.htm> and settlement at <http://www.sec.gov/litigation/litreleases/2014/lr22945.htm#>.

### Require Admissions in Certain Cases

In fiscal year 2013, the SEC announced a new settlement protocol by which it would require admissions in certain cases where there is a heightened need for public accountability. For example, admissions may be required in cases where violations of federal securities laws include particularly egregious conduct, large numbers of investors were harmed, the markets or investors were placed at significant risk, or the conduct obstructed the SEC's investigation, the admission can send a particularly important message to the markets, or the wrongdoer poses a particular further threat to investors or the markets.<sup>334</sup>

In a civil action implementing this new approach, New York-based hedge fund adviser Phillip A. Falcone and his advisory firm, Harbinger Capital Partners, admitted to multiple acts of misconduct that harmed investors and interfered with the normal functioning of the securities markets. In the settlement, the defendants agreed to be barred from the securities industry for five years and to pay disgorgement, prejudgment interest, and civil penalties totaling more than \$18 million.<sup>335</sup>

In another example, in 2013, in an administrative action, the SEC charged J.P. Morgan Chase & Co. with misstatements of its financial results and a lack of effective controls to prevent or detect a scheme to conceal the extent of massive trading losses. In the settlement, J.P. Morgan admitted to a statement of detailed facts and that its conduct violated federal securities laws and agreed pay a \$200 million civil penalty.<sup>336</sup>

In a more recent example, in 2014, the SEC charged Credit Suisse Group AG for violating the federal securities laws by providing cross-border brokerage and investment adviser services to U.S. clients when it was not registered with the SEC. In the settlement, the firm admitted to wrongdoing, and agreed to pay \$82,170,990 in disgorgement, prejudgment interest of \$64,340,024, and a \$50 million civil money penalty, in addition to being censured, ordered to cease and desist from such violations and future violations, and committing to certain undertakings.<sup>337</sup>

<sup>334</sup> See Chair Mary Jo White's Speech at the 41<sup>st</sup> Annual Securities Regulation Institute (January 27, 2014) available at <http://www.sec.gov/News/Speech/Detail/Speech/1370540677500>.

<sup>335</sup> *SEC v. Falcone, Harbinger Capital Partners Offshore Manage, L.L.C., Harbinger Capital Partners Special Situations GP, L.L.C.*, 12 Civ. 5028 (PAC), S.D.N.Y., August 16, 2013, signed settlement available at <http://www.sec.gov/litigation/litreleases/2013/consent-pr2013-159.pdf>.

<sup>336</sup> *In the Matter of JPMorgan Chase & Co.*, Exchange Act Release No. 70458, September 19, 2013, available at <http://www.sec.gov/litigation/admin/2013/34-70458.pdf>.

<sup>337</sup> *In the Matter of Credit Suisse Group AG*, Exchange Act Release No. 71593, February 21, 2014, available at <http://www.sec.gov/litigation/admin/2014/34-71593.pdf>.

2.	Does the regulator or other competent authority within the jurisdiction have the following powers:
(a)	Power to seek court or judicial orders, to refer matters for civil proceedings or to take other action to ensure compliance with regulatory, administrative, and investigative powers?
(b)	Power to impose effective, proportionate and dissuasive administrative sanctions?
(c)	Power to initiate criminal proceedings or to refer matters for criminal prosecution?
(d)	Power to order the suspension of trading in securities or to take other appropriate actions?

Yes, the SEC has each of the powers listed in Question 11.2 (a)-(d). As noted above, the SEC is responsible for non-criminal enforcement of the federal securities laws and prosecutes cases in federal courts and in administrative actions. As also noted above, the SEC may bring civil actions in federal district court against an individual or an entity that the SEC believes has violated or is about to violate the federal securities laws. In addition, the SEC has the authority to bring administrative actions before an SEC ALJ.

### **Remedies in Civil Actions**

In a civil action, the SEC seeks a court-ordered injunction to compel the defendant to obey the law or refrain from specified conduct in the future. Violations of such an order can result in civil or criminal contempt proceedings. Civil contempt sanctions brought by the SEC are remedial rather than punitive in nature and serve to coerce compliance with the court's order and compensate the complainant for losses sustained.<sup>338</sup>

The SEC can also refer the contempt matter to the criminal authorities. A criminal contempt sanction is punitive in nature and is often characterized by the imposition of a fixed jail sentence or fixed fine.<sup>339</sup>

In addition to an injunction, in civil actions, the SEC may also seek, disgorgement of ill-gotten gains, pre-judgment interest, civil money penalties, an order prohibiting one from serving as an officer or director of a public company or from participating in an offering of penny stock, as well as other ancillary relief (such as an accounting from a defendant). The SEC may also seek, and

<sup>338</sup> See, for example, *SEC v. Anthony Coronati*, civil action No. 13-misc-0372-P1 (S.D.N.Y., order entered January 17, 2014). Litigation Release No. 22907, January 23, 2014 available at <http://www.sec.gov/litigation/litreleases/2014/lr22907.htm>; and *SEC v. Joseph S. Amundsen*, civil action No. 83-cv-00711(N.D. Cal.), Litigation Release No. 22150, November 10, 2011 available at <http://www.sec.gov/litigation/litreleases/2011/lr22150.htm>.

<sup>339</sup> See *U.S. v. Palladino*, criminal action No. 14-10100-DPW (D. Mass.), Litigation Release No. 22973, April 16, 2014 available at <http://www.sec.gov/litigation/litreleases/2014/lr22973.htm> (individual charged with 25 counts of criminal contempt based on his repeated violations of the court's orders obtained by the SEC in its civil action against him and his company.)

any federal court may grant, any other equitable relief that may be appropriate or necessary for the benefit of investors, under the equitable power of the court and pursuant to Exchange Act Section 21(d)(5).

As noted above, the SEC also may ask a federal court for emergency relief, when appropriate, generally in the form of a TRO. In seeking a TRO, the SEC often also requests that a court issue an order freezing the assets of defendants so that, at the successful conclusion of the case, these assets may be available for disgorgement, civil penalties, and potentially for distribution to harmed investors.

The Dodd-Frank Act made nationwide service of process available to the SEC in civil actions filed in federal courts. With nationwide service of process, the SEC may subpoena a witness located anywhere within the U.S. to testify at trial. The SEC also has the power to serve subpoenas to compel live testimony in administrative proceedings anywhere in the U.S. that a witness may be found.

### **Remedies in Administrative Actions**

As noted above, the SEC has the ability to institute administrative actions against a person or an entity that Enforcement alleges has violated the law. One type of administrative action is the Administrative Proceeding, which may be brought against regulated persons and entities, such as broker-dealers, investment advisers and persons associated with them. Thus, for example, in an Administrative Proceeding where there is a finding of a “willful” violation, the SEC may obtain securities industry suspensions of up to twelve months or bars as to regulated individuals. In other Administrative Proceedings, sanctions may include censures, limitations on activities, civil penalties in addition to disgorgement of ill-gotten gains or bars as to individuals, or revocation of the registration of an entity. For professionals, such as attorneys and accountants, the SEC can order in Rule 102(e) proceedings that the professional be censured. The SEC can also order that the professional be suspended from or denied the privilege of practicing before the SEC.<sup>340</sup>

The SEC may also bring a cease-and-desist proceeding against any person who violates or causes a violation of a provision of the federal securities laws. In cease-and-desist proceedings, in addition to imposing prophylactic orders to cease and desist from violating the law, the SEC may order that the defending party take steps to effect compliance with the law. In these proceedings, the SEC can also order the payment of disgorgement and civil money penalties.

In addition, under Section 8(d) of the Securities Act, after opportunity for a hearing, the SEC can

<sup>340</sup> See the SEC Rules of Practice, 17 C.F.R. § 201.102(e). See, for example, *In the Matter of Clayton T. Marshall*, Accounting and Auditing Enforcement Release No. 3542, March 11, 2014, available at <https://www.sec.gov/litigation/admin/2014/33-9557.pdf> (SEC Order among other findings, finds that a former Chief Financial Officer of a public company willfully violated, certain anti-fraud provisions, and denies him the privilege of appearing or practicing before the SEC as an accountant.)

issue a stop order suspending the effectiveness of a registration statement that includes any untrue statement of material fact or is misleading in that it omits to state a material fact.

Under Section 12(j) of the Exchange Act, the SEC can also, after opportunity for a hearing, deny, suspend for up to 12 months, or revoke the registration of security if the issuer is found to have failed to comply with the Exchange Act and the rules thereunder.

### **Referral of Matters for Criminal Prosecution**

The SEC has the authority to refer cases to federal and state criminal law enforcement authorities. In addition, the SEC routinely works in parallel with criminal law enforcement authorities to investigate potential violations of the securities laws. The SEC assists criminal law enforcement authorities by, among other things, providing access to SEC investigative files where appropriate and in accordance with applicable statutes and SEC procedures. In some cases, Staff may be appointed to serve as Special Assistant U.S. Attorneys (federal prosecutors) to assist in the criminal prosecution of a matter. The federal securities laws may be enforced criminally or civilly. A criminal prosecution does not preclude the SEC from taking civil action for the same conduct, and, similarly, SEC action does not preclude a subsequent criminal prosecution. In fiscal year 2013, prosecutors filed 126 indictments, informations (a type of charging instrument), or contempt actions in SEC-related criminal cases.

### **Trading Suspensions**

As noted above, the SEC may issue an order suspending trading in the securities of an issuer for up to 10 days pursuant to Section 12(k) of the Exchange Act, if, in the SEC's opinion, the public interest and the protection of the investors so requires. Reasons for suspending trading may include a lack of adequate and accurate public information about a security. For stocks that quote in the OTC market, broker-dealers may not enter unsolicited quotes after a 10-day trading suspension, unless they have complied with certain regulations. In particular, a broker-dealer must review specific information about the suspended issuer and satisfy itself that the issuer's financial statements are reasonably current and accurate in all material respects before it can resume entering unsolicited quotations for that issuer. In fiscal year 2013, the SEC halted trading in securities of 371 issuers about which there was inadequate public disclosure.

Additionally, securities exchanges have the authority to halt and delay trading in a security. A trading halt — which typically lasts less than an hour but can be longer — is called during the trading day to allow a company to announce important news or where there is a significant order imbalance between buyers and sellers in a security. A trading delay (or "delayed opening") is called if either of these situations occurs at the beginning of the trading day.



3.	Does the regulator or other competent authority have the investigative and enforcement power to require and to obtain from any person, including third party entities and individuals (whether regulated or unregulated), that are either involved in relevant conduct or who may have information relevant to a regulatory or enforcement inquiry/investigation:
(a)	Contemporaneous records sufficient to reconstruct all securities and derivatives transactions, including records of all funds and assets transferred into and out of bank and brokerage accounts relating to those transactions?
(b)	Records for securities and derivatives transactions that identify:
(i)	The client:
(1)	Name of the account holder?
(2)	Person authorized to transact business?
(ii)	The amount purchased or sold?
(iii)	The time of the transaction?
(iv)	The price of the transaction?
(v)	The individual and the bank or broker and brokerage house that handled the transaction?
(c)	Information located in its jurisdiction identifying persons who beneficially own or control non-natural persons organized in its jurisdiction?
(d)	Statements or testimony?
(e)	Any other information including documents and bank records?

Yes, the SEC has the investigative and enforcement powers to require and obtain documents and testimony from any person in order to obtain the information identified in Questions 3(a) through 3(e).

### **Broad Investigative Authority**

As noted above, the SEC has broad authority to investigate actual or potential violations of the federal securities laws. As also noted, the SEC may issue a formal order of investigation, which designates Enforcement staff who are authorized to administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, or other records which the SEC deems reasonably relevant or material to the investigation. The attendance of witnesses and the production of any records may be required from any place in the U.S. If persons from whom information is sought fail to comply with subpoenas issued by the SEC, the SEC may seek to have a federal district court enforce compliance with the subpoena.

### **Records from Regulated Entities**

The SEC can obtain records from regulated entities pursuant to its supervisory powers. These powers provide the SEC with comprehensive authority to obtain all the categories of records necessary to reconstruct securities and derivative transactions. As discussed in response to Questions 10.1 and 10.2 above, entities regulated by the SEC are required to make and keep for

prescribed periods such records, furnish copies of such records, and make and disseminate such reports as the SEC by rule prescribes as appropriate in the public interest, for the protection of investors, or in furtherance of the purposes of the Exchange Act. Such entities include, among others, national securities exchanges, their members, brokers or dealers who transact business in securities through the medium of any such member, registered securities associations, registered brokers or dealers, registered municipal securities dealers, municipal advisors, registered SIPs, registered clearing agencies, NRSROs, registered transfer agents, and the MSRB.

Exchanges are required to maintain records of the audit trail of a transaction (including the amount of the security purchased or sold, the time and price of the transactions, and the individual or entity that handled the transaction) under SRO rules that must be approved by the SEC. Exchange Act Rule 17a-1 requires securities exchanges to maintain their records and files for not less than five years. Rule 17a-3 requires a broker-dealer to make and keep current certain books and records. The required records include, among other records: blotters containing an itemized daily record of all purchases and sales of securities; ledgers reflecting all assets and liabilities, income and expense, and capital accounts; a securities record or ledger reflecting separately for each security as of the clearance dates all “long” or “short” positions; a memorandum of each brokerage order; a memorandum of each purchase or sale of a security for the account of the broker-dealer; and copies of confirmations and information identifying the owner of the account, as well as financial and other related information about the individual.

In 2012, the SEC adopted new Rule 613 under the Exchange Act to require the national securities exchanges and FINRA to establish a market-wide CAT to significantly enhance regulators’ ability to monitor and analyze trading activity.<sup>341</sup> The CAT must collect and accurately identify every order, cancellation, modification, and trade execution for all exchange-listed equities and equity options across all U.S. markets. The CAT will increase the data available to regulators investigating illegal activities such as insider trading and market manipulation, and it will significantly improve the ability to reconstruct broad-based market events in an accurate and timely manner.

Exchange Act Rule 17a-4 requires a broker-dealer to preserve additional records if the broker-dealer makes or receives the type of record. The categories of records include, among other records, check books, bank statements, bills receivable or payable, communications relating to the broker-dealer’s business as such, and written agreements. The Rule also establishes retention periods for all records required to be made and kept current under Rule 17a-3 and preserved under Rule 17a-4, and prescribes, among other things, how the records must be retained, including requirements for firms that preserve their records electronically. In addition, customer identification information required under the PATRIOT Act (which is also required

<sup>341</sup> See Press Rel. 2011-154.; see also 77 Fed. Reg. 45722.

under Rule 17a-3) must, under the SEC's rules implementing these PATRIOT Act provisions, be retained for not less than five years after the customer's account has been closed.<sup>342</sup>

Section 31(a) of the Investment Company Act and Rule 31a-1 thereunder require investment companies to maintain records identifying the account holder and any persons authorized to transact business, daily records of purchases and sales and transaction times, ledgers, and the individual or entity that handled the transaction. Under Investment Company Act Rule 31a-2, investment companies must preserve permanently certain ledger and account holder records, while other information must be retained for not less than six years. In addition, for open-end investment companies, customer identification information required under the PATRIOT Act must be retained for not less than five years after the customer's account has been closed.<sup>343</sup>

Section 204 of the Advisers Act and Rule 204-2 thereunder require investment advisers to maintain journal records of all transactions, ledgers, internal audit papers, powers of attorney, and other information about persons authorized to transact business, and records of transactions of securities transactions (among other information). Under Advisers Act Rule 204-2, investment advisers must maintain their records for not less than five years.

### **Bank Records**

As noted above, under its subpoena authority, the SEC can compel the production of documents or testimony from any person or entity anywhere within the U.S., including banking entities. However, the SEC must follow procedures set forth in the RFPa when the SEC is seeking financial records of a "customer" from a financial institution, such as a bank. A "customer" of a financial institution is generally defined as an individual or a small partnership of five or fewer individuals.

The RFPa provides that a government authority may access bank records of a "customer," as defined above, if the government authority takes certain steps, the financial records are reasonably described, and: (i) the customer has authorized such disclosure, or (ii) the financial records are disclosed in response to an investigative subpoena or summons that meets certain requirements.<sup>344</sup>

Additional detail about bank records may be found in the response to Principle 15.

### **Beneficial owner information or control by non-natural person organized in the U.S.**

Incorporation laws in the U.S. are at the state, rather than the federal, level. Generally, states

<sup>342</sup> SEC Release No. 34-46192 "Customer Identification Programs for Broker-Dealers."

<sup>343</sup> SEC Release No. IC-25657 "Customer Identification Programs for Mutual Funds."

<sup>344</sup> See 12 U.S.C. § 3402.

maintain registries of the companies incorporated in their jurisdiction, including the names and addresses of the individuals or entities serving as agents for service of process for these companies, or other non-natural persons. State laws also generally require that companies maintain an updated list of shareholders.

The SEC can therefore obtain these records directly from a state agency charged with maintaining company and incorporation records. To the extent determining beneficial ownership or control requires obtaining information from the entity itself, as discussed above, the SEC can issue a subpoena to the company, either directly or through its designated agent for service of process, compelling the production of the necessary records or information.

In regard to public companies, Section 13(d) of the Exchange Act requires public disclosure of the controlling ownership (defined as any ownership of more than 5% of a company's equity stock) of all U.S. companies whose shares are publicly traded.

Furthermore, Section 16(a) of the Exchange Act requires any person who is the beneficial owner of more than 10% of any class of equity security that is registered under the Exchange Act, as well as the officers and directors of such company, to file a report with the SEC indicating the amount of all equity securities of that company owned by such person. Amendments to Section 16(a) under the Sarbanes-Oxley Act require that any changes in that ownership be reported to the SEC within two days of the transaction.<sup>345</sup>

Section 17A of the Exchange Act and Exchange Act Rule 17Ad-6 require transfer agents to keep certain records relating to the transfer of securities, including transfer journals, master security holder files, and control books, as well as notices, inquiries, and other documents related to the transfer agent's business. Exchange Act Rule 17Ad-7 describes how long these and other records must be kept, ranging from six months to six years, where they must be kept, and in what form they must be kept. Rule 17Ad-7 also describes a transfer agent's obligations with respect to the delivery of records to a successor transfer agent. In addition, Rule 17Ad-10 requires every recordkeeping transfer agent (the registered transfer agent responsible for maintaining and updating the master security holder file) to maintain and keep current an accurate master security holder file and subsidiary files and an accurate control book, and to retain a record of all certificate detail deleted from the master security holder file for a period of six years from the date of deletion.

See also the response to Principle 15.

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<sup>345</sup> SEC Release No. 34-46313: Ownership Reports and Trading by Officers, Directors and Principal Security Holders.

4. Can private persons seek their own remedies for misconduct relating to the securities laws?

Yes, private persons can seek their own remedies for misconduct relating to the securities laws. The SEC's enforcement powers do not compromise private rights of action to seek remedies under the federal securities laws.

The federal securities laws provide for express remedies in favor of private parties who claim damages as result of specific violations of the federal securities laws. Section 11 of the Securities Act, for example, imposes liability for misstatements or omissions in registration statements; Section 12 of the Securities Act imposes liability for the sale of unregistered securities and for fraud in the sale of securities; and Section 15 of the Securities Act imposes liability on controlling persons. Additionally, private persons can seek remedies pursuant to Section 9 of the Exchange Act, which imposes liability for specified manipulations of exchange-traded securities. Moreover, Section 16 of the Exchange Act imposes liability for "short-swing" profits, and Section 18 of the Exchange Act imposes liability for misleading statements in periodic reports filed with the Commission. Additionally, private persons can seek remedies pursuant to Section 20 of the Exchange Act, which imposes liability on controlling persons and under Section 20A of the Exchange Act, which imposes insider trading liability on contemporaneous traders.

Federal courts have implied private rights of action under certain statutory provisions.<sup>346</sup> The most significant of these is the implied private right of action under Exchange Act Section 10(b) for securities fraud.

5. Where an authority other than the regulator must take enforcement or other corrective action, can the regulator share information obtained through its regulatory or investigation activities with that authority?

Yes, the SEC is authorized by law to share information with certain other authorities. As a general matter, the SEC maintains nonpublic information in its files and adheres to strict rules of confidentiality to ensure that the information remains nonpublic. Under Section 24(c) of the Exchange Act, however, the SEC can make nonpublic information and records in its possession available to persons the SEC deems appropriate, including domestic and foreign counterparts, if they have a need for the information and make appropriate assurances of confidentiality. The SEC also has adopted Rule 24c-1 under Section 24(c), which provides that the SEC can provide nonpublic information to a federal, state, local or foreign government, or to a foreign financial

<sup>346</sup> Courts have also implied private right of actions under Exchange Act Section 14(a), 15 U.S.C. § 78n(a) and Rule 14a-9 thereunder, 17 C.F.R. § 240.14a-9, which prohibits fraud in connection with the solicitation of proxies; Exchange Act Section 14(e), 15 U.S.C. § 78n(e) and Rule 14e-3 thereunder, 17 C.F.R. § 240.14e-3, which prohibits fraud in connection with tender offers; and Exchange Act Section 13(e)(1), 15 U.S.C. § 78m(e)(1), which prohibits fraud in connection with an issuer's repurchase of its own shares. The express and implied private rights found in the Securities Act and Exchange Act are cumulative. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380-87 (1983).

authority, among others.

For additional information about information sharing with domestic and foreign authorities see the responses to Principles 13, 14 and 15. As a condition to sharing nonpublic information in its possession with other competent authorities pursuant to Section 24(c) of the Exchange Act and Rule 24c-1, the SEC must receive assurances of confidentiality that the Commission deems appropriate from the authority seeking such nonpublic information.

For additional information about information sharing with foreign authorities see the responses to Principles 13, 14 and 15.

6. Where the regulator is unable to obtain information in its jurisdiction necessary to an investigation is there another authority that can obtain the information?

This question is not applicable. As set out in the response to Question 11.1, the SEC's broad investigative powers, including the power to compel testimony and documents from any person in the U.S., enable it to obtain information in its jurisdiction necessary to an investigation.

7. If yes: Are there respective arrangements between the regulator and the other domestic authority as regards the respective exchange of information in place?

This question is not applicable. We note that while the SEC is able to obtain information in its jurisdiction necessary to an investigation; it also has many valuable arrangements with domestic and foreign regulators. See the responses to Principles 13, 14 and 15.

**Principle 12 The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.**

**Key Questions**

**Introduction.** Yes, the SEC administers a regulatory system that ensures an effective and credible use of inspection, investigation, surveillance, and enforcement powers related to the securities industry, and the implementation of effective compliance programs throughout the industry. The SEC accomplishes this through OCIE and Enforcement, among other Offices and Divisions, as discussed in the introduction below and in responses to the specific questions of Principle 12. See also the responses to Principles 7, 9, 10, 11, 22, 33, 37, and 38.

- **OCIE**

OCIE carries out the SEC's examination authority through its National Examination Program (NEP). Specifically, OCIE examines or inspects (collectively, "examinations") securities firms registered with the SEC, including, among others, broker-dealers, municipal securities dealers, clearing agencies, transfer agents, investment advisers, investment companies, and municipal advisors (collectively, "registrants"). OCIE examines and oversees the SROs, which use a number of automated surveillance techniques to monitor trading activity on the exchange(s) for which the SROs provide additional regulatory oversight. In carrying out these responsibilities, OCIE uses a risk-based approach for selecting which firms, areas, and issues to examine and draws on a variety of resources, including its staff's specialized knowledge, risk analytics, and advanced technology, to target its resources most efficiently on the areas that pose the highest risk to investors, the markets, or capital formation. Moreover, over the last few years OCIE has implemented a number of enhancements to its multi-faceted approach to further ensure an effective examination and compliance program, a few of which are highlighted below as part of the introduction. These enhancements are also addressed in more depth in the answers to each of the specific assessment questions.

**Focusing Resources on Highest Risk Firms Through Risk-Based Examinations.**

In order to most effectively allocate its resources and focus on higher risk firms, including analyses by its Office of Risk Assessment Surveillance (ORAS), OCIE has developed a risk-based examination program. OCIE risk targets examinations through several processes: analyses of registrants' reports; analyses of data of clearing firms and large broker-dealers by the Risk Analysis Examination (RAE) team; the ongoing monitoring of large firms by its Office of Large Firm Monitoring (LFM); and staff reviews of TCRs. Such processes identify issues, risks, and firms that may be suitable for examination on either a firm-specific basis or in a coordinated manner, also referred to as a "sweep." These efforts are described in more detail below in response to Principle 12, Question 1(b).

One example of an enhancement to OCIE's risk assessment process over the last few years is the addition of risk assessment reviews of a large number of registrants. These reviews, which are

not considered “examinations,” vary in scope and breadth but typically involve one or more examiners reviewing information from a number of sources, including, but not limited to, publicly available information, reports filed with the SEC, and TCRs in order to increase their knowledge of an entity’s structure, business, and potential risks. Risk assessment reviews may not result in the execution of an examination, especially if OCIE concludes that the registrant under review presents less risk than other potential examination candidates under review but are nevertheless an important component of OCIE’s constant risk assessment process. See response to Principle 12, Question 1(b) for more information on OCIE’s risk assessment process.

**Technology.** OCIE utilizes technology and data analytics to continue to hone its risk-based examination approach. Over the last few years, OCIE has expanded resources in its QAU, a team of specialists with post-graduate degrees in fields such as computer science and mathematics, who are able to evaluate risks in the algorithms, models, and software of the most sophisticated investment firms. Such systems are used by registrants in investment decision-making and trading. The QAU also has been instrumental in developing analytics tools for examiners. For example, in 2014, OCIE introduced the National Exam Analytics Tool, which enables examiners in OCIE to access and systematically analyze years of trading data in minutes. Previously, such reviews often were limited to smaller sets of trading data and took examiners weeks or more to complete. See Principle 12, Question 1(b) for more information.

**Asset Verification.** OCIE has implemented a risk-based asset verification process to confirm the safety of client assets and compliance with custody requirements. As a result, examiners regularly contact third parties such as custodians, counter-parties, and customers during examinations to verify the existence and integrity of all, or part of, client assets managed by the firm. Additionally, in their pre-exam research, examiners focus not only on obvious signs of possible fraud, but also on more subtle signals that deserve closer inspection, such as a firm using an unknown accountant or no accountant at all. For example, because many examinations of investment advisers in the recent past frequently uncovered issues regarding the custody and safety of client assets under Advisers Act Rule 206(4)-2 (the Custody Rule), OCIE focused on a number of related issues in subsequent examinations of advisers including, but not limited to, whether advisers were: (i) appropriately recognizing situations in which they have custody as defined in the Custody Rule; (ii) complying with the Custody Rule’s “surprise exam” requirement; (iii) satisfying the Custody Rule’s “qualified custodian” provision; and (iv) following the terms of the exception to the independent verification requirements for pooled investment vehicles.

**Staff Expertise.** As of early 2014, OCIE had approximately 805 highly skilled examiners, many of whom are accountants, attorneys, and former industry professionals, devoted to examinations of registrants. Over the past several years, OCIE has built on this expertise, hiring staff with myriad skills critical to supervising the securities markets. These newly hired professionals complement OCIE’s existing talented and dedicated team of examiners. OCIE has added, for example, Senior Specialized Examiners who are industry professionals with specialized experience and expertise in trading, portfolio management, valuation, complex products, sales, compliance, and forensic accounting. OCIE also has formed six specialized working groups to focus on, and develop



greater expertise in, the following areas: (i) new and structured products; (ii) valuation; (iii) equity market structure and trading practices; (iv) fixed income and municipal markets; (v) microcap fraud; and (vi) marketing and sales practices. OCIE will continue to develop these specialized teams to focus on particular market issues as well as emerging issues that directly affect investors and the functioning of the markets.

Since the 2010 FSAP, OCIE has added a dedicated training manager, responsible for coordinating training for staff, who works closely with the SEC-wide training program managed through SEC University. In coordination with SEC University, OCIE has tailored staff training to focus on various areas, including hedge funds and specialized products; derivatives and options; the verification of trades and custody arrangements; and the use of databases maintained by exchanges and clearinghouses, among other things. Additionally, hundreds of staff members have been trained to become Certified Fraud Examiners, a program administered by the Association of Certified Fraud Examiners. OCIE also has strengthened examiner skill sets through the development of a new examiner training program.

**LFM Program.** LFM is responsible for enhancing OCIE's risk-based examination strategy. The LFM focuses on certain large and complex firms that could pose significant risk to the various markets and to their customers due to their size, complexity, and connectivity with other large firms and financial institutions. See Principle 12, Question 1(b) for more information.

**Improving Compliance Through Outreach.** Through both examinations and education, OCIE continuously promotes compliance by the industry. Examples include:

- *Annual Publication of Examination Priorities:* In 2013, OCIE began publishing its examination priorities annually to educate and inform registrants of particular areas of examination focus and to provide such entities an opportunity to evaluate their compliance systems and remediate any issues identified before they might be selected for examination. See Principle 12, Question 1(b) for more information on development of OCIE's examination priorities.
- *Risk Alerts:* OCIE periodically publishes risk alerts on risks, practices, and areas of non-compliance that OCIE has identified during examinations with respect to a variety of compliance topics.
- *Engagement with New Registrants:* Since the effective date of the Dodd-Frank Act, approximately 1,800 advisers to hedge funds and private equity funds have registered with the SEC for the first time. Throughout 2013 and continuing into 2014, OCIE has coordinated a national examination initiative designed to establish a meaningful presence with these newly registered advisers (the presence exam initiative). This initiative helps OCIE to better assess the issues and risks presented by these registrants' business models. OCIE began the initiative by contacting the industry, publishing letters, and appearing at industry conferences to share information about regulatory obligations

and to be as transparent as possible about where OCIE perceived risks and where OCIE therefore intended to probe, test, and ask questions during examinations.

- *Industry Outreach:* OCIE conducts outreach in creative ways, blending examinations and education, to reach larger segments of the industry. For example, the examination program's Fort Worth Regional Office launched an initiative in November 2013 in which a team of examiners went to Houston for a week to examine over 35 broker-dealers and investment advisers as well as to hold educational seminars for investors and the industry, including compliance officers, general counsels, and risk managers. The initiative was executed, in part, to reinforce the Fort Worth Regional Office's presence in Houston. In addition, other Regional Offices have conducted similar initiatives or scheduled them for the future.
- *Engaging Senior Management and Boards of Directors:* OCIE has always engaged with senior management during the examination process. However, beginning in 2012, OCIE increased its focus where appropriate on engagement with senior management and boards of large entities registered with the SEC, including their affiliates, to discuss how each firm identifies and mitigates conflicts of interest and legal, compliance, financial, and operational risks. This engagement initiative is designed to: evaluate firms' control environment and "tone at the top;" understand firms' approach to conflict and enterprise risk management; and initiate a dialogue on key risks and regulatory requirements. This initiative provides OCIE with an opportunity to assess overall risk management at certain registrants through discussions with independent board members, senior management, internal audit, key risk and control functions, and leaders of business lines. It is also designed to better inform OCIE's examinations of such firms as well as other registrants. Staff also may escalate findings to an entity's board of directors and/or senior management as deemed necessary and appropriate.

- **Enforcement**

Enforcement is responsible for investigating potential violations of the securities laws and bringing actions against market participants for such violations. For more information about Enforcement, see the responses to Principles 10 and 11 and the discussion below.

#### *Detecting Breaches*

1. Is there an effective system of inspection in place whereby the regulator carries out inspections:

Yes. As described below, the SEC has an effective system in place, pursuant to which it carries out inspections.

## (a) On a routine periodic basis?

Yes. The SEC and SROs, such as FINRA, conduct examinations and/or other types of reviews that result in supervisory coverage of securities market intermediaries. Below are descriptions of examinations the SEC and FINRA conduct on a routine, periodic basis. The SEC and SROs also conduct risk-based examinations. See response to Principle 12, Question 1(b) below for a description of the SEC's risk-based examinations and the SRO section below for a description of the SROs' risk-based examinations.

### **SEC Examinations**

- Examinations of Clearing Agencies – Pursuant to Title VIII of the Dodd-Frank Act, the FSOC has designated as systemically important six SEC-registered clearing agencies and, for purposes of the Dodd-Frank Act, the SEC is the supervisory agency for four of these six clearing agencies. OCIE examines these four clearing agencies at least once annually pursuant to the Dodd-Frank Act, Section 807, to determine the following for each: (i) the nature of its operations and related risks; (ii) the financial and operational risks that it presents to financial institutions, critical markets, or the broader financial system; (iii) its resources and capabilities to monitor and control such risks; (iv) its safety and soundness; and (v) its compliance with Title VIII and rules thereunder. See also Principle 37, Question 1(c) and Principle 38. OCIE may include reviews of other identified risks as part of these examinations. In addition, OCIE coordinates oversight of designated clearing agencies through frequent consultations with, and participation on examinations by, the Federal Reserve.
- Monitoring of Large Broker-Dealers – As set forth above, the LFM program, which conducts monitoring rather than examinations, conducts its monitoring primarily by meeting periodically with firms' risk and control functions. See the response to Principle 12, Question 1(b) for how this information is used in risk-based exam programs.
- Information Technology-Related Examinations of Exchanges, Clearing Agencies, and Certain ATSS – OCIE's TCP group conducts examinations of the trading and related information technology systems operated by the exchanges, clearing agencies, and certain high-volume ATSS in order to evaluate whether the systems have sufficient capacity and resiliency to accommodate conditions of increased volume and disruptions to normal operations. The TCP group conducts annual examinations of the Depository Trust and Clearing Corporation and the Options Clearing Corporation pursuant to Title VIII of the Dodd-Frank Act, while also conducting an annual exam of FINRA pursuant to Section 31 of the Exchange Act. In addition, the TCP group examines other entities on a tiered basis, based on the entity's market share and other criteria. See Principle 9, Question 3 and Principle 33, Question 3 for more details on the TCP and its examinations.

- Examinations of NRSROs – OCR is charged with administering the SEC’s rules with respect to NRSROs, promoting accuracy and enhanced disclosures in credit ratings issued by NRSROs, and helping to ensure that credit ratings are not unduly influenced by conflicts of interest. Pursuant to the Dodd-Frank Act, OCR conducts an examination of each of the 10 currently registered NRSROs at least annually. OCR’s essential findings are summarized in an annual report the SEC makes available to the public.<sup>347</sup> A more detailed description of OCR’s examination program for NRSROs can be found in the response to Principle 22.
- Risk Monitoring Program for Asset Management Industry – REO, which is part of IM, has a risk monitoring program that includes targeted, risk-based examinations to obtain information and evaluate potential financial or operational risks in the asset management industry (see the response to Principle 7, Question 1 for more information about the program). REO’s primary goal is to monitor emerging industry risks and trends among asset managers and products offered by them and to assess potential need for regulatory reform rather than to evaluate a firm’s compliance with existing regulations. REO examinations are conducted with the intent of developing a comparative view of the risks and risk management practices at different asset management firms and firm types over time for purposes of informing policy. REO also coordinates with OCIE and generally refers potential fraud or other violations identified during a risk monitoring exam to OCIE or Enforcement, as appropriate.

### **Broker-Dealer Examinations Conducted by SROs**

In addition to SEC examinations (discussed in 12(b) below), broker-dealers are subject to examinations by SROs, which are also subject to SEC oversight and examination. The SEC coordinates with SROs and evaluates their coverage of broker-dealers, including whether the SROs have appropriately fulfilled their oversight and examination obligations.

SROs, as regulators, are primarily responsible for establishing standards under which their members conduct business and have front line responsibility for overseeing broker-dealers for compliance with federal securities laws and SRO rules. Broker-dealers that are members of multiple exchanges have a single DEA, which is an SRO that is primarily responsible for the firm’s regulation. Many SROs have entered into an agreement with FINRA under Exchange Act Rule 17d-2 to allocate to FINRA the DEA responsibility for such members. As a result, FINRA is the SRO primarily responsible for examinations of nearly all 4,400 broker-dealers (*i.e.*, FINRA is not the DEA for fewer than 200 broker-dealers). Accordingly, the response below focuses on FINRA’s examination processes, which are executed by FINRA’s Market Regulation and FINRA’s Member Regulation Departments. An overview of these two FINRA departments and the types of exams each conducts is provided below.

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Available at <http://www.sec.gov/ocr>.

### Periodic Reviews by FINRA's Market Regulation

FINRA's Market Regulation Department is responsible for enforcing rules that govern order handling, trading, and trade reporting obligations of most broker-dealers. The TFCE within Market Regulation conducts cycle, cause, and sweep examinations of broker-dealers in FINRA's capacity as an SRO/DEA as well as on behalf of certain stock exchanges (exchange clients) pursuant to RSAs. Cycle examinations are risk-based examinations that may focus on a number of regulatory concerns and practices as well as firm supervision. Risk areas selected for review during a cycle examination are identified through surveillance alerts, discussions with other FINRA departments, and/or trends in the market that require further review and oversight. The scope of risk-based exams may change on a regular basis as market trends emerge and trading technology evolves. A cause examination is a targeted examination or review of a single firm. Sweep examinations focus on a regulatory issue or issues across multiple firms (e.g., involving ATS compliance, algorithm management, or order protection). Cause and sweep examinations may be conducted in response to: a complaint; exceptions detected on surveillance reports; the recommendation of another SRO; senior FINRA management; a referral from the SEC; or exchange client input. A cause or sweep examination may involve a review of issues identified during a cycle examination or surveillance review, concerns raised in a complaint or referral, compliance with a new rule or regulatory requirement, or the industry's response to an emerging regulatory issue.

TFCE is composed of four units: Equities, Options, Trading Examinations, and Financial Operations (FinOp).

- TFCE - Equities and Options: These units primarily conduct cycle trading examinations on behalf of FINRA and its exchange clients. The annual equities and options cycles are developed in coordination with FINRA's exchange clients and include factors such as: trading share volume; time between examinations; surveillance staff input; DEA status; disciplinary history; and exchange client input.
- TFCE – Trading Examinations Unit: This unit primarily conducts equities and options cause and sweep examinations.
- TFCE – FinOp: This unit primarily conducts cycle, financial, and operational examinations, including FinOp DEA examinations performed under an RSA. Many of the assigned firms are subject to a cycle that is determined primarily by exchange client requirements, while other firms are subject to a cycle that is determined by quantitative and qualitative analyses that assess individual firms' risks and other factors. TFCE - FinOp utilizes a risk-based approach to determine the areas of review to be included in each cycle examination.

### Periodic Reviews by FINRA's Member Regulation

FINRA's Member Regulation Department is responsible for conducting routine cycle examinations and for cause examinations. Cycle examinations are conducted in the District Office Program and by the ROOR Group. The District Offices examine for business conduct risk at all member firms and financial and operational risk at primarily introducing firms. ROOR examines for financial and operational risk at the largest carrying and clearing broker-dealers and their affiliates. Member Regulation also conducts municipal examinations as well as examinations pursuant to RSAs.

The Member Regulation program is risk-based with regard to both the frequency of examinations as well as the scope of the examination. Frequency is dictated by the impact of the firm as measured by variables such as employees, branch offices, and revenue as well as the risks presented by the firm's business lines and activities and aggravated by factors such as the registered representatives the firm employs, the products it sells and the customers it does business with. There are four levels of impact against which a firm is measured (1-4) and five levels of risk (A-E). From a risk perspective, firms categorized as A or B risk are examined annually, C on a 2-year cycle, D on a 3-year cycle and E on a 4-year cycle. Additionally, all "impact 1" firms, which are typically the largest carrying and clearing firms, are reviewed annually.

During the course of a routine cycle examination, the District Offices and ROOR utilize a risk-based approach to developing an examination strategy. The District Offices often include the following risks in strategy: unsuitable transactions; excessive trading; misrepresentation; money laundering; inadequate due diligence; and conflicts of interest. District Office cycle examinations will also include one or more branch office examinations where examiners will review for the same risks as well as for implementation of the firm's policies, procedures, and controls.

ROOR examiners will focus on areas such as net capital, protection/segregation of customer cash and securities, operations (*i.e.*, clearance and depository reconciliation, suspense, Regulation SHO), financing (*i.e.*, stock borrow/loan, repo/reverse repo), and customers (*i.e.*, margin, portfolio margin, day-trading margin, prime brokerage, bank sweeps). Additionally, ROOR examines for risk management practices over items such as market risk, credit risk, and liquidity risk.

The District Offices execute Member Regulation's cause program. Cause matters are typically triggered by customer complaints, terminations for cause, regulatory tips, arbitrations, litigations, referrals from other regulators and other sources, and sweep examinations. Cause matters may also be executed as a branch office examination. Additionally, ROOR conducts thematic examinations and ANC application examinations, as either cycle or cause examinations.

## (b) Based upon a risk assessment?

Yes, OCIE has developed a risk-based program for selecting firms and activities for examination. OCIE assesses risk in all of its examinations. Because broker-dealers, investment advisers, and SROs represent the vast majority of the SEC's registrant population, the process described below focuses on these registrants.

**Risk Assessment Process for Broker-Dealers and Investment Advisers**

The risk assessment process is a dynamic and continuous process that involves, among other things: (i) identifying high-risk firms through a variety of technologies and monitoring; and (ii) identifying risk themes, or risk priorities, from a range of factors including news, tips, and the collaborative efforts of Staff. This identification of higher-risk firms and risk priorities helps guide examination planning and focus the scope of examinations, among other things. OCIE staff at regional and program levels use this information on higher-risk firms and risk priorities as well as qualitative information developed at the regional or program level to identify specific firms to examine. OCIE staff then engages in a separate firm-level risk assessment process as part of each individual examination. OCIE also utilizes this process, among additional risk assessment techniques, during OCIE's examinations of SROs. This process is discussed in more depth below.

**Identifying Higher-Risk Firms**

In 2011, OCIE created ORAS to enhance OCIE's ability to perform more sophisticated data analytics to identify the firms and practices that present the greatest risks to investors, markets, and capital formation. As part of the risk assessment process for broker-dealers and investment advisers, ORAS has constructed risk models that attempt to identify potential areas of risk at all investment advisers and broker-dealers based on information contained in reports that entities are required to file with the SEC or FINRA, such as FOCUS, Form ADV, Form BD, Form BR, and U4s, among others. These models employ various analytics whose output helps inform the examination candidate selection process as well as the exam scoping process across OCIE. Also, OCIE frequently leverages extracted material from filings data (*i.e.*, specific fields or answers to certain questions) more broadly based on real-time market events in order to identify potential examination targets.

In addition, in 2011, OCIE formed the RAE team to develop a more consistent, risk-based approach to the selection of broker-dealers for examination. The RAE team accomplishes this by applying rigorous data analytics to structured data of large firms to identify and isolate issues and risks, triage results, and refer firms with the highest risk behavior. Utilizing this data, the RAE team has identified a wide range of problematic behavior including, among other things: unsuitable recommendations; misrepresentations; inadequate supervision; churning; and reverse churning.

OCIE's LFM program, noted above, conducts its monitoring primarily by meeting periodically



with firms' risk and control functions, including: market risk; credit risk; treasury; finance; internal audit; operations; operational risk; legal; compliance (including AML); and new products. Using the information gathered at these meetings, LFM provides information to other OCIE staff regarding individual firm and cross firm risks and developments for use in examination planning. The LFM team also supports OCIE's enterprise risk management reviews, which include meetings between senior regulators and firms' senior management, board members, and heads of control functions. LFM coordinates with other regulators, including the Federal Reserve, and non-U.S. regulators, as well as with staff within the SEC, including staff from TM.

As discussed within the response to Principle 12 Question 1(c), OCIE reviews and analyzes TCRs as well as suspicious activity reports (SARs) as yet another mechanism to identify high-risk firms.

Finally, as discussed in the introduction to this Principle, OCIE conducts risk-assessment reviews of a large number of registrants as part of its risk-assessment process. These reviews are not considered or counted as "examinations," but may help identify candidates for examination.

#### Developing Risk Themes and Areas of Focus

The key areas of focus and risk themes for a given year are developed collaboratively by senior management from OCIE's twelve offices, as well as by senior representatives of other SEC Divisions and Offices, based on an assessment of a range of factors, including, for example:

- News and other information sources, such as industry publications;
- Information reported by registrants in required SEC filings;
- Comments and tips received directly from investors and registrants;
- Communications with other U.S. and international regulators and agencies; and
- Information gathered through OCIE's and other regulators' examinations.

See National Exam Program Examination Priorities for 2014, available at <http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf>; see also National Exam Program Examination Priorities for 2013, available at <http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf>.

Using the risk themes developed from these factors, OCIE creates examination priorities and, beginning in fiscal year 2013, published an Examination Priorities Memorandum that compiles the key risk themes for the year. The Memorandum's objective is to focus OCIE's resources on those activities (principally examinations) that are expected best to support the achievement of OCIE's mission to improve compliance, prevent fraud, monitor risk, and inform policy, all of which also align with the SEC's mission.



Although OCIE's risk assessment process includes formal, routine processes described above, it is continually evolving, as OCIE must respond to emerging issues and trends in the industry. This real-time, generally qualitative work supplements the routine processes outlined above.

### **Selecting Candidates for Examination and Determining Examination Scope**

As noted above, generally OCIE staff assesses the information developed on higher-risk firms described above, areas of focus identified in the Examination Priorities Memorandum as well as well as qualitative registrant-specific information from regional and program levels to identify specific firms to examine.

Once a firm (or firms) is selected for examination, OCIE staff engages in a firm-level risk assessment process through a review of publicly available data, risks associated with the firm's business, and other information in order to select areas to examine at that particular firm. OCIE uses several tools to determine risks associated with the firm's business, to gather other information, and also to identify potentially violative behavior. For example, as discussed in the Introduction, the National Exam Analytics Tool enables examiners across OCIE to access and analyze systematically years of trading data in minutes. Previously, such reviews often were limited to smaller sets of trading data and took examiners weeks or more to complete. In addition, the SEC launched a powerful new analytical tool called MIDAS that enables the SEC to analyze, almost instantaneously, large amounts of trading data across markets. OCIE utilizes MIDAS in two ways: (i) for direct support of ongoing examinations focusing on potential trading or execution issues, and (ii) for analysis of order information to identify changes and anomalies occurring at a particular exchange over time or during a specific period. OCIE also conducts thematic reviews or "sweeps" of regulated entities. Generally a set of potential candidates for a sweep is determined based on a review of filing information and other data in order to determine which firms are involved in the particular industry or business practice that is the core focus area of the sweep or thematic review. Additional criteria may be included to ensure that a cross-section of the industry is included in the initiative (e.g., regulatory assets under management (RAUM), type of clients, and location). The list of candidates also may be further refined by the SEC Regional Offices participating in the initiative.

### **SEC Examinations of SROs**

The SEC has a multi-faceted approach to its oversight of SROs, which includes use of some of the risk assessment tools described above. Accordingly, OCIE conducts comprehensive risk-based examinations of the SROs' regulatory programs, pursuant to which OCIE may review, among other things, the SROs' examination and surveillance programs for member financial responsibility and operational compliance, regulatory programs for monitoring trading activity, disciplinary and enforcement programs, exchange listing programs, membership programs, and arbitration programs. Risk areas identified as part of the risk assessment process help examiners target which of these areas to review. In addition, OCIE specifically monitors FINRA, which also

assists in the risk scoping of FINRA examinations. Recent risk areas identified for examinations of exchanges include: the internal controls and governance around their rule making process; their supervision of RSAs; order types used by the options exchanges and the surrounding governance process systems outages, errors and integrity; and, exchanges' business continuity planning.

As another part of this risk assessment process and SRO oversight, in 2013 OCIE completed an examination of FINRA that focused on 10 specified areas outlined in Dodd-Frank Act Section 964; for future examinations, OCIE has developed a process to evaluate risks and prioritize areas of focus in examinations of FINRA regarding these areas. See the discussion under Principle 9 for additional information on Section 964.

As yet another facet in the risk-assessment process, OCIE staff considers FINRA's oversight of a broker-dealer when determining whether OCIE should examine that broker-dealer. Specific oversight examinations of broker-dealers are opened in situations where examiners identify significant deficiencies, not identified by FINRA, but which occurred during the period of a FINRA examination. Oversight examinations serve the dual purposes of evaluating the quality and effectiveness of an SRO's examination of its member firms, as well as detecting violations or compliance risks at broker-dealers.

Importantly, through its comprehensive risk-assessment process, OCIE has been able to establish a baseline for comparing the effectiveness of compliance programs across the SROs, and OCIE is continuing to monitor closely industry developments and specific events to further enhance risk assessments and focus, including coordination with the SROs and collaboration with TM and Enforcement on SRO-related matters.

### **SRO Examinations of Broker-Dealers**

SROs, as regulators, are primarily responsible for establishing standards under which their members conduct business. The SROs also have the front-line responsibility for overseeing broker-dealers for compliance with federal securities laws as well as SRO rules. While many broker-dealers are members of multiple exchanges and therefore subject to regulation by multiple SROs, the vast majority of broker-dealers are subject to examination by FINRA. Therefore, the SEC's responses in Principle 12 focus on FINRA's examination processes, which contain both risk-based and periodic components and are described in further detail in response to question 12.1(a).

(c) On a non-periodic basis in response to intelligence received (e.g. investor complaints and tips and complaints from other sources)?

Yes. As mentioned above, OCIE examines registrants on a non-periodic basis in response to a range of information sources, including TCRs received from securities industry professionals, investors, and other regulators, among others.

**TCRs and BSA Filings**

OCIE reviews and evaluates TCRs from a variety of external sources in accordance with the SEC-wide TCR system and related policies. Particular attention is given to TCRs alleging or indicating fraud. This process helps inform the selection of registrants for examination and the scope of such examinations.

The SEC has direct electronic access to SARs and other reports financial institutions are required to file under the BSA. SARs are reports of possible violations of the law, for use in criminal, tax or regulatory investigations or proceedings, as well as for intelligence or counter-intelligence activities aimed at protecting against international terrorism. OCIE uses its direct electronic access to SARs to identify possible examination candidates and conduct risk assessments of regulated entities during an examination. Specifically, OCIE identifies SARs or other reports that the examined entity has filed (if a broker-dealer or investment company) or that any financial institution has filed on the examined entity. This intelligence, along with other information, allows OCIE to identify any compliance risk areas it should review as part of the examination. In addition, Enforcement's OMI, through its own review process, may refer SARs to OCIE staff for further review and assessment, and OCIE may decide to open an examination based on information provided in the SAR.

**Coordination with/and Intelligence Received From Other Regulators**

OCIE coordinates examinations and shares examination-related information with both domestic and foreign regulators during discussions, through existing cooperation mechanisms such as MOUs, and in response to requests for access to OCIE's examination files. In addition, OCIE has initiated quarterly meetings with FINRA and the Chicago Board Options Exchange (CBOE), (the largest U.S. options exchange, discussed in more detail in Question 12.2 below) and semi-annual meetings with the Chicago Stock Exchange (CHX). Further, OCIE convenes the inter-regulator Summit of Securities Regulators, which includes FINRA, CBOE, CHX, the MSRB, the North American Securities Administrators Association, the Federal Reserve Board, various Federal Reserve Banks, and the CFTC. This group meets to discuss issues and concerns regarding registrants and current regulatory developments and to identify common risks and collaboration opportunities. In addition to these recent initiatives, the SEC has been a key participant in the ISG since its formation in the 1980s. The ISG provides a critical venue for sharing investigative information and surveillance data among domestic and foreign market centers, market regulators, and exchanges, including both securities and futures exchanges. For many years, the SEC has been engaged in numerous and ongoing efforts to increase cooperation and the flow of information relevant to market oversight among international regulators through various means, including cooperative arrangements, such as MOUs, informal and formal bilateral discussions, and participation in multilateral organizations. The SEC's international supervisory MOUs can be found at: [http://www.sec.gov/about/offices/oia/oia\\_cooparrangements.shtml](http://www.sec.gov/about/offices/oia/oia_cooparrangements.shtml). OCIE also consults frequently with the Office of International Affairs (OIA) about international market oversight issues.

In addition, OCIE's broker-dealer exam program collaborates regularly with SROs and other regulators. For example, OCIE staff meets quarterly with FINRA's senior management to discuss current examination findings, new risks, and areas where their respective staffs can coordinate efforts. OCIE staff holds quarterly calls with staff from FINRA and OIEA to discuss any trends in complaints received from the public. Also, on a quarterly basis, OCIE and FINRA discuss firms that have net capital deficiencies. Finally, OCIE and FINRA discuss different methods by which information and data may be shared between the two programs to improve their respective regulatory programs.

With respect to NRSROs, the OCR has established "colleges" of regulators to facilitate information sharing and collaboration with foreign counterparts regarding large, global CRAs. See Principle 22 for additional information on OCR.

OCIE and TM staff also participate in a broad interagency group, known as the AML Task Force, whose mission is to take an in-depth look at the entire U.S. AML/CFT (counter-finance terrorism) framework. Aside from Staff, the AML Task Force is composed of representatives from Treasury, Financial Crimes Enforcement Network (FinCEN), the Federal Reserve, OCC, FDIC, the NCUA, CFTC, IRS, and the DOJ's Criminal Division.

All of the groupings described above provide opportunities to gather and share information that can be considered when setting examination priorities.

2. Is there an automated system which identifies unusual transactions on authorized exchanges and regulated trading systems?

Yes. The U.S. has automated systems that identify unusual activity on exchanges and on regulated trading systems.

The SROs use a number of automated surveillance techniques to monitor trading activity on the exchange(s) for which they provide regulatory oversight. These include techniques designed to detect various types of manipulative trading. Surveillance information gathered by each SRO is routinely shared with the SEC and between SROs for effective detection of possible breaches of the securities laws. Below are examples of some surveillances used to regulate the markets.

### **Surveillances of Equities Markets and Fixed Income Markets**

Some SROs contract out all, or part, of their surveillance programs through the use of RSAs. At this time, FINRA conducts cross market surveillance for 90% of the U.S.-listed equity market. By combining data from FINRA's markets with data from its exchange clients, FINRA has been able to develop cross-market surveillances, which can detect potentially violative trading behavior occurring across multiple markets. With the planned integration of the BATS Exchange in the first quarter of 2015, it is expected that FINRA's cross market surveillance program will cover 99%

of the listed equities market in the U.S. FINRA also conducts exchange-specific surveillance for some of its exchange clients, while other FINRA clients conduct their own exchange-specific surveillance. All FINRA exchange clients conduct their own real-time “market watch” surveillance. FINRA runs numerous surveillance “patterns” to monitor equities, fixed income, and options trading. FINRA also oversees OTC participants and broker-dealers allocated to FINRA under 17d-2 Agreements.

FINRA Surveillance:

More specifically, FINRA’s Market Regulation department has developed automated market surveillance systems to surveil for unusual market activity. Pursuant to RSAs, FINRA performs market-specific surveillance for certain SROs in addition to cross-market surveillance, which examines activity occurring on numerous exchanges. As an SRO itself, FINRA also is responsible for regulating OTC markets in equities and certain fixed income instruments. Market Regulation’s surveillance systems for the equities market include alert detection patterns for: abusive trading algorithms that are designed to improperly create momentum in the market (e.g., layering or “spoofing,” which is the practice of placing orders and then cancelling them within seconds prior to the market open or close with the intent to manipulate the price or create artificial interest in a security); wash sales; frontrunning (trading on nonpublic order information); marking-the-close (a form of manipulative activity); and locked/crossed markets (monitoring for violations of rules prohibiting the entry of bids and offers that lock or cross a market). FINRA conducts some surveillance on a T+1 (one day after the trade date) basis, and FINRA’s surveillance systems produce surveillance alerts in batches on a cycle or on a real-time basis.

FINRA’s Office of Fraud Detection and Market Intelligence has teams dedicated to the review of specific instances of potential fraud and insider trading activity based upon information generated by surveillance patterns. With respect to potential fraud, FINRA conducts surveillance for itself as the SRO for the OTC markets and exchange clients pursuant to RSAs. With respect to insider trading surveillance for equities, FINRA provides surveillance to all U.S. exchanges. For options insider trading surveillance, the Options Regulatory Surveillance Authority, which is operated by all the U.S. options exchanges, has contracted with the CBOE to provide unified surveillance.

With respect to fixed income securities, FINRA surveils corporate bond transactions and certain agency debt transactions reported through its own Trade Reporting and Compliance Engine, and municipal securities transactions reported through the MSRB’s Real-Time Transaction Reporting System. In addition to monitoring to ensure the proper reporting of transactions, FINRA also surveils for the fair pricing of transactions (markups and best execution) and certain forms of manipulative activity (some examples include parking, daisy chains, and pair-offs).

FINRA’s automated surveillance system prioritizes generated alerts, and FINRA performs an initial triage and assigns them to its analysts for further review or investigation as warranted. The review or investigation includes various measures to determine if there are potential violations of

SRO rules or federal securities laws, including contacting the firms involved in a specific transaction. The resolution of the reviews and investigations is memorialized in writing, and FINRA management reviews the findings to ensure the appropriate resolution. If a review or investigation develops evidence of potential misconduct, the matter is referred to the Legal Department within FINRA's Market Regulation for further action. In some instances, such as those in which the potential wrongdoer is not a FINRA member, FINRA refers the matter to SEC Enforcement. FINRA analysts also look at surveillance data to assist in reviewing of complaints and examinations and in performing other regulatory functions.

### SRO Specific Surveillance

Certain SROs perform their own market specific surveillances in-house. For example, CHX (other than for insider trading) and the National Securities Exchange do not outsource any surveillance functions to FINRA and conduct all surveillances in-house. The National Association of Securities Dealers Automated Quotation (NASDAQ) OMX Group outsources cross-market surveillance functions to FINRA, but uses NASDAQ's own SMARTS surveillance technology to run specific surveillance patterns for NASDAQ's three markets – NASDAQ, NASDAQ BX, and NASDAQ PHLX.

The NASDAQ Regulation Group uses the SMARTS surveillance system to assist its analysts and investigators in identifying potential violations. The NASDAQ- run SMARTS surveillance patterns are specific to NASDAQ exchange data.

After an initial validation of the alerts and some preliminary investigation work, NASDAQ refers the potential violations to FINRA for investigation and enforcement work. As part of NASDAQ's disaster and recovery protocol, NASDAQ utilizes multiple locations for surveillance work in addition to remote access capability for staff.

The BATS Exchange also conducts its own surveillance of exchange-specific activity and refers matters to FINRA for further review.

### **Surveillance of Options Markets**

SROs that operate options markets also are responsible for monitoring trading activity on their exchanges. FINRA conducts surveillances, investigations, and examinations through RSAs and 17d-2 Agreements with certain options exchanges. CBOE, the largest options exchange in the U.S., monitors trading activity on its hybrid marketplace and the electronic C2 exchange. Both FINRA and CBOE are discussed below as examples of options market surveillance.

### FINRA

FINRA's Market Regulation Department has an Options Regulation Section that conducts automated options surveillance for U.S. options exchanges. Operating primarily out of New York, FINRA monitors trading activity in hybrid and electronic options marketplaces. Through RSAs,

FINRA conducts varying levels of oversight of trading activity on: NYSE Arca; NYSE MKT LLC; the International Securities Exchange; International Securities Exchange Gemini; BATS Exchange, Inc., (BATS Options is an options market operated by BATS Exchange, Inc.); the BOX Options Exchange; the NASDAQ Options Market; NASDAQ OMX PHLX; and NASDAQ OMX BX Options. FINRA also oversees OTC participants and broker-dealers allocated to FINRA under 17d-2 Agreements.

FINRA conducts surveillances of both electronic and floor-based trading activity. The surveillances cover potential concerns such as: best execution; priority, including the mismarking of origin codes; floor broker practices; market manipulation; market maker obligations; Regulation SHO violations; and improperly executed qualified contingent crosses. FINRA also investigates potential rule violations based on, among other things, reviews of surveillance reports and complaints by market participants. If merited based on the investigation, FINRA will then refer a matter to Market Regulation's Legal Department.

### CBOE

As noted above, CBOE is the largest U.S. options exchange. CBOE is a hybrid market, consisting of both floor-based and electronic trading activity. CBOE's parent company, CBOE Holdings, Inc., also runs another fully electronic options market called C2 Options Exchange, Incorporated (C2). C2 operates as a separate SRO from CBOE with its own set of rules.

The CBOE's Regulatory Services Division (RSD) is responsible for monitoring CBOE and C2 member compliance with trading rules and procedures through its surveillance and examinations programs in order to provide a fair and equitable marketplace. RSD is also responsible for investigating potential trading-related rule violations, as well as regulatory complaints and referrals from customers, members, the SEC, other exchanges and regulatory bodies, exchange employees, and floor officials. RSD addresses potential violations related to, among other things, floor broker practices, market maker obligations, and manipulation, through its surveillance and trade practice examination programs. RSD also has a Trading Floor Liaison unit which has a presence on the trading floor and, among other things, responds to questions from the trading floor concerning Exchange rules and member complaints regarding potential regulatory issues.

RSD administers more than 100 surveillance programs covering CBOE and C2. For example, among other things, RSD conducts surveillance to detect: potential capping and supporting activity (*e.g.*, manipulative trading intended to move the price of an option's underlying stock to trigger or prevent the exercise of an option); front running activity (trading on nonpublic information); best execution violations (*e.g.*, trading through the NBBO); and marking the open and close activity (trading intended to manipulate the open/close price). RSD also administers financial and trade practice examination programs, which, among other things, provides additional oversight of trading practices and policies, including, but not limited to, the integrity of trading desk supervision and information barriers, the SEC's Market Access Rule, Regulation NMS and the Net Capital Rule.



Because CBOE runs a hybrid market, RSD's surveillance and investigative work concerns trading conduct both on and off the trading floor. If RSD staff finds evidence of a potential violation through surveillance or examination, then RSD will conduct further investigation in order to build a case. Once the case is established, RSD investigators will involve Office of Enforcement staff and, as applicable, seek authorization from the CBOE (or C2) Business Conduct Committee to initiate a disciplinary action against the CBOE (or C2) member who may have violated a rule. Enforcement staff will also provide assistance as needed during the development of an investigation.

### **Oversight of SRO Surveillance Through OCIE Examinations**

As described above in 12.1(b), OCIE examiners conducts of examinations of SROs and may review SROs' surveillance programs during examinations. When inspecting an SRO's surveillance program, the Staff's objectives are to determine whether (i) the parameters of SRO automated surveillance systems are appropriately designed to generate alerts that identify potential instances of noncompliance with SRO rules and federal securities laws and (ii) the systems are effectively detecting such activity. OCIE begins by reviewing applicable SRO rules, a description of the parameters for the surveillance systems designed to monitor the markets for compliance with these rules, and logs of the alerts that these systems generated. OCIE staff then reviews this information to determine whether the system is appropriately designed to identify noncompliance and whether it is functioning as designed. If a surveillance pattern or surveillance program is determined to be ineffective, the examination team will inform the SRO during the exit conference of any issues and note it as a risk in the examination report. If the examination team identifies a potentially serious violation of the federal securities laws or of the SROs own procedures or if the problem persists at the SRO, the examination team may refer the matter to Enforcement.

3. Can the regulator demonstrate adequate mechanisms and procedures to detect and investigate:

(a) Market and/or price manipulation?

(b) Insider trading?

(c) Misrepresentations of material information or other fraudulent or manipulative practices relating to securities and derivatives?

(d) Failure of compliance with other regulatory requirements, for example: conduct of business, capital adequacy, disclosure or segregation of client assets?

Yes. The SEC has adequate mechanisms and procedures to detect and investigate suspected breaches of the federal securities laws, including those covering violations described in (a) through (d).

For example, both the SEC and the SROs have mechanisms that identify unusual transactions on authorized exchanges and regulated trading systems. See response to Question 12.2 above for



additional information on SROs' automated surveillance systems and OCIE examinations related to such systems. OCIE may obtain information regarding trading activity on a particular market during the SRO examination process or on an *ad hoc* basis, if necessary, to assess an exchange's market activity on a specified date or in a particular security. Moreover, the violations described above in (a) – (d) are potential areas of focus in all examinations of all registrants. Additionally, the Office of Market Surveillance (OMS) coordinates with the SROs to detect anomalous market activity, including suspicious trading by persons or entities. Data collected by the SROs and OMS facilitates timely investigation of potential violations of the securities laws, including both market manipulation and insider trading activity.

In addition, the regulatory system contemplates the participation of certain professional gatekeepers, such as accountants, attorneys, and transfer agents to help in the detection and prevention of fraud and compliance failures. These gatekeepers are tasked with various regulatory requirements and professional standards that govern their work. The SEC monitors and investigates these gatekeepers, and the SEC and the SROs may take disciplinary action including suspending or barring such persons, as appropriate, where failures are found.

Additional mechanisms and procedures designed specifically to detect each of the four violations listed in Question 3(a) through (d) are described below.

### **Market and/or Price Manipulation**

#### **Examinations and Surveillance**

OCIE has a number of mechanisms and procedures designed to detect and investigate market or price manipulation. The mechanisms include, but are not limited to, OCIE's review of SARs and other reports filed under the BSA; tips, complaints or referrals received through the SEC's TCR system; trade analysis conducted through the National Examination Analytics Tool and OCIE's RAE initiative; and the work performed in OCIE's six specialized working groups on: (i) new and structured products; (ii) valuation; (iii) equity market structure and trading practices; (iv) fixed income and municipal markets; (v) microcap fraud; and (vi) marketing and sales practices. In addition, market and price manipulation are potential areas of focus in all of OCIE's examinations of registrants.

#### **Enforcement**

As noted previously, the SEC enforces the federal securities laws. Among those are laws that broadly prohibit market manipulation. Prohibited conduct includes engaging in wash sales or other attempts to create a false or misleading appearance of active trading in any security, as well as effecting a series of transactions to raise or depress the price of a security for the purpose of inducing transactions in the security by others.

Statutes enforced in market manipulation cases may include Sections 9, 10(b), and 15(c) of the

Exchange Act. Section 9 of the Exchange Act outlaws manipulative practices in connection with the trading of securities and also provides a private remedy for investors injured by the prohibited manipulative conduct. Section 9(a)(6) of the Exchange Act gives the SEC the authority to promulgate rules prohibiting “pegging, fixing or stabilizing” securities prices. Section 10(b) of the Exchange Act empowers the SEC to promulgate rules barring manipulative and deceptive conduct. Section 10(b) of the Exchange Act applies to the purchase or sale of all securities transactions utilizing an instrumentality of interstate commerce. Section 15(c) of the Exchange Act prohibits fraudulent and manipulative conduct by broker-dealers. Section 15(c) of the Exchange Act covers the OTC markets and municipal securities. Several additional provisions of, and rules under, the Exchange Act govern specific manipulation activities.<sup>348</sup>

Enforcement uses various techniques to detect market manipulation. Enforcement’s Market Abuse Unit and Microcap Fraud Task Force focus on these issues using specialized techniques and specialized personnel. More information about Enforcement’s investigative mechanisms and techniques and prosecutorial powers can be found in Principles 10 and 11 and in response to Question 12.9 below.

Over the most recent five years, the following enforcement actions were primarily classified<sup>349</sup> as market manipulation cases:

Fiscal Year	Market Manipulation Cases
2013	50
2012	46
2011	35
2010	34
2009	39

More information about the SEC’s market manipulation cases is available at: <http://www.sec.gov/spotlight/microcap-fraud.shtml>.

<sup>348</sup> See, e.g., Sections 9(b) and (e), 13(e), 14(e), 10(a) and (b), and 15(c) of the Exchange Act; Rules 10b-1, 10b-3, 10b-5, 10b-9, 10b-10, 14e-3, 14e-4, 14e-5, 10b-16, 10b-17, 10b-18, 15c1-2, 15c1-3, 15c1-5, 15c1-6, 15c1-7, 15c1-8, 15c1-9, 15c2-1, 15c2-4, 15c2-5, 15c2-7, 15c2-8, and 15c2-11 thereunder; and Regulation M. These requirements and prohibitions against market manipulation are supplemented by rules of the SROs and the MSRB.

<sup>349</sup> Primary classifications are based upon an assignment by Enforcement staff of a primary subject matter classification to each investigation. Please note, however, that many investigations include violations of several substantive areas of the law. Therefore, these figures may underrepresent the number of cases filed which pertain to a given subject area.

**Insider Trading**

Under U.S. law, insider trading is generally described as trading on the basis of material nonpublic information that has been used or obtained in a breach of a fiduciary duty or a duty of trust or confidence. The fundamental prohibition against insider trading under the federal securities laws is not based on an explicit statutory prohibition. Instead, federal courts have interpreted the general anti-fraud provisions of Section 17(a) of the Securities Act, as well as the Exchange Act (primarily Section 10(b) and Rule 10b-5 thereunder) to prohibit trading based on material nonpublic information in violation of a duty.

**Examinations and Surveillance**

To detect insider trading, FINRA has established automated surveillance systems that monitor their markets, and all other markets, for aberrational movements in a stock's price or volume of shares traded, among other things, and generate alerts if a stock's price or volume of shares traded moves outside of set parameters. These systems link trade activity data to: news and research about corporate transactions (such as mergers, acquisitions, or earnings announcements); public databases of listed company officers and directors; and other internal and external sources of information to detect possible insider trading. In conducting reviews of these alerts, FINRA staff considers such factors as the materiality of news, the existence of any previous news announcements, and the profit potential. If, in reviewing the trading associated with the alert, FINRA staff determines there is a strong likelihood of insider trading, they can expand this review to a full investigation. In the course of a full investigation, SROs gather information from their member broker-dealers and the issuer of the traded stock to determine whether there is any relationship between those individuals who traded the stock and those individuals who had advance knowledge of the transaction or event. For example, FINRA staff will typically request from their member broker-dealers the names of individuals and organizations that traded in advance of a corporate transaction or event, a process known as Bluesheeting. These data are then cross-referenced with information the SRO staff obtains from the issuer of the stock, including a chronology of the events leading up to the corporate transaction or event and the names of individuals who had knowledge of inside information. The CBOE's surveillance of insider trading in options is similar to this process. In addition, insider trading is a potential area of focus in all of OCIE's examinations of registrants.

**Enforcement**

Insider trading enforcement actions may be brought against the person who traded on the basis of material, nonpublic information, and against a "tipper," a person who disclosed material, nonpublic information in violation of a duty to a "tippee" who then traded on the basis of that information. Actions also may be brought against the tippee if he or she knew or should have known that the information was provided in breach of a duty.

Section 14(e) of the Exchange Act and Rule 14e-3 thereunder establish a specific insider trading

prohibition in the context of a specific type of corporate transaction known as a “tender offer.” Together these provisions prohibit trading while in possession of material, nonpublic information if any person has taken substantial steps toward a tender offer, and the person knows or had reason to know that the information was nonpublic and came from a proscribed source, such as the offeror.

In addition, Section 16(b) of the Exchange Act imposes liability for short-swing profits in the issuer’s stock upon all persons required to file reports under Section 16(a) of the Exchange Act (officers, directors, and beneficial owners of more than 10% of any class of equity security). These statutory insiders must disgorge to the issuer any profit realized as a result of a purchase and sale or a sale and purchase of covered equity securities occurring within a six-month period.

Enforcement uses a variety of methods to detect insider trading. For example, Enforcement’s Market Abuse Unit and Automated Bluesheet Analysis Project focus on the detection and investigation of suspicious trading. More information about Enforcement’s investigative mechanisms and techniques, and prosecutorial powers can be found in Principles 10 and 11 and in response to Principle 12, Question 9 below.

In the most recent five years, the following enforcement actions were primarily classified as insider trading cases:

Fiscal Year	Insider Trading Cases
2013	44
2012	58
2011	57
2010	53
2009	37

More information about insider trading cases is available at:

<http://www.sec.gov/spotlight/insidertrading/cases.shtml>.

### **Misrepresentations, Manipulative Practices and Offerings**

As discussed above, the SEC investigates all types of potential securities fraud, manipulation, and misrepresentations (including schemes and offering frauds), and misleading disclosures. The federal securities laws, including Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Section 17(a) of the Securities Act, previously discussed, prohibit fraud and misrepresentations.

### Examinations and Surveillance

Most of the OCIE examination program's mechanisms and procedures detect misrepresentations and manipulative practices and also detect failure to comply with other regulatory requirements, as discussed in depth below. In addition, misrepresentation and manipulative practices are potential areas of focus in all of OCIE's examinations of registrants. The SEC also has the authority to request a variety of trading information to identify and verify trades and clearing of issuer securities, including, for example, market-maker price movement reports and equity clearing runs. The SEC also maintains an electronic Bluesheet System that allows the SEC to review trading data from broker-dealers. The SEC uses this market data to detect possible fraud, among other manipulative practices.

### Enforcement

Enforcement staff investigates many different types of schemes and offering frauds, including Ponzi schemes, pyramid schemes, Prime Bank schemes, and other scams designed to defraud investors. Enforcement's JOBS Act Task Force and Microcap Fraud Task Force focus on detection and investigation of fraudulent offerings. See response to Principle 12, Question 9 for more information.

Over the most recent five years, the following enforcement actions were primarily classified as securities offering cases, as illustrated in the chart below:

<b>Fiscal Year</b>	<b>Securities Offering Cases</b>
2013	103
2012	89
2011	123
2010	144
2009	141

More information about securities offering fraud cases is available at:  
<http://www.sec.gov/spotlight/enf-actions-ponzi.shtml>.

Enforcement also investigates many different types of fraud due to misrepresentations and omissions, ranging from complicated accounting and financial reporting misrepresentations and omissions made in the public filings of large multinational corporations to fraudulent disclosures made in microcap issuer cases. Enforcement's Financial Reporting and Audit Task Force focuses on the detection and investigation of fraudulent accounting and financial reporting. More information about Enforcement's investigative mechanisms and techniques, and prosecutorial powers can be found in Principles 10 and 11 and in response to Principle 12 Question 9 below.

Over the most recent five years, the following enforcement actions were primarily classified as issuer reporting and disclosure cases:

Fiscal Year	Issuer Reporting and Disclosure Cases
2013	68
2012	79
2011	89
2010	126
2009	143

### **Failure to Comply with Other Regulatory Requirements**

#### Examinations and Surveillance

- *Broker-Dealers*

SEC examinations review a wide range of risk-based topics, including, for example, conduct of business, capital adequacy, and disclosures or segregation of client assets. For example, broker-dealers are required to maintain a certain level of financial soundness. This is regulated through broker-dealer financial responsibility rules, which are designed to: provide safeguards with respect to customer funds and securities held at registered broker-dealers; promote accountability of those funds and securities; require the maintenance of accurate books and records; and require the broker-dealer to maintain sufficient liquid assets so that, if necessary, it can be liquidated in an orderly manner without the need for a formal proceeding.

Rule 15c3-1 under the Exchange Act, the “net capital rule,” prescribes minimum liquidity standards for broker-dealers. Its purpose is to ensure that broker-dealers maintain sufficient liquid assets to satisfy promptly the claims of customers in the event the broker-dealer fails plus a cushion of liquid assets in excess of liabilities to cover potential market and credit risks.

Rule 15c3-3 under the Exchange Act, the “customer protection rule,” protects customer funds and securities held by the broker-dealer. It requires a broker-dealer to have possession or control of all fully paid and excess margin securities of customers, and to make a daily determination to ensure that it is complying with this aspect of the rule. Additionally, the rule requires a broker-dealer to segregate and make a periodic computation of credits in excess of debits.

SEC rules under the Exchange Act require a broker-dealer to file periodic reports containing financial and operational data with the SRO that is its DEA. Most broker-dealers must also file with the SEC and their DEAs an annual audited report containing: a statement of financial condition; a statement of income or loss; a statement of changes in financial position; a

statement of changes in shareholders' equity; and a statement of changes in subordinated liabilities. The annual audited report is accompanied by a supplemental accountant's report setting forth any material inadequacies. Finally, the rules require broker-dealers carrying customer accounts to send their customers an audited balance sheet and other information.

Other regulatory requirements that may be reviewed in broker-dealer examinations include:

- Reserve formula computations;
- Proper accounting for, and safekeeping of, customer funds and securities;
- Internal controls issues, including trading risk management, credit risk management, operational and legal controls, and internal auditing;
- Supervision;
- Sales practice issues, including suitability, churning, misrepresentations, cold calling, and unauthorized trading;
- Underwriting and distribution issues; and
- AML.

The matters referred to Enforcement for possible investigation from broker-dealer examinations vary, but historically have involved such issues as unsuitable transactions, misrepresentations and omissions, employment of manipulative and deceptive devices, inadequate supervisory practices, inadequate preservation of books and records, and inadequate net capital.

Additionally, staff also meets regularly with broker-dealers, with an emphasis on six ANC Broker-Dealers (*i.e.*, that use VAR to compute regulatory net capital). Staff monitors ANC Broker-Dealers on a regular basis focusing on, among other things, market risk, credit risk, liquidity risk, price verification, treasury, finance, and internal audit. Market events may cause the office to monitor the firms more closely, sometimes on a daily basis.

- *Investment Companies*

Regulatory requirements that may be reviewed in investment company examinations include valuation procedures, suitability, disclosure, revenue sharing, performance representations, and misappropriation of fund assets. Topics covered in investment company examinations include determining whether:

- Custodial records reconcile with fund and investment advisers' records and all discrepancies are resolved;

- Information that is created, recorded, maintained, and reported is protected from unauthorized use, alteration, and destruction;
- Fund/shareholder order processing and cash-book reconcile;
- Clients' funds and assets are safely maintained;
- Fund asset pricing and fund NAV calculations are fair and accurate;
- Personal trading of access persons are reported and reviewed;
- Allocation of blocked trades and trades with limited offerings are fair and consistent with policies;
- Order placement practices are consistent with seeking best execution and disclosures;
- Fund performance information is fair and accurate;
- Fund corporate governance is robust; and
- Independent, third-parties have control over periodic account statements to clients.

The matters referred to Enforcement from investment company examinations for possible investigation vary, but historically have involved such issues as conflicts of interest, (including transactions with affiliates), personal trading activities of fund personnel, distribution of fund shares, compliance program or internal control deficiencies, corporate governance, books and records, and pricing of fund assets.

- *Investment Advisers*

Regulatory requirements reviewed in investment adviser examinations include determining whether:

- Block trades and IPOs are allocated fairly and are consistent with disclosures;
- Client assets are priced fairly;
- Clients receive periodic account statements from third parties;
- Information that is created, recorded, maintained, and reported is protected from unauthorized use, alteration, and destruction;



- Portfolio management decisions are consistent with client mandates;
- Clients' funds and assets are safely maintained;
- The firm maintains a strong compliance culture;
- Orders are placed in ways that result in best execution;
- Clients receive disclosure that accurately describes the services rendered, compensation charged, and the conflicts surrounding the relationship;
- Personal trading of access persons are reported and reviewed; and
- Performance information provided to clients is presented fairly.

The matters referred to Enforcement for possible investigation from investment adviser examinations vary, but historically have involved such issues as: conflicts of interest; safety of client assets; brokerage and execution practices; personal securities transactions; compliance program or internal control deficiencies; materially misleading or omitted disclosures; false and misleading advertisements or performance calculations; and books and records concerns.

- *SROs*

SROs are responsible for establishing, reviewing, and enforcing standards of conduct for their members and, accordingly, make rules governing sales practices, trading and business practices, member financial responsibility, and enforcement of those rules and the relevant SEC laws and rules. In addition, the SEC conducts risk-based examinations of the SROs' examination, regulatory, and surveillance programs. See response to Principle 12, Question 1(b) for additional information on the SEC's examinations of SROs.

#### Enforcement

When Enforcement receives referrals from OCIE or SROs regarding an entity's failure to comply with regulatory requirements, it determines whether to conduct additional investigation into these failures. Where appropriate, Enforcement recommends to the Commission that it bring an action against those persons who appear to have violated the securities laws. More information about Enforcement's investigative mechanisms and techniques, and prosecutorial powers can be found in Principles 10 and 11 and in response to Principle 12, Question 9 below.

4. Does the regulator have an adequate system to receive and respond to the intelligence that it receives?

Yes. The SEC has adequate systems to receive and respond to the intelligence it receives.

In fiscal year 2013, the SEC received approximately 16,000 TCRs through its TCR Portal, located on its website ([www.sec.gov](http://www.sec.gov)), as well as letters, calls, and emails sent to Enforcement, OIEA, and other offices. OMI, which was created in 2010, collects, analyzes, refers, and monitors TCRs submitted by the public, whistleblowers, other domestic and foreign government agencies, and various SROs. Other Divisions and Offices within the SEC also provide referrals to Enforcement when they uncover potentially violative activity. OMI also reviews thousands of reports submitted by financial institutions, as required under the BSA. OMI reviews intelligence for further disposition, which may include assignment to investigation or examination staff for appropriate follow up and pursuit.

OMI includes OMS, which coordinates with SROs to gather intelligence on anomalous market activity, and coordinates with the Office of the Whistleblower (OWB), which was established to administer the SEC's whistleblower program.

**Intelligence Provided by Investors and the General Public**

Staff thoroughly reviews and evaluates information provided by investors so that it may be referred to the appropriate SEC office. OIEA handles certain general questions about the securities laws and complaints relating to financial professionals or a complainant's personal financial matters. The professionals in OIEA counsel investors regarding possible remedies and may, under appropriate circumstances, approach brokerage firms, advisers, or other financial professional concerning matters raised.

Enforcement staff evaluates TCRs concerning potential violations of the federal securities laws. If a TCR warrants followup or investigation, Enforcement staff is assigned and proceeds accordingly. It is the general policy of the SEC to conduct its investigations on a confidential basis in order to preserve the integrity of its investigative process as well as to protect persons against whom unfounded charges may be made or where the SEC determines that enforcement action is not necessary or appropriate. If an investigation finds potential violations of the securities laws, public enforcement actions, including administrative proceedings and federal district court actions, may result, as discussed in Principle 11.

**Intelligence Provided by Whistleblowers**

The OWB, established following the enactment of new whistleblower provisions in the Dodd-Frank Act, administers the SEC's whistleblower program, gathers intelligence from whistleblowers, and refers matters to other Enforcement staff for further investigation where appropriate. Assistance and information from whistleblowers can help the SEC identify possible

fraud and other violations much earlier than might otherwise have been possible. Whistleblower intelligence and assistance helps the SEC to minimize the harm to investors, better preserve the integrity of the U.S. capital markets, and more swiftly hold accountable those responsible for unlawful conduct.

Among other things, Enforcement's whistleblower program enables the SEC to pay an award, under regulations prescribed by the SEC and subject to certain limitations, to eligible whistleblowers who voluntarily provide the SEC with original information about a potential violation of the federal securities laws that leads to the successful enforcement of a covered judicial or administrative action, or a related action, as defined by the Dodd-Frank Act. The SEC may provide monetary awards to eligible individuals who come forward with high-quality, original information that leads to an enforcement action in which over \$1,000,000 in sanctions is ordered. The range for awards is between 10% and 30% of the money collected. In recent years, significant awards were paid to whistleblowers that provided Enforcement with original information and assistance in bringing successful enforcement actions against securities law violators. For example, one claimant received an award exceeding \$14 million in recognition of the significance of the information and assistance provided.<sup>350</sup> For another example, multiple claimants received 5% each of the monetary sanctions collected in two related actions.<sup>351</sup>

The Dodd-Frank Act also provides various confidentiality protections to whistleblowers and expressly prohibits retaliation by employers against individuals who become whistleblowers under SEC rules. In a recent SEC case, a hedge fund paid over \$2 million to settle claims of retaliation against a whistleblower that shed light on securities violations.<sup>352</sup> In addition, the U.S. Occupational Safety and Health Administration's Office of the Whistleblower Protection Program continues to administer the whistleblower protection provisions under the Sarbanes Oxley Act of 2002.

### **Intelligence Provided by Market Participants**

For more information about intelligence gathered by market participants and coordinated through OMS, please see the response to Principle 12, Question 2.

<sup>350</sup> See *In the Matter of the Claim for Award in Connection with [Redacted]*, (Release No. 70554) (September 30, 2013), available at <http://www.sec.gov/rules/other/2013/34-70554.pdf>.

<sup>351</sup> See *In the Matter of the Claim for Award in Connection with SEC v. Andrey C. Hicks and Locust Offshore Management, LLC*, (Release No. 70293) (August 30, 2013), available at <http://www.sec.gov/rules/other/2013/34-70293.pdf>.

<sup>352</sup> See *Paradigm Capital Management, Inc.*, (Release No. 34-72393, IA-3857) (June 16, 2014), available at <http://www.sec.gov/litigation/admin/2014/34-72393.pdf>.

### **Examination Program Handling of Complaints and Other Intelligence**

Enforcement and OIEA may refer to OCIE complaints regarding entities subject to the SEC's examination authority and their associated persons. OCIE also will receive complaints from other Divisions or Offices within the SEC, other regulators, investors, concerned citizens, employees of entities allegedly engaged in fraud, and anonymous sources. Referred complaints are reviewed for further investigation or examination by the appropriate Staff, including staff within other OCIE examination groups, in one of the SEC's 12 Offices, or other SEC Divisions; or staff of the appropriate SRO(s).

In addition to intelligence received through TCRs, the examination program leverages intelligence received from third parties, such as other regulators and FINRA, and subscribes to certain third-party information. Examination teams review this data as part of their pre-examination due diligence in an attempt to understand as much about a registrant's business and operations as possible. From a risk assessment perspective, as discussed in Principle 12, Question 1(b), this data helps staff identify potential risks, conflicts of interest, and regulatory weaknesses. Additionally, the data and information may be used to identify potential industry risks and trends as well as potential examination candidates.

Lastly, OCIE's review of SARs, as discussed in Question 12.1(c) above, is another example of how the SEC proactively reviews and assesses intelligence received from the financial industry.

### **Compliance System**

5. Does the regulator require regulated entities to have in place supervisory and compliance procedures reasonably designed to prevent securities laws violations?

Yes, the SEC and SROs require regulated entities to have in place supervisory and compliance procedures reasonably designed to prevent violations of the federal securities laws and the SRO rules. Moreover, as discussed in the introduction to this Principle, OCIE continues to work on new initiatives to promote and enhance compliance in larger segments of the industry both through examinations and education.

### **SEC and SRO Rules Related to Supervision and Compliance**

There are several SEC and SRO rules that specifically require regulated entities to have in place supervisory and compliance procedures reasonably designed to prevent securities laws violations. These rules are discussed below.

#### **Investment Adviser and Investment Company Rules**

Rule 206(4)-7 of the Advisers Act, Compliance Procedures and Practices, makes it unlawful for registered investment advisers to provide investment advice unless they have adopted and

implemented written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder. The rule also requires that the firm review at least annually the adequacy of its policies and procedures and the effectiveness of their implementation and designate a CCO who is responsible for administering them.

Rule 204A-1, the Investment Adviser Code of Ethics, requires that registered investment advisers establish, maintain, and enforce a written code of ethics and states that firms must require supervised persons to acknowledge receipt of the code of ethics in writing.

Rule 38a-1 promulgated under the Investment Company Act, Compliance Procedures and Practices of Certain Investment Companies, requires that investment companies (funds) adopt, implement, and review at least annually written policies and procedures reasonably designed to prevent violation of the federal securities laws by the fund, including policies and procedures that provide for the oversight of compliance by each adviser, principal underwriter, administrator, and transfer agent of the fund. The fund board of directors must approve these procedures. The rule also requires that the fund designate a CCO responsible for administering the policies and procedures.

#### SRO Rules

FINRA rules related to supervision and compliance include FINRA Rule 3130, Annual Certification of Compliance and Supervisory Procedures, which requires that each member firm designate a CCO. The Rule also requires that the chief executive officer certify annually that the member has in place processes to establish, maintain, review, test, and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with FINRA and MSRB rules and the federal securities laws. This rule also requires a certification that the chief executive officer has conducted one or more meetings with the CCO in the preceding 12 months to discuss such processes.

NASD rules related to supervision and compliance include: (i) NASD Rule 3010(a), Supervision, which requires each member to have a supervisory system in place that is reasonably designed to achieve compliance with the federal securities laws and NASD rules. Each registered representative must be assigned a supervisor and must have an annual meeting with a firm designee regarding compliance matters relevant to the registered representative; (ii) NASD Rule 3010(b), which requires its members to develop written procedures to supervise the types of business in which they engage and to supervise the activities of their employees and other associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations and NASD rules; (iii) NASD Rule 3010(c), which sets forth the requirements for firms to conduct internal inspections of offices of supervisory jurisdiction and other branch and non-branch locations; and (iv) NASD Rule 3010(d), which requires firms to have written procedures regarding the supervision of transactions and for the review of correspondence by registered representatives. The NASD, prior to becoming FINRA, published several notices reminding members of their supervision responsibilities and providing guidance on supervision.

NYSE rules related to supervision and compliance include: (i) NYSE Rule 342.16, Offices – Approval, Supervision and Control, which states that supervision of registered representatives would ordinarily include at least approval of new accounts and reasonable procedures for review of registered representatives’ communications with the public; (ii) NYSE Rule 342.19, which provides for the supervision of producing branch managers; and (iii) NYSE Rule 342.24, which requires member firms to conduct annual branch examinations (with limited exceptions).

Following the consolidation of the NASD and the member regulation, enforcement and arbitration functions of NYSE Regulation into FINRA, FINRA began working to harmonize and streamline existing rules in order to develop a consolidated rulebook. The rulebook consolidation process is occurring in phases. FINRA Rule 3110, which will supersede the NASD and NYSE rules discussed above beginning in December 2014, sets forth the same requirements as those described above. See

[http://finra.complinet.com/en/display/display.html?rbid=2403&element\\_id=11470](http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=11470)

### **Compliance Examinations and Enforcement**

OCIE and the SROs test regulated entities’ supervisory and compliance procedures through examinations as discussed in response to Principle 12, Question 1. As part of each examination, OCIE and the SROs generally review at least a portion of a firm’s written supervisory policies and procedures and test to ensure that these policies and procedures are being followed.

The federal securities laws authorize the SEC to commence an enforcement action against regulated entities, including broker-dealers, investment advisers, transfer agents, NRSROs, and municipal advisors, for supervisory failures when a person subject to supervision has violated the law. Associated persons at such regulated entities, such as, for example, registered representatives also are subject to such enforcement action. See Question 12.7 for more information.

For example, as to broker-dealers, under Section 15(b)(4)(E) of the Exchange Act, the SEC brings enforcement actions against broker-dealers for failures reasonably to supervise “with a view to preventing violations” of the federal securities laws. The SEC also brings actions against individuals who fail reasonably to supervise others under Section 15(b)(6)(A)(i) of the Exchange Act.

Similarly, the SEC brings enforcement actions under Section 203(e)(6) of the Advisers Act against investment advisers for failure reasonably to supervise, in the same terms as applied to broker-dealers.

6. Does the regulator monitor how compliance procedures are executed and communicated to employees of such entities?

Yes, the SEC and SROs monitor how compliance procedures are executed and communicated to employees.

Through the annual CEO certification and investment adviser and company annual review requirements discussed in response to Principle 12, Question 5, firms are required to do annual monitoring of the adequacy of their written supervisory procedures and the implementation of those procedures. FINRA staff review broker-dealer annual CEO certifications and utilize them to select potential examination candidates. OCIE staff review investment advisers and investment company annual compliance reviews as part of examinations of those entities. Additionally, OCIE examination staff and the SROs conduct reviews of the adequacy of firms' written supervisory procedures and test whether the procedures are being implemented. Areas reviewed may include:

- Determining whether the firm has written supervisory procedures;
- Reviewing the written supervisory procedures to determine whether they are reasonably designed to achieve compliance with applicable securities laws and SRO rules and that they are updated as necessary;
- Ascertaining whether employees received the written supervisory procedures and any updates;
- Reviewing investment adviser employees' acknowledgements of receipt of the code of ethics; and
- Testing various provisions of firms' written supervisory procedures in order to determine whether they are carried out in practice.

OCIE's examinations also may include a review of the SRO's examination programs, in which case OCIE examination staff may review whether the SROs are adequately reviewing their respective member firms' written supervisory procedures.

During an enforcement investigation concerning potentially violative misconduct at a regulated entity, Enforcement staff will regularly investigate not only the violations of the primary wrongdoer but also any failures of supervision that may have taken place in connection with the wrongdoing. In addition to investigating individual supervisors, Enforcement staff will review the regulated entity's policies and procedures in order to determine whether additional charges are warranted.

7. Can the regulator take measures against or discipline or sanction regulated entities for failure to supervise reasonably subordinate personnel whose activities violate the securities laws?

Yes, the SEC can take measures against or discipline or sanction intermediaries for failure reasonably to supervise subordinate personnel whose activities violate the federal securities laws, as discussed in more detail below. In addition, some supervisory and disciplinary responsibilities are handled by the SROs. As discussed in response to Principle 12, Question 5, the SROs have detailed rules regarding the supervision of personnel.

As discussed in response to Principle 12, Question 9, the SROs investigate and discipline firms that fail to abide by these rules but in some cases may refer a firm to Enforcement for further investigation. As discussed in response to Principle 12, Question 1, OCIE conducts examinations of the SROs regulatory programs, including their investigative and disciplinary processes. If examiners find deficiencies in an SRO's regulatory programs, the SRO would typically be sent a deficiency letter outlining the deficiencies and requesting that the SRO improve its examination program accordingly. If examiners find serious deficiencies, they may refer the SRO to Enforcement for further investigation. For more information on deficiency letters see Principle 10, Question 7(c).

### **SEC Disciplinary Actions**

The SEC may sanction broker-dealers and investment advisers and their associated persons for failure to reasonably supervise individuals subject to their supervision who commit violations of the federal securities laws. A broker-dealer or investment adviser can be charged with failure to supervise when it fails to have or to implement supervisory and compliance policies reasonably designed to detect and prevent violations of the federal securities laws by subordinate personnel. Moreover, supervisors associated with a broker-dealer or investment adviser may be charged for failure to supervise if, for example, they failed to investigate suspicious trading activity or other suspicious activity by subordinate personnel.

Allegations of failure to supervise under the Exchange Act and the Advisers Act may only be adjudicated in SEC administrative proceedings. Under Section 15(b) of the Exchange Act, the SEC can censure, suspend, or revoke the registration of a broker-dealer or place limitations on its activities. Examples of such limitations may include the imposition of suspensions or bars from particular activities, such as suspending a firm from opening new accounts or participating in underwritings. Similar sanctions for failure to supervise are available against investment advisers. These sanctions are available in administrative proceedings, under Sections 203(e) and 203(f) of the Advisers Act. Civil penalties may be ordered in administrative proceedings against broker-dealers and investment advisers for failure to supervise violations (pursuant to Exchange Act Section 21B(a), and Advisers Act Section 203(i)).



**SRO Rules Related to Discipline or Sanctions for Failure to Supervise**

**SRO Rules:** FINRA Rule 8310, Sanctions for Violations of the Rules, describes the sanctions that FINRA can impose on member firms including censure, fine, suspension, expulsion, and a cease-and-desist order. FINRA Rule 3310 provides sanctions for failure to supervise. See response to Principle 9, Question 1(c) for additional details on SRO disciplinary authority.

8. Does the regulator require market surveillance mechanisms that permit an audit of the execution and trading of all transactions on authorized exchanges and regulated trading systems?

Yes. Section 19(g) of the Exchange Act requires each SRO to enforce compliance with the SRO's rules by its members, which includes mechanisms for surveilling the markets including establishing an audit trail.

For example, NASD established its Order Audit Trail System (OATS) in 1996, which required NASD (now known as FINRA) members to report certain trade and order data on NASDAQ-listed equity securities. OATS fulfilled one of the undertakings contained in the order issued by the SEC relating to the settlement of an enforcement action against the NASD for failure to adequately enforce its rules.<sup>353</sup> OATS was later expanded to include OTC equity securities. Additionally, several options exchanges implemented the Consolidated Options Audit Trail System in order to fulfill one of the undertakings in an order issued by the SEC for failure to adequately enforce their respective rules.<sup>354</sup> Since the issuance of these two SEC orders, all other exchanges have created their own audit trails to assist in surveillance activities.

In addition, in July 2012 the Commission adopted Rule 613 requiring that SROs submit an NMS plan to create, implement and maintain a CAT with respect to the trading of NMS securities that would capture customer and order event information for orders in NMS securities across all markets from the time of order inception through routing, cancellation, modification, or execution. The SROs engaged in a request for proposal process to facilitate the development of the CAT NMS plan and to eventually select an entity (the CAT plan processor) to create, implement, and maintain the CAT. Rule 613 requires the SROs to file the CAT NMS plan with the Commission. After the SROs submit the CAT NMS plan to the Commission, the Commission will publish it for notice and comment. Following the comment period, the Commission may approve the CAT NMS plan. Should the Commission approve the CAT NMS plan, implementation of the CAT itself may commence. The SROs would be required to report data to

<sup>353</sup> See SR-NASD 97-56 (1998), available at <http://www.sec.gov/rules/sro/nd9756o.htm>.

<sup>354</sup> See In the Matter of Certain Activities of Options Exchanges, Administrative Proceeding File No. 3-10282, Exchange Act Release No. 43268 (September 11, 2000) (Order Instituting Public Administrative Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions), available at <http://www.sec.gov/litigation/admin/34-43268.htm>.

the central repository within one year of the effectiveness of the CAT NMS plan, and broker-dealers (except those members that qualify as small broker-dealers) would be required to report data to the central repository within two years of the effectiveness of the CAT NMS plan.

The SEC examines FINRA and the SROs to evaluate the adequacy of the SROs' surveillance efforts. Additionally, as part of the SEC's examinations of SROs and examinations of broker-dealers, examiners often review portions of the SROs' audit trails. Moreover, the SROs also have rules requiring their members to maintain certain order, execution, and quote information.

### *Effectiveness*

9. Based on articulated criteria, does the regulator or other competent authority have an effective enforcement program in place in order to enforce securities laws?

Yes. As set out below, the SEC has an effective enforcement program in place to enforce securities laws.

### **The Enforcement Program**

The SEC has approximately 1,300 employees in Enforcement, many of whom are attorneys, accountants, and other professionals charged with investigating and prosecuting violations of the federal securities laws. Enforcement staff is located in each of the Regional Offices and in Washington, D.C.

At the end of fiscal year 2013, Enforcement had over 1,444 ongoing investigations, excluding litigation and other post investigative activities. In that year, the SEC brought 676 enforcement actions, 15% of which were filed in investigations characterized as high impact or of a national priority. Many of these cases represent some of Enforcement's most complex matters. In its investigations, Enforcement continued to bring high-quality actions, obtaining relief in 93% of actions brought in 2013.

Enforcement continues to work with other regulators. In 2013, Staff provided assistance and access to files to domestic regulators in 504 investigations and to foreign regulators in 508 investigations. Enforcement also continued to work with criminal authorities, providing assistance and working in parallel in matters where criminal action was taken in 126 cases in 2013.

In fiscal year 2013, the SEC budgeted \$449.35 million for the Enforcement program. Enforcement's resources have steadily grown to support its overall program, enhanced capabilities, and expanded specializations and initiatives, as reflected below:

- FY 2012: \$416.82 million allocated for the Enforcement program;
- FY 2011: \$415.43 million allocated for the Enforcement program;
- FY 2010: \$361.65 million allocated for the Enforcement program; and
- FY 2009: \$324.35 million allocated for the Enforcement program.

### Quantitative Snapshot

Each year, the SEC brings well over 600 enforcement actions, and obtains significant sanctions against the persons charged with wrongdoing. The tables below provide a quantitative snapshot of enforcement actions and certain key sanctions in the last five years.

<b>Fiscal Year</b>	<b>Enforcement Actions</b>
2013	676
2012	734
2011	735
2010	681
2009	664

### Examples of Sanctions Ordered in Enforcement Actions

<b>Fiscal Year</b>	<b>Disgorgement Ordered</b>	<b>Penalties Ordered</b>	<b>Officer and Director Bars</b>	<b>Trading Suspensions</b>
2013	\$2.257 billion	\$1.167 billion	81	371
2012	\$2.083 billion	\$1.021 billion	120	651
2011	\$1.878 billion	\$928 million	82	276
2010	\$1.82 billion	\$1.03 billion	71	254
2009	\$2.09 billion	\$345 million	90	192

In addition to quantitative measures, the SEC uses quality, breadth, and impact of its Enforcement efforts to measure its effectiveness. For example, in the last five years, the SEC charged 169 individuals and entities in enforcement actions arising from the financial crisis. These cases resulted in orders for more than \$3 billion in disgorgement, penalties, and other monetary relief for the benefit of harmed investors. The individuals charged include 70 senior corporate executives.

In addition, in 2013, the SEC brought enforcement actions against wrongdoers in a number of key sectors of the securities industry, including:

- exchanges to ensure they operate fairly and in compliance with applicable rules;
- investment advisers and broker-dealers for taking undisclosed fees and for disrupting the markets through failures in their automated trading systems;
- issuers involving financial reporting failures;
- auditors and others who serve as gatekeepers in the financial system;
- large multinational corporations in FCPA cases;
- municipal issuers, and
- individuals who violate the prohibition on insider trading.

#### Examples of Developments in Enforcement in Recent Years

- One measure of the strength of an enforcement program is its ability to adjust to meet changed circumstances and evolving means of wrongdoing. In recent years, enactment of new legislation and developments within the division further enhanced Enforcement's effectiveness.

#### Enactment of the Dodd-Frank Act

Enacted in 2010, the Dodd-Frank Act strengthened the SEC's enforcement powers. Among other important provisions, and of particular relevance to Enforcement, the Dodd-Frank Act:

- provided for nationwide service of subpoenas in civil actions;
- authorized the SEC to impose civil money penalties in cease-and-desist proceedings;
- authorized the SEC, as noted in Principle 11, to impose industry-wide collateral bars;
- clarified the obligations of foreign firms to produce audit documentation and provided for service of process by requiring foreign firms to have an agent for service of process;
- clarified the standard for aiding and abetting liability in civil actions for violations of the Exchange Act;
- provided authority for charging aiding and abetting liability under the Securities Act and Investment Company Act;

- authorized the SEC to obtain penalties against aiders and abettors in civil actions brought under the Advisers Act;
  - clarified that “control person” liability under Exchange Act Section 20(a) applies in SEC enforcement actions;
  - specified that manipulative short sale transactions are unlawful; and
  - authorized the SEC to sue persons associated with NRSROs.
- Significant Enforcement Developments and Initiatives

### Cooperation Program

In January 2010, the Commission announced a series of measures to strengthen its enforcement program by encouraging greater cooperation from individuals and companies in its investigations and enforcement actions. The program established incentives for individuals and companies to cooperate and assist with SEC investigations and enforcement actions and provided new tools to help investigators develop evidence. Over the past four years, Enforcement has developed and refined the program to enhance its capabilities. The SEC uses an analytical framework to evaluate whether, how much, and in what manner to credit the cooperation by individuals and companies in its investigations and enforcement actions. The benefits to cooperators can range from reduced charges and sanctions in enforcement actions to taking no enforcement action at all. For additional information, see the [\*Policy Statement of the Securities and Exchange Commission Concerning Cooperation by Individuals in its Investigations and Related Enforcement Actions\*](#), SEC Rel. No. 34-61340 (Jan. 13, 2010).

### Admissions

In fiscal year 2013, the SEC announced a new settlement protocol to require admissions in certain cases where there is a heightened need for public accountability. Under the new policy, admissions may be required in cases where violations of federal securities laws include particularly egregious conduct, significant investor harm, significant market risk, obstruction of an SEC’s investigation, an admission can send a particularly important message to the markets, or the wrongdoer poses a particular further threat to investors or the markets. For more information, please also refer to Principle 11.

### Implementation of Specialized Units

In 2010, Enforcement launched five national specialized units to target staff and other Division resources to areas of significant concern. In the years since, the units continue to enhance Enforcement’s ability to detect and investigate specialized

types of securities fraud. The units have brought significant actions. The units focus on the key areas of: Asset Management; Municipal Securities and Public Pensions; FCPA; Complex Financial Instruments (originally called Structured and New Products); and Market Abuse. The units were created in order to more efficiently focus personnel in these important areas and to build expertise and knowledge of these areas.

*Asset Management Unit (AMU)*: The AMU focuses on violations of the federal securities laws in the asset management area. Through their work on investigations involving asset managers and specialized training, AMU members develop insights into the operating environments and strategies of investment companies, mutual funds, hedge funds, and private equity funds, and their investment advisers. Among other areas, the AMU focuses on conflicts of interest, fee structures, valuation practices, disclosure, fund governance, compliance practices, portfolio management, and other conduct or practices related to the asset management business. The AMU uses its specialized knowledge to develop proactive investigative approaches and to identify emerging risk areas. The AMU has a number of industry experts, including in the areas of private funds and portfolio management, mutual fund operations, hedge fund due diligence, mutual fund governance, and risk management.

The AMU has brought a number of significant enforcement actions, including the following recent examples: The SEC brought a settled action against a California-based investment adviser for concealing investor losses that resulted from a coding error and engaging in nearly 300 impermissible cross transactions that favored certain clients over others. Western Asset Management Company, which is a subsidiary of Legg Mason, agreed to pay more than \$21 million to settle the SEC's charges as well as a related matter by the U.S. Department of Labor.<sup>355</sup> The SEC brought a settled action against a registered hedge fund adviser, an unregistered affiliated adviser, and their principal for violations for custody, anti-fraud, compliance, reporting, and books-and-records provisions related to investments in a significant amount of a fund-of-fund client's assets in promissory notes as a material deviation from the fund's stated investment strategy. The Respondents also engaged in undisclosed principal transactions.<sup>356</sup> The Commission instituted settled cease-and-desist proceedings against five trustees, the CCO, and the administrator of the Northern Lights series trusts for disclosure, compliance, reporting and

<sup>355</sup> *In the Matter of Western Asset Management Co.*, Release No. IA-3762 (Jan. 27, 2014), available at <http://www.sec.gov/litigation/admin/2014/ia-3762.pdf>.

<sup>356</sup> *In re Further Lane Asset Management LLC*, Release No. IA-3707 (Oct. 28, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-70759.pdf>.

recordkeeping violations related to the investment advisory contract approval process under Section 15(c) of the Investment Company Act.<sup>357</sup> The SEC brought settled public administrative and cease-and-desist proceedings against two investment advisers at Oppenheimer & Co. for misleading investors about the valuation policies and performance of a private equity fund they manage. Oppenheimer agreed to pay more than \$2.8 million to settle the SEC's charges.<sup>358</sup>

Additionally, the AMU has a number of initiatives, including joint initiatives with OCIE, including the Compliance Program Initiative and the Undisclosed Adviser Revenue Initiative.

*Municipal Securities and Public Pensions Unit (MSPPU):* The MSPPU focuses on the Commission's enforcement efforts to police misconduct in the \$3.7 trillion market for municipal securities and in connection with pension funds for state and local government employees, which hold approximately \$2.7 trillion of assets. Members of the unit include specialized experts in the municipal securities market. The unit focuses on proactively identifying market activities that pose the greatest risk of harm to investors and is currently focusing its efforts on investigating and pursuing enforcement actions in specific categories of misconduct, including: (i) offering and disclosure fraud; (ii) pay-to-play and public corruption violations; (iii) public pension accounting and disclosure violations; and (iv) valuation and pricing fraud.

The MSPPU has expanded the Commission's enforcement presence in the municipal securities area with a comprehensive program that seeks to develop case law and legal precedent through high-impact cases. The Unit has brought several high profile enforcement actions including the following recent examples: The SEC brought the first action involving a penalty against a municipal issuer.<sup>359</sup> The SEC brought the first case charging a municipal issuer with falsely stating to bond investors that it had been properly providing annual financial information and notices required as part of its prior bond offerings.<sup>360</sup> The SEC brought the first case against an underwriter for violations of the MSRB's pay-to-play rule for "in-kind" political donations.<sup>361</sup>

<sup>357</sup> *In re Northern Lights Compliance Services, LLC*, Release No. IC-30502 (May 2, 2013), available at <http://www.sec.gov/litigation/admin/2013/ic-30502.pdf>.

<sup>358</sup> *In the Matter of Oppenheimer Asset Management Inc. and Oppenheimer Alternative Investment Management, LLC*, Release No. 33-9390 (Mar. 11, 2013), available at <http://www.sec.gov/litigation/admin/2013/33-9390.pdf>.

<sup>359</sup> *In the Matter of the Greater Wenatchee Regional Events Center Public Facilities District*, Release No. 33-9471 (November 5, 2013), available at <http://www.sec.gov/litigation/admin/2013/33-9471.pdf>.

<sup>360</sup> *In the Matter of West Clark Community Schools*, Release No. 33-9435 (July 29, 2013), available at <http://www.sec.gov/litigation/admin/2013/33-9435.pdf>.

<sup>361</sup> *In the Matter of Goldman Sachs*, Release No. 34-67934 (September 27, 2012), available at <http://www.sec.gov/litigation/admin/2012/34-67934.pdf>.

Additionally, the MSPPU recently launched a novel cooperation initiative - the Municipalities Continuing Disclosure Cooperation Initiative - to encourage issuers and underwriters who have conducted offerings that have included false representations as to prior compliance with Rule 15c2-12 annual filing requirements to self-report those violations in exchange for favorable settlement terms.

*Foreign Corrupt Practices Act Unit (FCPAU):* The FCPAU investigates possible bribery of foreign government officials by issuers and their employees, officers, and agents, and related books and records and internal controls violations. The Unit conducts large-scale FCPA investigations that are international in scope. In addition to FCPA investigations, the Unit handles investigations involving international financial fraud, reporting violations arising from business in countries subject to trade sanctions, and various cross border issues. The FCPAU is the principal point of contact with the DOJ and FBI for FCPA matters, and provides guidance and support throughout the Division for this subject area. FCPAU members regularly work with the DOJ and FBI, as well as foreign regulators, banking regulators, and other foreign law enforcement agencies. The FCPAU also works closely on international efforts to combat global corruption, including work with international organizations like the Organization for Economic Cooperation and Development and the United Nations Convention Against Corruption. The Unit has expert personnel, including dedicated forensic accounting specialists.

The FCPAU has brought of number of significant enforcement actions, including the following recent examples: The SEC brought a settled action against global aluminum producer Alcoa Inc. for violating the FCPA when its subsidiaries repeatedly paid bribes to government officials in Bahrain to maintain a key source of business. Alcoa agreed to settle the SEC's charges and a parallel criminal case by the DOJ by paying a total of \$384 million.<sup>362</sup> The SEC brought one of the first cases for books and records and internal controls violations arising from schemes to conceal transactions to countries subject to U.S. trade sanctions, in addition to authorizing bribes and improper travel and entertainment for foreign officials in the Middle East and Africa to win business. In settlement, the company paid over \$250 million to SEC, DOJ and other U.S. regulators.<sup>363</sup>

Additional examples of recent cases include the following: The SEC brought a settled action against Smith & Wesson Holding Corporation for violating the FCPA when employees and representatives of the U.S.-based parent company authorized

<sup>362</sup> *In the Matter of Alcoa, Inc.*, Release No. 34-71261 (Jan. 9, 2014), available at <http://www.sec.gov/litigation/admin/2014/34-71261.pdf>.

<sup>363</sup> *SEC v. Weatherford International*, 4:13-cv-03500 (S.D. Tex. 2013).



and made improper payments to foreign officials while trying to win contracts to supply firearm products to military and law enforcement overseas. The company agreed to pay \$2 million in disgorgement, prejudgment interest, and penalties.<sup>364</sup> The SEC brought a settled action against Hewlett-Packard for violating the FCPA when its subsidiaries in three different countries made improper payments to government officials to obtain or retain lucrative public contracts. Hewlett-Packard agreed to pay more than \$108 million to settle the SEC's charges and a parallel criminal case by the DOJ.<sup>365</sup>

Complex Financial Instruments Unit (CFIU): CFIU was the lead unit charged with investigating and litigating cases stemming from the recent financial crisis. These include the landmark \$550 million settlement with Goldman Sachs relating to the structuring and marketing of ABACUS 2007-AC1, a synthetic CDO tied to the performance of residential mortgage-backed securities.<sup>366</sup>

Other significant matters include settled CDO cases against Citigroup (\$285 million), JP Morgan (\$154 million) and Mizuho (\$128 million) and settled residential mortgage-backed securities cases against JP Morgan (\$297 million) and Credit Suisse (\$120 million).<sup>367</sup> The total amount recovered in financial crisis related cases developed by this unit is approximately \$1.7 billion.

In the wake of the financial crisis, CFIU's focus has shifted to misconduct in opaque OTC markets for complex financial instruments. These new matters include the manner in which products such as Commercial Mortgage-Backed Securities, Residential Mortgage-Backed Securities, Collateralized Loan Obligations, CDS, and derivatives are rated, sold, traded, and valued by market participants. CFIU also proactively seeks to deter and target misconduct in the sale of complex structured products to retail investors. In a recent action, the SEC charged a global investment bank and brokerage firm with failing to supervise employees on its mortgage-backed securities desk who were lying to customers about pricing. In settlement,

<sup>364</sup> *In the Matter of Smith & Wesson Holding Corporation*, Release No. 34-72678 (Jul. 28, 2014), available at <http://www.sec.gov/litigation/admin/2014/34-72678.pdf>.

<sup>365</sup> *In the Matter of Hewlett-Packard Co.*, Release No. 34-71916 (Apr. 9, 2014), available at <http://www.sec.gov/litigation/admin/2014/34-71916.pdf>.

<sup>366</sup> See *SEC v. Goldman, Sachs & Co.*, No. 10 Civ. 3229 (S.D.N.Y. filed Apr. 16, 2010) <http://www.sec.gov/litigation/litreleases/2010/lr21592.htm>.

<sup>367</sup> See *SEC v. Citigroup Global Markets Inc.*, No. 11 Civ. 7387 (S.D.N.Y. filed Oct. 19, 2011) <http://www.sec.gov/litigation/litreleases/2011/lr22134.htm>; *SEC v. JP Morgan Sec., LLC*, No. 11 Civ. 4206 (S.D.N.Y. filed June 21, 2011) <http://www.sec.gov/litigation/litreleases/2011/lr22008.htm>; *SEC v. Mizuho Sec. USA Inc.*, No. 12 Civ. 5550 (S.D.N.Y. filed July 18, 2012) <http://www.sec.gov/litigation/litreleases/2012/lr22417.htm>; *SEC v. J.P. Morgan Sec. LLC*, No. 1:12 Civ. 01872 (D.D.C. filed Nov. 16, 2012) <http://www.sec.gov/litigation/litreleases/2012/lr22533.htm>; *In re Credit Suisse Sec. (USA) LLC*, Release No. 33-9368 (Nov. 16, 2012), available at <http://www.sec.gov/litigation/admin/2012/33-9368.pdf>.

the firm agreed to, among other terms, make payments to customers totaling more than \$11 million, pay a \$4.2 million penalty to the SEC, and retain a compliance consultant. In a parallel settlement with the U.S. Attorney's Office for the District of Connecticut the firm agreed to pay an additional \$9.8 million.<sup>368</sup>

*Market Abuse Unit (MAU)*: MAU specializes in identifying and investigating abusive market practices that harm or threaten the fair and efficient operation of securities markets on a large scale. The Unit focuses on suspected abuses of market structure (including violations by exchanges, other institutional market centers, and market professionals), large scale insider trading rings, large cap market manipulations (including by high-frequency/algorithmic trading firms), abusive short selling, and other deceptive market and trading conduct.

The MAU has brought many significant enforcement actions in recent years, including the following examples: The SEC brought a settled action against New York-based LavaFlow Inc., a Citigroup business unit operating an ATS, for failing to protect the confidential trading data of its subscribers. LavaFlow agreed to pay \$5 million to settle the SEC's charges, including a \$2.85 million penalty that is the agency's largest to date against an ATS.<sup>369</sup> The SEC brought a settled action against New York based brokerage firm operating a dark pool ATS that improperly used its subscribers' confidential trading information in its marketing services. Liquidnet agreed to settle the SEC's charges and pay a \$2 million penalty.<sup>370</sup> The SEC brought a settled action against the NYSE for compliance failures that gave certain customers improper early access to trading information. NYSE and its parent company NYSE Euronext agreed to a \$5 million penalty and significant undertakings to settle the SEC's charges. It marks the first-ever SEC financial penalty against an exchange.<sup>371</sup> The SEC brought a settled action against NASDAQ for securities laws violations resulting from its poor systems and decision-making during the IPO and secondary market trading of Facebook shares. NASDAQ agreed to settle the SEC's charges by paying a \$10 million penalty – the largest ever against an exchange.<sup>372</sup>

<sup>368</sup> See *In the Matter of Jeffries LLC* (formerly known as Jefferies & Co., Inc.), Release No. 34-71695 (March 12, 2014), available at <http://www.sec.gov/litigation/admin/2014/34-71695.pdf>.

<sup>369</sup> *In the Matter of LavaFlow, Inc.*, Release No. 34-72673 (Jul. 25, 2014), available at <http://www.sec.gov/litigation/admin/2014/34-72673.pdf>.

<sup>370</sup> *In the Matter of Liquidnet, Inc.*, Release No. 33-9596 (Jun. 6, 2014), available at <http://www.sec.gov/litigation/admin/2014/33-9596.pdf>.

<sup>371</sup> *In the Matter of New York Stock Exchange LLC and NYSE Euronext*, Release No. 34-67857 (Sep. 14, 2012), available at <http://www.sec.gov/litigation/admin/2012/34-67857.pdf>.

<sup>372</sup> *In the Matter of the NASDAQ Stock Market, LLC and NASDAQ Execution Services, LLC*, Release No. 34-69655 (May 29, 2013), available at <http://www.sec.gov/litigation/admin/2013/34-69655.pdf>.

In addition, attorneys in the MAU work closely with the MAU's Analysis & Detection Center, which is staffed with industry experts, including a Trading Strategies Specialist, Quantitative Analysts, and a Securities Operations Specialist. Using quantitative methods to identify potential violations, the MAU develops proactive investigative approaches that utilize the specialized skills of the MAU's members, expertise within other Divisions and Offices, and Enforcement's technological capabilities, including the Commission's bluesheet system (see discussion of Enforcement Initiatives, below) and other analytical tools. The MAU also works with criminal authorities and other governmental agencies to investigate harmful conduct. The collaboration between the MAU and criminal authorities and other governmental agencies has resulted in the filing of highly significant civil and criminal actions across the country.

#### Implementation of Enforcement Initiatives

In addition to creating the units, Enforcement has implemented a range of initiatives designed to increase its ability to identify hidden or emerging threats to the markets and to act quickly to halt misconduct and minimize investor harm. These and other initiatives are designed to minimize investor losses by identifying wrongdoing as early as possible and maximizing the deterrent impact of our efforts. These ongoing initiatives include the following:

*Automated Bluesheet Analysis Project:* The Automated Bluesheet Analysis Project is led by the MAU and focuses on the analysis of suspicious trading patterns and relationships among multiple traders using the Division's electronic database of over six billion electronic equities and options trading records. It seeks to generate high-quality leads for new investigations and to automate and improve analyses commonly run in existing investigations.

*Center for Risk and Quantitative Analytics:* The Center for Risk and Quantitative Analytics coordinates risk identification, risk assessment, and data analytic activities, with the goals of proactively identifying threats to investors and bringing cutting-edge analysis to bear on the Division's work.

*Compliance Program Initiative:* The Compliance Program Initiative works closely with OCIE and Enforcement in coordinating efforts to identify and bring cases against registered investment advisers who lack the type of effective compliance programs and procedures that are required under the law.

*Operation Broken Gate:* Operation Broken Gate focuses on holding accountable gatekeepers who fail to carry out their duties and responsibilities consistent with professional standards, including wrongdoing by auditors. More generally, the initiative also targets the conduct of attorneys and other gatekeepers who have

special duties and responsibilities to ensure that the interests of investors are safeguarded.

#### Implementation of Enforcement Task Forces

In addition to units and initiatives, Enforcement has also created several task forces, which have enabled the Division to quickly mobilize attorneys, professionals, and industry experts to concentrate on high-priority areas and share their expertise and promising leads division-wide, including the following:

*Financial Reporting and Audit Task Force:* The Financial Reporting and Audit Task Force focuses on financial reporting and accounting fraud. The Task Force develops state-of-the-art techniques for identifying and uncovering accounting fraud. The team relies on data analytics tools and outside services to identify high-risk companies and potential accounting issues. The team also evaluates the conduct of auditors, determining whether proper audit procedures were followed and performed according to generally accepted auditing standards. The Task Force pursues false financial information that can erode investor confidence and the integrity of the markets. In turn, these efforts promote comprehensive, accurate, and reliable financial reporting.

*Microcap Fraud Task Force:* The Microcap Fraud Task Force closely monitors and pursues misconduct related to microcap securities. Abuses in this area frequently involve entities that use false or misleading marketing campaigns and manipulative trading strategies, largely at the expense of less sophisticated, retail investors. These abuses have proliferated due to the increased use of the Internet and social media to publicize fraudulent schemes. The Task Force engages in initiatives that target executives, gatekeepers, and other repeat players who help facilitate these schemes. The Task Force also aims to identify and shut down schemes in their early stages in order to halt misconduct and mitigate investor harm.

*Broker-Dealer Task Force:* The Broker-Dealer Task Force focuses on current issues and practices within the broker-dealer community. The group collaborates with the broker-dealer program within OCIE, as well as TM, to develop initiatives that can be implemented Division-wide. Among other areas, the Task Force created initiatives relating to AML regulations and recidivist brokerage firms that engage in abusive activities.

*JOBS Act Task Force:* The JOBS Act Task Force is a nationwide group dedicated to preparing Enforcement to enforce the new capital-raising rules under the JOBS Act, including rules related to general solicitation and crowdfunding. The group has created risk-based initiatives to identify parties that are not adhering to the

new regulations, including issues related to inadequate efforts to verify investor accreditation.

#### Modernization of the Handling of TCRs

Each year, the SEC receives thousands of TCRs. In order to improve the way it handles this information, the SEC has updated its policies and procedures and implemented a centralized information technology system for tracking, analyzing, and reporting on the handling of TCRs. In addition, the SEC is developing additional tools and methods to apply data analytics to this information to increase the agency's ability to detect fraud in an increasingly timely manner.

Enforcement created OMI in order to gather all TCRs in one place; combine them with other public and confidential information on the persons or entities identified; and match investigative resources with those matters presenting the greatest potential for investor harm or market disruption. OMI also serves a strategic function, harvesting data to identify newly emerging schemes and trends in securities fraud.

#### Expanded and Targeted Training

Enforcement has both expanded and targeted training for its staff. Enforcement has focused on revamping training for new employees as well as providing training on complex topics for more experienced staff. For example, new employee training is significantly revised to make it more interactive and centered on actual investigations, including insider trading investigations. Enforcement has also created a series of new courses that cover the types of investigations typically brought by Enforcement. "On-your-feet" training in testimony-taking and advocacy skills also continues to be provided to staff. In addition, Enforcement provides specialized training for the forensic IT staff, and training in forensic accounting and financial fraud investigations, eDiscovery, digital currency, etc. is also offered.

#### **The SROs' Programs to Enforce Regulatory Requirements**

The SROs also have programs in place to enforce regulatory requirements. SROs evaluate and resolve disciplinary actions and enforce the SROs' own rules and the SEC's rules against the SROs' members and the members' associated persons. SROs investigate potential violations discovered through their examination programs, market surveillance, and/or through customer complaints or tips. Investigations can result in no action, informal disciplinary action, or formal disciplinary action. Informal actions result in either a letter of caution or a compliance conference. Formal action cases are handled by enforcement departments who after their own assessment can settle or litigate actions. The largest SRO, FINRA, has an independent Office of Disciplinary Affairs that must authorize the initiation and/or settlement of all formal disciplinary

actions. Litigated cases are heard by professional hearing officers. Formal disciplinary action cases can result in fines, restitution, suspensions, and/or bars from the industry. Respondents can appeal the decisions to the SEC.

As discussed in response to Principle 12, Question 1, OCIE conducts examinations of the SROs' regulatory systems including the effectiveness of their enforcement programs. If the programs or certain aspects of the programs are deemed ineffective or violative of the federal securities laws in some way, OCIE takes one of the following actions: (i) sends an examination report to the SRO requesting that the SRO take corrective action; (ii) if the matter is serious, refers the SRO to Enforcement; and (iii) in instances where rule making by the SEC potentially needs to occur, OCIE would refer the matter to TM.

**Principle 13 Regulator should have the authority to share both public and nonpublic information with domestic and foreign counterparts.**

**Key Questions**

1. For each of the regulators identified, does the regulator have authority to share with other *domestic* regulators and authorities information on:
  - (a) Matters of investigation and enforcement?
  - (b) Determinations in connection with authorization, licensing or approvals?
  - (c) Surveillance?
  - (d) Market conditions and events?
  - (e) Client identification including persons who beneficially own or control non-natural persons organized in the regulator's jurisdiction?
  - (f) Regulated entities?
  - (g) Listed companies and companies that seek a listing of their securities?

**Nonpublic Information**

Yes, pursuant to Section 24(c) of the Exchange Act and Rule 24c-1 promulgated thereunder, the SEC has authority to share nonpublic information in its possession with other domestic regulators about such matters as set forth in Question 13.1(a)-(g).

As explained in more detail below, two conditions must be satisfied before the SEC can share such information with an authority: (i) there must be a demonstrated need for the shared information, and (ii) the SEC must receive assurances of confidentiality for the shared information.<sup>373</sup>

Section 24 addresses "Public Availability of Information." Part (c) of Section 24 provides that the SEC may, in its discretion and upon a showing that such information is needed, provide all "records" (as defined in subsection (a)) and other information in its possession to such persons, both domestic and foreign, as the Commission deems appropriate by rule, if the person receiving such records or information provides such assurances of confidentiality as the Commission deems appropriate. Records are defined in Section 24(a) of the Exchange Act to include "all applications, statements, reports, contracts, correspondence, notices, and other documents filed with or otherwise obtained by the Commission pursuant to this title or otherwise."

Rule 24c-1 addresses the sharing of nonpublic information with domestic and foreign authorities. Rule 24c-1 states the Commission may, in its discretion and upon a showing that such information is needed, provide nonpublic information in its possession to any of the following persons: a federal, state, local, or foreign government or any political subdivision, authority,

<sup>373</sup>

See Exchange Act Section 24 and Rule 24c-1 under the Exchange Act, 17 C.F.R. 240-24c-1.

agency, or instrumentality of such government, if the person receiving such nonpublic information provides such assurances of confidentiality as the Commission deems appropriate.

Rule 24c-1 broadly defines “nonpublic information” to mean records, as defined in Section 24(a) of the Exchange Act (addressed above), and other information in the SEC’s possession, which are not available for public inspection and copying.

“Nonpublic information,” as defined in Rule 24c-1, would generally cover the types of information identified in Question 13.1(a)-(g).

### **Public Information**

Yes, public information in the U.S. is available to everyone, including other regulators, domestic and foreign. The SEC regularly assists other regulators, domestic and foreign, in locating and accessing information listed in Question 13.1(a)-(g) that may be publicly available. For example, the registration status of SEC-registered persons, such as broker-dealers and investment advisers, is publicly available. A number of public resources, including websites, provide information for identifying the registration status and disciplinary history of certain persons, entities, and companies in the U.S., including broker-dealers, investment advisers, and issuers of publicly offered securities. Some of this information is available on SEC public websites. Examples of websites that may provide some of the information listed in Question 13.1(a)-(g) include:

- The SEC’s website contains information on, among other items, the federal securities laws, SEC proposed and final rules, rule changes submitted by SROs, and SEC orders granting approval of proposed rule changes. See <http://www.sec.gov>.
- The SEC’s website also contains information on SEC enforcement proceedings including descriptions of, among other things: SEC civil suits filed in federal court, administrative proceedings filed before the SEC, and trading suspensions. See <http://www.sec.gov/divisions/enforce/enforceactions.shtml>.
- The SEC’s Electronic Data Gathering, Analysis, and Retrieval system (EDGAR) database provides access to the SEC filings of companies that have registered transactions or registered securities with the SEC and that are subject to the reporting requirements of the Exchange Act. See <http://www.sec.gov/edgar/searchedgar/webusers.htm>.
- The SEC’s Investment Adviser Public Disclosure website provides the public with the ability to view the registration and reporting forms that investment advisers file with the SEC, as well as other information. See [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov).
- FINRA’s website provides public information about member firms (which are registered broker-dealers) and their associated persons, including registration status, address information, types of business conducted, legal status, and disciplinary history. See



<a href="http://www.finra.org/">http://www.finra.org/</a> .	
2.	Can the regulator share the information described in Key Question 1 for regulatory and enforcement purposes with other domestic authorities without the need for external approval such as from a relevant government minister or attorney?
Yes, the SEC may share information with other domestic authorities, as described in response to Key Question 1 for regulatory and enforcement purposes, without the need for external approval such as from a relevant government minister or attorney. See response to Question 13.1.	
3.	Does the regulator have the authority to share information with foreign counterparts with respect to each of the matters listed in Question 1, specifically?
(a)	Matters of investigation and enforcement?
(b)	Determinations in connection with authorization, licensing or approvals?
(c)	Surveillance?
(d)	Market conditions and events?
(e)	Client identification including persons who beneficially own or control non-natural persons organized in the regulator's jurisdiction?
(f)	Regulated entities?
(g)	Listed companies and companies that seek a listing of their securities?
<p><b>Nonpublic Information</b></p> <p>Yes, as described in response to Question 1, pursuant to Section 24(c) of the Exchange Act and Rule 24c-1 promulgated thereunder, the SEC has authority to share nonpublic information in its possession with foreign counterparts about such matters as set forth in Question 13.3(a)-(g). See response to Question 13.1.</p> <p>Section 24(c) of the Exchange Act and Rule 24c-1 permit sharing of nonpublic information in its possession with foreign counterparts in the same manner as sharing such information with domestic regulators. See response to Question 13.1. Rule 24c-1 further additionally includes "a foreign financial regulatory authority" among the persons to whom the Commission may, in its discretion and upon a showing that such information is needed, provide nonpublic information in its possession, if the person receiving such nonpublic information provides such assurances of confidentiality as the Commission deems appropriate.<sup>374</sup> The term "foreign financial regulatory authority" is defined in Section 3(a)(52) of the Exchange Act and includes, among other entities, foreign securities authorities, other foreign governmental bodies, or foreign equivalents of an SRO empowered by a foreign government to administer or enforce its laws related to financial activities.</p>	

<sup>374</sup> See *supra* note 373. Exchange Act Rule 24c-1 (b)(3).

In addition, for information other than that the SEC already possesses at the time a request is received, Section 21(a)(2) of the Exchange Act permits the SEC, on request from a foreign securities authority, to conduct an investigation as the SEC “deems necessary to collect information and evidence pertinent to the request for assistance.” This other information could include the types of information identified in Question 13.3(a)-(g).

Under Section 21(a)(2) of the Exchange Act, the SEC has the authority to provide assistance to a foreign securities authority if the requesting authority states that it is conducting an investigation that it deems necessary to determine whether any person has violated or is violating or is about to violate any laws or rules relating to securities matters that the requesting authority administers or enforces. Section 21(a)(2) states that the SEC may provide such assistance without regard to whether the facts stated in the request would constitute a violation of U.S. laws. In exercising this authority, Section 21(a)(2) of the Exchange Act requires the SEC to consider: (i) whether the requesting authority has agreed to provide reciprocal assistance to the SEC and (ii) whether compliance with the request would prejudice the public interest of the U.S. While not a prerequisite for sharing information with a foreign counterpart, requests made pursuant to the terms of an MOU between the SEC and a foreign authority, including the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (IOSCO MMOU), generally would be designed to satisfy the reciprocity inquiry.

The SEC may use its subpoena powers under Section 21(b) of the Exchange Act to compel the production of documents and testimony that the Commission deems relevant from any entity or individual in the U.S. As part of providing assistance to a foreign securities authority under Section 21(a)(2), the SEC may conduct an investigation and use its compulsory powers under Section 21(b) of the Exchange Act, as it would in its own investigations. This power includes requiring the production of documents held by regulated entities as well as the ability to use the SEC’s subpoena powers to compel the production of documents or testimony from any person or entity anywhere within the U.S. This power is extremely broad in scope, authorizing any member of the Commission or any officer designated by it to administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, or other records that the Commission deems relevant or material to the inquiry. Such attendance of witnesses and the production of any such records may be required from any place in the U.S. at any designated place of hearing.

Moreover, the SEC routinely provides enforcement and supervisory assistance to its counterparts. In fiscal year 2013, for example, the SEC cooperated with 508 requests from foreign regulators for enforcement assistance.<sup>375</sup>

As discussed in response to Question 13.3, there are no bank secrecy, blocking, or other statutes

<sup>375</sup> SEC 2013 Accountability and Performance Report, available at <http://www.sec.gov/about/secpar/secpar2008.pdf>; <http://www.sec.gov/about/secpar/secafr2013.pdf>.

that would restrict the ability of the SEC to share this information.

### Public Information

Yes, public information in the U.S. is available to everyone, including other regulators, domestic and foreign. The SEC regularly assists other regulators, domestic and foreign, in locating and accessing information listed in Question 13.3(a)-(g) that may be publicly available. As stated in the response to Question 13.1, some of the information listed in Question 13.3(a) - (g) may be publicly available. See the response to Question 13.1.

4. Can the regulator share the information identified in Key Question 3 above, for enforcement and regulatory purposes with *foreign* counterparts without the need for external approval, such as from a relevant government minister or attorney?

Yes, the SEC may share information, as described in response to Question 3, without the need for any form of external approval, such as from a relevant government minister or attorney. See responses to Questions 13.1 and 13.3.

5. Can the regulator provide information to other *domestic* and *foreign* authorities on an unsolicited basis?

Yes, under Section 24(c) of the Exchange Act, the SEC is permitted provide information to other domestic and foreign authorities on an unsolicited basis. The SEC may share such information if it is nonpublic upon a showing that it is needed and that the authority receiving the information provides assurances of confidentiality as the Commission deems appropriate. In some instances, both of these requirements can be satisfied in advance by the terms and conditions set forth in MOUs to which SEC is a signatory.<sup>376</sup> For example:

- Most of the SEC's supervisory MOUs with foreign authorities contain an advanced notification provision. This language provides that the SEC may inform the other authority "in advance of" (i) pending regulatory changes that may have a significant impact on the operations, activities, or reputation of a cross-border regulated entity in the other jurisdiction and (ii) any material event that could adversely impact the regulated firm in the other jurisdiction, as well as enforcement or regulatory actions or sanctions concerning the entity.<sup>377</sup>

<sup>376</sup> See [http://www.sec.gov/about/offices/oia/oia\\_cooparrangements.htm](http://www.sec.gov/about/offices/oia/oia_cooparrangements.htm) for a list of the SEC's MOUs with foreign authorities.

<sup>377</sup> See, e.g., Paragraph 22 of the MOU Concerning Consultation, Cooperation and the Exchange of Information related to Market Oversight and the Supervision of Financial Services Firms between the SEC and the Australian Securities and Investments Commission (August 2008); Paragraph 20 of the MOU Concerning Consultation, Cooperation and the Exchange of Information Related to Supervision of Cross-Border Regulated Entities between the SEC and the *Comisión Nacional Bancaria y de Valores* of the United Mexican States (October 2012).

- Section 13 of the IOSCO MMOU,<sup>378</sup> to which the SEC is one of more than 100 signatories, provides that “[e]ach Authority will make all reasonable efforts to provide, without prior request, the other Authorities with any information that it considers is likely to be of assistance to those other Authorities in securing compliance with Laws and Regulations applicable in their jurisdiction” (emphasis added).
- Pursuant to Paragraph 9(a) of the MOU between the Federal Reserve, CFTC, and SEC regarding CCPs for CDSs,<sup>379</sup> the parties agree “[t]o the extent practicable and as appropriate in the particular circumstances, to inform each other, in advance where feasible and otherwise as soon as practicable, of issues that may affect the respective regulatory or supervisory interests of the other Party or Parties with respect to CCPs and CDSs” (emphasis added).

In addition, the SEC regularly makes enforcement referrals to other domestic authorities – including the DOJ, state securities regulators, SROs such as FINRA and the NYSE – and to foreign securities authorities.

6. Can the regulator share information with *foreign* counterparts even if the alleged conduct would not constitute a breach of the laws of the regulator's jurisdiction if conducted within that jurisdiction?

Yes, Section 21(a)(2) of the Exchange Act explicitly authorizes the SEC to provide assistance to a foreign securities authority without regard to whether the facts as stated in the foreign securities authority's request would also constitute a violation under U.S. laws.

In addition, Section 24(c) of the Exchange Act and Rule 24c-1 thereunder permit the SEC, at its discretion, to share nonpublic information in its possession with foreign government authorities, provided it receives assurances of confidentiality as the Commission deems appropriate.

See responses to Questions 13.1 and 13.3.

7. Can the regulator share with *domestic* and *foreign* counterparts information and records

<sup>378</sup> Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, International Organization of Securities Commissions (May 2002).

<sup>379</sup> Memorandum of Understanding Between the Board of Governors of the Federal Reserve System, the U.S. Commodity Futures Trading Commission and the U.S. Securities and Exchange Commission Regarding Central Counterparties for Credit Default Swaps (November 2008). See <http://www.sec.gov/news/press/2008/2008-269.htm>.

<p>identifying the person or persons beneficially owning or controlling bank accounts related to securities and derivatives transactions and brokerage accounts as well as the necessary information to reconstruct a transaction, including bank records?</p>	<p>Yes. See responses to Questions 13.1 and 13.3. The SEC may share nonpublic information in its possession with domestic and foreign counterparts pursuant to Section 24(c) of the Exchange Act and Rule 24c-1 promulgated thereunder. Such information could include information concerning the beneficial ownership or control of a bank or brokerage account as well as information necessary to reconstruct a transaction, including bank records, provided the requesting authority shows that such information is needed and provides the SEC with assurances of confidentiality as the Commission deems appropriate.</p> <p>For additional detail regarding how the SEC can access these records, see response to Question 15.1. Moreover, as discussed in the response to Question 13.3, the SEC may use its subpoena powers under Section 21(b) of the Exchange Act to compel the production of documents and testimony from any entity or individual in the U.S. In addition, as part of providing assistance to a foreign authority under Section 21(a)(2) of the Exchange Act, the SEC may conduct an investigation and use its compulsory powers under Section 21(b) under the Exchange Act as it would in its own investigations. This power includes requiring the production of documents held or controlled by regulated entities as well as the ability to use the SEC's subpoena powers to compel the production of documents or testimony from any person or entity anywhere within the U.S. Accordingly, insofar as information concerning the beneficial ownership or control of a bank or brokerage account is relevant to such an investigation, the SEC has the authority to use its subpoena powers to obtain this information regardless of where it is located in the U.S. See also response to Question 13.1.</p> <p>As discussed in response to Question 13.3, there are no bank secrecy, blocking, or other statutes that would restrict the ability of the SEC to share this information.</p> <p>See responses to Questions 13.1 and 13.3.</p>
<p>8. Does the regulatory system provide enough assurance that the confidential information gathered by the Regulator in the exercise of its functions or powers that is shared with another competent authority, either domestically or internationally, is subject to appropriate rules of confidentiality?</p>	<p>Yes, the regulatory system provides sufficient assurance that the confidential information gathered by the SEC in the exercise of its functions or powers that is shared with another competent authority, either domestically or internationally, is subject to appropriate standards of confidentiality. See responses to Questions 13.1 and 13.3. As a condition to sharing nonpublic information in its possession with other competent authorities pursuant to Section 24(c) of the Exchange Act and Rule 24c-1, the SEC must receive assurances of confidentiality that the</p>

Commission deems appropriate from the authority seeking such nonpublic information.

Moreover, SEC has procedures in place designed to ensure that assurances of confidentiality are obtained either through an MOU or access request letters, among other processes, and in a manner consistent with applicable statutory and rule requirements. See response to Question 14.7. Typically, the terms and conditions of the SEC's MOUs with domestic and/or foreign authorities are designed to satisfy the requirement for confidentiality assurances. Furthermore, Staff has written procedures addressing the manner in which information-sharing is to occur with other regulatory authorities and law enforcement (both foreign and domestic), as discussed in the response to Question 14.7.

**Principle 14 Regulators should establish information sharing mechanisms that set out when and how they will share both public and nonpublic information with their domestic and foreign counterparts**

**Key Questions**

1. Does the regulator have the power, by legislation, rules or as a matter of administrative practice, to enter into information-sharing agreements (whether formal or informal) with other domestic authorities?

Yes the SEC has the power to enter into information-sharing agreements (whether formal or informal) with other domestic authorities. The SEC can cooperate and share nonpublic information with domestic authorities, whether on an *ad hoc* basis or under an information-sharing arrangement, generally known as an MOU, pursuant to Section 24(c) of the Exchange Act and Rule 24c-1 thereunder, provided, among other things, that the SEC has received assurances of confidentiality regarding the use of nonpublic information as the Commission deems appropriate. See response to Question 13.1. For purposes of the responses to Principle 14, the SEC's information-sharing arrangements are referred to as MOUs, although in practice some such arrangements may have other titles, for example, such as "Protocol," "Understanding" or "Statement of Intent."

Moreover, the SEC enters into MOUs to facilitate consultation, cooperation and the exchange of information, public or nonpublic, with other domestic authorities. MOUs are statements of intent to consult, cooperate and exchange information, which are approved by the SEC and signed by the Chair or her designee. MOUs facilitate cooperation by establishing clear mechanisms for the exchange of information, including setting forth the terms and conditions for sharing and protecting the confidentiality of nonpublic information. Assurances of confidentiality are typically incorporated in the terms of the SEC's MOUs.

Such MOUs are not a prerequisite for the SEC to cooperate with domestic authorities, as the SEC can cooperate and share nonpublic information with domestic authorities on an *ad hoc* basis, as explained above. See also responses to Questions 13.1 -13.8.

2. Does the regulator have the power, by legislation, Rules or as a matter of administrative practice, to enter into information-sharing agreements (whether formal or informal) with foreign counterparts?

Yes, the SEC has the power to enter into information-sharing agreements (whether formal or informal) with foreign counterparts. The SEC can cooperate and share nonpublic information with foreign counterparts, as it can with domestic authorities, whether on an *ad hoc* basis or under an MOU, pursuant to Section 24(c) of the Exchange Act and Rule 24c-1 thereunder, provided, among other things, that the SEC has received assurances of confidentiality regarding the use of nonpublic information as the Commission deems appropriate. See responses to Question 14.1 and Questions 13.1 – 13.8.

As a matter of practice, as it does with domestic authorities, the SEC can enter into MOUs to facilitate consultation, cooperation and the exchange of information, public or nonpublic, with foreign counterparts on the same basis as set forth in the response to Question 14.1. Indeed, the SEC has a long history of executing MOUs with foreign counterparts, both bilaterally and multilaterally, for enforcement and supervisory purposes. MOUs are approved by the SEC and signed by the Chair or her designee, as with domestic authorities. See the following link for a list of the SEC's MOUs with foreign authorities:

[http://www.sec.gov/about/offices/oia/oia\\_cooparrangements.shtml](http://www.sec.gov/about/offices/oia/oia_cooparrangements.shtml). Assurances of confidentiality are typically incorporated in the terms of the SEC's MOUs.

Such MOUs are not a prerequisite for the SEC to cooperate with foreign counterparts, as the SEC can cooperate and share nonpublic information with foreign counterparts on an *ad hoc* basis, as explained above. See also responses to Question 14.1 and Questions 13.1 -13.8.

3. Is the regulator a signatory to the IOSCO MMOU (in the affirmative, please skip Question 4(a))?

Yes, the SEC became a signatory to the IOSCO MMOU in 2004.

4. Has the relevant regulator developed information-sharing mechanisms to:

(a) Facilitate the detection and deterrence of cross-border misconduct?

(b) Assist in the discharge of licensing, surveillance and enforcement responsibilities?

Yes, the SEC has continued to develop MOUs with domestic and foreign counterparts for purposes of cooperation in both enforcement and supervisory matters. As set forth in the response to 14.3, the SEC is a signatory to the IOSCO MMOU and therefore not responding to 14.4(a).

Such MOUs are not a prerequisite for the SEC to cooperate with domestic and foreign counterparts, as the SEC can cooperate and share nonpublic information with foreign counterparts on an *ad hoc* basis, as explained above. See also responses to Question 14.1 and Questions 13.1 -13.8.

### **Enforcement Cooperation**

In addition to the SEC's ongoing activities providing *ad hoc* assistance to other regulators, domestic and foreign, the SEC's MOUs for enforcement cooperation facilitate the ability of the SEC and its foreign counterparts to assist one another in investigations and enforcement proceedings in connection with cross-border securities fraud. Such mechanisms reduce or eliminate the need to address information sharing on an *ad hoc* basis and help address new



information-sharing needs that arise from the global financial activities of the securities markets. In 2004, the SEC became one of the first to sign the IOSCO MMOU.<sup>380</sup> The IOSCO MMOU has enabled the SEC to increase the number of potential information-sharing partners for enforcement matters; the MMOU currently has more than 100 signatories.

The MMOU has been an important framework for Staff to obtain information and evidence for enforcement actions from regulators with whom the SEC did not otherwise have an information-sharing arrangement.<sup>381</sup> In addition, within the context of being an active member of IOSCO's Committee 4 on Enforcement Cooperation and Information Exchange, Staff has been exposed to and been able to share information concerning new and/or emerging enforcement-related issues.

Before the establishment of the IOSCO MMOU, the SEC signed bilateral information-sharing MOUs for enforcement cooperation with the securities authorities of 20 different countries. Bilateral MOUs have proven on a continuing basis to be crucial to investigations undertaken by Enforcement staff. As such, the SEC continues to consider these bilateral arrangements to be a useful supplement to the information-sharing mechanism of the MMOU. In light of the MMOU, the Staff generally recommends the negotiation of bilateral MOUs for enforcement cooperation only if a foreign securities authority is empowered to provide assistance beyond the minimum required by the IOSCO MMOU, such as the ability to compel testimony or the gathering of internet service provider, phone, and records other than bank, broker, and beneficial owner information on behalf of the requesting authority.

### **Regulatory Cooperation**

Domestically, the Staff coordinates and meets with domestic regulators to share information. While the SEC cooperates and shares nonpublic information with other domestic authorities on an *ad hoc* basis, as explained above, mechanisms such as MOUs reduce or eliminate the need to address information sharing on an *ad hoc* basis and help address new information-sharing needs

<sup>380</sup> In 2002, IOSCO created the MMOU. Pursuant to the MMOU, signatories, including the SEC, agree to provide one another with the fullest mutual assistance possible within their laws and regulations. MMOU signatories agree to provide, at a minimum, certain critical information, to permit use of that information in civil or administrative proceedings which are public, to onward share information with SROs and criminal authorities investigating the same general conduct, and to keep such information confidential. In particular, the MMOU provides for the following:

- sharing information and documents held in the regulators' files;
- obtaining information and documents regarding transactions in bank and brokerage accounts, and the beneficial owners of such accounts; and
- taking or compelling a person's statement or, where permissible, a person's testimony.

<sup>381</sup> The MMOU requirement that regulators provide the "fullest assistance permissible" under the regulators' respective laws has facilitated the Staff's ability to obtain from counterparts assistance, such as audit workpapers, Internet service provider records, telephone records, and compelled testimony, that goes beyond the minimum threshold.

that arise from the global financial activities of the securities markets.

The SEC has entered into MOUs to facilitate supervisory cooperation with other domestic regulatory agencies, including, but not limited to:

- In November 2008, the SEC, the Federal Reserve and the CFTC entered into an MOU that establishes a framework for consultation and information sharing on issues related to CDS CCPs.<sup>382</sup>
- In July 2008, the SEC and the Federal Reserve signed an MOU to share information and cooperate across a number of important areas of common interest.<sup>383</sup>
- In March 2008, the SEC and CFTC signed an MOU that establishes a permanent regulatory liaison between the agencies and provides for enhanced information sharing, and sets forth several key principles guiding their consideration of novel financial products that may reflect elements of both securities and commodity futures or options.<sup>384</sup>

The Staff also shares nonpublic regulatory information with the Federal Reserve and enforcement information with other domestic regulatory and criminal authorities including, for example, the OCC, Treasury, DOJ and the FBI.

The SEC also enters into supervisory MOUs with foreign counterparts that provide a clear mechanism for the SEC and its foreign counterparts to consult, cooperate, and share information on a confidential basis regarding regulated entities that operate across borders. The scope of these MOUs may vary for each arrangement depending on the level and type of cross-border activity between the U.S. and the relevant jurisdiction, but may include: exchanges and other trading venues; brokers or dealers; investment advisers, investment fund managers, or investment companies; clearing agencies; transfer agents; and CRAs. In addition, the SEC has entered into protocols that cover the sharing of nonpublic issuer-specific information relating to the application of IFRS and U.S. GAAP by dually listed issuers.

In 2013, the SEC finalized supervisory arrangements with 26 EU and three European Economic Area member states' financial regulators pursuant to the EU Alternative Investment Fund Managers Directive of 2011. These arrangements provide a framework for SEC and EU/EEA member state national regulators to exchange information related to the oversight of certain

<sup>382</sup> Memorandum of Understanding Between the Board of Governors of the Federal Reserve System, the U.S. Commodity Futures Trading Commission and the U.S. Securities and Exchange Commission Regarding Central Counterparties for Credit Default Swaps (November 2008). See <http://www.sec.gov/news/press/2008/2008-269.htm>.

<sup>383</sup> See <http://www.sec.gov/news/press/2008/2008-134.htm>.

<sup>384</sup> See <http://www.sec.gov/news/press/2008/2008-40.htm>.

entities in the asset management industry, such as investment advisers and investment fund managers that operate across national borders.<sup>385</sup> The SEC has entered into comprehensive supervisory MOUs with counterparts in the UK, Germany, Australia, Canada, Brazil, Mexico, and the Cayman Islands. In some cases, the SEC enters into MOUs that are entity or type of entity specific. A list of the SEC's MOUs, including MOUs for supervisory cooperation, is available on the SEC's website at: [http://www.sec.gov/about/offices/oia/oia\\_cooparrangements.shtml](http://www.sec.gov/about/offices/oia/oia_cooparrangements.shtml).

5. Where warranted by the scope of cross-border activity and the ability to provide reciprocal assistance does the regulator actively try to establish information-sharing arrangements with *foreign* regulators?

Yes, the SEC establishes information-sharing arrangements with foreign regulators, where warranted by the scope of cross-border activity and the ability to provide reciprocal assistance. Since the early 1990s, the SEC has actively worked to establish information-sharing arrangements with foreign regulators for enforcement and cooperation in the supervision of financial services and the oversight of markets, where warranted, as evidenced by the number of MOUs for enforcement and supervisory cooperation between the SEC and its foreign counterparts. See the response to Question 14.4.

In addition, the SEC has established a number of bilateral dialogues with its foreign counterparts aimed at:

- identifying and discussing regulatory issues of common concern;
- improving cooperation and the exchange of information in cross-border securities enforcement matters; and/or
- continuing and expanding upon the existing program of training and technical assistance provided by the SEC to the foreign regulator.

These dialogues include both regular meetings and *ad hoc* information exchanges at the staff level and between senior representatives of the SEC and the foreign regulator. Information regarding the SEC's dialogues with foreign regulatory authorities is available on the SEC's website at: [http://www.sec.gov/about/offices/oia/oia\\_bilateraldialogs.shtml](http://www.sec.gov/about/offices/oia/oia_bilateraldialogs.shtml).

<sup>385</sup> The EU member-state regulators with whom the SEC signed these MOUs are from Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Spain, Sweden, and the United Kingdom. The EEA signatories to the MOUs are regulators from Iceland, Liechtenstein, and Norway.

6. Are these arrangements documented in writing?

Yes, all of the SEC's MOUs are in writing. As stated in responses to Questions 14.1 and 14.2, MOUs are approved by the SEC and signed by the Chair or her designee. The SEC's arrangements with foreign authorities are available on the SEC's website at: [http://www.sec.gov/about/offices/oia/oia\\_cooparrangements.shtml](http://www.sec.gov/about/offices/oia/oia_cooparrangements.shtml). Information relating to the SEC's arrangements with domestic authorities is also available on the SEC's website. See response to Question 14.4.

See also responses to Questions 13.1 – 13.8 for further descriptions of the authority for information-sharing. In addition, there are established information-sharing procedures for the Staff. See response to Question 14.7 below.

7. Does the regulator take steps to assure safeguards are in place to protect the confidentiality of information transmitted consistent with its uses?

Yes, as described below the SEC has taken steps to assure safeguards are in place to protect the confidentiality of information transmitted consistent with its uses.

**Confidentiality of SEC Files**

Officers and employees of the SEC are prohibited from making confidential information or documents or any other nonpublic record<sup>386</sup> of the SEC available to anyone other than a member, officer, or employee of the Commission.<sup>387</sup> Upon joining the SEC, Commission members and employees acknowledge this obligation in writing. This obligation remains in place beyond the term of a person's employment with the SEC. Under the Exchange Act, SEC officers or employees who fail to comply with SEC regulations may, upon conviction, be fined up to \$5,000,000 and/or imprisoned for a period not exceeding 20 years.<sup>388</sup>

**Disclosure under the FOIA and Protection of Privileged Information Provided by a Foreign Law Enforcement Authority**

Section 24(d) of the Exchange Act provides a basis for denying a third-party request made under the FOIA for certain records obtained from a foreign securities authority.<sup>389</sup> The Section 24(d)

<sup>386</sup> Records are defined in Section 24(a) of the Exchange Act to include "all applications, statements, reports, contracts, correspondence, notices, and other documents filed with or otherwise obtained by the Commission pursuant to this title or otherwise."

<sup>387</sup> See Rule 24c-1 under the Exchange Act, 17 C.F.R. 240-24c-1. See also 17 C.F.R. 230.122, 240.0-4 and 260.0-6

<sup>388</sup> Section 32(a) of the Exchange Act.

<sup>389</sup> Information obtained from a foreign securities authority in a manner that does not satisfy the specific requirements of Section 24(d) still may be withheld if such information is entitled to another FOIA exemption.

exception may be invoked where the information requested was provided by a foreign securities authority, and the foreign securities authority has in good faith determined and represented to the SEC that disclosure of such information would violate the domestic laws applicable to the foreign securities authority.<sup>390</sup>

Section 24(f) of the Exchange Act also provides that, “[t]he Commission shall not be compelled to disclose privileged information obtained from any foreign securities authority, or foreign law enforcement authority, if the authority has in good faith determined and represented to the Commission that the information is privileged.” Section 24(f) also defines the term “privilege” to include any work-product privilege, attorney-client privilege, governmental privilege, or other privilege recognized under federal, state, or *foreign law*; and defines the term “foreign law enforcement authority” to mean any foreign authority that is empowered under foreign law to detect, investigate, or prosecute potential violations of law.

### **Disclosure to Congress**

Section 24(g) of the Exchange Act provides that: “nothing in this Section shall ... authorize the Commission to withhold information from the Congress or prevent the Commission from complying with an order of a court of the United States in an action commenced by the United States or the Commission.” The Congress has oversight responsibility for the SEC and is entitled to obtain certain information from the SEC. It is the practice of the SEC to undertake to keep information provided by a foreign securities authority nonpublic with the understanding that disclosure could harm the SEC’s relationship with the foreign securities authority and adversely affect the SEC’s ability to obtain information from the foreign securities authority in the future. Requests for nonpublic information of this type from Congress are infrequent and Congress has been sensitive to the need to preserve confidentiality of nonpublic information held by the SEC.

### **Assurances of Confidentiality**

The SEC requires assurances of confidentiality, pursuant to Section 24(c) of the Exchange Act and Rule 24c-1 thereunder, before it will share nonpublic information with domestic or foreign counterparts. Section 24(c) of the Exchange Act and Rule 24c-1 thereunder permit the SEC, in its discretion, to share nonpublic information in its possession with domestic or foreign authorities, provided it receives assurances of confidentiality as the Commission deems appropriate. See responses to Questions 13.1 and 13.3. These confidentiality assurances do not restrict the domestic or foreign authority’s ability to use the information for the purposes of the SEC’s investigation and/or proceeding or any resulting proceedings or the SEC’s ability to transfer the information to criminal law enforcement authorities and SROs. Typically, the terms and conditions of the SEC’s MOUs with domestic and/or foreign authorities are designed to satisfy

<sup>390</sup> See also footnote 386 above. The term “records” would cover correspondence from the foreign securities authority and notes from consultations between or among the authorities involved requesting assistance.

the requirement for assurances of confidentiality as well as the requirement of demonstrated need for such information (according to the statute and rules, the two conditions that the SEC must meet in order to share such information with another authority). See also responses to Questions 13.1 and 13.3.

### SEC Staff Procedures

The SEC has procedures governing the manner in which the Staff may share nonpublic information with other authorities on an *ad hoc* basis (*i.e.*, absent an MOU that includes confidentiality safeguards). For example, the process Enforcement staff follows requires that all information obtained or generated by Staff during investigations or examinations is presumed confidential and nonpublic unless disclosure has been specifically authorized. The SEC's Rules permit the Staff, by delegated authority, to grant access to nonpublic information to domestic and foreign governmental authorities, SROs, and other persons specified in Section 24(c) of the Exchange Act and Rule 24c-1 thereunder (they also provide that disclosures of such information to members of the general public will normally be made only pursuant to FOIA). These procedures are described generally in the SEC Enforcement Manual.<sup>391</sup>

These procedures, among other things, require that all access requests made to the Enforcement staff be in writing and any approval be signed by a senior SEC official at the Associate Director level or higher. Such procedures are designed to assist Staff in complying with Section 24(c) of the Exchange Act and Rule 24c-1. As previously discussed, the two conditions that the SEC must meet in order to share nonpublic information with an authority are: (i) a demonstrated need for such information and (ii) assurances of confidentiality for the shared information. See response to Questions 13.1. Generally, Rule 24c-1 authorizes disclosure, with assurances of appropriate safeguards, to the following classes of requestors, and their agents: federal, state, local and foreign governmental authorities; SROs; foreign financial regulatory authorities; SIPC and its trustees; trustees in bankruptcy; court-appointed persons charged with performing functions arising from securities litigation, such as receivers; and professional licensing or oversight authorities that are government-sponsored, such as bar associations that are part of a state court system. When a foreign counterpart requests examination or enforcement information, the same process is followed as when the request is from a domestic regulator, the only difference being that Staff coordinates with OIA staff.

8. Can the regulator maintain the confidentiality of the request for information received from a foreign regulator consistent with Art. 11 of the IOSCO MMOU?

Yes, the SEC can maintain the confidentiality of the request for information received from a foreign regulator consistent with Art. 11 of the IOSCO MMOU. See response to Question 14.7.

<sup>391</sup>

See <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>.

9. Can the regulator demonstrate that it shares information, where appropriate safeguards are in place, when it is requested by another domestic authority or foreign counterpart?

Yes, the SEC can share information, where appropriate safeguards are in place, when it is requested by another domestic authority or foreign counterpart. See responses to Questions 14.4 and 14.5. The SEC routinely consults, cooperates, and shares information, in accordance with statutory requirements, with domestic and foreign authorities for both enforcement and supervisory purposes. See also responses to Questions 13.1 -13.8.

### **Domestic**

Staff coordinates and meets with other domestic regulators to share information: (i) when necessary to perform the SEC's regulatory functions; (ii) when an authority requests or Congress directs the SEC do so; and (iii) on an as-needed basis. See response to Question 14.4 above. Staff also shares examination, enforcement, and other information pursuant to MOUs with regulators upon their request for information. See responses to Questions 14.5 and 14.6.

As discussed in response to Question 14.7 above, Staff has written procedures for sharing information, which address obtaining appropriate written requests from the regulators making the requests and obtaining the appropriate authorization to share the information, among other things.

### **Foreign**

In fiscal year 2013, the SEC responded to 508 requests for enforcement assistance from foreign authorities and made 717 requests for such assistance to foreign authorities.<sup>392</sup> In addition, the SEC provided assistance to and received assistance in cross-border examinations and other supervisory matters from foreign counterparts. Requests for assistance for cooperation from foreign authorities (or to foreign authorities) are handled centrally by OIA, in close coordination with Enforcement and the other Divisions and Offices, including OCIE and OCR.

With respect to regulatory cooperation with foreign counterparts, a list of the SEC's MOUs, including MOUs for supervisory cooperation, is available on the SEC's website at: [http://www.sec.gov/about/offices/oia/oia\\_cooparrangements.shtml](http://www.sec.gov/about/offices/oia/oia_cooparrangements.shtml). See also response to Question 14.4.

In addition, pursuant to a number of regulatory dialogues, Staff meets with foreign counterparts regularly on a bilateral and multilateral basis to discuss regulatory and other issues of shared concern. For example, as discussed in the responses to Principle 12 and consistent with the

<sup>392</sup> See SEC 2013 Accountability and Performance Report, available at <http://www.sec.gov/about/secpar/secpar2013secpar2013.pdf>.

*IOSCO Final Report on Supervisory Colleges for Credit Rating Agencies*, OCR took the lead in a collaboration by international supervisors to establish Supervisory Colleges (Colleges) for each of the large, globally active CRAs (Fitch, Moody's and S&P). The first in-person meetings for the Colleges took place in November 2013. The Colleges serve as a resource for CRA supervisors by facilitating, among other things, information exchange.



**Principle 15 The regulatory system should allow for assistance to be provided to foreign Regulators who need to make inquiries in the discharge of their functions and exercise of their powers.**

**Key Questions**

1. Is the *domestic* regulator able to offer effective and timely assistance to *foreign* regulators in obtaining:
  - (a) Contemporaneous records sufficient to reconstruct all securities and derivatives transactions, including records of all funds and assets transferred into and out of bank and brokerage accounts relating to those transactions?
  - (b) Records for securities and derivatives transactions that identify:
    - (i) The client:
      - (1) Name of the account holder?
      - (2) Person authorized to transact business?
    - (ii) The amount purchased or sold?
    - (iii) The time of the transaction?
    - (iv) The price of the transaction?
    - (v) The individual and the bank or broker and brokerage house that handled the transaction?
  - (c) Information located in its jurisdiction identifying persons who beneficially own or control non-natural persons organized in its jurisdiction?

Yes, the SEC offers effective and timely assistance to foreign regulators in obtaining the information described in Question 15.1 (a) – (c). Moreover, under the federal securities laws, the SEC is the U.S. government agency with jurisdiction over these matters with respect to securities. Under the comprehensive framework for regulating swaps and SBS established in Title VII of the Dodd-Frank Act, the SEC is given regulatory authority over SBS, the CFTC is given regulatory authority over swaps, and the two agencies have authority jointly to prescribe regulations regarding mixed swaps as may be necessary to carry out the purposes of Title VII.<sup>393</sup>

See responses to Questions 13.1 and 13.3 for a description of the SEC's legal authority to:

- (i) share records and nonpublic information with other authorities, including a foreign authority, pursuant to Section 24(c) of the Exchange Act and Rule 24c-1 promulgated thereunder;<sup>394</sup>
- (ii) conduct an investigation on behalf of a foreign authority under Section 21(a)(2) of the Exchange Act, including use of compulsory powers; and (iii) assist in locating public information.

<sup>393</sup> See Joint SEC and CFTC Final Rule, Jul. 18, 2012, Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping 77 Fed. Reg. 48207 (Aug. 13, 2012).

<sup>394</sup> The two conditions that the SEC must meet in order to share nonpublic information with an authority are: (i) a demonstrated need for such information, and (ii) assurances of confidentiality for the shared information. See Exchange Act Section 24 and Rule 24c-1 under the Exchange Act, 17 C.F.R. 240-24c-1.

Rule 24c-1 addresses the sharing of nonpublic information with domestic and foreign authorities. Rule 24c-1 defines “nonpublic information” to mean records, as defined in Section 24(a) of the Exchange Act, and other information in the SEC’s possession which are not available for public inspection and copying.

“Records” are defined in Section 24(a) of the Exchange Act to include “all applications, statements, reports, contracts, correspondence, notices, and other documents filed with or otherwise obtained by the Commission pursuant to this title or otherwise.”

“Nonpublic information,” as defined in Rule 24c-1, generally would cover the types of information identified in Question 15.1(a)-(c). See also responses to Questions 13.1 and 13.3.

In addition, for information that the SEC does not already possess, Section 21(a)(2) of the Exchange Act permits the SEC, on request from a foreign securities authority, to conduct an investigation as the SEC “deems necessary to collect information and evidence pertinent to the request for assistance.” See responses to Questions 13.1 and 13.3. This other information could include the types of information identified in Question 15.1(a)-(c).

Each year, as discussed in the response to Question 14.9, the SEC receives hundreds of requests from foreign securities authorities for assistance with cross-border investigations, including requests for the types of information described under Question 15.1(a)-(c). The SEC has the legal authority to cooperate and share nonpublic information with foreign authorities whether on an *ad hoc* basis or under an MOU pursuant to Section 24(c) of the Exchange Act and Rule 24c-1 thereunder, provided, among other things, that the SEC has received assurances of confidentiality regarding the use of nonpublic information as the Commission deems appropriate. See also responses to Questions 14.1, 14.2, 13.1 and 13.3.

Many of these requests come from jurisdictions with which the SEC interacts frequently and with which the SEC has an MOU. Some also come from jurisdictions the SEC interacts with less frequently or with which the SEC does not have an MOU. The SEC also can assist these jurisdictions, pursuant to Section 24(c) of the Exchange Act and Rule 24c-1 thereunder, or Section 21(a)(2). See responses to Questions 14.1, 14.2, 13.1 and 13.3.

The SEC has designated OIA as the office to receive all requests for assistance in securities enforcement matters from foreign regulators. OIA has intake procedures in place to receive and respond to requests from foreign authorities. OIA coordinates closely with other Staff, including Enforcement staff, and the foreign regulators to provide the information requested in a timely fashion. When responsive, the SEC provides foreign regulators with nonpublic information in the SEC’s files, information obtained from regulated entities under Section 17(a) of the Exchange Act, and/or information obtained pursuant to an SEC investigation. As a practical matter, requests requiring that the SEC open an investigation and use its compulsory powers to provide assistance may take longer to complete than requests for information maintained by regulated entities or in the SEC’s files. The specific assistance that is the subject of this question falls

generally within the parameters of the IOSCO MMOU. As discussed in responses to Questions 14.3 and 14.4, the SEC is a signatory to the IOSCO MMOU and routinely provides assistance well beyond the scope of the minimum level of assistance required by it.

**Brokerage records**

Entities regulated by the SEC, which include national securities exchanges, broker-dealers, registered clearing agencies and registered transfer agents, are required to make certain records and maintain them for prescribed periods of time pursuant to Section 17(a) of the Exchange Act and the rules thereunder. Given that the SEC can obtain records from regulated entities pursuant to its supervisory powers, as discussed in responses to Questions 31.2 and 31.13, below, the SEC can obtain these records for a foreign authority in a relatively short period of time.

Exchange Act Rule 17a-1 requires each securities exchange to maintain all documents made or received by it in the course of its business for at least five years. Exchanges maintain records of the audit trail of a transaction (including the amount of the security purchased or sold, the time and price of the transactions, and the individual or entity that handled the transaction) under SRO rules that must be approved by the SEC. In 2012, the SEC also adopted Exchange Act Rule 613 requiring exchanges to jointly create a plan to implement and maintain a CAT (including a record of the material terms of an order, the date and time of key events, the broker-dealer routing the order, and customer account information).

Exchange Act Rule 17a-3 requires broker-dealers to make and keep certain records, including records identifying the name and address of the account's beneficial owner and, for margin accounts, the signature of the owner, or in the case of a joint account or corporate account, the name and address of the person(s) authorized to transact business in such account. Broker-dealers are also required to make and keep other records, including a record of the amount of each security purchased or sold, the time of entry, price of the security and the broker-dealer's associated person who entered the transaction (or, if the customer entered the order on an electronic system, a notation of that entry). Some other records broker-dealers must make and keep include blotters containing an itemized daily record of all purchases and sales of securities, all receipts and deliveries of securities, all receipts and disbursements of cash, and all other debits and credits. Other records broker-dealers must make and keep include a general ledger, a stock record, memoranda of proprietary orders, and trade confirmations.

Exchange Act Rule 17a-4 requires broker-dealers to retain, among other things, certain records including trade blotters and securities ledgers for at least six years, while certain other records, including memoranda of brokerage and proprietary orders, trade confirmations, and accountholder records, must be preserved for at least three years. In addition, customer

identification information required under the PATRIOT Act must be retained for not less than five years after the customer's account has been closed.<sup>395</sup>

See also responses to Question 24.11 for a discussion on recordkeeping requirements for CISs and 31.13 for a discussion on recordkeeping requirements for investment advisers.

### **Bank records**

As discussed in Question 13.3, under Section 21(a)(2) of the Exchange Act, the SEC may conduct an investigation on behalf of a foreign authority and use its compulsory powers under Section 21(b) of the Exchange Act as it would in its own investigations. This power includes use of the SEC's subpoena powers, subject to certain statutory requirements such as those described below, to compel the production of documents or testimony from any person or entity anywhere within the U.S., including banking entities.

As discussed in Principle 11, the SEC can obtain bank records through its subpoena authority; however, if the SEC is seeking financial records of a "customer" (defined as an individual or a partnership of five or fewer individuals) from a covered financial institution (such as a bank), the SEC must follow procedures set forth in the RFP. The RFP provides that a government authority may have access to or obtain copies of bank records of customers fitting the above description if certain steps are taken by the authority seeking the records: the financial records are reasonably described and the customer has either authorized such disclosure or the financial records are disclosed in response to an investigative subpoena or summons that meets certain requirements.<sup>396</sup> The SEC typically does not seek authorization by the customer but instead issues an investigative subpoena that sets forth a reason to believe that the bank records are relevant to a legitimate law enforcement inquiry. The SEC must also ensure that a copy of the subpoena has been served on the customer or mailed to the last known address, and 10 days have expired from the date of service or 14 days have expired from the time of mailing and the customer has not challenged the inquiry. The SEC may also obtain bank records for a customer without first notifying the customer through a delayed notice provision, which involves seeking approval from an appropriate court to delay notice to the customer if:

- (i) a delay in obtaining access to bank records would result in a flight from prosecution, destruction or tampering with evidence, transfer of assets or records outside the United States, improper conversion of investor assets, or impeding the ability to identify or trace the source or disposition of funds;
- (ii) a delay is necessary to identify or trace the record or beneficial ownership interest in

<sup>395</sup> SEC, Customer Identification Programs for Broker-Dealers, Release No. 34-47752 (July 12, 2002), 67 Fed. Reg. 48306 (July 23, 2002).

<sup>396</sup> See 12 U.S.C. § 3402.

any security;

(iii) the acts or practices under investigation involve the dissemination of materially false or misleading information concerning any security, issuer or market or failure to make disclosures required under the securities laws, or a financial loss to investors or other persons which remains substantially uncompensated; or

(iv) the acts or practices under investigation involve significant financial speculation in securities or endanger the stability of any financial or investment intermediary.

Finally, OCIE may seek information from banks on a voluntary basis to confirm account balances and other information related to accounts managed by registered broker-dealers.

**Information identifying persons who beneficially own or control non-natural persons organized in the U.S.**

The SEC assists foreign regulators in obtaining information identifying persons who beneficially own or control non-natural persons organized in the U.S., using public records, as described in responses to Questions 13.1 and 13.3, and/or pursuant to Section 24(c) of the Exchange Act and Rule 24c-1 promulgated thereunder, or its authority to conduct an investigation on behalf of a foreign authority under Section 21(a)(2) of the Exchange Act, including use of compulsory powers, such as the SEC's subpoena authority, as described above, and in responses to Questions 13.1 and 13.3.

As discussed in the responses to Principle 11, in the U.S., some information identifying persons who beneficially own or control non-natural persons organized in this country is publicly available.

Incorporation laws in the U.S. are promulgated at the state, rather than the federal, level. As with corporations, other non-natural persons, such as limited liability companies (LLCs) or limited partnerships, also are established pursuant to state, rather than federal, law. Generally, states maintain registries of the companies incorporated in their jurisdiction, including the names and addresses of the individuals or entities serving as agents for service of process for these companies or other non-natural persons. State laws also generally require that companies maintain an updated list of shareholders.

In addition, certain federal securities laws and regulations require public disclosure of information identifying persons who beneficially own or control certain non-natural persons. In regard to public companies, Section 13(d) of the Exchange Act requires public disclosure of the controlling ownership (defined as any ownership of more than 5% of a company's equity securities) of all U.S. companies whose shares are registered under the Exchange Act.

Furthermore, Section 16(a) of the Exchange Act requires any person who is the beneficial owner

of more than 10% of a class of equity securities registered under the Exchange Act, as well as the officers and directors of such company, to file a report with the SEC indicating the amount of all equity securities of that company owned by such person. Any changes in that ownership must be reported to the SEC within two business days of the transaction. These reports must be filed electronically through the EDGAR system. These filings are immediately publicly available upon filing.

Section 17A of the Exchange Act and Exchange Act Rule 17Ac2-1 and Form TA-1 thereunder require transfer agents to keep certain records relating to control persons of the transfer agent, including those who indirectly control, or are under common control with, the transfer agent. Control persons are reported on the transfer agent's Form TA-1, which is made publicly available.

2. Is the *domestic* regulator able to offer effective and timely assistance to *foreign* regulators in securing compliance with laws and regulations related to:

(a) Insider dealing, market manipulation, misrepresentation of material information and other fraudulent or manipulative practices relating to securities and derivatives, including solicitation practices, handling of investor funds and customer orders?

(b) The registration, issuance, offer, or sale of securities and derivatives, and reporting requirements related thereto?

(c) Market intermediaries, including investment and trading advisers who are required to be licensed or registered, collective investment schemes, brokers, dealers and transfer agents?

(d) Markets, exchanges and clearing and settlement entities?

Yes, the SEC offers effective and timely assistance to foreign regulators in securing compliance with laws and regulations related to the types of activity identified in Question 15.2(a)-(c), as described in responses to Questions 13.1, 13.3, and 15.1.

See also responses to Questions 14.1, 14.2, and 14.4, which discuss the SEC's information-sharing arrangements covering these areas.

3. Is the *domestic* regulator able, according to its domestic laws and regulations, to provide effective and timely assistance to *foreign* regulators regardless of whether the *domestic* regulator has an independent interest in the matter?

Yes, the SEC provides effective and timely assistance to foreign regulators regardless of whether it has an independent interest in the matter. The SEC is not restricted from sharing information or obtaining information if it does not have an independent interest in a matter. As discussed in response to Question 13.6, Section 21(a)(2) of the Exchange Act authorizes the SEC to provide assistance to a foreign securities authority at its discretion, without regard to whether the facts as stated in the foreign securities authority's request constitute a violation under U.S. laws. In exercising this authority, Section 21(a)(2) of the Exchange Act directs the SEC to consider whether

(i) the requesting authority has agreed to provide reciprocal assistance to the SEC, and  
(ii) compliance with the request would prejudice the public interest of the U.S. In addition, Section 24(c) of the Exchange Act and Rule 24c-1 thereunder permit the SEC, at its discretion, to share nonpublic information in its possession with foreign authorities, provided the SEC receives assurances of confidentiality regarding the material's use.

4. Is the *domestic* regulator able to offer effective and timely assistance to *foreign* regulators in obtaining information on the regulatory processes in its jurisdiction?

Yes, the SEC offers effective and timely assistance to foreign regulators in obtaining information on the regulatory processes in its jurisdiction. As discussed in the responses to Question 13.1 and 13.3, Section 24(c) of the Exchange Act and Rule 24c-1 thereunder permit the SEC, at its discretion, to share nonpublic information with other domestic and foreign governmental authorities, provided the SEC receives assurances of confidentiality regarding the material's use as the Commission deems appropriate. The responses to Questions 13.1 and 13.3 also discuss the wide availability of information through public sources in the U.S.

The SEC also has entered into several MOUs for supervisory cooperation, which facilitate consultation and cooperation on issues of regulatory concern and may include a discussion of regulatory processes. In addition, the SEC has established a number of bilateral dialogues with its foreign counterparts. See responses to Questions 14.2, 14.4 and 14.5.

Staff also conducts training and technical assistance programs both in the U.S. and abroad for foreign authorities. These programs – which are led by experienced Staff and can also include staff from SROs and industry – cover a wide variety of regulatory and enforcement issues, including regulatory processes. The SEC also routinely meets with foreign regulators on an individual basis to discuss a variety of regulatory- and enforcement-related topics. Additionally, the Staff is available to address specific inquiries from foreign counterparts on a variety of questions.

5. Is the *domestic* regulator able to offer effective and timely assistance to *foreign* regulators in requiring or requesting:

(a) The production of documents?

(b) Taking a person's statement or, where permissible, testimony under oath?

Yes, the SEC offers effective and timely assistance to foreign regulators in requiring or requesting documents and a person's statement or testimony. As discussed in the responses to Questions 13.1 and 13.3, as part of providing assistance to a foreign securities authority, the SEC may conduct an investigation and use its compulsory powers as it would in its own investigations. This power includes requiring the production of documents held by regulated entities as well as the ability to use the SEC's subpoena powers to compel the production of documents or testimony from any person or entity anywhere within the U.S., subject to certain statutory requirements such as those described in response to Question 15.1. In addition, as



described in responses to Questions 13.1 and 13.3, providing this kind of assistance falls under the IOSCO MMOU, but the SEC's authority to provide this kind of assistance extends generally to foreign authorities.

6. Is the *domestic* regulator able to offer effective and timely assistance to *foreign* regulators in obtaining court orders, if permitted, for example, urgent injunctions?

Yes. The SEC assists in advising foreign authorities on how to initiate a proceeding in civil court or request the assistance of the DOJ. Additionally, the SEC may assist in contacting an individual or entity on behalf of a foreign authority to facilitate, on a non-compulsory basis, the repatriation of property to the foreign jurisdiction. In matters in which the SEC does not have an independent interest, however, it does not have the power to use its statutory authority to seek court orders, such as urgent injunctions and asset freezes, on behalf of foreign authorities.

### **Civil Proceedings**

A final judgment issued by a foreign court may be enforced by a plaintiff (e.g., a foreign authority) in a private civil action against a judgment debtor in the U.S. State law applies to such actions. Judgments issued by foreign courts generally are recognized by state law if they are issued by foreign courts of competent jurisdiction that have afforded the defendant appropriate notice, if: (i) the judgment was not obtained by fraud, (ii) enforcement would not offend the public policy of the state in which enforcement is sought, and (iii) the judgment complies with U.S. notions of due process of law.

In addition, many states of the U.S. have either adopted or follow the Uniform Foreign Money Judgments Recognition Act or the Uniform Foreign-Country Money Judgments Recognition Act, which provide for recognition of foreign judgments.

Alternatively, a plaintiff that seeks a U.S. court judgment may initiate a civil proceeding in a U.S. court against a party in interest and proceed on the merits of the matter. To preserve the property at issue, the plaintiff may make a motion for pre-judgment relief as part of the proceeding on the merits. A pre-judgment attachment freezes the asset and places it in the custody of a marshal or other official.

### **Assistance from DOJ**

Foreign regulators may also pursue assistance in obtaining court orders through a mutual legal assistance treaty or a multilateral instrument such as the U.N. Convention against Transnational Organized Crime (UNTOC). DOJ has the ability to assist foreign regulators and foreign criminal authorities in obtaining court orders to issue search warrants, obtain asset freezes, summon witnesses, and compel the production of documents and other evidence. The ability to assist a foreign regulator depends on the specific language of the mutual legal assistance treaty between the U.S. and the foreign country or the terms of UNTOC; typically the remedies offered are only



available to prosecutors for violations with a criminal nexus.

There are two provisions of the U.S. Code that may provide DOJ with the ability to assist a foreign authority in obtaining court ordered asset freezes:

(i) 28 U.S.C. Section 2467 (the enforcement of a foreign judgment). Section 2467 provides that "A foreign nation seeking to have a forfeiture or confiscation judgment registered and enforced by a district court of the United States ... shall ... submit a request to the Attorney General ... which request shall include - a summary of the facts of the case and a description of the proceedings that resulted in the forfeiture or confiscation judgment; a certified copy of the forfeiture or confiscation judgment; an affidavit or sworn declaration establishing that the foreign nation took steps, in accordance with the principles of due process, to give notice of the proceedings to all persons with an interest in the property in sufficient time to enable such persons to defend against the charges and that the judgment rendered is in force and is not subject to appeal; and such additional information and evidence as may be required by the Attorney General...."

Section 2467 is designed to preserve and confiscate property located in the U.S. subject to "civil or criminal forfeiture under foreign law." There is a requirement that there be a treaty or other formal agreement in effect between the U.S. and the foreign state providing for mutual forfeiture assistance, that the foreign requesting authority is pursuing forfeiture or confiscation of the assets located in the U.S., that the acts underlying the criminal offenses giving rise to forfeiture or confiscation in the requesting state would give rise to confiscation under U.S. law if those acts or omissions had occurred in the U.S., and that the foreign procedures used to forfeit and confiscate the proceeds comport with certain due process and other standards.

(ii) 18 U.S.C. Section 981 (non-conviction based confiscation provision). Section 981 may be used by DOJ to initiate non-conviction based forfeiture proceedings in response to a request for a freeze of assets by a foreign authority, but only where the assets are the proceeds of, traceable to, or property involved in the underlying foreign crime. A non-conviction based forfeiture action is an original action by DOJ to forfeit the property at issue and render it the property of the U.S. government. Forfeiture actions under Section 981 for violations of foreign law are usually submitted to DOJ pursuant to a treaty or letter rogatory request, but they may also be initiated based upon sufficient evidence provided by a foreign authority informally.

Section 981 includes provisions permitting DOJ to seek an *ex parte* TRO (for 30 days, and which may be extended for good cause) based on the fact that the foreign authority has an arrest warrant for or charged a suspect with a foreign offense that would give rise to forfeiture of the property under U.S. law. To extend the temporary order, DOJ would need to be gather evidence to initiate a non-conviction based forfeiture action in federal district court, as described above. Following the filing of the complaint in a non-

conviction based forfeiture proceeding under Section 981, interested parties are provided notice and the opportunity to file a claim in the action. DOJ would need to prove its case by a preponderance of the evidence, *i.e.*, 51%, in order for the court to issue an order forfeiting the property. Once property is forfeited to the U.S. government under Section 981 or other criminal process, DOJ can return proceeds to the foreign authority through broad asset-sharing provisions in bilateral treaties and UNTOC, or via 19 separate bilateral asset-sharing agreements. These asset-sharing provisions and bilateral asset-sharing agreements generally provide that the U.S. government would be reimbursed for all expenses incurred. To date, the U.S. government has distributed over \$250 million forfeited proceeds of crime with 45 different foreign governments. The Attorney General also has authority to “remit” forfeited assets directly to the victims of the offenses giving rise to forfeiture.

7. Is the *domestic* regulator able to provide effective and timely assistance to *foreign* regulators regarding information about financial conglomerates subject to its supervision and more precisely assistance in relation, for example, to:

- (a) The structure of financial conglomerates?
- (b) The capital requirements in conglomerate groups?
- (c) Investments in companies within the same group?
- (d) Intra-group exposures and group-wide exposures?
- (e) Relationships with shareholders?
- (f) Management responsibility and the control of regulated entities?

Yes. See response to Question 13.3 for a description of the SEC’s legal authority to share nonpublic information with a foreign authority under Section 24(c) of the Exchange Act and to conduct an investigation on behalf of a foreign authority under Section 21(a)(2) of the Exchange Act, including use of compulsory powers. The types of information the SEC possesses, can obtain, and share with a foreign authority could include the information described in Question 15.7(a)-(f), provided that the SEC receives assurances of confidentiality regarding the information’s use and other prerequisites set forth in the law are met.

The SEC also enters into supervisory MOUs to provide a mechanism by which the SEC and its counterparts can consult, cooperate, and share information on a confidential basis about regulated entities that operate across borders. The scope of these MOUs covers a wide range of regulated entities that may vary for each arrangement depending on the level and type of cross-border activity between the U.S. and the relevant jurisdiction, but may include: exchanges and other trading venues; brokers or dealers; investment advisers; investment fund managers or investment companies; clearing agencies; transfer agents; and CRAs. A list of the SEC’s MOUs, including MOUs for supervisory cooperation, is available on the SEC’s website at: [http://www.sec.gov/about/offices/oia/oia\\_cooparrangements.shtml](http://www.sec.gov/about/offices/oia/oia_cooparrangements.shtml). See response to Question 14.4.

8. If the regulator cannot directly obtain the information set out in Key Question 1, can the regulator obtain that information from another domestic authority and share that information with the requesting regulator?

The SEC can directly obtain the information set out in Question 15.1. See response to Question 15.1.

9. May the requesting authority use the information furnished by the domestic authority for the purposes set forth under Art. 10(a) of the IOSCO MMoU?

Yes. For information provided by the SEC in response to a request pursuant to the IOSCO MMoU, the requesting authority can use the information provided for (i) the purposes set forth in the request for assistance, including ensuring compliance with the laws and regulations related to the request, and (ii) a purpose within the general framework of the use stated in the request for assistance, including conducting a civil or administrative enforcement proceeding, assisting in an SRO's surveillance or enforcement activities (insofar as the SRO is involved in the supervision of trading or conduct that is the subject of the request), assisting in a criminal prosecution, or conducting any investigation for any general charge applicable to the violation of the provision specified in the request where such general charge pertains to a violation of the laws and regulations administered by the requesting authority. This use includes foreign enforcement proceedings, which may be public.

**Principle 16**      **There should be full, accurate and timely disclosure of financial results, risk and other information which is material to investors' decisions.**

**Key Questions**

*Full Disclosure*

1. Does the regulatory framework have clear, comprehensive and reasonably specific disclosure requirements that apply to:

- (a) Public offerings, including the conditions applicable to an offering of securities for public sale, the content and distribution of prospectuses and other offering documents (and, where relevant, short form profile or introductory documents) and supplementary documents prepared in the offering?

Yes. The U.S. regulatory framework has clear, comprehensive, and reasonably specific disclosure requirements that apply to public offerings.

**General Conditions Applicable to an Offering of Securities**

The federal securities regulatory system is based on the principle of full and fair disclosure to investors. Under the Securities Act, every offer or sale of a security must be registered with the SEC unless an exemption is available.<sup>397</sup> The registration statement used to register an offering includes a prospectus containing material information about the issuer and the offering, which is delivered or made available to investors.

Exemptions are available to permit issuers to offer and sell securities without Securities Act registration. The Securities Act provides exemptions from registration for specific types of securities or transactions. Examples of Securities Act exemptions relating to types of securities are: offerings of any security issued or guaranteed by a bank (but not a bank holding company); offerings of short-term commercial paper; and certificates of indebtedness issued by the trustee or receiver in connection with court-overseen bankruptcies.

The principal Securities Act exemptions for transactions are:

- Section 4(a)(1) – transactions by persons other than issuers, underwriters, or dealers. It is this exemption under which ordinary secondary market transactions are effected, because most investors do not fall within the specified categories of “underwriters” or “dealers”.<sup>398</sup>

<sup>397</sup> Securities Act Sections 3-5.

<sup>398</sup> Persons who are deemed to control an issuer (such as directors, executive officers, and large security holders) are generally restricted in their ability to freely resell that issuer's securities holdings.

- Section 4(a)(2) – transactions by an issuer not involving a public offering.<sup>399</sup> This is the “private placement” exemption under which issuers may sell securities in nonpublic offerings without registration under the Securities Act. The securities that are sold under this exemption may not generally be freely resold until at least six months (or sometimes one year) after the initial sale. This restriction is intended to ensure that an unregistered private placement does not result in a public offering of securities that should have been registered under the Securities Act;
- Regulation S<sup>400</sup> – provides a safe harbor from registration under the Securities Act for offers and sales of securities occurring outside the U.S.. The safe harbor outlines various procedures for different types of securities from different types of issuers, depending in part on the likelihood of “flow-back” of the offered securities into the U.S.

In general, in the U.S. there are limited exemptions available for offers and sales of securities to the general public by domestic issuers.<sup>401</sup> Issuers offering and selling any security (equity, debt, warrants, or other type) in a public offering, whether in an IPO or subsequent offering, must register the offering with the SEC under the Securities Act.<sup>402</sup>

The remainder of this section discusses the disclosure requirements applicable to public offerings of securities registered with the SEC under the Securities Act.

### **Content and Distribution of Prospectuses**

To register a securities offering under the Securities Act, an issuer must file a registration statement with the SEC. The registration statement includes a prospectus that contains a

<sup>399</sup> Under the JOBS Act, the SEC was directed to amend its rules to permit general solicitation and general advertising under the Rule 506 safe harbor in Regulation D under the Securities Act, provided that all purchasers in the offering are accredited investors and that the issuer has taken reasonable steps to verify the purchasers are, in fact, accredited investors. The JOBS Act rulemaking to eliminate the general solicitation ban for certain Rule 506 offerings was completed in July 2013 and issuers have been permitted to publicly solicit investors for these offerings since September 2013.

<sup>400</sup> 17 C.F.R. §§ 230.901 – 230.905.

<sup>401</sup> In some cases, an exemption may be available to foreign issuers. Any issuer seeking to rely on an available exemption must meet the conditions of such exemption. For example, Regulation A is an exemption available to U.S. and Canadian companies for public offerings of securities up to \$5 million in any 12-month period. Regulation A also includes requirements with respect to disclosure that must be provided to investors. Under the JOBS Act, the SEC was directed to exempt offerings of securities up to \$50 million annually from the registration requirements of the Securities Act. In 2013, the SEC proposed rule amendments to Regulation A to implement this provision of the JOBS Act. SEC Release No. 33-9497 (December 18, 2013). As another example, the new exemption under Rule 506, discussed above, is available to domestic and foreign issuers.

<sup>402</sup> For certain purposes, persons and entities in a control relationship with the issuer (often referred to as “affiliates”) are treated in the same manner as the issuer. This treatment is intended to deter issuers from effecting an unregistered public offering of securities through their affiliates.

description of the issuer and its business, information about the issuer's directors and senior management, executive compensation, the offering and the securities to be registered, audited financial statements, and management's discussion and analysis (MD&A) of the issuer's financial condition and results of operations, presenting a view of the issuer through the eyes of management and explaining material trends and commitments. MD&A addresses liquidity and capital resources issues as well as events and uncertainties known to the issuer's management that may cause the reported results not to be indicative of future financial performance. A registration statement also includes certain other information that is not required to be included in a prospectus, as well as exhibits. Registration statements, including any amendments, are publicly available through the EDGAR system as soon as they are filed with the SEC, as discussed in this section below.

In addition to the specific line-item disclosure requirements described below, the prospectus and registration statement must include "such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading."<sup>403</sup> To help assure that issuers disclose material information to investors in connection with a registered public offering of securities, the federal securities laws provide for the liability of certain parties if a registration statement "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."<sup>404</sup>

In general, a prospectus<sup>405</sup> includes disclosure of the following items:

- information with respect to the issuer, including:
  - a description of the business;<sup>406</sup>
  - material legal proceedings;
  - a description of property;<sup>407</sup>
  - financial statements meeting the requirements of Regulation S-X;<sup>408</sup>

<sup>403</sup> Rule 408 of Regulation C.

<sup>404</sup> Section 11(a); *cf.* Section 12(a)(2) of the Securities Act.

<sup>405</sup> See, *e.g.*, Part I of Form S-1.

<sup>406</sup> The section describing the business includes the issuer's current and planned business operations, principal products and services, principal markets and distribution methods, source and availability of raw materials, dependence on customers, and inventory practices.

<sup>407</sup> This disclosure also includes oil and gas reserve and other extractive reserve disclosures, if applicable.

<sup>408</sup> Regulation S-X contains, among other things, the form and content requirements for financial statements included in filings made with the SEC. It also includes many provisions on matters in addition to compliance with U.S.

(continued)

- supplementary financial information;
  - selected financial data (five years of sales, income, dividends, and other data);
  - management's discussion and analysis of financial condition and results of operations;
  - quantitative and qualitative disclosures about market risk;
  - changes in and disagreements with accountants on accounting and financial disclosure;
  - identification of directors and executive officers;
  - executive compensation and corporate governance;
  - security ownership of certain beneficial owners and management; and
  - transactions with related persons, promoters, and certain control persons.
- a description of the securities to be registered;<sup>409</sup>
  - risk factors relating to the issuer and the offering;
  - dilution;
  - use of proceeds;
  - a plan of distribution;
  - the manner of determining the offering price; and
  - the interests of named experts and counsel.

GAAP, for example, requirements for auditor qualifications and reports. See 17 C.F.R. §§ 210.1-01 – 210.12-29. Refer to the discussion of the JOBS Act in Question 16.5, below, regarding the financial statement requirements for emerging growth companies. Smaller reporting companies, generally companies that have a public float of less than \$75 million, are subject to scaled financial statement requirements.

<sup>409</sup> The SEC's disclosure rules require an issuer to provide disclosure of the material terms of the securities to be registered. Regulation S-K specifies the terms an issuer should disclose for equity, debt, warrants, and rights and requires similar disclosure for other securities.

A registration statement also will include certain information that is not required to be contained in a prospectus, such as detailed expenses of the offering and information about the issuer's indemnification policies and disclosure regarding recent sales of unregistered securities. An issuer must also file as exhibits to a registration statement various documents such as the underwriting agreement, the issuer's certificate of incorporation and bylaws, legal opinions, material contracts, and indentures or other agreements detailing the rights of holders of the securities being registered. A registration statement must be signed by the issuer's principal executive, financial and accounting officers, and by at least a majority of the board of directors.

With respect to the distribution of prospectuses, the Securities Act requires delivery of a prospectus meeting specified requirements under the Securities Act, known as a "final prospectus," to each investor in a registered offering. The SEC has noted that an investor's purchase commitment generally occurs before the final prospectus is required to be delivered under the Securities Act, and liability is based on the information made available at the time of sale. The SEC's prospectus delivery requirements, which were updated in 2005, are intended to facilitate effective access to information, while taking into account advances in technology and the practicalities of the offering process.<sup>410</sup> These rules are based on an "access equals delivery" model, under which investors are presumed to have access to the Internet, and issuers and intermediaries can satisfy their delivery requirements if the documents are posted to a website. These rules have been well accepted by market participants, streamlining the offering process while maintaining essential investor protections.

Pursuant to Rule 460 under the Securities Act, the persons making the offering should take reasonable steps to make the information contained in the registration statement conveniently available to underwriters and dealers who are reasonably anticipated to participate in the distribution of the security to be offered or sold. At a minimum, reasonable steps involve the distribution of as many copies of the proposed form of preliminary prospectus as would appear to be reasonable to secure adequate distribution to each underwriter and dealer, a reasonable time in advance of the anticipated effective date of the registration statement. In practice, the lead representative of the underwriters often will inform the Staff in writing of the number of preliminary prospectuses distributed to investors. In an IPO, Rule 15c2-8 under the Exchange Act requires a broker or dealer to deliver a preliminary prospectus to investors at least 48 hours before the confirmation of the sale of the securities is sent.

### **Availability of Information – The EDGAR System**

The SEC's website provides public access to the EDGAR system. EDGAR provides free electronic access to the information that companies that have offerings or securities registered with the SEC file in disclosure documents. The EDGAR system performs automated collection, validation, indexing, acceptance, and forwarding of submissions by issuers and others who are required by

<sup>410</sup> SEC Release 33-8591 (July 19, 2005).



law to make filings with the SEC. Its primary purpose is to increase the efficiency and fairness of the securities market for the benefit of investors and corporations by accelerating the receipt, acceptance, dissemination, and analysis of information filed with the agency.

### **Interactive Disclosure through XBRL**

In 2009, the SEC adopted rules that now generally require domestic and foreign filers that use U.S. GAAP to provide their financial statements in interactive data format using eXtensible Business Reporting Language (XBRL) by submitting them to the SEC as exhibits and posting them on their websites.<sup>411</sup> Data become interactive when labeled or “tagged” using a computer mark-up language, such as XBRL, that software can process for analysis. The disclosure in interactive data format is in addition to, rather than instead of, disclosure in the traditional electronic filing formats of ASCII or HTML. These rules also generally will require the same of foreign filers that use IFRS, as issued by the International Accounting Standards Board (IASB), once the SEC specifies a suitable list of tags, when available, for use by these foreign filers in preparing their interactive data.

### **Incorporation by Reference**

Disclosure under the federal securities laws operates under an “Integrated Disclosure System,” which is based on the premise that certain information need not be repeated in a prospectus if the information has previously been disclosed in an annual, quarterly, or current report filed under the Exchange Act.

Because of the statutory framework in the U.S., under which the Securities Act focuses on prospectus disclosure in connection with offerings and the Exchange Act focuses on ongoing disclosure, at one time an issuer’s disclosure filings under each Act were considered separate and distinct. “Integrated Disclosure” recognizes that the disclosure regime under the two laws should operate together to provide investors with access to information whether they are purchasing securities from the issuer in an offering registered under the Securities Act or in an ordinary secondary market transaction on a stock exchange.

The SEC’s rules under the Securities Act allow for different methods to present information in the prospectus, depending on the characteristics of the issuer and the offering transaction. In most IPOs, all information must be directly presented in the prospectus. For other types of transactions, an issuer may be permitted to use “incorporation by reference,” under which a prospectus refers to past or future reports that are filed under the Exchange Act. By using incorporation by reference, an issuer is able to avoid repeating disclosure in a prospectus if that disclosure has already been included or will be included in an Exchange Act report. Incorporation by reference, which has been allowed for over 30 years, reduces burdens on issuers

<sup>411</sup>

SEC Release 33-9002 (January 30, 2009) as corrected by SEC Release 33-9002A (April 1, 2009).

by allowing them to prepare streamlined prospectuses and provides parallel information to investors in both the primary and secondary markets.

Incorporation by reference does not change the liabilities associated with a registration statement or prospectus. The SEC has stated that “[i]nformation presented in the registration statement, whether or not incorporated by reference, must be true and complete in all material respects and verified where appropriate. Likewise, nothing in the [SEC’s] integrated disclosure system precludes conducting adequate due diligence.”<sup>412</sup>

### **Staff Review of Prospectuses**

The Securities Act does not specifically provide for the Staff to review or clear prospectuses in connection with public offerings of securities. However, the Staff has assumed a review function for registration statements and prospectuses under the Securities Act as a result of the statutory framework under the Securities Act:

- Under Section 5 of the Securities Act, a registration statement must be “in effect” for securities to be sold under that registration statement.
- Under Section 8 of the Securities Act, while a registration statement becomes “effective” automatically 20 days after filing,<sup>413</sup> the SEC has the authority to accelerate the effective date (the SEC has delegated this authority to the Staff).
- Also under Section 8 of the Securities Act, the SEC has the power to issue a “stop order” to suspend the effectiveness of a registration if it appears that a registration statement includes an untrue statement of material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading.

As a result, it is a long-standing practice for the Staff to comment on preliminary versions of registration statements, for issuers to revise registration statements in response to Staff comments, and for issuers to request the Staff to accelerate effectiveness of registration statements under the Securities Act. This practice reduces the possibility that the SEC would take action to stop an offering once it had started. It also allows issuers and underwriters to sell securities shortly after pricing, thus avoiding the significant market risk that would exist if the issuer and the underwriters had to wait 20 days after pricing for automatic effectiveness. The Staff will accelerate effectiveness when it has had the opportunity to consider, among other things, the adequacy of the disclosures in the registration statement, the public interest, and the protection of investors.

<sup>412</sup> SEC Release 33-6335 (August 6, 1981), 46 Fed. Reg. 42015, at 42020.

<sup>413</sup> Issuers routinely include a delaying amendment to prevent a registration statement from becoming effective automatically 20 days after filing with the SEC.

The Staff's review and the acceleration of effectiveness do not constitute an assessment by the SEC of the adequacy or accuracy of the information contained in the registration statement. See the response to Question 16.5, below for a more detailed description of the review process undertaken by the Staff of issuer disclosure documents.

### **Shelf Registration of Securities**

The SEC has implemented a securities registration process under the Securities Act under which issuers may register securities up to three years in advance of publicly selling those securities. These sales may occur all at once, in several transactions over a period of time, or on a continual basis. This process, known as "shelf registration," allows issuers to offer and sell securities in registered offerings without the delay that would be involved with filing a new registration statement for each offering. Once a shelf registration statement has become effective under the Securities Act, issuers may "take securities off the shelf" by means of filing a prospectus or prospectus supplement with the SEC, with no action required by the SEC to permit the offering to go forward.

Over time, the SEC has expanded the shelf registration process to provide some issuers with additional flexibility. Under the current process, eligible issuers can register a dollar amount of securities without allocating how much would be sold of any particular type of security (common equity, preferred equity, senior or subordinated debt, warrants, or other). Generally, prospectuses under shelf registration statements are updated through incorporation by reference to subsequently filed annual reports.

In practice, under shelf registration, an issuer would file a "short-form" registration statement and prospectus that incorporate by reference virtually all information about the issuer from its Exchange Act reports and that include a generic description of the various types of securities that may be offered. After a review by the Staff, this registration statement is made effective by the SEC. The information in the registration statement and prospectus is deemed automatically updated with each filing of an annual report on Form 10-K, a quarterly report on Form 10-Q, or a current report on Form 8-K regarding certain enumerated events. From time to time, the issuer and one or more underwriters may identify windows of opportunity to sell securities "off the shelf." The issuer and the underwriters prepare a short supplement to the prospectus that describes the pricing terms of the offering and the specific description of securities. The shelf registration process has been in place for over 30 years and provides issuers with great flexibility in raising capital. From time to time, the SEC has revised its rules to expand the availability of the shelf registration process.

### **Exchange Requirements**

Issuers whose securities are listed on a U.S. stock exchange also are subject to the listing rules of that exchange. Refer to the discussion of Listing Documents and Exchange Rules in

Question 16.3. The disclosure obligations under exchange listing rules are separate from the SEC's reporting requirements under the Exchange Act. The exchange rules supplement the SEC's rules.

The listing requirements also require issuers to meet corporate governance requirements. For example, the NYSE, the NYSE MKT, and the NASDAQ all require listed issuers to have, among other things, a majority of independent directors and independent audit, compensation, and nominating committees, or, in certain cases, directors performing similar functions.

### **Issuers Subject to Scaled Disclosure Requirements**

The response to Principle 16 principally addresses the disclosure requirements for domestic companies<sup>414</sup> that are large accelerated filers<sup>415</sup> or accelerated filers.<sup>416</sup> This section identifies the scaled disclosure requirements that apply to emerging growth companies and smaller reporting companies.

**Emerging Growth Companies:** In 2012, the JOBS Act established a new category of issuer called the emerging growth company that may comply with scaled disclosure requirements in its IPO and subsequent periodic reports. An emerging growth company is a company that has total annual gross revenues of less than \$1 billion during its most recently completed fiscal year. By identifying itself as an emerging growth company in its prospectus, the issuer's disclosure informs investors that the issuer is eligible to use the scaled disclosure requirements permitted for those issuers. This scaled disclosure includes:

- permitting the issuer to provide two years of audited financial statements for an IPO of common equity securities;
- requiring the issuer to provide the selected financial data only for the periods it included in the registration statement for the IPO and for subsequent periods in documents it files after its IPO;

<sup>414</sup> The differences in disclosure requirements for foreign private issuers are discussed in response to Question 16.9, below.

<sup>415</sup> A large accelerated filer is an issuer that had aggregate worldwide public float of \$700 million or more, as of the last business day of its most recently completed second fiscal quarter; has been subject to the periodic and current reporting requirements of the Exchange Act for a period of at least twelve calendar months; has filed at least one annual report; and is not eligible to use the reporting requirements for smaller reporting companies.

<sup>416</sup> An accelerated filer is an issuer that had aggregate worldwide public float of \$75 million or more and less than \$700 million, as of the last business day of its most recently completed second fiscal quarter; has been subject to the periodic and current reporting requirements of the Exchange Act for a period of at least twelve calendar months; has filed at least one annual report; and is not eligible to use the reporting requirements for smaller reporting companies.

- complying with reduced executive compensation disclosure requirements permitting the issuer to omit a compensation discussion and analysis (CD&A) and not subjecting the issuer to the Dodd-Frank Act requirement to conduct the shareholder advisory votes described further in response to Question 17.1(a) below;
- permitting the issuer to omit the Sarbanes-Oxley Act Section 404(b) auditor attestation of internal control over financial reporting;
- permitting the issuer not to comply with new or revised accounting pronouncements until the date that a private company would be required to comply;
- allowing the issuer not to comply with any rule the PCAOB issues with respect to mandatory audit firm rotation or the auditor reporting model; and
- any new PCAOB auditing standard will not apply to the issuer unless the SEC finds it necessary and appropriate in the public interest, after considering the protection of investors, and the promotion of efficiency, competition, and capital formation.

These reduced disclosure requirements apply as long as the issuer is an emerging growth company.<sup>417</sup>

**Smaller Reporting Companies:** The SEC has adopted scaled disclosure requirements for smaller reporting companies.<sup>418</sup> Smaller reporting companies generally are companies that have a public float of less than \$75 million. The scaled disclosure requirements permit smaller reporting companies to:

- include less extensive narrative disclosure than required of other reporting companies, particularly in the description of executive compensation, which does not require smaller reporting companies to provide CD&A;
- provide audited financial statements for two fiscal years, in contrast to other reporting companies, which must provide audited financial statements for three fiscal years; and
- permit the issuer not to provide the Sarbanes-Oxley Act Section 404(b) auditor attestation of internal control over financial reporting.
- 

<sup>417</sup> An issuer will no longer qualify as an emerging growth company on the earliest of: (i) the last day of the fiscal year following the fifth anniversary that it first sold equity securities; (ii) the last day of the fiscal year in which its total annual gross revenues are \$1 billion or more; (iii) the date on which it becomes a large accelerated filer; or (iv) the date on which it has issued more than \$1 billion in non-convertible debt in the previous three years.

<sup>418</sup> See SEC Release No. 33-8876 (December 19, 2007).

## Municipal Securities

The “Tower Amendment”<sup>419</sup> prohibits the SEC and the MSRB from requiring state and local government issuers of municipal securities, either directly or indirectly through their underwriters, to make any specific disclosure filing with the SEC or MSRB prior to sale of these securities. The Dodd-Frank Act required a study and review by the Comptroller General of municipal securities disclosure, possible recommendations for municipal issuer disclosure requirements, and the advisability of the repeal or retention of the Tower Amendment. This report, issued in July 2012, found that current regulatory requirements for municipal securities disclosure broadly reflected seven principles of effective disclosure that were developed by IOSCO, although regulators and market participants said that there are some limitations on the enforceability and efficiency of the regulations. The report also discussed options for improving the information issuers disclose to investors of municipal securities. On July 31, 2012, the SEC issued a comprehensive Report on the Municipal Market that provided a number of recommendations for potential further consideration, including legislative changes, SEC rulemaking, MSRB rulemaking, and enhancement of industry “best practices.”

### (b) Annual reports?

Issuers are subject to the periodic reporting requirements of the Exchange Act under the following circumstances:

**Listed Issuers:** Before an issuer may list a class of securities (equity, debt, or other) on a national securities exchange, such as the NYSE or NASDAQ, it must register those securities under Section 12(b) of the Exchange Act. Registration generally takes place concurrently with an issuer’s IPO registered under the Securities Act. In this situation, registration under the Exchange Act is effected through a short-form registration statement, because an issuer would have prepared a prospectus for its IPO. Companies with a class of securities registered under Section 12(b) are subject to the reporting requirements under Section 13(a) of the Exchange Act.

**Non-Listed Companies:** A U.S. issuer which, on the last day of its fiscal year, has more than \$10 million in total assets and a class of equity securities held by either (i) 2,000 or more record holders or (ii) 500 or more record holders who are not accredited investors must register that class of securities under Section 12(g) of the Exchange Act.<sup>420</sup> These issuers are generally smaller issuers whose securities trade in the OTC market. Registration of the class of securities is

<sup>419</sup> Exchange Act Section 15B(d).

<sup>420</sup> In the case of an issuer that is a bank or bank holding company which, on the last day of its fiscal year, has more than \$10 million in total assets and a class of equity securities held by 2,000 or more record holders, it must register that class of securities under Section 12(g) of the Exchange Act. The JOBS Act raised the registration threshold under the Exchange Act from the requirement that an issuer which, on the last day of its fiscal year, has more than \$10 million in total assets and a class of equity securities held by 500 or more record holders to the current thresholds described above.

required even though the issuer is not raising capital. In this situation, the registration statement filed with the SEC must contain substantially all of the information required to be contained in a registration statement under the Securities Act other than offering-specific information.

Notwithstanding the fact that companies trading in the OTC market are not always subject to the Exchange Act reporting requirements, other rules help to assure that there is sufficient information about these companies, which tend to be smaller and thinly traded. For example, if a broker-dealer quotes securities that are not registered with the SEC, the broker-dealer may rely on Exchange Act Rule 15c2-11 to quote the securities if the broker-dealer reviews and maintains certain basic, reasonably current information about the issuer.<sup>421</sup>

**Voluntary Filers:** Additionally, an issuer may voluntarily register a class of equity securities under Section 12(g) of the Exchange Act. Once a company registers under Section 12(g), even if registration is voluntary, the Exchange Act requires it to file periodic reports.

**ABS:** Please refer to Question 16.2, below, for a discussion of ABS.

**Issuers with Recent Registered Offerings:** For previously non-reporting issuers, a reporting obligation arises under Section 15(d) of the Exchange Act upon the effectiveness of a Securities Act registration statement. Pursuant to Section 15(d), such issuers must comply with the reporting requirements of Section 13(a), in the same way as listed companies.

### Annual Disclosure Requirements

Yes. The regulatory framework has clear, comprehensive, and reasonably specific disclosure requirements that apply to annual reports.

Section 13(a) of the Exchange Act requires issuers to file an annual report each year that contains comprehensive information about an issuer.<sup>422</sup> Generally, the annual report requires disclosure about the company in all of the same areas, and addresses the same topics, as is required in a prospectus for an IPO under the Securities Act, other than offering-related information. The annual report must be signed by the issuer's principal executive, financial and accounting

<sup>421</sup> Rule 15c2-11 generally requires basic information about the issuer, including its name, address, state of incorporation, title and class of security to be quoted, number of securities outstanding as of the fiscal-year end, name and address of transfer agent, nature of its business, and products or services offered, name of chief executive officer and board members, its most recent balance sheet and statements of profit and loss and retained earnings, similar financial information for the two preceding fiscal years, and whether the issuer or a related person has directly or indirectly submitted the quotation.

<sup>422</sup> The reports are filed within 60 days of fiscal year-end with respect to large accelerated filers, within 75 days of fiscal year-end with respect to accelerated filers, and within 90 days of fiscal year-end with respect to all other U.S. filers. Foreign private issuers file their annual reports within four months of fiscal year-end.

officers, and at least a majority of the board of directors. The annual report is required to disclose<sup>423</sup>:

- Information about the company's business;
- Risk factors;
- Unresolved material comments from Staff filing reviews;
- Information about the company's properties;
- Legal proceedings;
- Mine safety disclosures;<sup>424</sup>
- A description of the market for the issuer's equity, any related stockholder matters, and any of the issuer's purchases of equity securities;
- Selected financial data (five years of sales, income, dividends, and other data);
- Management's discussion and analysis of financial condition and results of operation;
- Quantitative and qualitative disclosures about market risk;
- Financial statements (audited consolidated financial statements) and supplementary data;<sup>425</sup>
- Changes in and disagreements with accountants on accounting and financial disclosure;
- Information regarding the effectiveness of the issuer's disclosure controls and procedures;
- A management assessment and auditor report<sup>426</sup> on whether the issuer's internal control over financial reporting is effective and, if not, the material weaknesses in such controls;

<sup>423</sup> See discussion of the parallel prospectus disclosure requirements and related footnotes in the response to Question 16.1(a), above.

<sup>424</sup> An issuer that is an operator of coal or other mines in the United States is required to disclose information about health and safety violations, orders, and citations, total assessments proposed and legal actions, and mining-related fatalities.

<sup>425</sup> Depending on the business of the issuer, Item 802 of Regulation S-K sets forth certain industry-specific information for issuers, such as bank holding companies, insurance companies, and other specialized industries.



- Information about the company's directors, executive officers,<sup>427</sup> and corporate governance;<sup>428</sup>
- Executive officer and director compensation information, including a CD&A<sup>429</sup> and a compensation committee report;
- Security ownership of certain beneficial owners and management;
- Certain relationships, related transactions, and director independence;
- Principal accountant fees and services, including the audit committee's pre-approval policies for auditor services; and
- Exhibits<sup>430</sup> and financial statement schedules, including certifications by the issuer's principal executive and financial officer.

The financial statements required include three years of statements of income, cash flow, and changes in shareholders' equity, two years of balance sheets, and a discussion of subsequent events.<sup>431</sup> The issuer must present the information on a consolidated basis and provide comprehensive footnote disclosure. The financial statements must be audited by an independent public accountant registered with the PCAOB. Please see the discussion in

<sup>426</sup> Smaller reporting companies and emerging growth companies are not required to provide the auditor's attestation of internal control over financial reporting.

<sup>427</sup> Required disclosure includes a description of the business experience, directors' experience, qualifications, attributes, or skills that led to the conclusion that the director should serve as a director, and involvement in certain legal proceedings.

<sup>428</sup> The corporate governance disclosures include identification of and disclosure about the issuer's audit, compensation, and nominating committees (or committees performing a similar function in the case of the compensation and nominating committees); whether the issuer has an audit committee financial expert and code of ethics, and if not, why; disclosure regarding the role of compensation consultants; compensation committee interlocks; and disclosure regarding board meetings, committees, and the policy for director attendance at annual meetings. Typically, most of this information is disclosed in the proxy statement for the annual meeting of shareholders and incorporated by reference into the issuer's annual report.

<sup>429</sup> Smaller reporting companies and emerging growth companies are not subject to the requirement to provide CD&A.

<sup>430</sup> Principal exhibits include material contracts, charter documents and bylaws, instruments defining the rights of security holders, and code of ethics from Item 601 of Regulation S-K.

<sup>431</sup> Regulation S-X may require additional financial statements in certain instances, such as financial statements of acquired businesses and real estate operations, financial statements of subsidiaries not consolidated and 50% or less owned persons, and financial statements of guarantors. In addition, in the event of certain transactions, such as a merger or an acquisition, the issuer must provide *pro forma* financial information about the effect of the transaction by showing how it might have affected historical financial statements if the transaction had been consummated at an earlier time.

Principles 18 through 21 for more detail relating to financial statement and auditor qualification requirements.

Although MD&A is not a part of the financial statements, it must accompany financial statements. The MD&A presents a view of the issuer through the eyes of management and explains material trends and commitments. As required by Regulation S-K, MD&A addresses liquidity and capital resources as well as events and uncertainties known to the issuer's management that may cause the reported results not to be indicative of future financial performance.<sup>432</sup> This disclosure also includes off-balance sheet disclosures and contractual obligations.

(c) Other periodic reports?

Yes, the SEC has a framework for periodic reporting that is clear, comprehensive, and reasonably specific. Issuers must file quarterly reports on Form 10-Q. In addition to periodic reports, issuers must file current reports on Form 8-K upon the occurrence of certain enumerated events. Further, should an issuer decide to selectively disclose information to certain individuals, it must also disseminate the same information through a means designed to distribute the information to the public on a non-exclusionary basis.

### Quarterly Reports

Issuers that are subject to the reporting requirements under the Exchange Act must also file quarterly reports for the first three fiscal quarters on Form 10-Q.<sup>433</sup> Issuers must describe their financial condition and results of operations for the preceding fiscal quarter and the corresponding period from the prior fiscal year and also include condensed financial statements. Foreign private issuers<sup>434</sup> are not subject to quarterly reporting requirements.

The financial statements in quarterly reports include balance sheets as of the close of the quarter and the comparable quarter of the preceding year, comparative statements of operations for the quarter and for the beginning of the year through quarter-end, and comparative statements of cash flow from the beginning of the year through quarter-end. These financial statements are not required to be audited; however, they are required to be reviewed by an independent public accountant pursuant to Rule 10-01(d) of Regulation S-X, although a review report is not usually filed as part of the Form 10-Q.

Financial statements in quarterly reports also are required to be accompanied by MD&A. The

<sup>432</sup> 17 C.F.R. § 229.303.

<sup>433</sup> The reports are generally required to be filed within 40 days of quarter-end. See response to Question 16.3(a), below.

<sup>434</sup> Defined below in response to Question 16.9.

quarterly financial statement requirements and MD&A are intended to provide interim updates of the financial statement and related information included in an issuer's annual report.

Other significant information required to be disclosed in quarterly reports includes:

- Quantitative and qualitative disclosures about market risk;
- Controls and procedures disclosures;
- Legal proceedings;
- Any material changes from risk factors as previously disclosed;
- Unregistered sales of equity securities and use of proceeds for an IPO;
- Defaults on senior securities;
- Mine safety disclosures;
- Current reporting information for the quarter not previously disclosed in a Form 8-K report;
- Changes in director nomination procedures; and
- Exhibits required by Item 601 of Regulation S-K, including certifications by the issuer's principal executive and financial officer.

The requirements for quarterly reports with respect to non-financial statement and related information are not as extensive and do not require updating of all the information required in the annual report. For example, an issuer is not required to update its business description, disclosure relating to directors and executive officers, or disclosure relating to the security ownership of certain beneficial owners and management. However, some of these matters may be required to be disclosed in a current report on Form 8-K.

### **Current Reports**

Domestic issuers subject to the periodic reporting requirements under the Exchange Act also must file current reports on Form 8-K upon the occurrence of enumerated events. The SEC has expanded the number of events that are reportable on Form 8-K from time to time, consistent with the "real-time issuer disclosure" mandate in Section 409 of the Sarbanes-Oxley Act. This section requires issuers to disclose "on a rapid and current basis" material information regarding changes in an issuer's financial condition or operations as the SEC by rule determines to be necessary or useful. The primary subject headings under Form 8-K are:

- Section 1 – Registrant’s Business and Operations
  - Item 1.01 – Entry into a Material Definitive Agreement
  - Item 1.02 – Termination of a Material Definitive Agreement
  - Item 1.03 – Bankruptcy or Receivership
  - Item 1.04 – Mine Safety – Reporting of Shutdowns and Patterns of Violations
- Section 2 – Financial Information
  - Item 2.01 – Completion of Acquisition or Disposition of Assets
  - Item 2.02 – Results of Operations and Financial Condition
  - Item 2.03 – Creation of a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement of a Registrant
  - Item 2.04 – Triggering Events that Accelerate or Increase a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement
  - Item 2.05 – Costs Associated with Exit or Disposal Activities
  - Item 2.06 – Material Impairments
- Section 3 – Securities and Trading Markets
  - Item 3.01 – Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing
  - Item 3.02 – Unregistered Sales of Equity Securities
  - Item 3.03 – Material Modifications to Rights of Security Holders
- Section 4 – Matters Related to Accountants and Financial Statements
  - Item 4.01 – Changes in Registrant’s Certifying Accountant
  - Item 4.02 – Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review
- Section 5 – Corporate Governance and Management
  - Item 5.01 – Changes in Control of Registrant
  - Item 5.02 – Departure of Directors or Principal Officers; Election of Directors; Appointment of Certain Officers; Compensatory Arrangements of Certain Officers
  - Item 5.03 – Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year
  - Item 5.04 – Temporary Suspension of Trading under Registrant’s Employee Benefit Plans
  - Item 5.05 – Amendments to the Registrant’s Code of Ethics, or Waiver of a Provision of the Code of Ethics
  - Item 5.06 – Change in Shell Company Status
  - Item 5.07 – Submission of Matters to a Vote of Security Holders

- Section 6 – Asset-Backed Securities
  - Item 6.01 – ABS Informational and Computational Material
  - Item 6.02 – Change of Servicer or Trustee
  - Item 6.03 – Change in Credit Enhancement or Other External Support
  - Item 6.04 – Failure to Make a Required Distribution
  - Item 6.05 – Securities Act Updating Disclosure
- Section 7 – Regulation FD
  - Item 7.01 – Regulation FD Disclosure
- Section 8 – Other Events
  - Item 8.01 – Other Events

Typically, a Form 8-K report providing appropriate disclosure is required to be filed within four business days of the subject event.

### Selective Disclosure – Regulation FD

As part of the current reporting requirements, reporting issuers are subject to Regulation FD, which addresses the selective disclosure of information by reporting issuers. This regulation is designed to promote full and fair disclosure among all classes of investors in reporting issuers. It requires a reporting issuer to make simultaneous or prompt public disclosure, depending on whether the disclosure was intentional, when it discloses material nonpublic information to certain individuals or entities (generally, securities market professionals, such as stock analysts or holders of the issuer's securities who may trade on the basis of the information). Regulation FD defines "Public Disclosure" as furnishing or filing a Form 8-K, or disseminating the information through another method that is reasonably designed to provide broad, non-exclusionary distribution of information to the public.<sup>435</sup>

#### (d) Shareholder voting decisions?

Yes. Any solicitation of a proxy with respect to an equity security registered under Section 12 of the Exchange Act must comply with the proxy rules under Regulation 14A under the Exchange Act. Generally, these rules require that a proxy statement contain specific disclosures, including material information about the matters that will be voted on, and that the proxy statement be delivered to shareholders that are being asked to vote on those matters. When the proxy statement relates to an annual meeting of the shareholders of an issuer at which directors are to be elected, the proxy rules are designed to require companies to provide shareholders with information about directors, corporate governance, executive compensation, and the independent auditors, as well as certain proposals by security holders, to make an informed

<sup>435</sup>

17 C.F.R. § 243.101.

voting decision. Foreign private issuers are not subject to the proxy rules under Regulation 14A under the Exchange Act.

When the proxy statement relates to a merger or acquisition, the proxy rules provide that certain material information about the terms of the transaction be disclosed to shareholders on Schedule 14A. When the merger or acquisition involves the issuance of shares or other securities by the acquiring company to shareholders of the public target company, the transaction is generally deemed to be a public offering of securities by the acquiring company, which is required to be registered under the Securities Act. In this case, the proxy statement for the vote by shareholders of the target company is also a prospectus of the acquiring company, and the document is required to contain extensive financial and non-financial disclosure about the acquiring company, the target company, and the transaction, including *pro-forma* financial statements. If the merger or acquisition involves solely cash consideration payable by the acquiring company to target shareholders, more limited information is required.

In general, a proxy statement filed on Schedule 14A requires disclosure about some or all of the following items, depending on the matters being acted upon:

- date, time, and place of the meeting;
- revocability of the proxy;
- persons making the solicitation;
- interest of certain persons in matters to be acted upon;
- voting securities and principal holders thereof;
- directors and executive officers;
- compensation of directors and executive officers, including CD&A;<sup>436</sup>
- independent public accountants;
- compensation plans;

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<sup>436</sup> In 2006, the SEC substantially revised the disclosure requirements for executive compensation in order to obtain more clear and complete disclosure relating to the compensation for the principal executive officer, the principal financial officer, the three other highest paid executive officers, and the directors. SEC Release 33-8732A (August 29, 2006). This revision added CD&A that elicits disclosure relating to the objectives and implementation of executive compensation programs, focusing on the most important factors underlying each company's compensation policies and decisions.

- authorization or issuance of securities otherwise than for exchange;
- modification or exchange of securities;
- financial and other information;
- mergers, consolidations, acquisitions, and similar matters;
- dissenters' right of appraisal;
- acquisition or disposition of property;
- restatement of accounts;
- action with respect to reports;
- matters not required to be submitted;<sup>437</sup>
- amendment of charter, bylaws, or other documents;
- other proposed action;<sup>438</sup>
- voting procedures;
- delivery of documents to security holders sharing an address; and
- shareholder approval of executive compensation.

In 2009, the SEC adopted rules that require enhanced disclosure in an issuer's proxy statement.<sup>439</sup> Under these rules, an issuer must discuss its policies and practices of compensating all employees if the compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the issuer. An issuer must provide information about directors and nominees for director, including:

- the particular experience, qualifications, attributes, or skills that led the company's board to conclude that the person should serve as a director of the company;

<sup>437</sup> This involves an action to be taken with respect to any matter not required to be submitted to a vote of security holders for reasons of state corporate law or otherwise.

<sup>438</sup> If action is to be taken on any matter not specifically referred to in Schedule 14A.

<sup>439</sup> SEC Release 33-9089 (December 16, 2009).

- any directorships at public companies and registered investment companies that each director and director nominee held at any time during the past five years; and
- legal proceedings, such as SEC securities fraud enforcement actions against the director or nominee, going back 10 years and an expanded list of legal proceedings covered by the rule.

These rules require disclosure of whether and, if so, how a nominating committee considers diversity in identifying nominees for director. If the nominating committee or the board has a policy with regard to the consideration of diversity in identifying director nominees, these rules require disclosure of how this policy is implemented and how the nominating committee or the board assesses the effectiveness of its policy.

These rules also require the issuer to disclose the company's board leadership structure, including whether the company has combined or separated the chief executive officer and chairman position, and why the company believes its structure is appropriate. In certain circumstances, the company should disclose whether and why it has a lead independent director and the specific role of such director. These rules also require disclosure of the extent of the board's role in risk oversight, such as how the board administers its oversight function and the effect it has on the board's leadership structure.

The 2009 amendments require a company to disclose on Form 8-K the results of a shareholder vote within four business days after the end of the meeting at which the vote was held. These rules require revised disclosure regarding the reporting of stock and option awards in the compensation tables for officers and directors. These rules also require enhanced disclosure about the fees paid to compensation consultants and their affiliates in certain circumstances. In 2010, the Dodd-Frank Act was signed into law. Among other matters, the Dodd-Frank Act contains numerous provisions that affect governance matters, including compensation disclosure, which for most U.S. companies is included/contained in the proxy statement for the annual shareholders' meeting and incorporated by reference into a company's annual report. For example:

- Section 951 requires companies to provide for advisory votes of shareholders about executive compensation and golden parachutes. This section also requires specific disclosure of, and an advisory vote on, golden parachutes in merger proxies. See Question 17.1(a) for a further discussion of shareholder advisory votes and disclosure of golden parachutes.
- Section 952 requires disclosure about the role of, and potential conflicts involving, compensation consultants. As required by this section, the SEC directed the exchanges to adopt listing standards that include certain enhanced independence requirements for members of compensation committees, and established competitively neutral independence factors for all who are retained to advise compensation committees.



- Section 953 requires additional disclosure about certain compensation matters, including pay versus performance (Section 953(a)) and the amounts of and ratio between the CEO's annual total compensation and the median annual total compensation for all other company employees (Section 953(b)).
- Section 954 requires the SEC to direct the exchanges to prohibit the listing of securities of issuers that have not developed and implemented compensation claw-back policies.
- Section 955 requires disclosure about whether directors and employees are permitted to hedge or offset any decrease in market value of the company's stock.

The Dodd-Frank Act required the SEC to adopt rules to implement these provisions. To date, the SEC has adopted rules with respect to the provisions of Sections 951 and 952<sup>440</sup> and proposed rules with respect to Section 953(b).<sup>441</sup>

(e) Advertising of public offerings outside of the prospectus?

Yes. Prior to the SEC adopting reforms to the offering process in 2005, the Securities Act and the SEC's rules thereunder provided for significant restrictions on the types of offering communications that issuers or other parties subject to the Securities Act's provisions, such as underwriters, could use during a registered public offering. The nature of the restrictions depended on the time period during which the communications were to occur (and the restrictions were separate from those that depend on the accuracy of the information contained in the communication).<sup>442</sup>

Several factors, combined with advances in technology, led to rule changes so that investors and the market would benefit from greater access to permissible communications where protection of investors is maintained through the appropriate Securities Act liability standards for materially deficient disclosures in prospectuses and oral communications.

Issuers, underwriters, and other offering participants have made extensive use of the new regulatory framework relating to offering communications. This initiative has greatly reduced the compliance burden associated with offering communications while maintaining and promoting

<sup>440</sup> SEC Release No. 33-9178 (January 25, 2011) and SEC Release No. 33-9330 (June 20, 2012).

<sup>441</sup> SEC Release No. 33-9452 (September 18, 2013).

<sup>442</sup> For example, prior to the changes discussed below, between the filing of the registration statement and its effectiveness, the only written material that was permitted in connection with the offering of the securities was a preliminary prospectus meeting the requirements of Section 10 of the Securities Act. After the registration statement was declared effective, offering participants could make written offers only through a statutory prospectus, except that they could use additional written offering materials if a final prospectus that met the requirements of Section 10(a) was sent or given prior to or with those materials.

investor protections.

As a result of the regulatory changes in 2005, the SEC's rules permit issuers and other offering participants to communicate more openly and freely with investors and the marketplace.<sup>443</sup>

Under SEC rules:

- the largest publicly traded companies (e.g., those with a public float in excess of \$700 million, among other criteria) are permitted to engage at any time in oral and written offering communications, subject to enumerated conditions (including, in specified cases, filing the communications with the SEC);
- all reporting issuers are permitted, at any time, to continue to publish regularly released factual business information and forward-looking information;
- non-reporting issuers are permitted, at any time, to continue to publish regularly released factual business information that is intended for use by persons other than in their capacity as investors or potential investors;
- communications by issuers more than 30 days before filing a registration statement are permitted so long as they do not reference a securities offering that is or will be the subject of a registration statement;
- all eligible issuers and offering participants in eligible issuer offerings are permitted to use "free writing prospectuses" (written offering materials that may not contain all of the information contained or required in a statutory prospectus meeting the requirements of Section 10(a) of the Securities Act, as described in response to Question 16.1(a), used generally after the filing of the registration statement, subject to enumerated conditions (including, in specified cases, filing with the SEC));
- a broader category of routine communications regarding issuers, offerings, and procedural matters, such as communications about the schedule for an offering or about account-opening procedures, are excluded from the definition of "prospectus"; and
- the exemptions for research reports were expanded.

Most of these rules are not available to blank check companies, penny stock issuers, or shell companies.

<sup>443</sup>

SEC Release 33-8591 (July 19, 2005).

2. Does the regulatory framework require accurate, sufficiently clear and comprehensive, and reasonably specific and timely disclosure of:

(a) events that are material to the price or value of securities;

Yes. As noted above, Forms 10-Q and 8-K require issuers to disclose on a regular and current basis material financial and non-financial information. See Question 16.1(c) for a discussion about the timeliness of these filings. These reports are available online to investors immediately upon filing through the EDGAR system and, as also noted above, may be in XBRL format. Also, see Question 16.1(c) for a discussion of Regulation FD.

In addition, each registered securities exchange generally requires its listed companies to:

- timely disclose information that may affect security values or influence investment decisions; and
- timely provide the exchange with other information in order to maintain an orderly market in the company's securities.

As an example from the largest national securities exchanges, Section 202.05 of the Listed Company Manual for the NYSE provides that a listed company is expected to release quickly to the public any news or information that might reasonably be expected to materially affect the market for its securities. Additionally, it provides that a listed company should also act promptly to dispel unfounded rumors that result in unusual market activity or price variations. Likewise, NASDAQ Rule 5250(b)(1) provides that a listed company shall make prompt disclosure of any material information that would reasonably be expected to affect the value of its securities or influence investors' decisions. Further, NASDAQ IM-5250-1 provides that a company may be required to make a clear public announcement if rumors or unusual market activity indicates that information on impending developments or information from a source other than the company has become known to the investing public.

As described in the response to Question 9.2(d), the rules and rule amendments of a national securities exchange are subject to the regulatory oversight of the SEC and must be submitted to the SEC pursuant to Exchange Act Section 19(b). Additionally, the exchanges' enforcement of their own rules is subject to the SEC's oversight and inspection. These exchange rules therefore supplement the SEC's rules and are a key part of the regulatory framework of issuer disclosure in the U.S.

(b) the most significant risks of investing in the security; and

Yes. As discussed above, an issuer is required to provide disclosure in a prospectus, under the caption "Risk Factors," of the most significant factors that make an investment in the offering speculative or risky. The discussion must be concise and organized logically. The issuer should only discuss risks that are specific to the issuer or the offering, and the issuer should avoid

including generic risk factors. In an annual report, an issuer (other than a smaller reporting company) is required to disclose applicable risk factors and update any material changes in quarterly reports.

An issuer's MD&A should include a discussion of a risk to the extent it represents an event, trend, or uncertainty that is reasonably likely to have a material effect on the issuer's results of operations, liquidity, or financial condition or would cause reported financial information not to be necessarily indicative of future operating results or financial condition. An issuer is required to include MD&A in a prospectus and in an annual or quarterly report.

If the risk arises from a material pending legal proceeding to which an issuer or any of its subsidiaries is a party, the issuer may need to provide disclosure of the legal proceeding. The disclosure should include the name of the court in which the proceeding is pending, the date instituted, the principal parties, a description of the factual basis alleged to underlie the complaint, and the relief sought. Legal proceedings disclosure is required in an issuer's prospectus and in an annual report or quarterly report, and it could be required to be disclosed in a current report on Form 8-K.

An issuer is required to provide quantitative and qualitative disclosure about market risk. This disclosure includes risks arising from changes in interest rates, foreign currency exchange rates, commodity prices, equity prices, and other market changes that affect market-risk-sensitive instruments. An issuer is required to provide this disclosure in a prospectus and an annual report or a quarterly report.

As discussed in response to Question 16.1(d) above, in 2009 the SEC adopted rules that require enhanced disclosure about an issuer's compensation policies and practices that present material risks to the company and about the board of directors' role in risk oversight.

(c) important relevant information about the issuer and its activities?

Yes. Please refer to the response to Question 16.1 above.

### **Disclosure Requirements for ABS**

The discussion of ABS has been consolidated under Question 16.2 based, in part, on the 2013 IOSCO Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation. Under Key Question 2, the 2013 IOSCO Methodology sets forth key issues that the assessor should consider in determining whether the regulatory framework requires comprehensive and specific disclosure requirements for offerings of ABS.

### **Overview**

ABS are securities backed by a discrete pool of self-liquidating financial assets. Asset-backed securitization is a financing technique in which financial assets, in many cases themselves less

liquid, are pooled and converted into instruments that may be offered and sold in the capital markets. ABS and ABS issuers differ from corporate securities and operating companies. The issuing entity of an ABS is designed to be a solely passive entity without management, and in an ABS offering there is generally no business or management to describe. Therefore, information about the transaction structure and the characteristics and quality of the asset pool and servicing is often what is most important to ABS investors.

### **Regulation AB**

In 2004, the SEC adopted new rules and amendments to address Securities Act registration, disclosure, communications during the offering process, and ongoing reporting under the Exchange Act for ABS.<sup>444</sup> The disclosure requirements were codified in Regulation AB, which is a principles-based set of disclosure items that form the basis for disclosure in both Securities Act registration statements and Exchange Act reports. The specific disclosure requirements in ABS registration statements and forms are keyed to items in Regulation AB in a manner consistent with the integrated disclosure system applicable to other issuers.

As part of these rules, the SEC also adopted a definition of asset-backed security to determine the securities that may be registered on a shelf registration statement. This definition includes a requirement that the underlying assets are a discrete pool of financial assets that by their terms convert into cash within a finite time period. Therefore, certain ABS that are backed by a managed asset pool – for example, CDOs or collateralized loan obligations – will not meet the definition of an asset-backed security and may not take advantage of shelf registration for ABS. Foreign ABS may be registered on the same Securities Act registration forms as domestic ABS and are subject to the same disclosure requirements in Regulation AB, as appropriate.

In August 2014, the SEC adopted significant revisions to Regulation AB and other rules regarding the offering process, disclosure, and reporting for ABS (revised Regulation AB).<sup>445</sup> In addition, in 2011, the SEC adopted several rules to implement provisions of the Dodd-Frank Act governing the disclosure for ABS, including requiring disclosure of fulfilled and unfulfilled repurchase requests, requiring issuers to review the assets underlying the ABS, and providing for the suspension of the duty to file reports under Section 15(d) of the Exchange Act.<sup>446</sup>

<sup>444</sup> See SEC Release No. 33-8518 (December 22, 2004).

<sup>445</sup> For more information about revised Regulation AB, see SEC Release No. 33-9638 (September 4, 2014), available at <http://www.sec.gov/rules/final/2014/33-9638.pdf>.

<sup>446</sup> See SEC Release No. 33-9175 (January 20, 2011), SEC Release No. 33-9176 (January 20, 2011), and SEC Release No. 34-65148 (August 17, 2011).

### Specific Disclosure Requirements under Regulation AB

**Disclosure about the Transaction Parties:** Regulation AB contains specific, line-item requirements relating to the background, experience, performance, and roles of the relevant transaction parties, such as the sponsor, originators, servicer, and trustee as their roles often can be as important to the performance of an ABS transaction as the transaction structure or its governing documents.<sup>447</sup> This information provides context to analyze the ABS and the characteristics and quality of the asset pool. For example, the disclosure rules require both a general discussion of the sponsor's experience in securitizing assets of any type and a more detailed discussion of the sponsor's experience in and overall procedures for originating or acquiring and securitizing the assets of the type to be included in the transaction.<sup>448</sup> Similarly, understanding the material aspects of the entire servicing function – both the collection and asset maintenance activities as well as cash flow allocation and distribution functions – is important to understanding how servicing may impact expected performance. Regulation AB therefore requires, among other things, information about the entire servicing function, including a clear description of the roles, responsibilities, and oversight requirements of the entire servicing process and parties involved.

**Static Pool Information:** Regulation AB requires disclosure of static pool information, to the extent material, about delinquencies, cumulative losses, and prepayments for prior securitized pools of the sponsor. This information indicates how the performance of groups, or static pools, of assets, such as those originated at different intervals, are performing over time. By presenting comparisons between originations at similar points in the assets' lives, such data allow the detection of patterns that may not be evident from overall portfolio numbers and thus reveal a more informative picture of material elements of portfolio performance and risk.

**Pool Assets:** Information about the composition and characteristics of the asset pool is a cornerstone of the disclosure necessary for an investor to make an informed investment decision about an ABS. Regulation AB sets forth the disclosure requirements for the pool assets and requires information about:

- the types of pool assets to be securitized and the selection criteria;
- pool characteristics;

<sup>447</sup> For more information about the disclosure requirements for each of the transaction parties, see Items 1104 (sponsors), 1106 (depositor), 1107 (issuing entities), 1108 (servicers), 1109 (trustees), and 1110 (originators).

<sup>448</sup> SEC disclosure rules also require disclosure in the prospectus concerning assets securitized by the sponsor that were subject to a repurchase or replacement for a breach of representations or warranties. As part of revised Regulation AB, the SEC adopted a rule to require disclosure of the financial condition of certain parties (e.g., sponsors and originators) required to repurchase assets when there is a breach, pursuant to the transaction agreements, of a representation and warranty related to pool assets.

- delinquency and loss information;
- sources of pool cash flow;
- representations and warranties and repurchase obligations for pool assets;
- claims on pool assets; and
- revolving periods, prefunding accounts, and other changes to the asset pool.

To provide increased transparency about the underlying assets of a securitization, the Commission recently adopted rules as part of revised Regulation AB requiring issuers to provide standardized asset-level information for ABS backed by residential and commercial mortgages, auto loans and leases, and debt securities (including resecuritizations). The new asset-level disclosures generally would include information about: the credit quality of obligors; the collateral related to each asset; and the cash flows related to a particular asset, such as the terms, expected payment amounts, and whether and how payment terms change over time. The asset-level information will be required in the offering prospectus and in ongoing reports.

Securities Act Rule 193 requires ABS issuers in registered offerings to conduct a review of the assets underlying the ABS. The review must be designed and effected to provide reasonable assurance that the prospectus disclosure about the assets is accurate in all material respects. Disclosure about the nature of the review and the findings and conclusions of the review is required to be provided in the prospectus. ABS issuers must also provide disclosure in the prospectus about any assets in the pool that deviate from the disclosed underwriting criteria, including data on the amount and characteristics of those assets that did not meet the disclosed underwriting criteria.<sup>449</sup>

**Significant Obligors:** SEC rules require additional disclosure for any significant obligor in an asset pool. Descriptive information includes the identity of the significant obligor, its organizational form, the general character of its business, the nature of the concentration and material terms of the pool assets and the agreements with the obligor involving the pool assets. Different levels of financial information are required depending upon the level of concentration of the obligor. For example, if the pool assets relating to a significant obligor represent 20% or more of the asset pool, audited financial statements of the obligor meeting the requirements of Regulation S-X are required.

**Description of the Securities and Structure of the Transaction:** Regulation S-K sets forth the core disclosure requirements for the securities being offered, including the identification of the exchange if the securities have been accepted for listing. Regulation AB also requires, among

<sup>449</sup>

See Item 1111(a)(8).

other things, disclosure about the types or categories of securities that may be offered, how principal and interest on each class of securities is calculated and payable, and a clear description of the flow of funds for the transaction. An ABS issuer also must file all governing documents and material agreements for the offering, which for ABS includes the pooling and servicing agreement, the indenture, and other related transaction documents.

**Credit Enhancement:** An ABS issuer is required to provide disclosure about credit enhancement and other support that is designed to assure the servicing or timely distribution of proceeds to security holders. Disclosure of the material terms of the agreement to provide such enhancement or support is required, including any limits on the timing or amount of the enhancement or any conditions that must be met before the enhancement can be accessed. For significant providers of credit enhancement or other support, issuers are required to provide additional descriptive and financial information.

**Derivative Instruments:** SEC disclosure rules require information about derivative instruments, such as interest rate or currency swaps, that are used to alter the payment characteristics of the cash flows from the issuing entity. In particular, an ABS issuer must provide descriptive information about the derivative counterparty, the operation and material terms of the derivative instrument, and substitution of the instrument, if applicable. Disclosure is also required about the financial significance of the derivative instrument and, if significant, additional financial information is required.

**Reports and Additional Information:** In determining whether to invest in a particular ABS, investors consider the availability and quality of transaction reporting. Regulation AB requires an ABS issuer to provide prospectus disclosure about reports required under the transaction documents, reports to be filed with the SEC, and whether such reports will be accessible on a website.

**Other Disclosure Items:** In addition to the disclosure items discussed above, the SEC's rules also require disclosure of, among other things, the following matters:

- the most significant risk factors that make the ABS offering speculative and risky and how those risks affect investors, including tailored disclosure if certain risks affect only certain classes of investors;
- tax matters, including a discussion of the tax treatment of the ABS transaction under federal income tax laws;
- legal proceedings pending against the key transaction parties that are material to security holders; and



- affiliations and certain relationships and related transactions.<sup>450</sup>

### **Securities Act Registration for ABS**

Public offerings of ABS are typically registered on a shelf registration statement, which provides important timing and flexibility benefits to issuers. Offerings of ABS that are registered on a shelf registration statement must meet certain conditions.<sup>451</sup> An issuer with an effective shelf registration statement can conduct delayed offerings “off the shelf” under Securities Act Rule 415 without prior review by Staff. For each takedown of securities, an ABS issuer is required to file at the time of the takedown a final prospectus supplement describing the specific terms of the transaction, including the assets underlying the securities and the structure of the transaction.

### **Communications during the ABS Offering Process**

The SEC’s rules governing communications during the offering process also apply to ABS offerings. For additional information about those rules, please see the response to Question 16.1(e). ABS issuers regularly use free-writing prospectuses to provide investors with information about the potential payouts of the financial assets and the ABS as well as information about the structure of the offering or the underlying asset pool.

### **Ongoing Reporting for ABS Issuers under the Exchange Act**

The SEC has adopted an ongoing reporting regime tailored for ABS. If ABS are to be listed on a national securities exchange, they must be registered pursuant to Section 12 of the Exchange Act and the issuer must file reports pursuant to Section 13 of the Exchange Act. If the ABS are not to be listed on an exchange, an offering of ABS pursuant to an effective Securities Act registration statement triggers a reporting obligation under Section 15(d) of the Exchange Act with respect to those securities until they are no longer held by non-affiliates of the depositor.<sup>452</sup>

<sup>450</sup> For additional information, please see the response to Question 8.

<sup>451</sup> As part of revised Regulation AB, the SEC adopted revisions to some of the conditions to shelf registration for ABS, including requiring that ABS issuers provide investors with more time to consider transaction-specific information before the first sale in any takedown of securities and replacing the investment grade ratings requirement with new shelf eligibility requirements. The new shelf transaction requirements will require: the CEO of the depositor to provide a certification about the disclosure contained in the prospectus and the structure of the securitization, a provision in the transaction agreement for the review of the assets for compliance with the representations and warranties upon the occurrence of certain trigger events, a dispute resolution provision for repurchase requests in the underlying transaction documents, and a mechanism to facilitate communication among investors.

<sup>452</sup> Staff reviews of ABS filings made under the Securities Act and the Exchange Act are consistent with Staff reviews of non-ABS filings. For additional information about the filing review process, see response to Question 16.5.

**Annual Reports:** Asset-backed issuers subject to the Exchange Act reporting requirements must file an annual report on Form 10-K with modified requirements. For ABS investors, the performance of the servicing function is of material importance to the performance of the ABS transaction. As a result, in lieu of audited financial statements, the issuing entity must file as exhibits to the Form 10-K: (i) a report on assessment of compliance with the required servicing criteria from each party participating in the servicing function, and (ii) an attestation report from a registered public accounting firm about the servicer's assessment of compliance with the required servicing criteria. Additionally, a servicer compliance statement must be filed as an exhibit to the Form 10-K, which addresses the servicer's compliance with its obligations under the servicing agreement for that particular ABS transaction.

Similar to operating companies, asset-backed issuers must include a certification pursuant to Section 302 of the Sarbanes-Oxley Act with their annual report on Form 10-K. The senior officer in charge of securitization of the depositor or the senior officer in charge of the servicing function of the servicer, depending on whether the depositor or servicer signs the Form 10-K, must certify to the accuracy and completeness of the information contained in the issuing entity's Exchange Act periodic reports.<sup>453</sup> The annual report for asset-backed transactions must be filed within 90 days after the end of the fiscal year covered by the report.

**Periodic Reports:** Under the modified reporting system for ABS issuers, in lieu of quarterly reports, an ABS issuer is required to file reports on Form 10-D containing periodic distribution and pool performance information for each distribution period. An ABS issuer is required to provide information about, among other things, the calculated amounts and distribution of the flow funds for the period itemized by type and priority of payment, updated information on the composition of the asset pool after giving effect to payment activity, delinquency and loss information for the period, and information about any material breaches of representations, warranties, or covenants. Additionally, certain non-financial disclosures, such as legal proceedings and matters submitted to a vote of security holders, that occurred during the period are also required to be included in the Form 10-D. The Form 10-D must be filed within 15 days after each required distribution date on the ABS.

**Current Reports:** Asset-backed issuers subject to the periodic reporting requirements under the Exchange Act also must file current reports on Form 8-K upon the occurrence of enumerated events as set forth in the response to Question 16.1(c).

<sup>453</sup> See Exchange Act Rules 13a-14 and 15d-14 and Item 601(b)(31) of Regulation S-K for the content and form of the certification.

3. Does the regulatory framework require:

- (a) Financial information and other required disclosure in prospectuses, listing documents, annual and other periodic reports, and, where applicable, in connection with shareholder voting decisions, to be of sufficient timeliness to be useful to investors?

### Prospectuses

Yes. The SEC's rules relating to the age of financial statements are designed so that financial information in prospectuses, listing documents, and periodic reports is sufficiently up-to-date to be useful to investors.

**Financial Information:** Until 45 days following the issuer's fiscal year-end, a prospectus for an IPO may include audited annual financial statements covering the prior fiscal year and unaudited interim period financial statements covering the first three fiscal quarters of the most recent fiscal year.<sup>454</sup> After 45 days following the issuer's fiscal year-end, a prospectus for an IPO must include audited annual financial statements covering the most recent fiscal year. Until 135 days following the end of the issuer's interim period fiscal quarter, a prospectus for an IPO is not required to include financial statements covering that fiscal quarter.<sup>455</sup> After such 135-day period, an IPO prospectus must contain interim period financial statements covering the most recently ended fiscal quarter.

For prospectuses relating to offerings by issuers that are subject to the periodic reporting requirements under the Exchange Act, the age of financial statement requirements are generally consistent with the filing requirements applicable to annual reports and quarterly reports, described below. However, if such an issuer has not filed all reports required to be filed under the Exchange Act, the same timing rules that apply to an IPO would apply.

**Non-Financial Information:** There is no specific regulatory requirement relating to the timeliness of non-financial information in a prospectus. However, the regulatory framework under the Securities Act is designed so that information contained in a prospectus and registration statement is current. For example, the liability provisions under Section 11 of the Securities Act are based on the date the registration statement becomes effective.

Additionally, other liability provisions also help ensure that information in a prospectus used for the offer and sale of a security is sufficiently timely to be useful to investors. For example, under Section 12(a)(2) of the Securities Act, sellers of securities have liability to purchasers for offers and sales by means of a prospectus or oral communication that includes an untrue statement of material fact or omits to state a material fact that makes the statements made, based on the

<sup>454</sup> Rule 3-01 of Regulation S-X.

<sup>455</sup> *Id.*

circumstances under which they were made, not misleading. Also, Section 17(a) of the Securities Act (a general anti-fraud provision) provides, among other things, that it shall be unlawful for any person in the offer and sale of a security to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. Liability under Sections 12(a)(2) and 17(a)(2) attaches when an investor has committed to purchase the securities.

### **Listing Documents**

As noted previously, the principal disclosure documents prepared by issuers under the federal securities laws are prospectuses for the offering of securities and annual and other reports under the Exchange Act. Listing documents do not play a significant role in the disclosure framework in the U.S. for offerings of securities. Companies generally become listed on a U.S. stock exchange in three situations:

- in connection with an IPO, in which case the issuer prepares a Securities Act registration statement, including a prospectus, and a short-form Exchange Act registration statement;
- in connection with a spin-off (demerger), in which case the issuer prepares a registration statement under the Exchange Act with substantially all of the information required in a prospectus; or
- in connection with moving from OTC market trading to an exchange listing, in which case the issuer will already be registered under the Exchange Act and filing reports or will be required to file an Exchange Act registration statement.

Pursuant to Section 12(a) of the Exchange Act, securities listed on a U.S. national securities exchange must be registered under Section 12(b) of the Exchange Act. Companies with a class of securities registered under Section 12(b) are subject to the reporting requirements under Section 13(a) of the Exchange Act. That section requires the filing of specified information and documents, as the SEC requires, to keep the information contained in the issuer's registration statement reasonably current. Also, refer to Question 16.2(a) for a discussion of exchange requirements related to the public release of information.

### **Annual Reports**

Large accelerated filers must file annual reports within 60 days of the fiscal year-end covered by the report, accelerated filers must file annual reports within 75 days of the fiscal year-end covered by the report, and all other U.S. filers must file annual reports within 90 days of the fiscal year-end covered by the report. Foreign private issuers must file annual reports on Form 20-F within four months of the fiscal year-end covered by the report. Disclosure is to be given as of the latest practicable date before filing except for information required to be provided for the

fiscal year or as of a specified date.

### **Quarterly Reports**

Large accelerated filers and accelerated filers must file a quarterly report within 40 days after the end of the fiscal quarter covered by the report. All other domestic filers must file within 45 days after the end of the fiscal quarter covered by the report. Foreign private issuers are not required to file quarterly reports.

### **Current Reports**

Unless otherwise specified, a current report must be filed or furnished within four business days after occurrence of the reportable event. When the current requirements were adopted in 2004, the SEC stated that, by moving its rules towards a system emphasizing current reporting, markets might become more effective as price discovery mechanisms during periods between periodic reports and enhance investor confidence in the financial markets.<sup>456</sup> In turn, confidence in receiving enhanced disclosure should provide greater certainty to investors that they are making investment decisions in a more transparent market, which should reduce market volatility resulting from uncertainty about the availability of accurate timely information about public companies.

### **Voting Decisions**

The SEC's proxy rules require issuers to offer Internet delivery of proxy materials to their shareholders.<sup>457</sup> Under these rules, issuers are required to post their proxy materials (the notice of a shareholders' meeting, the proxy statement prepared in accordance with Schedule 14A or information statement prepared in accordance with Schedule 14C under the Exchange Act, the form of proxy, and the annual report of shareholders) on an Internet website and send a Notice of Internet Availability of Proxy Materials to their shareholders. Issuers have the choice of: (i) providing all shareholders with a full set of paper copies of the proxy materials (as has traditionally been done) with a copy of the Notice of Internet Availability; (ii) ceasing to mail paper copies and instead implementing a "notice-and-access" model; or (iii) combining the two options, one for some shareholders and the other for the remainder.

Under the "notice-and-access" model, the issuer must mail the Notice of Internet Availability of Proxy Materials at least 40 days prior to the shareholders' meeting, informing shareholders of the Internet availability of proxy materials. The 40-calendar-day time frame does not apply to the option to deliver paper copies.

<sup>456</sup> SEC Release 33-8400 (March 16, 2004), 69 Fed. Reg. 15594, at 15611.

<sup>457</sup> SEC Release 34-55146 (January 22, 2007).

### Exchange Rules

Exchange rules also promote the timely disclosure of financial and other required information. For example, the NYSE has an “immediate release” policy which, as set forth in Section 202.05 of the Listed Company Manual, requires a listed company to release quickly to the public any news or information that might reasonably be expected to materially affect the market for its securities.

In accordance with the NYSE’s Procedures for Public Release of Information, Section 202.06 of the Listed Company Manual, the quick release of information required by the Exchange’s policy should be effected by any Regulation FD-compliant method. NASDAQ Listing Rule 5250(b)(1) generally requires a listed company to make prompt disclosure to the public through any Regulation FD-compliant method (or combination of methods) of disclosure of any material information that would reasonably be expected to affect the value of its securities or influence investors’ decisions. As discussed above, in response to Question 16.1(c), Regulation FD requires a company to make public disclosure *simultaneously* with any other disclosure if such other disclosure is intentional, and *promptly* if such other disclosure is not-intentional (“promptly” is interpreted to be “as soon as practicable” after a senior official of the issuer learns that there has been a non-intentional disclosure, but in no event after the later of 24 hours or the commencement of next day’s trading on the NYSE). “Public Disclosure” under Regulation FD is defined as disclosure made by furnishing or filing a Form 8-K, or disseminating the information through another method that is reasonably designed to provide broad, non-exclusionary distribution of information to the public.

- (b) Periodic information about financial position and results of operations (which may be in summary form) to be made publicly available to investors?

Yes. As noted in the responses to Questions 16.1(b), (c), and 16.2(a), above, periodic reports must contain MD&A, which addresses liquidity and capital resources as well as events and uncertainties known to the issuer’s management that may cause the reported results not to be indicative of future financial performance. Such disclosure also includes off-balance-sheet disclosures, and an issuer must provide disclosure about contractual obligations in an annual report. The financial statements in quarterly reports include balance sheets as of the close of the quarter and the comparable quarter of the preceding year, comparative statements of operations for the quarter and for the beginning of the year through quarter-end, and comparative statements of cash flow from the beginning of the year through quarter-end.

(c) Appropriate measures to be taken (for example, provision of more recent unaudited financial information) when the audited financial statements included in a prospectus for public offerings are not current?
Yes. As noted in the responses to Question 16.3(a), above, financial statements contained in a prospectus must be periodically updated so as to keep the financial information presented in such prospectus useful to investors.
<i>General Disclosure</i>
4. In addition to specific disclosure requirements, is there a general requirement to disclose either all material information or all information necessary to keep the disclosures made from being misleading?
<p>Yes. The framework for the issuer disclosure requirements under the federal securities laws includes both principles-based standards for issuer disclosure and specific “line-item” disclosures that are required in various disclosure documents. This combination of principles-based standards and specific line-item requirements is designed to provide investors with material information in order to make informed investment and voting decisions.</p> <p><b>Materiality and SEC Rules</b></p> <p>Materiality is an important standard in determining what must be disclosed under the federal securities laws. The SEC has adopted rules under the Securities Act and the Exchange Act that provide that, in addition to the information expressly required to be included, such further material information, if any, shall be added as may be necessary in order to make the required statements, in the light of the circumstances under which they are made, not misleading.<sup>458</sup> Securities Act Rule 408 applies the materiality standard to registration statements, Exchange Act Rule 12b-20 applies the materiality standard to Exchange Act statements or reports, and Exchange Act Rule 14a-9 applies the materiality standard to proxy statements or other solicitation materials.</p> <p>In connection with the SEC’s disclosure requirements relating to financial statements, Rule 3-13 of Regulation S-X provides that the SEC also may require the filing of other financial statements in addition to, or in substitution for, the statements specifically required in any case where such statements are necessary or appropriate for an adequate presentation of the financial condition of any person whose financial statements are required, or whose statements are otherwise necessary for the protection of investors.</p>

<sup>458</sup>

See Securities Act Rule 408 and Exchange Act Rule 12b-20 and Rule 14a-9.

### General Disclosure Principles

The laws and rules that govern publicly held companies in the U.S. derive from the principle that all investors in securities, whether large institutions or private individuals, must be provided with material information in order to make informed investment and voting decisions. In pursuit of this aim, the federal securities laws, and the rules and regulations of the SEC, require issuers to disclose material financial and non-financial information when publicly offering securities and on a periodic basis. The concept of materiality is important to understanding the approach to disclosure under the federal securities laws. There is no statutory or regulatory definition of “material” and there is no “bright-line” test for materiality, such as a certain percentage of an issuer’s revenues or assets.<sup>459</sup> The U.S. Supreme Court has stated that information is material if a reasonable investor would consider it important in making an investment decision or if the information would significantly alter the total mix of information made available.<sup>460</sup>

Approximately 9,000 issuers have registered a class of securities or a transaction and are reporting to the SEC under the Exchange Act. For certain purposes, as described below, the SEC has established various classes of issuers such as large accelerated filers, accelerated filers, smaller reporting companies, and foreign private issuers. The discussion set forth below principally addresses the disclosure requirements of large accelerated filers and accelerated filers.<sup>461</sup>

SEC rules relating to issuer disclosure requirements address the content, accuracy, and timing of disclosure documents. Issuers are required to accurately disclose and report various categories of information, including financial statements that have been prepared using a comparable basis of accounting and audited by an independent public accountant. Disclosure documents from companies registering transactions or classes of securities with the SEC are filed electronically on EDGAR and are publicly available on the Internet at no cost.

<sup>459</sup> See Staff Accounting Bulletin Topic 1 M and Staff Accounting Bulletin Release No. SAB 99 (August 12, 1999).

<sup>460</sup> The U.S. Supreme Court cases of *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) and *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) provide the strongest authorities on materiality. Expressly adopting the standard of materiality set forth in *TSC Industries*, in *Basic* the Supreme Court defined materiality in the following manner:

there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available.

Recently, the U.S. Supreme Court expressly rejected a bright-line test that would require a plaintiff to allege a statistically significant number of adverse events to satisfy the materiality requirement in a claim for securities fraud. *Matrixx Initiatives, Inc., et al. v. James Siracusano et al.*, 563 U.S. \_\_\_, 131 S. Ct. 1309, 179 L. Ed 2d 398 (2011).

<sup>461</sup> Foreign private issuers are discussed in more detail below in response to Question 16.9. The SEC has adopted scaled disclosure requirements for smaller reporting companies and revised disclosure requirements for foreign private issuers. See SEC Release Nos. 33-8876 (December 19, 2007) and 33-8959 (September 23, 2008), respectively. Under the JOBS Act, there are scaled disclosure requirements for emerging growth companies, as described in response to Question 16.5, below.



In addition to requiring disclosures, the federal securities laws impose on issuers requirements relating to the maintenance of books and records, internal controls over financial reporting, and disclosure controls and procedures. Depending on whether the issuer's securities are listed on an exchange, an issuer may be subject to varying levels of corporate governance requirements, such as oversight of financial reporting by an independent audit committee of the issuer.

As described in more detail below, a key component of the statutory liability structure of the federal securities laws is a materiality standard for the disclosure of information.

### **Statutory Liability for Issuer Disclosures**

The federal securities laws contain strong liability provisions to protect investors from false and misleading information and to provide issuers with incentives to provide full disclosure. These liability provisions are based on a general standard of materiality.

### **Securities Act Liability**

Remedies available under the Securities Act include damages, the right to rescind the sale of the securities at issue, and injunctive relief.

- **Section 11 Liability.** Under Section 11 of the Securities Act, the issuer, the principal executive, financial and accounting officers, members of the board of directors, the underwriters, and certain other parties involved with the preparation of the registration statement may be liable to purchasers of securities if any part of the registration statement, when it became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading. Section 11 is enforceable by private litigants rather than the SEC. See the response to Question 16.6 for more information.
- **Section 12 Liability.** Under Section 12 of the Securities Act, any person who offers or sells a security by means of a prospectus or oral communication which includes an untrue statement of material fact or omits to state a material fact necessary in order to make the statement, in the light of the circumstances under which they were made not misleading may be liable to the person purchasing the security. The term "seller" is interpreted broadly to include persons other than the person who transfers title to a security. Section 12 is enforceable by private litigants rather than the SEC.
- **Section 17 Liability.** Under Section 17 of the Securities Act, it is unlawful for any person in the offer or sale of any security to employ any device, scheme, or artifice to defraud; obtain money or property by means of an untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or to engage in any

transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser. Section 17 is enforceable by the SEC.

### Exchange Act Liability

Remedies available under the Exchange Act include damages and injunctive relief.

- **Section 10(b) and Rule 10b-5.** Section 10(b) of the Exchange Act and one of its implementing regulations, Rule 10b-5, are the most commonly used provisions against securities fraud under the Exchange Act. Section 10(b) states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange ... to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 10(b) and Rule 10b-5 are enforceable by private litigants and the SEC.

- **Section 18 Liability.** Section 18 of the Exchange Act provides an express private cause of action for a “statement [that] was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact.” This applies to investors who can demonstrate that they relied on such statements contained in a document filed with the SEC under the Exchange Act when they purchased or sold the securities and the false or misleading statements caused their damages.

### Practical Application of the General Requirement

Much of the SEC’s work relating to issuer disclosure involves the application of the general disclosure requirements discussed above. While the Staff’s review process, discussed in response to Question 16.5, may address disclosure deficiencies based on line-item requirements, much of the review work and requests for further information and disclosure are based on the Staff’s view that additional material information may be necessary to enable the issuer to better fulfill its disclosure obligations under the federal securities laws.

*Sufficiency, Accuracy, Timeliness and Accountability for Disclosure*

5. Are there measures available to the regulator (e.g., review, certification, supporting documentation, sanctions) to address concerns with the sufficiency, accuracy and timeliness of the required disclosures?

Yes. There are several measures available to the SEC that support and promote robust issuer disclosure, including:

- the Staff's filing review process;
- required certifications relating to the content of disclosure and eligibility to use scaled disclosure;
- the loss of certain benefits if disclosure obligations are not met in a consistent and timely manner; and
- a registration statement stop order, investigation, or enforcement actions concerning violations of the disclosure requirements.
- 

**Filing Review Process**

CF selectively reviews filings made under the Securities Act and the Exchange Act to monitor and enhance compliance with disclosure and accounting requirements. In its filing reviews, CF concentrates its review resources on critical disclosures that appear to conflict with the SEC's rules or the applicable accounting standards and on disclosure that appears to be materially deficient in explanation or clarity.

CF does not evaluate the merits of any transaction to determine whether an investment is appropriate for any investor. CF's review process is not a guarantee that the disclosure is complete and accurate – responsibility for complete and accurate disclosure lies with the company and others involved in the preparation of a company's filings.

CF performs its primary review responsibilities through 12 offices staffed with approximately 80% of CF's employees. The members of these 12 offices have specialized industry, accounting, and disclosure expertise.<sup>462</sup> CF assigns filings by companies in a particular industry to one of the twelve review offices. CF has staffed each office with 25 to 35 professionals, primarily accountants and lawyers.

<sup>462</sup> The 12 review offices are organized by industry and include: healthcare and insurance; consumer products; information technologies and services; natural resources; transportation and leisure; manufacturing and construction; financial services I; real estate and commodities; beverages, apparel, and mining; electronics and machinery; telecommunications; and financial services II.

**Required and Selective Review:** As required by Section 408 of the Sarbanes-Oxley Act, CF undertakes some level of review of the periodic reports made under Section 13(a) of the Exchange Act of each reporting company at least once every three years. CF reviews a significant number of companies more frequently. In addition, CF selectively reviews transactional filings – documents companies file when they engage in public offerings, business combination transactions, and proxy solicitations.

In deciding how to allocate Staff resources among filings, CF may undertake a substantive evaluation of the company's disclosure in what it calls a preliminary review. To preserve the integrity of the selective review process, CF does not publicly disclose its preliminary review criteria. Based on its preliminary review, CF decides whether to undertake any further review of the company's filings.

**Levels of Review:** If CF selects a company or a filing for further review, the extent of that further review will depend on many factors, including the results of the preliminary review. The level of further review may be:

- a full cover-to-cover review in which the Staff will examine the entire filing for compliance with the applicable requirements of the federal securities laws and regulations;
- a financial statement review in which the Staff will examine the financial statements and related disclosure, such as MD&A of Financial Condition and Results of Operations, for compliance with the applicable accounting standards and the disclosure requirements of the federal securities laws and regulations; or
- a targeted issue review in which the Staff will examine the filing for one or more specific items of disclosure for compliance with the applicable accounting standards and/or the disclosure requirements of the federal securities laws and regulations.

Much of CF's review involves evaluating the disclosure from a potential investor's perspective and asking questions that an investor might ask when reading the document. When the Staff identifies instances where it believes a company can materially improve its disclosure or enhance its compliance with the applicable disclosure requirements, it provides the company with comments. The range of possible comments is broad and depends on the issues that arise in a particular filing review. The Staff completes many filing reviews without issuing any comments.

In addition to a first-level examiner, in nearly all cases a second person reviews a filing and the proposed comments to help achieve consistency in comments across filing reviews.

**Staff Comments:** CF views the comment process as a dialogue with a company about its disclosure. CF's comments are based on a company's disclosure and other public information and reflect the Staff's understanding of that company's facts and circumstances. In issuing

comments to an issuer, the Staff may request that a company provide additional supplemental information so the Staff can better understand the company's disclosure. The Staff may also request that the issuer revise disclosure in a document on file with the SEC, provide additional disclosure in a document on file with the SEC, or provide additional or different disclosure in a future filing with the SEC.

For Securities Act transactional filings, the Staff seeks to provide initial comments on filings selected for review within 30 days of the filing date. The target of 30 days or less has become a *de facto* industry expectation for the maximum time to receive initial comments from CF on Securities Act transactional filings. There is no comparable target for Exchange Act filings. In the following fiscal years, CF issued initial comments on Securities Act filings selected for review on average in the following number of days:

Fiscal Year	Average Days
2013	25.6
2012	24.9
2011	24.4
2010	24.1
2009	25.3

**Issuer Responses to Comments:** A company generally responds to each comment in a letter to the Staff and, if appropriate, by amending its filings. A company's explanation or analysis of an issue will often resolve a comment. Depending on the nature of the issue, the Staff's concern, and the company's response, the Staff may issue additional comments following its review of the company's response to its prior comments. This comment and response process continues until CF and the company resolve the comments.

**Closing a Filing Review:** Under current practice, when a company has resolved all of CF's comments on a Securities Act registration statement, the company may request that the SEC declare the registration statement effective so that it can proceed with the transaction. When taking that action, CF, through authority delegated from the SEC, gives public notice on the SEC's EDGAR system that the registration statement is effective.

When a company has resolved all comments from CF on an Exchange Act registration statement, a periodic or current report, or a preliminary proxy statement, CF provides the company with a "no further comment" letter to confirm that its review of the filing is complete.

To increase the transparency of the review process, when CF completes a filing review it makes its comment letters and company responses to those comment letters public on the SEC's EDGAR system. CF makes this correspondence public no earlier than 20 business days after it has completed its review of a periodic or current report or declared a registration statement

effective. CF includes the “no further comment” letter in this public posting of correspondence. The Sarbanes-Oxley Act requires that the SEC review the disclosures of all companies reporting under the Exchange Act at least once every three years.

In the following fiscal years, CF reviewed the following percentage of companies:

Fiscal Year	% Reviewed
2013	52%
2012	48%
2011	48%
2010	44%
2009	40%

### **Creation of New Offices**

CF plans to continue its multi-year effort to enhance its disclosure review program for large or financially significant companies; provide increased interpretive guidance; and evaluate trends in the increasingly complex offerings of ABS and other structured financial products. In 2010, three specialized offices were created to enhance CF’s disclosure review and policy operations. The three specialized offices focus on large financial institutions, ABS and other structured products, and securities offering trends. In 2013, an office was created to evaluate the outcomes of CF’s filing review program and create a self-assessment structure. The CF review program is sufficiently flexible to permit CF to adjust its review presence in light of market developments and associated risks with respect to certain industries and products.

**Bank Holding Companies and Other Large Financial Institutions:** Through the financial services II office, CF concentrated Staff expertise and developed review techniques to strengthen its review program relating to the periodic disclosure documents filed by the largest bank holding companies and other large publicly traded financial institutions, including investment advisers and broker-dealers. The financial services II office also facilitates sharing information about the firms it reviews with others throughout the agency involved in regulatory oversight of these firms.

**ABS and Other Structured Finance Products:** The structured finance office reviews disclosures in ABS and other structured finance product offerings and monitors their impact on the markets. This office also leads rulemaking and interpretive activities related to structured products. See the response to Question 16.2 above for a more detailed description of the disclosure requirements for ABS and other structured finance products.

**Capital Market Trends:** This office evaluates trends in securities offerings and capital markets to determine whether rules and regulations are keeping pace and working effectively. The office

also conducts market research and selectively reviews securities offering documents and coordinates CF's consideration of new products.

**Disclosure Standards:** The disclosure standards office evaluates the outcomes of the filing review program. This office helps CF to maintain effective controls to conduct filing reviews in a consistent and professional manner and conducts ongoing assessments to evaluate the effectiveness of the CF internal supervisory controls.

**CF Review of Confidential Submissions:** As discussed above, the JOBS Act established a new category of filers called emerging growth companies that may comply with scaled disclosure requirements in IPOs and subsequent periodic reports. Under the JOBS Act, these companies also may submit draft registration statements before their IPO date for confidential nonpublic review by the Staff. The Staff review of these draft registration statements is the same as the Staff review of filings made under the Securities Act described above.

### **Certification and Supporting Documentation**

**Sarbanes-Oxley Section 302 Certifications:** Pursuant to Section 302 of the Sarbanes-Oxley Act, the SEC adopted rules,<sup>463</sup> as amended,<sup>464</sup> which require an issuer's principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, each to certify in each quarterly and annual report, including transition reports, filed or submitted by the issuer under Section 13(a) or 15(d) of the Exchange Act that:

- They each reviewed the report;
- The report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading;
- The financial information included in the report fairly present in all material respects the financial condition, results of operations and cash flows of the registrant;
- They each are responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting to ensure that material information is made known to them and to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements. They must evaluate and disclose their conclusions about the effectiveness of the disclosure controls and procedures and disclose in this report any change in the registrant's internal control over financial reporting that occurred during the most recent fiscal quarter.

<sup>463</sup> SEC Release 33-8124 (August 29, 2002).

<sup>464</sup> SEC Release 33-8238 (June 5, 2003).

- They have disclosed to the registrant's auditors and the audit committee of the registrant's board of directors all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize, and report financial information, and any fraud that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

**Sarbanes-Oxley Section 906 Certifications:** Section 906 of the Sarbanes-Oxley Act added a new section to the U.S. Criminal Code which contains a certification requirement separate and distinct from the certification requirement mandated by Section 302 and subject to specific U.S. federal criminal provisions.

Section 906 requires each periodic report containing financial statements filed by an issuer to be accompanied by a written statement by the chief executive officer and chief financial officer (or equivalent thereof) certifying that:

- the periodic report containing the financial statements fully complies with the requirements of section 13(a) or 15(d) of the Exchange Act; and
- information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.

### **Loss of Benefits**

**Issuer Categories:** The sufficiency, accuracy, and timeliness of required disclosure is also addressed through the potential loss of benefits associated with specific classifications of issuers created under the federal securities laws. As indicated above in response to Question 16.3, there are a number of different issuer categories. Certain rules and benefits may apply to each category, relating to such matters as form eligibility, filing deadlines, and required disclosure. Some Securities Act and Exchange Act filings require that an issuer identify itself as belonging to a certain category of issuer, such as a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or a shell company by checking the box pertaining to such classification.

These categories are important because, as described in Section 16.1(e) above, the relaxation of certain communications restrictions, including the use of a "free-writing prospectus," is available only to certain classes of larger issuers.

Additionally, Forms S-3 and F-3, which are the "short forms" used by issuers to register securities offerings under the Securities Act, are available only to those issuers that have a class of securities registered under Section 12 of the Exchange Act or are required to file reports pursuant to Section 15(d) of the Exchange Act and have timely filed all the material required to



be filed pursuant to Sections 13, 14 or 15(d), subject to certain limited exceptions, for at least the year preceding the filing of the Form S-3 or F-3. These forms allow such companies to rely on their reports filed under the Exchange Act to satisfy the form's disclosure requirements and enables companies to conduct primary offerings "off the shelf" under Rule 415 of the Securities Act. Rule 415 provides considerable flexibility in accessing the public securities markets from time to time in response to changes in the markets and other factors. The shelf eligibility resulting from Form S-3 eligibility and the ability to forward incorporate information on Form S-3, therefore, allow companies to avoid additional delays and interruptions in the offering process and can reduce or even eliminate the costs associated with preparing and filing post-effective amendments to the registration statement.

Form S-8, which provides for the automatic registration of an issuer's securities pursuant to employee benefit plans, is not available to a shell company or former shell company (unless at least 60 calendar days has passed since it filed current information equivalent to that contained in a registration statement reflecting its non-shell status) and is available only to reporting companies that are current in their Exchange Act reporting obligations.

Smaller reporting companies are required to indicate they qualify as such so that investors may be alerted that the issuer is eligible to use the scaled disclosure requirements available to smaller reporting companies, and thus permitted to disclose less information, both non-financial and financial in nature.

**Registration Stop Order, Delinquent Filings Program, and other Enforcement Efforts:**

Pursuant to Section 8 of the Securities Act, the SEC may at any time issue an order preventing or suspending the effectiveness of a registration statement if it has reason to believe that such registration statement includes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein, in the light of the circumstances under which such prospectus is or is to be used, not misleading.

Another important means by which the SEC helps to ensure the sufficiency, adequacy, and timeliness of required disclosure is through its Delinquent Filings Program. In an effort to ensure that investors have access to up-to-date financial and other information about the issuers of securities, Enforcement conducts investigations into possible violations of the federal securities laws by issuers for failing to make required filings with the SEC, as well as by corporate insiders who fail to file the appropriate forms with the SEC regarding their personal securities trades, and prosecutes civil actions and administrative proceedings in this area.

Pursuant to Section 12(j) of the Exchange Act, the SEC is authorized to deny, to suspend the effective date of, to suspend for a period not exceeding 12 months, or to revoke the registration of a security, if the SEC finds, on the record after notice and opportunity for hearing, that the issuer of such security has failed to comply with any provision of the Exchange Act or the rules and regulations thereunder. As a result, no member of a national securities exchange, broker, or

dealer may effect any transaction in, or induce the purchase or sale of, any security where the registration of that security has been and is suspended or revoked pursuant to Section 12(j).

6. Does regulation ensure that issuers and others involved in the issuing process, which may include underwriters, directors, authorizing officers, promoters, experts and advisers, are liable for the content of disclosures they make?

Yes. The Securities Act provides for rights of action against persons who sold or are involved in the sale of securities in an offering.

Under Section 11 of the Securities Act, the following people may be liable in a private action for material misstatements or omissions in a registration statement (which includes the prospectus or offering document):

- the issuer;
- each of its directors;
- each underwriter;
- each person signing the registration statement, which includes the issuer's principal executive officer, its principal financial officer, and its principal accounting officer (comptroller);
- the independent accountant with respect to audited financial statements included in the registration statement upon which the accountant renders an audit report; and
- each expert with respect to information included in the registration statement in reliance upon the expert (*e.g.*, an appraiser, mining engineer, or petroleum consultant).

Issuers are subject to strict liability. All persons other than the issuer are entitled to certain due diligence defenses which generally require them to demonstrate that, after reasonable investigation, they had reasonable ground to believe that the matters in question were true.

Pursuant to Section 12 of the Securities Act, any person who offers or sells a security by means of a prospectus or oral communication which includes an untrue statement of material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading, may be liable to the person purchasing the security for an amount equal to the consideration paid for such security with interest thereon, less the amount of any income received thereon, or for damages if such person no longer owns the security.

Under Section 12 of the Securities Act, however, an ordinary negligence standard applies and the

seller is also entitled to assert a due diligence defense in order to demonstrate that, after reasonable investigation, it had reasonable grounds to believe that the matters in question were true.

In addition, Section 17(a) of the Securities Act is a general anti-fraud provision, enforceable by the SEC, which imposes liability upon any person who commits fraud in connection with the offer or sale of securities.

Since Exchange Act filings are often incorporated by reference into Securities Act filings, issuers may also be liable under Section 10(b), Rule 10b-5, and Section 18 of the Exchange Act. See “Exchange Act Liability” in the response to Question 16.4.

#### *Derogations*

7. Are there circumstances where disclosures may be omitted or delayed limited to trade secrets, similar proprietary information or other valid business purposes, such as incomplete negotiations?

Yes. Generally speaking, the disclosure obligations under the federal securities laws do not allow for derogations. However, in limited circumstances, the SEC’s rules permit certain limited information not to be publicly disclosed.

#### **Confidential Treatment of Certain Information Contained in Filed Exhibits**

As discussed throughout this assessment, the federal securities laws generally require any company that is publicly held or that is registering its securities for public sale to disclose a broad range of financial and non-financial information in registration statements, annual reports, and other filings made with the SEC.

Significantly, an issuer must file publicly all contracts material to its business other than those it enters into in the ordinary course of business.<sup>465</sup> However, public disclosure of information required by the regulations can sometimes raise concern among issuers that such disclosure may adversely affect a company’s business and financial condition due to competitive harm. Typical examples of such concern include pricing terms, technical specifications, and milestone payments. To address the potential disclosure hardship, the SEC allows companies to request confidential treatment of certain information filed under the Securities Act and the Exchange Act.

The SEC may grant an issuer’s request for confidential treatment, provided the subject information is filed with the SEC for review on a nonpublic basis and the information meets the legal test for exclusion provided by FOIA.

<sup>465</sup> Item 601(b)(10) of Regulation S-K.

FOIA requires all federal agencies to make specified information available to the public, including the information required to be filed by SEC rules. FOIA contains nine specific exemptions from this requirement.<sup>466</sup> The SEC's confidential treatment rules require that requests for confidential treatment contain an analysis of the applicable FOIA exemption. Specifically, Rules 406 and 24b-2 set forth the primary means for obtaining confidential treatment of information contained in a document required to be filed under the Securities Act and under the Exchange Act, respectively. Often, issuers applying for confidential treatment in connection with filings rely on the FOIA exemption that covers "trade secrets and commercial or financial information obtained from a person and [that is] privileged or confidential" which is commonly referred to as "the (b)(4) exemption."<sup>467</sup>

In practice, these requests usually relate to information in the material contracts that the issuer must file as exhibits to its filings. Confidential treatment cannot be granted if the information has not been kept confidential, is material to the issuer, or if the request is overly broad. For example, the Staff might permit an issuer to omit the specific pricing terms in a supply contract but not the entire contract. Similar to the selective review process for registration statements, the Staff will undertake a preliminary review of a confidential treatment application to determine whether it will receive a full review, a targeted issue review, or a no review. Following the resolution of any comments and the completion of the Staff's review, the Staff will publicly grant an order for the confidential treatment of the redacted information, if appropriate.

### **Incomplete Negotiations**

Disclosure is required only for agreements that provide for obligations that are material to and enforceable against a company, or rights that are material to a company and enforceable by the company against one or more other parties to the agreement.<sup>468</sup> In adopting its rules, while noting that there may be instances in which a company is required to provide disclosure (e.g., in order to avoid an omission of material fact that would otherwise make a statement misleading), the SEC recognized that the disclosure of letters of intent and other non-binding agreements may cause significant competitive harm to a company and create excessive speculation in the market in certain cases.<sup>469</sup>

Such circumstances would not include a material definitive agreement that is subject to customary closing conditions, such as the delivery of legal opinions or comfort letters, completion of due diligence, or regulatory approval, when such agreement is enforceable against or by the company despite the fact that such conditions have not yet been satisfied. On the

<sup>466</sup> 5 U.S.C. 552(b).

<sup>467</sup> 5 U.S.C. 552(b)(4); 17 C.F.R. 200.80(b)(4).

<sup>468</sup> SEC Release 33-8400 (March 16, 2004), 69 Fed. Reg. 15594, at 15596.

<sup>469</sup> *Id.*

other hand, if a company enters into a non-binding letter of intent or MOU that also contains some binding, but non-material elements, such as a confidentiality agreement or a no-shop agreement, the letter or memorandum does not need to be filed because the binding provisions are not material.<sup>470</sup>

The SEC has provided interpretive guidance that MD&A, as applied to preliminary merger negotiations, would not require disclosure of preliminary negotiations where disclosure is not otherwise required, and has not otherwise been made. In those circumstances, MD&A need not contain a discussion of the impact of those negotiations where, in the issuer's view, inclusion of that information would jeopardize completion of the transaction. If disclosure is otherwise required or has otherwise been made by or on behalf of the issuer, the interests in avoiding premature disclosure no longer exist. In that case, the negotiations would be subject to the same disclosure standards under MD&A as any other known trend, demand, commitment, event, or uncertainty.<sup>471</sup>

8. Where there are derogations from disclosure, is regulation sufficient to provide for fulfilment of the objective of full and timely disclosure by allowing for:

(a) Temporary suspensions of trading?

Yes. When issuers deviate from the objective of full and timely disclosure, the SEC has measures available to provide for the temporary suspension of trading. See response to Question 11.2 discussing the SEC's authority to issue an order under Section 12(k) of the Exchange Act temporarily suspending trading in an issuer's security for a period of up to 10 business days.

The exchanges in the U.S. have adopted rules relating to the temporary suspension of trading of listed securities in certain circumstances relating to the pending announcement of material information. For example, Rule 202.06(B) of the NYSE Listed Company Manual provides that a listed company must notify its exchange representatives by telephone at least 10 minutes prior to a news announcement of a material event or a statement addressing a rumor. At that time, the NYSE will be in a position to consider whether, in its opinion, trading in the security should be temporarily halted. A delay in trading provides a period of calm for public evaluation of the announcement. The halt also allows customers to revise the terms of limit orders. Rule 202.07 of the NYSE Listed Company Manual notes that the NYSE will monitor the situation closely, noting that if an announcement is not made by the issuer, the exchange may open or re-open trading. If the announcement is not made within approximately 30 minutes after the delay or halt is implemented, the exchange may commence the opening or re-opening of trading, though the time period would vary depending on the circumstances. The NASDAQ Stock Market has similar procedures.

<sup>470</sup> *Id.*

<sup>471</sup> SEC Release 33-6835 (May 18, 1989).

(b) Restrictions on, or sanctions regarding, the trading activities of persons with superior information?
Yes. See response to Question 12.3 above for a discussion relating to prohibitions on insider trading.
<i>Cross-Border Matters</i>
9. If public offerings or listings by foreign issuers are significant within the jurisdiction, are the jurisdiction's disclosure requirements for such offerings or listings of equity and debt securities by foreign issuers consistent with IOSCO's International Disclosure Standards for (i) Cross-Border Offerings and Initial Listings by Foreign Issuers and (ii) Cross-Border Offerings and Listings of Debt Securities by Foreign Issuers?
<p>Yes. There are approximately 940 foreign private issuers<sup>472</sup> that have registered a class of securities or a transaction and file reports with the SEC under the Exchange Act. For nearly 35 years, the SEC has had in place a separate disclosure regime specifically tailored to foreign private issuers. While this regime largely elicits equivalent disclosures in connection with public offerings of securities and annual reports as for U.S. companies, the SEC's disclosure system for foreign private issuers contains targeted disclosure modifications that promote participation by foreign private issuers in the U.S. public capital markets in a manner consistent with investor protection.</p> <p>In September 1999, the SEC substantially revised its disclosure requirements for foreign private issuers to fully incorporate the IOSCO International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers.<sup>473</sup> In adopting these revisions, the SEC stated: "We believe IOSCO's disclosure standards represent a strong international consensus on fundamental disclosure topics, and that they can be used to produce offering and listing documents that will contain the same high level of information we traditionally have required .... The international disclosure standards replace most, but not all, of the previous requirements of Form 20-F, the combined registration and annual report form for foreign private issuers under the Exchange Act."<sup>474</sup></p>

<sup>472</sup> A foreign company is defined as a foreign private issuer unless:

- more than 50% of its outstanding voting securities are held of record (directly or indirectly) by residents of the United States; and
- any one of the following is true:
  - o the majority of its executive officers or directors are U.S. citizens or residents;
  - o more than 50% of the issuer's assets are located in the United States; or
  - o the issuer's business is administered principally in the U.S.

<sup>473</sup> SEC Release 34-41936 (September 28, 1999), 64 Fed. Reg. 53900.

<sup>474</sup> *Id.*, at 53901.

The SEC's debt disclosure standards for foreign private issuers are consistent with the IOSCO International Disclosure Principles for Cross-Border Offerings and Listings of Debt Securities by Foreign Issuers, though the SEC has not taken specific actions to incorporate them into its disclosure requirements for filings with the SEC by foreign private issuers. The SEC's current disclosure standards for foreign private issuers relating to debt securities are substantially the same as those relating to equity securities.

In general, foreign private issuers must provide financial statements prepared in accordance with U.S. GAAP or which contain a reconciliation to U.S. GAAP. Foreign private issuers also may provide financial statements prepared in accordance with IFRS, as issued by the IASB, without a reconciliation to U.S. GAAP.<sup>475</sup> Other disclosure requirements for foreign private issuers differ from those for U.S. issuers in the following ways:

- Foreign private issuers are exempt from the requirements to file proxy or information statements under the Exchange Act;
- Foreign private issuers' securities are exempt from Section 16 of the Exchange Act;
- Foreign private issuers are required to file annual reports within four months of the fiscal year-end as opposed to the deadlines for domestic issuers discussed in response to Question 16.1(b);
- Foreign private issuers are not subject to the Exchange Act requirements to file quarterly reports on Form 10-Q and current reports on Form 8-K. Instead, foreign private issuers furnish certain information on Form 6-K;<sup>476</sup>
- Foreign private issuers are not subject to Regulation FD;
- Foreign private issuers are permitted to follow home country requirements for disclosure of executive compensation; and
- Eligible Canadian foreign private issuers may file reports under the multijurisdictional disclosure system and satisfy certain securities registration and reporting requirements of the Commission by providing disclosure documents prepared in accordance with the requirements of Canadian securities regulatory authorities.<sup>477</sup>

<sup>475</sup> SEC Release 33-8879 (December 21, 2007).

<sup>476</sup> The information and documents furnished on Form 6-K shall not be deemed to be "filed" for purposes of Section 18 of the Exchange Act or otherwise subject to the liabilities of Section 18.

<sup>477</sup> SEC Release No. 33-6902 (July 1, 1991).

**Principle 17     Holders of securities in a company should be treated in a fair and equitable manner.**

**General Overview of the U.S. Regulatory Environment**

In the U.S., there are four primary sources of law, regulation and entitlements relating to corporate governance and the rights of shareholders: state corporate law; a company's articles of incorporation and bylaws; the federal securities laws; and the listing rules of U.S. exchanges. These sources operate in an inter-relationship that supports shareholders as the owners of corporate entities in an environment characterized by thousands of publicly traded companies ranging from many of the largest companies in the world to micro-cap companies. Shareholder bases for these companies range from a few hundred to millions of shareholders, and shareholder populations range from individuals with modest shareholdings to institutions with billions of dollars under management to invest in equity securities. Furthermore, technology permits corporate communications to be increasingly electronic and Internet-based, and U.S. law allows shareholders to bring claims against companies, directors, and corporate management to enforce their rights.

**State corporate laws:** No federal securities laws exist that govern the formation and incorporation of corporations in the U.S. Instead, the formation and incorporation of corporate entities is governed under state law. The corporation laws of the 50 states of the U.S. (and the District of Columbia) are enabling statutes that provide for the formation and incorporation of corporate entities and the terms of governance among shareholders, the board of directors, and management. State corporate law is embodied in both the enacted statutory provisions and judicial decisions interpreting those provisions. In fact, several key facets of the corporate governance framework in the U.S., such as directors' duties of loyalty and fairness, are derived from judicial decisions. This response focuses on the Delaware General Corporation Law (DGCL) as the reference point for its state law discussions.<sup>478</sup>

**Corporate chartering documents:** In many areas, state corporate laws often provide for flexibility in order to permit companies to structure their governance as shareholders, directors, and management determine appropriate. State corporate law permits the basic chartering documents of a corporation – the certificate or articles of incorporation that are filed with the state of incorporation and the bylaws of the company – to provide for different rights than may be set out under the statutory provisions. For example, as discussed below, DGCL Section 212(a) provides that each stockholder is entitled to one vote for each share of capital stock held by such

<sup>478</sup> More than 60% of the Fortune 500 companies are incorporated in Delaware, and Delaware corporate law statutes and related jurisprudence are well-developed. See *Why Corporations Choose Delaware*, Lewis Black, Jr. (Delaware Department of State 2007). Because it does not administer state corporate law, the SEC relies on underlying reported sources for this response.



stockholder, unless otherwise provided in the company's certificate of incorporation.

**Federal securities laws:** As discussed above in the response to Question 16, the Securities Act and the Exchange Act regulate offerings and sales of securities and ongoing disclosure by public company issuers. The Exchange Act also regulates the process by which public companies solicit proxies in connection with shareholder meetings. Regulation of the proxy process and disclosure is a core function of the SEC, stemming from a Congressional belief that "fair corporate suffrage is an important right that should attach to every equity security bought on a public exchange."<sup>479</sup> The SEC's rules relating to proxies seek to improve the corporate proxy process so that it functions, as nearly as possible, as a replacement for an actual in-person meeting of shareholders.

**Exchange rules:** The rules adopted by the various stock exchanges that apply to listed companies provide an additional source of corporate governance requirements. In order to maintain a listing of a security on one of the stock exchanges in the U.S., a company must comply with various corporate governance requirements, as well as other requirements. The corporate governance listing requirements of the several stock exchanges, including the NYSE and NASDAQ, the principal markets in the U.S., are broadly similar, but they do vary in some respects. As noted in response to Question 16.2(a), all rules of the exchanges are subject to approval by the SEC.

## Key Questions

### *Rights of Shareholders*

1. Does the regulatory and legal frameworks address the rights and equitable treatment of shareholders in connection with the following:

- (a) Voting:

### State Corporate Laws

Yes. Pursuant to DGCL Section 211(a), stockholder meetings may be held at any place either within or outside of Delaware, as either determined by the board of directors or in the manner provided in the certificate of incorporation or bylaws. The board may, in its sole discretion, determine that a meeting shall not be held at any place but, rather, may instead be held solely by means of remote communication. Additionally, shareholders not physically present at a meeting may participate, and be deemed present for voting purposes, by means of remote communication.

Pursuant to DGCL Section 212(b), each stockholder entitled to vote at a meeting of stockholders, or to express consent or dissent to corporate action in writing without a meeting, may authorize

<sup>479</sup> H.R. Rep. No. 1383, 73d Cong., 2d Sess., at 13 (1934).

another person or persons to act for such stockholder by proxy.

Pursuant to DGCL Section 222, written notice of any meeting must be given not less than 10 days and not more than 60 days before the date of the meeting and shall set forth the place (if not held solely by means of remote communication), the date, and the hour of the meeting.

Pursuant to DGCL Section 212(a), each stockholder is entitled to one vote for each share of capital stock held by such stockholder, unless otherwise provided in the certificate of incorporation. Pursuant to DGCL Section 213, the board of directors may fix a record date for determining stockholders eligible to vote, which record date shall not precede the date upon which the board adopts a resolution to such effect and which shall not be more than 60 or less than 10 days before the date of the meeting. If the meeting is adjourned, the board may fix a new record date as long as the same 60 day/10 day notice provisions required for an initial meeting date are observed.

Pursuant to DGCL Section 151, a corporation may provide for different voting rights to be conferred on stockholders by issuing more than one class or series of stock with voting powers as stated either in the certificate of incorporation or of any amendment thereto, or in the resolution or resolutions providing for the issue of such stock.

### **Federal Securities Laws**

The federal securities laws provide a framework that supports compliance with the state law requirements set forth above. For example, the federal securities laws require disclosure of matters to be voted upon in the form of a proxy statement for a stockholders' meeting pursuant to Schedule 14A under the Exchange Act or an information statement relating to action taken in connection with or in lieu of a stockholders' meeting pursuant to Schedule 14C under the Exchange Act.

Pursuant to Schedule 14A, a proxy statement must set forth the date, time, and place of the stockholders meeting as well as the record date for determining eligibility to vote. Schedule 14A requires disclosure of the manner by which stockholders may exercise their votes, the voting powers designated to each class or series of stock, and the availability and effect of cumulative voting (if any). In the case of Schedule 14C, if matters are to be acted upon in lieu of a stockholders' meeting or without a vote at a meeting, information must be furnished with respect to all of the items contained in Schedule 14A that would be applicable to any matter to be acted upon at the meeting if proxies were to be solicited in connection with the meeting.

As further described below in response to Question 17.1(c), the federal securities laws also contain other requirements relating to the efficient distribution of proxies and information statements to beneficial owners.

In 2011, the SEC adopted amendments to its rules to implement provisions of the Dodd-Frank

Act that expand stockholder voting rights to executive compensation and “golden parachute” compensation arrangements.<sup>480</sup> Under these rules, a company is required, not less frequently than once every three years, to conduct a separate stockholder advisory vote to approve the compensation of their named executive officers, as disclosed pursuant to Item 402 of Regulation S-K. These rules require a company to conduct a separate stockholder advisory vote at least once every six years to determine whether the stockholder advisory vote on executive compensation will occur every one, two, or three years. In addition, a company soliciting votes to approve merger or acquisition transactions must provide disclosure of certain “golden parachute” compensation arrangements. A separate stockholder advisory vote to approve the “golden parachute” arrangements will be required if those arrangements had not previously been subject to a separate stockholder advisory vote on compensation of executives. Following the enactment of the JOBS Act in 2012, these rules do not apply to emerging growth companies.

### **Exchange Rules**

Stock exchange rules also address the rights and equitable treatment of shareholders in the context of voting decisions. Section 401.01 of the Listed Company Manual of the NYSE requires a company to provide immediate publicity for a shareholders’ meeting where any matter affecting the rights or privileges of shareholders or any other matter not of a routine nature is to be considered. Such publicity should adequately describe the matter(s) to be considered.

Section 402.04 of the Listed Company Manual of the NYSE requires actively operating companies to solicit proxies for all meetings of shareholders so as to provide shareholders with a convenient method of voting with adequate disclosure on the matters to be presented. Such proxy materials must be in the format and distributed by such means as permitted or required by applicable law or regulation, including those of the SEC. Section 5620 of the NASDAQ Listing Rules has similar requirements.

Section 402.08 of the Listed Company Manual of the NYSE prohibits broker discretionary voting of uninstructed shares in a stockholder vote on the election of directors, executive compensation, the frequency of the stockholder vote on executive compensation, merger or acquisition transactions, transactions that would alter the terms or conditions of existing stock, and other significant matters. NASDAQ Rule 2251 does not permit broker discretionary voting on any matter, but it allows a member to follow the rules of any national securities exchange of which it is a member, provided its records are clear which exchange rule it is following. NASDAQ Rule 2251 also makes clear that, in any case, members are prohibited from voting uninstructed shares on the election of members of the board of directors, executive compensation, or any other significant matter, as determined by the SEC.

Section 313.00 of the Listed Company Manual of the NYSE and Section 5640 of the NASDAQ

<sup>480</sup>

SEC Release 33-9178 (January 25, 2011).

Listing Rules provide that the voting rights of existing shareholders of publicly traded common stock registered under Section 12 of the Exchange Act cannot be disparately reduced or restricted through any corporate action or issuance. Examples of such corporate action or issuance include, but are not limited to, the adoption of time phased voting plans, the adoption of capped voting rights plans, the issuance of super voting stock, or the issuance of stock with voting rights less than the per share voting rights of the existing common stock through an exchange offer.

Although there is no exchange rule addressing the interval between record and meeting dates, the NYSE recommends that a minimum of 30 days be allowed so as to provide ample time for the solicitation of proxies, as explicitly stated in Section 401.03 of its Listed Company Manual.

(i) For election of directors?

Yes. In addition to the requirements noted above, an annual meeting of stockholders must be held for the election of directors on a date and at a time designated by or in the manner provided in a company's bylaws pursuant to DGCL Section 211(b). In the alternative, stockholders may act by written consent to elect directors unless the certificate of incorporation provides otherwise. However, the written consent must be unanimous unless all of the directorships to which directors could be elected are vacant and are filled by such action.

Pursuant to DGCL Section 214, cumulative voting is possible if provided for in a company's certificate of incorporation. Under cumulative voting, each holder of stock is entitled to the number of votes attached to the number of shares they hold multiplied by the number of directors to be elected by the holder. The stockholder may cast all of such votes for a single director or may distribute them among any two or more candidates as such holder may see fit.

(ii) On corporate changes affecting the terms and conditions of their securities?

Yes. The rights, preferences, restrictions, and conditions of shareholders are set forth in a company's certificate of incorporation. In addition to the requirements noted above, there are specific state law requirements relating to corporate changes affecting the terms and conditions of securities.

Pursuant to DGCL Section 242(a), a corporation may amend its certificate of incorporation in order to take the following actions:

- To increase or decrease its authorized capital stock or to reclassify the same (including, but not limited to, by changing the number, par value, designations, preferences, or other special rights of the shares or by subdividing or combining the outstanding shares of any class or series of a class of shares into a greater or lesser number of outstanding shares);

- To cancel or otherwise affect the right of the holders of the shares of any class to receive dividends which have accrued but have not been declared; or
- To create new classes of stock having rights and preferences either prior and superior or subordinate and inferior to the stock of any class then authorized, whether issued or unissued.

Such amendment(s) must be made in the manner set forth in DGCL Section 242(b), which requires the company's board to adopt a resolution setting forth the amendment proposed, declaring its advisability, and either calling a special meeting or directing that the amendment proposed be considered at the next annual meeting. A special or annual meeting must be called and held upon the notice provisions of DGCL Section 222, discussed above. The notice must set forth the proposed amendment(s) in full or provide a brief summary of the proposed amendments. The proposed amendment(s) become effective only if a majority of the outstanding stock entitled to vote thereon, and a majority of the outstanding stock of each class entitled to vote thereon as a class, vote in favor of the amendment(s).

If the proposed amendment(s) would:

- increase or decrease the aggregate number of authorized shares of such class;
- increase or decrease the par value of the shares of such class; or
- alter or change the powers, preferences, or special rights of the shares of such class so as to affect them adversely;

then the holders of the outstanding shares of a class are entitled to vote as a class regardless of whether specifically set forth in the certificate of incorporation. If the proposed amendment(s) would not affect the entire class but would adversely affect the powers, preferences, or special rights of one or more series of any class, then the shares of the series potentially affected are considered a separate class for voting eligibility purposes.

Exchange rules also impose requirements relating to voting decisions affecting the terms and conditions of securities. For example, Section 204.13 of the Listed Company Manual of the NYSE requires a company to give at least 20 days' advance notice with respect to any proposed changes in the form or nature of listed securities or in the rights or privileges attached to such securities. These changes will require the filing of a listing application.

Section 312.03 of the Listed Company Manual of the NYSE requires shareholder approval under the following four circumstances:

- a) the issuance of common stock, or of securities convertible into or exercisable for

common stock, in any transaction or series of related transactions if:

- the common stock has, or will have upon issuance, voting power equal to or in excess of 20% of the voting power outstanding before the issuance of such stock or of securities convertible into or exercisable for common stock; or
- the number of shares of common stock to be issued is, or will be upon issuance, equal to or in excess of 20% of the number of shares of common stock outstanding before the issuance of the common stock or of securities convertible into or exercisable for common stock;

though shareholder approval will not be required for any such issuance involving any public offering for cash or any *bona fide* private financing involving a sale of common stock (or securities convertible into or exercisable for common stock) for cash at a price at least as great as each of the book and market value of the issuer's common stock;

- b) an issuance that will result in a change of control of the issuer; or
- c) an issuance of securities in an equity compensation plan; or
- d) the issuance of common stock, or of securities convertible into or exercisable for common stock, in any transaction or series of related transactions, to:
  - a director, officer, or substantial security holder of the company (each a Related Party);
  - a subsidiary, affiliate, or other closely related person of a Related Party; or
  - any company or entity in which a Related Party has a substantial direct or indirect interest;

if the number of shares of common stock to be issued, or if the number of shares of common stock into which the securities may be convertible or exercisable, exceeds either 1% of the number of shares of common stock or 1% of the voting power outstanding before the issuance.

However, if the Related Party involved in the transaction is classified as such solely because such person is a substantial security holder, and if the issuance relates to a sale of stock for cash at a price at least as great as each of the book and market value of the issuer's common stock, then shareholder approval will not be required unless the number of shares of common stock to be issued, or unless the number of shares of common stock into which the securities may be convertible or exercisable, exceeds either 5% of the number of shares of common stock or 5% of the voting power outstanding before

the issuance.

Likewise, Section 5635 of the NASDAQ Listing Rules requires shareholder approval under similar circumstances.

(iii) On other fundamental corporate changes?

Yes. In addition to changes affecting the terms and conditions of a security, the U.S. regulatory framework and legal infrastructure also addresses the rights and equitable treatment of shareholders in connection with votes relating to fundamental corporate changes such as mergers and consolidations of companies, transfer of assets, or dissolution.

### **Mergers and Consolidations**

Under DGCL Section 251, any two or more corporations may merge into a single corporation, which may be either one of the constituent corporations or a new corporation formed by the consolidation, pursuant to an agreement of merger or consolidation. The company's board of directors must adopt a resolution declaring the advisability of the proposed merger and then either call a special meeting of the stockholders entitled to vote on such amendment or direct that the amendment proposed be considered at the next annual meeting of the stockholders, either at least 20 days prior to the date of the meeting. The notice must contain a copy of the agreement or a brief summary thereof. Adoption of the merger or consolidation generally requires the approval of a majority of the outstanding stock of the corporation entitled to vote upon such matters. DGCL Section 251(h), adopted in 2013, establishes a limited exception to this voting requirement: if a board of directors of a public company approves, a merger agreement can provide that no stockholder vote is required if the acquiring corporation makes a tender offer open to all shares, acquires in that tender offer a percentage of shares sufficient to approve the merger were it to be submitted to a stockholder vote, consummates the merger as soon as reasonably practicable after completion of the tender offer, and provides the same consideration in the merger as paid in the tender offer. Also, under DGCL Section 253, no stockholder vote is required for a merger (known as a "short-form merger") where at least 90% of the outstanding voting stock is owned by another corporation (parent company) that is to merge with the corporation.

As noted above, if a merger or consolidation would entail the issuance of common stock (or of securities convertible into or exercisable for common stock), exchange rules also impose stockholder voting requirements when such issuances would amount to more than 20% of the voting power or number of common shares outstanding before the issuance.

### **Transfer of Assets**

Pursuant to DGCL Section 271(a), a corporation may sell, lease, or exchange all or substantially all of its property and assets. Such action may be taken only if its board of directors deems it to be

expedient and for the best interests of the corporation, a majority of the outstanding stock of the corporation entitled to vote thereon adopt a resolution to such effect at a meeting called upon at least 20 days' notice, and the notice of such meeting states that such a resolution will be considered.

### **Appraisal Rights**

Pursuant to DGCL Section 262(c), any corporation may provide for appraisal rights in its certificate of incorporation for any class or series of its stock as a result of an amendment to its certificate of incorporation, any merger or consolidation, or the sale of all or substantially all of the assets of the corporation. Even in the absence of such a provision, DGCL Section 262(b) also confers appraisal rights upon stockholders if they are required in the merger to accept cash or certain other consideration for their shares. Pursuant to DGCL Section 262(d), the corporation must notify stockholders of the shares for which appraisal rights are available no less than 20 days prior to the meeting at which the proposed merger or consolidation is to be submitted.

### **Dissolution**

Pursuant to DGCL Section 275(a), a corporation may dissolve if it is deemed advisable in the judgment of the board and a majority of the outstanding stock of the corporation entitled to vote thereon adopts a resolution to such effect at a meeting called for that purpose. Alternatively, pursuant to DGCL Section 275(c), dissolution may also be authorized without action of the directors if all the stockholders entitled to vote thereon consent in writing.

#### **(b) Timely notice of shareholder meetings and voting decisions?**

Yes. DGCL Section 222 requires written notice of any stockholders meeting to be provided not less than 10 days and not more than 60 days before the date of the meeting. This notice must set forth the place, if any, the date, and the hour of the meeting. Section 401.02 of the NYSE Listed Company Manual requires a company to notify the Exchange a minimum of 10 days prior to the record date of any stockholders meeting called. NASDAQ advises listed companies that a company that files its proxy statement via EDGAR in connection with an annual shareholder meeting does not have to provide any additional notice to NASDAQ about its annual meeting.<sup>481</sup> However, if the company does not file a proxy statement via EDGAR, it must send its proxy statement or other shareholder notice to NASDAQ no later than when it is mailed to shareholders.<sup>482</sup>

As noted above, these advance notice requirements are in addition to the federal securities law

<sup>481</sup> See NASDAQ Frequently Asked Questions, available at [https://listingcenter.nasdaqomx.com/Material\\_Search.aspx?cid=16&mcd=LQ](https://listingcenter.nasdaqomx.com/Material_Search.aspx?cid=16&mcd=LQ).

<sup>482</sup> *Id.*



requirement that a form of proxy or information statement be mailed to record holders sufficiently in advance of the meeting date to allow five business days for processing by the banks and brokers for delivery to beneficial holders and an additional period to provide ample time for delivery of the materials, consideration of the materials by the beneficial owners, return of their voting instructions, and transmittal of the vote from the bank or broker to the tabulator.

As discussed in response to Question 16.1(c) above, a domestic issuer subject to the periodic reporting requirements under the Exchange Act must file current reports on Form 8-K upon the occurrence of enumerated events, including the results of any matter submitted to a vote of stockholders through the solicitation of proxies or otherwise. Item 5.07 to Form 8-K requires an issuer to disclose on the form the results of a stockholder vote at an annual or special meeting and requires the issuer to have that information filed within four business days after the end of the meeting at which the vote was held.

(c) Procedures that enable beneficial owners to give proxies or voting instructions efficiently?

Yes. As described in response to Question 17.1(a), above, each stockholder entitled to vote at a meeting of stockholders, or to express consent or dissent to corporate action in writing without a meeting, may authorize another person or persons to act for such stockholder by proxy pursuant to DGCL Section 212(b).

In recognition of the fact that most beneficial holders of securities are not also necessarily the record holders, domestic issuers have an obligation under the proxy rules to distribute proxy and other soliciting material to banks and brokers on a timely basis in order to forward them to beneficial owners. Pursuant to Rule 14a-13(a) under the Exchange Act, domestic issuers subject to the proxy rules are required, among other things: (i) to inquire of each bank and broker of the number of copies of proxy soliciting materials necessary to furnish to beneficial owners at least 20 business days prior to the record date absent certain circumstances and (ii) to supply, in a timely manner, copies of the proxy and other proxy soliciting material in such quantities as reasonably requested by the bank or broker in order to send such material to each beneficial owner of securities. This notice also applies to the obligation of domestic issuers to distribute information statements (and, if directors are to be elected, annual reports to shareholders) to banks and brokers pursuant to Rule 14c-7(a)(4) under the Exchange Act.

Although the rules do not specify the number of days before the meeting by which domestic issuers must make their proxy materials available for distribution to the beneficial owners of their securities, in order to comply with the timeliness requirement, the materials must be mailed sufficiently in advance of the meeting date to allow five business days for processing by the banks and brokers pursuant to Rules 14b-1(b)(2) and 14b-2(b)(2) under the Exchange Act and an additional period to provide ample time for delivery of the material, consideration of the material

by the beneficial owners, return of their voting instructions, and transmittal of the vote from the bank or broker to the tabulator.<sup>483</sup>

NYSE Rules 450-455 contain requirements intended to facilitate the solicitation of proxies held in the names of brokers or their nominees, while safeguarding the rights of beneficial holders. Their purpose is to aid companies in meeting quorum requirements and obtaining a representative vote of shareholders. NYSE Rule 452 was amended in 2010 to prohibit broker discretionary voting of uninstructed shares for a stockholder vote on executive compensation or a stockholder vote on the frequency of the stockholder vote on executive compensation.<sup>484</sup> NYSE Rule 452 also prohibits broker discretionary voting of uninstructed shares in connection with the election of directors, merger and acquisition transactions, transactions that would alter the terms or conditions of existing stock, and other significant matters. NASDAQ Rule 2251 does not permit broker discretionary voting on any matter, but it allows a member to follow the rules of any national securities exchange of which it is a member, provided its records are clear which exchange rule it is following. NASDAQ Rule 2251 also makes clear that, in any case, members are prohibited from voting uninstructed shares on the election of members of the board of directors, executive compensation, or any other significant matter, as determined by the SEC.<sup>485</sup>

Section 402.05 of the Listed Company Manual of the NYSE requires companies or others soliciting proxy material through brokers to make inquiry of such brokers at least 10 days in advance of the record date in order to determine the number of sets of proxy soliciting materials necessary to enable brokers to supply each beneficial owner with a set. This period of time matches the minimum 10 days prior notice to the Exchange required by Section 401.02.

(d) Ownership registration (in the case of registered shares) and transfer of their shares?

Yes. Requirements relating to ownership registration and transfer are addressed by state corporate laws and the listing requirements of exchanges.

Under the DGCL, the officer who has charge of the stock ledger of a corporation is required to prepare and make, at least 10 days before every meeting of stockholders, a complete list of the stockholders entitled to vote at the meeting, arranged in alphabetical order, and showing the address of each stockholder and the number of shares registered in the name of each stockholder.<sup>486</sup> The stockholder list is required to remain accessible to any stockholder during the time of the meeting. That shareholder list is the only evidence of stockholders that are

<sup>483</sup> SEC Release 34-33768 (March 16, 1994).

<sup>484</sup> SEC Release 34-62874 (September 9, 2010).

<sup>485</sup> SEC Release 34-62992 (September 24, 2010).

<sup>486</sup> DGCL § 219(a).

eligible to examine the list or to vote at any stockholders meeting, either in person or by proxy,<sup>487</sup> thereby providing the means through which shareholders can address their rights through voting. The accessibility of the list to all shareholders appearing on it provides for the equitable treatment of all shareholders, regardless of the number of shares they hold.

Exchange rules also may require that an issuer of listed securities utilize a qualified registrar, most often a transfer agent, to perform the registrar function where all of its listed securities may be registered.<sup>488</sup> Transfer agents serve as the custodians of security holder records for issuers and are primarily record keepers. Their primary statutory functions involve keeping track of security holders and their securities positions and facilitating the transfer of securities. Because transfer agents often act as intermediaries between issuers and security holders, transfer agents may also provide additional services beyond their statutory recordkeeping and transfer functions, such as disseminating security holder communications and facilitating dividend and interest payments. They may also provide a variety of reports on security holders and securities activity, facilitate mailings to the security holders, provide a variety of annual meeting services, and perform any of a number of other related services, including paying dividends and assisting security holders with their needs. Transfer agents must register with and are regulated by the SEC pursuant to Section 17A of the Exchange Act.

(e) Receipt of dividends and other distributions, when, as, and if declared?

Yes. State corporate laws provide the primary source of substantive regulation about the payment of dividends. As a general matter, state corporate laws require that a corporation that declares a cash dividend on common stock pay that dividend to stockholders of record on the declared record date. Dividends on shares directly registered on the books of the corporation are paid directly to stockholders while dividends on shares held through a broker or other intermediary are paid by the corporation to the broker or other intermediary.

Under the DGCL,<sup>489</sup> the directors of every corporation, subject to any restrictions contained in its certificate of incorporation, may declare and pay dividends upon the shares of its capital stock either (i) out of its surplus, or (ii) in case there shall be no such surplus, out of its net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year. If the capital of the corporation is diminished by depreciation in the value of its property, or by losses, or otherwise, to an amount less than the aggregate amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets, the DGCL does not permit the directors of a corporation to declare and pay out of such net profits any dividends upon any shares of any classes of its capital stock until the deficiency in the

<sup>487</sup> DGCL § 219(c).

<sup>488</sup> See, for example, NYSE Listed Company Manual § 601.00 and 601.01.

<sup>489</sup> DGCL § 170.

amount of capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets shall have been repaid.

Under the DGCL,<sup>490</sup> dividends may be paid in cash, in property, or in shares of the corporation's capital stock. If the dividend is to be paid in shares of the corporation's previously unissued capital stock, the board of directors shall, by resolution, direct that there be designated as capital in respect of such shares an amount which is not less than the aggregate par value of par value shares being declared as a dividend and, in the case of shares without par value being declared as a dividend, such amount as shall be determined by the board of directors.

The federal securities laws require disclosure relating to dividends in an issuer's registration statements and annual reports.<sup>491</sup> Under those requirements, an issuer must disclose, among other information, the frequency and amount of any cash dividends declared on each class of common equity declared over the last two fiscal years for which financial statements are provided and any interim periods. An issuer must also disclose information about any material limitations on its ability to pay dividends currently or in the future. If an issuer has not paid a cash dividend but has the ability to do so, the federal securities laws encourage disclosure about the issuer's intention to pay cash dividends. Additionally, Exchange Act Rule 10b-17 prohibits a dividend to be paid without 10 days' notice prior to the record date for determining holders entitled to receive the dividend, including the amount to be paid per share and the date of payment.

Exchanges also have provisions relating to the payment of dividends as part of their listing standards. For example, Section 204.12 of the Listed Company Manual of the NYSE requires notice to the exchange of any dividend or distribution related to a listed stock, including the postponement or omission of a dividend. This information includes the record and payment dates for the dividend as well as any conditions that must be satisfied for the distribution to be made. Although there is no restriction on the interval between the record and the payment date under NYSE rules, the NYSE advises that it is desirable that the interval should be as short as possible. Similarly, Section 5250(e)(6) of the NASDAQ Listing Rules requires an issuer to provide notice to the exchange by filing the appropriate form and to the public using a Regulation FD-compliant method of any dividend action or action relating to a stock distribution of a listed stock, no later than 10 calendar days before the record date of such action.

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<sup>490</sup> DGCL § 173.

<sup>491</sup> Item 201(c) of Regulation S-K.

(f)	Transactions involving:
(i)	A takeover bid?
<p>Yes, the U.S. regulatory and legal frameworks address the rights and equitable treatment of shareholders in connection with transactions that we interpret to be equivalent to takeover bids. The underlying purpose of federal tender offer regulation is to provide disclosure and certain procedural safeguards to shareholders who hold securities that are subject to a tender offer. Neither the term “takeover bid” nor its U.S. iteration commonly referred to as a “tender offer,” is a defined term under the federal securities laws or the SEC’s rules. Judicial decisions have enumerated various characteristics of tender offers, essentially defining a tender offer as any public offer to purchase securities from security holders. The determination of whether a particular course of conduct is a tender offer is important because tender offers are subject to the federal securities laws and the SEC’s rules. Given that the manner in which securities are sought to be acquired may vary, and may become more innovative and complex over time, the absence of a definition in the federal regulatory provisions for the term “tender offer” provides flexibility in determining whether attempts to acquire shares should be subject to our comprehensive regulatory framework for tender offers.</p> <p>Although applicable state corporate laws and exchange rules may apply, the conduct of tender offers and the disclosure provided to security holders are principally governed by the SEC’s rules, which include both principles-based standards and specific line-item disclosures. These requirements provide security holders with information about the proposed offer so that they are able to make informed decisions about whether to tender their securities to the bidder. A bidder is a person who makes a tender offer or on whose behalf a tender offer is made. In this response, we refer to a “bidder” as an “offeror.” These disclosure requirements also operate to impose liability on the offeror for material misstatements or omissions.</p> <p>Federal tender offer regulation is based on SEC rules, and regulations, in combination with Section 13(e); Section 14(d); and Section 14(e) of the Exchange Act. The applicability of each section and its underlying regulations depends on: (i) the party conducting the offers; (ii) the nature of the subject security; (iii) whether the security is registered under Section 12 of the Exchange Act; and (iv) whether the offeror would own more than 5% of a class of equity securities after the tender offer. A tender offer is distinguishable from a merger that is subject to a security holder vote. In a merger, security holders act collectively to decide whether to sell their shares; the minority, subject to appraisal rights, is bound by the decision of the majority. On the other hand, in a tender offer, security holders act individually in determining whether to sell their securities to an offeror. No statutory voting requirements exist in connection with a tender offer.</p> <p>The consideration used to effectuate tender offers may be cash, stock, debt securities, or some combination thereof. A tender offer is not always for all of the outstanding securities of a class; it may be for only a specified amount. Tender offers made by persons other than the issuer are often undertaken to acquire control or outright ownership of an issuer.</p>	

**Third Party (Non-Issuer) Tender Offers**

The federal regulatory requirements that apply to tender offers made by parties other than the issuer include two statutory provisions under the Exchange Act, Sections 14(d) and (e), and rule provisions promulgated by the SEC and codified within Regulations 14D and 14E. Section 14(d) and corresponding Regulation 14D apply to all tender offers for Exchange Act-registered equity securities made by parties other than the issuer so long as upon consummation of the tender offer the offeror would beneficially own more than 5% of the class of equity securities subject to the offer. An offeror must include any shares it owns before the commencement of the tender offer in calculating the 5% amount.

Section 14(d) of the Exchange Act requires any person or group intending to make a tender offer meeting the requirements noted in the preceding paragraph to file with the SEC a disclosure document on Schedule TO outlining the terms of the offer. This disclosure document must be filed electronically and is immediately available through the SEC's EDGAR system. Section 14(d) and the rules thereunder also require compliance with certain procedural safeguards that include dissemination of the Schedule TO to security holders. Regulations 14D and 14E prescribe detailed disclosure and procedural requirements with respect to third party tender offers, including withdrawal rights, proration, and protection to ensure the equal treatment of all security holders. These provisions were designed to require disclosure of material information to security holders and the marketplace and provide procedural protections that preserve the ability of security holders to act on that information without coercion. Tender offers featuring an offer to exchange securities are further subject to having the securities offering aspect of the transaction registered under the Securities Act. See the response to Question 16.1(a).

Exchange Act Section 14(d)(5) provides that persons who have deposited their securities pursuant to a tender offer may withdraw them at any time within 7 calendar days after the time definitive copies of the offer are first published, sent, or given to security holders, or at any time after 60 calendar days from the date of the original offer. The SEC, by Rule 14d-7, has substantially expanded these statutory withdrawal rights. Rule 14d-7(a) grants each security holder the right to withdraw, at any time during the offering period, any securities it has tendered. If the offering period is extended for any reason, withdrawal rights are automatically extended for the duration of the offering period. Under Rule 14d-7(a), an offeror may not purchase securities during a time in which a security holder maintains the right to withdraw the securities. Accordingly, an offeror is effectively prohibited from purchasing any securities that have been tendered until the offering period has expired. This rule-based withdrawal right supplements the statutory right of withdrawal under Section 14(d)(5).

When the tender offer is for less than 100% of the outstanding class of equity securities, a so-called "partial tender offer," a statutory safeguard becomes available in order to give all security holders an equal opportunity to participate in a partial tender offer and to protect security holders against pressure to make an early tender. Exchange Act Section 14(d)(6) provides that

where more shares are tendered in a partial tender offer within the first 10 calendar days of an offer than the offeror is bound or willing to take up, the securities must be taken up *pro rata*, disregarding fractions, according to the number of securities deposited by each tendering security holder.

The SEC has expanded the protections introduced by this statutory provision through rulemaking. If the aggregate number of shares tendered in an offer for less than all of the outstanding securities of a class exceeds the maximum number of shares that the purchaser has offered to buy at the end of an offering period, Rule 14d-8 requires the purchaser to purchase tendered securities on a *pro rata* basis.

Section 14(d)(7) of the Exchange Act requires that if the purchaser increases the consideration offered, it must pay the highest amount for all securities purchased, regardless of whether securities were tendered before or after the change in consideration. In practice, Section 14(d)(7) has become known as the “Best Price” provision. The express purpose of Section 14(d)(7), as specified in the U.S. Congressional legislative history, is to “assure fair treatment of those persons who tender their shares at the beginning of the tender period, and to assure equality of treatment among all shareholders who tender their shares.”<sup>492</sup> Rule 14d-10, adopted in furtherance of this goal, provides that the offer must be open to all shareholders in the class of equity securities sought in the offer and that each tendering security holder must receive the highest consideration paid to any security holder during the period of the tender offer.

Regulation 14D requires the offeror to make specific disclosures to security holders and mandates certain other procedural protections. The disclosure focuses on the terms of the offer and information about the offeror. Rules 14d-4(c) and 14d-6(d) require an offeror to disclose promptly, in an amendment to its tender offer materials, any material change in information previously disseminated to target security holders in a manner reasonably designed to inform them of this change. This requirement necessarily includes a requirement that security holders be given adequate time to consider the new information. The procedural protections include the right to withdraw tendered securities while the offer remains open and the right to have tendered securities accepted on a *pro rata* basis throughout the term of a partial tender offer. Also, Regulation 14D requires the offeror to file its offering documents and other information with the SEC and deliver a copy to the target issuer and any competing offerors. Rule 14d-9 further requires the target of the tender offer to send to security holders specific disclosure about its recommendation, file a Schedule 14D-9 containing that disclosure, and send the Schedule 14D-9 to the offeror. The SEC has taken enforcement actions for a failure to comply with the disclosure requirements of Schedule 14D-9.<sup>493</sup>

Section 14(e) of the Exchange Act is an anti-fraud provision and prohibits an offeror from making

<sup>492</sup> H.R. Rep. No. 1711, 90th Cong., 2d Sess., at 11 (1968).

<sup>493</sup> See, e.g., SEC Release No. 34-71717 (March 13, 2014) and SEC Release No. 34-24727 (July 22, 1987).



material misstatements or omitting to state any material fact necessary in order to make a statement made not misleading. Section 14(e) further prohibits any fraudulent, deceptive, or manipulative acts in connection with any tender offer. Section 14(e) and Regulation 14E apply to tender offers for any type of security (including most debt). These provisions apply both to registered and unregistered securities (including securities issued by a private company) and irrespective of the amount sought or the amount that would be owned after the consummation of the offer. Section 14(e) and Regulation 14E apply to tender offers made under Regulation 14D, as well as those made under Rule 13e-4 (issuer tender offers), discussed below. Section 14(e) and the rules promulgated thereunder apply to tender offers for securities regardless of whether the class is registered under Section 12 of the Exchange Act.

Rule 14e-1(a) of Regulation 14E requires that an offer remain open for a minimum offering period of 20 business days from the date the offer commences. Rule 14e-1(b) of Regulation 14E requires that the offer remain open for 10 business days following a change in the offering price or the percentage of the class of securities being sought. Rule 14e-1(c) of Regulation 14E requires that the offeror promptly pay for or return securities when the tender offer expires. If an offeror voluntarily or involuntarily extends the offering period, it must provide notice of such an extension pursuant to Rule 14e-1(d) of Regulation 14E. Such notice must be given by press release or other public announcement prior to 9:00 a.m. Eastern time and identify the number of securities tendered. Rule 14e-2 of Regulation 14E also requires the target company to state its position about the offer within 10 business days after the offer begins. The target must state either that it recommends that its security holders accept or reject the offer; that it expresses no opinion and remains neutral toward the offer; or that it is unable to take a position on the offer. There are no filing requirements with the SEC in connection with tender offers that are only subject to Section 14(e).

### **Issuer Tender Offers**

Section 13(e) of the Exchange Act authorizes the SEC to prescribe rules governing repurchases of equity securities by an issuer that is obligated to file reports under Section 12 of the Exchange Act. Rule 13e-4, promulgated under Section 13(e) of the Exchange Act, applies to all tender offers by an issuer for its equity securities when the issuer has a class of equity securities registered under Section 12 or when the issuer files periodic reports under Section 15(d) of the Exchange Act. Pursuant to Section 13(e), Rule 13e-4 regulates cash tender offers and exchange offers by issuers for their equity securities. Rule 13e-4 also applies to a tender offer by an affiliate of the issuer for the issuer's securities where the tender offer is not subject to Section 14(d). Rule 13e-4 is different from Regulation 14D because it applies even if the class of securities sought in the offer is not registered under Section 12. Rule 13e-4 also applies regardless of the amount of securities sought in the offer. Rule 13e-4 provides for disclosure, filing, and procedural safeguards that generally mirror those provided under Section 14(d) and Regulation 14D. The rule defines certain fraudulent, deceptive, or manipulative acts or practices in connection with issuer cash tender or exchange offers and prescribes the disclosure and dissemination of certain information, among other requirements, as measures reasonably



designed to prevent such acts or practices. The rule also requires that an issuer making a cash tender offer or exchange offer for its equity securities allow that tendering security holders be given the opportunity to withdraw their tendered securities. Also, Rule 13e-4(f)(8), commonly viewed as the “equal treatment provision,” provides that the offer must be open to all security holders in the class of equity that is the subject of the offer and that each tendering security holder must receive the highest consideration paid to any security holder during the period of the tender offer.

(ii) Other change of control transactions?

The federal securities laws would not apply to a change of control transaction if the transaction did not involve a tender offer, an offer of securities, or a shareholders’ vote. State corporate law generally would not apply to a change of control transaction if the transaction did not involve a business combination or a shareholders’ vote on a matter. However, parties involved in a change of control transaction may be required to disclose the transaction afterward (for example, under Exchange Act Section 16, see response to Question 17.5). In addition, an issuer must disclose a change in control in a current report on Form 8-K within four business days after occurrence of the event, including: the identity of the person(s) who acquired control; the date and a description of the transaction(s) which resulted in the change in control; the basis of the control, including the percentage of voting securities of the issuer beneficially owned directly or indirectly by the person(s) who acquired control; the amount of the consideration used by such person(s); the source(s) of funds used by the person(s); the identity of the person(s) from whom control was assumed; and any arrangements or understandings among members of both the former and new control groups and their associates with respect to election of directors or other matters.

When two companies combine by means of a statutory merger or consolidation, state corporate law generally requires that the transaction be approved by security holders of one or both of the companies. The federal securities laws do not require the solicitation of proxies. However, if one of the companies is a publicly held company with a class of securities registered under Section 12 of the Exchange Act, if it solicits proxies, the solicitation must be in accordance with the SEC’s proxy rules codified within Regulation 14A and adopted under Exchange Act Section 14(a).

Under Regulation 14A, persons soliciting proxies must file a proxy statement prepared in accordance with Schedule 14A that contains comprehensive disclosures about the proposals being introduced, the interests of the parties in the solicitation, and other important information. Unlike the federal securities laws that regulate tender offers, no “equal treatment” provision exists under the federal proxy rules that govern change of control transactions, which guarantee all security holders in the class will be invited to participate or that they have an equal opportunity to be paid the highest form of consideration available, although such transactions may also be governed by state law. Moreover, “change of control” transactions may be deemed to occur without any consideration being offered to security holders where the solicitation of proxies relates only to the replacement of a majority of the board directors.

Section 14(c) of the Exchange Act requires issuers that are not soliciting proxies or consents from

each holder entitled to vote or take action by written consent to distribute to such holders an information statement describing the corporate action to be taken. Section 14(c) imposes disclosure obligations for those situations where the issuer chooses not to or has no opportunity to solicit proxies from some or all of its security holders. Instances where Section 14(c) may become operative include those where management may control sufficient shares to assure a quorum and a favorable vote (*e.g.*, majority-owned subsidiary), where a solicitation of proxies is made of only certain security holders, or in instances where security holders unilaterally act to take action. Regulation 14C, promulgated under Section 14(c), applies to the issuer only and governs the disclosure and mechanics of distributing an information statement containing the disclosure specified by Schedule 14C.

(g) Holding the company, its directors and senior management accountable for their involvement or oversight resulting in violations of law?

Yes. Under Section 11 of the Securities Act, purchasers of a security may sue the issuer, its directors, and each person who signs the registration statement, which includes the issuer's principal executive officer, its principal financial officer, and its principal accounting officer, for material misstatements or omissions in a registration statement.<sup>494</sup>

In addition, under Section 12 of the Securities Act, any person selling a security in a public offering may be held liable to the purchaser for material misstatements or omissions determined as of the date of sale. This may include directors and officers, including those who are not signatories of the registration statement, among other persons.

An issuer and its directors and officers may also face liability under Section 17(a) of the Securities Act for misstatements and misleading statements in a registration statement if they commit fraud in connection with the offer or sale of a security or obtain money or property in connection with the offer and sale of a security by means of any untrue statement or material fact or omission to state a material fact necessary to make the statements in the registration statement not misleading. Section 17 does not provide for a private right of action and is enforceable only by the SEC.

Under the Exchange Act, Section 18 imposes liability for false and misleading statements in documents filed with the SEC, including annual reports and proxy statements. Under Section 18, any person who makes or causes a false and misleading statement to be made in a filing with the SEC may be held liable. Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit fraudulent and deceptive practices and untrue statements or omissions in connection with the sale of any security. This anti-fraud provision applies not only to filings made with the SEC but

<sup>494</sup> Section 11 liability also extends to each underwriter, the independent accountant (with respect to audited financial statements upon which the accountant renders an audit report), and each expert (with respect to information included in reliance upon the expert).

also to any information released to the public by an issuer.

Under SEC rules adopted pursuant to Section 404 of the Sarbanes-Oxley Act, companies are required to include in their annual reports a report of management, and an accompanying auditor's attestation report, on the effectiveness of the company's internal control over financial reporting and to evaluate, as of the end of each fiscal quarter, any change in the company's internal control over financial reporting that occurred during the period that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.<sup>495</sup> Emerging growth companies and companies that are not accelerated filers or large accelerated filers are not required to include in their annual reports an auditor's attestation report on the effectiveness of the company's internal control over financial reporting.

Under Section 302 of the Sarbanes Oxley Act, the SEC has also adopted rules under which the principal executive and principal financial officers, or persons performing similar functions, of a company filing periodic reports under Section 13(a) or 15(d) of the Exchange Act must provide a certification of the disclosure contained in each quarterly and annual report filed with the SEC and as to the effectiveness of disclosure controls and procedures and internal control over financial reporting.<sup>496</sup> Section 906 of the Sarbanes-Oxley Act also contains a certification requirement for periodic reports that is subject to specific federal criminal provisions and that is separate and distinct from the certification requirement mandated by Section 302. See Principle 16.5 for additional information.

Certain state corporate law remedies are available to shareholders in order to hold the company, its directors, and senior management accountable for their involvement or oversight in violations of law. For example, pursuant to DGCL Section 102(b), a company's certificate of incorporation may not contain any provision eliminating or limiting the personal liability of a director under the following circumstances:

- For any breach of the director's duty of loyalty to the corporation or its stockholders;
- For acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;
- For any unlawful payment of dividend or unlawful stock purchase or redemption; or
- For any transaction from which the director derived an improper personal benefit.<sup>497</sup>

<sup>495</sup> SEC Release 33-8238 (June 5, 2003).

<sup>496</sup> SEC Release 33-8124 (August 29, 2002).

<sup>497</sup> DGCL Section 102(b)(7) provides that a corporation's certificate of incorporation may contain a provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, with certain specifically enumerated exceptions.

Under the DGCL, shareholder derivative lawsuits provide additional means for holding directors and senior managers accountable for their oversight of a company's affairs. A shareholder derivative lawsuit enables a stockholder to file a lawsuit on behalf of the corporation for harm done to the corporation. Because a derivative lawsuit is being brought on behalf of the corporation, the recovery, if any, must go to the corporation. A stockholder who is directly injured, however, does retain the right to bring an individual action for injuries affecting his or her legal rights as a stockholder. Such a claim is distinct from an injury caused to the corporation alone. In such individual lawsuits, the recovery or other relief flows directly to the stockholders, not to the corporation.

(h) Bankruptcy or insolvency of the company?

Yes, federal bankruptcy laws govern how companies go out of business or reorganize their debt obligations, including the resolution of competing creditor claims. Federal securities laws, on the other hand, aim to protect investors and foster capital formation through disclosure.

There are two primary routes through business bankruptcy in the U.S. Under Chapter 11 of the Bankruptcy Code, a company usually attempts to reorganize its business and become profitable again. Management usually continues to run day-to-day business operations, but all significant business decisions must be approved by a bankruptcy court. Under Chapter 7, the company stops all operations and goes out of business. A trustee is appointed to liquidate the company's assets, and the money is used to pay off creditors and investors in accordance with the federal bankruptcy rules.

A company's securities may continue to trade even after the company has filed for reorganization under Chapter 11. Since its securities are still trading, a company must continue to file SEC reports and disclose material information to shareholders. In most instances, companies that file under Chapter 11 are generally unable to meet the listing standards to continue to trade on NASDAQ or the NYSE. However, even when a company is delisted from one of these major stock exchanges, its shares may continue to trade on either the OTC Bulletin Board or the Pink Sheets. There is no federal law that prohibits trading of securities of companies in bankruptcy.

Public companies generally file under Chapter 11 rather than Chapter 7 because they can continue to run their business and control the bankruptcy process. In a Chapter 11 bankruptcy, although a company may emerge from the process as a viable entity, the creditors and the bondholders generally become the new owners of the shares. In most instances, the company's plan of reorganization will cancel the existing equity shares. This happens in bankruptcy cases because secured and unsecured creditors are paid from the company's assets before common stockholders. In situations where shareholders do participate in the plan, their shares are usually subject to substantial dilution.

The SEC has statutory authority to participate in all Chapter 11 cases but generally limits its activity to large public company cases. The SEC focuses its activity in four principal areas: (i) ensuring that plans and disclosure statements contain adequate information; (ii) ensuring that public investors are adequately represented by an official committee, if appropriate; (iii) ensuring that Bankruptcy Code exemptions from Securities Act registration are not misused; and (iv) participating on legal issues that affect the rights of public investors (such as improper efforts by debtors to shield officers and directors from lawsuits for securities fraud). Although the SEC reviews disclosure of reorganization plans, the SEC does not get involved in the economic terms of plans.

2. Is full disclosure of all information material to an investment or voting decision required in connection with shareholder voting decisions generally and the transactions referred to in Questions 1(a)(iii), 1(f)(i) and 1(f)(ii) specifically?

Yes. Under the federal securities laws, full disclosure of information material to an investment or voting decision is required in connection with security holder voting decisions generally and other fundamental corporate changes, takeover bids, and change of control transactions specifically. For transactions involving an offer and sale of securities that must be registered under the Securities Act, a registration statement must be filed that contains specific line-item disclosures and information required by applicable regulations. The response to Question 16 discusses the full disclosure requirements for offerings that are registered under the Securities Act.

Under state corporate law, directors have a fiduciary duty to disclose to stockholders all reasonably available material facts in connection with any investment or voting decision presented by the corporation or the board of directors or on which the board of directors has presented advice to the stockholders. That duty arises, in particular, where the board of directors seeks a stockholder vote or makes a recommendation in response to a tender offer or where the corporation seeks to repurchase shares directly from a stockholder (as opposed to purchases in open market transactions).

**Other Fundamental Corporate Changes (Question 1(a)(iii)) / Other Change of Control Transactions (Question 1(f)(ii))**

Proxy statements containing the disclosures specified by Schedule 14A and information statements containing the disclosures specified by Schedule 14C must comply with line-item disclosure and other substantive disclosure requirements under the Exchange Act Regulations. Rules 10b-5 and 14a-9 or 14c-6 under the Exchange Act are designed so that proxy and information statements contain all material information. Each rule requires that a person not make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

**Takeover Bids (Tender Offers) (Question 1(f)(i))**

Tender offers filed on Schedule TO must comply with specific line-item disclosure requirements and provide comprehensive information about the offer terms, the offeror(s), and other important information pursuant to Regulation M-A. In addition, for tender offers filed on Schedule TO, Item 11 of that schedule requires the offeror(s) to disclose "other material information ... as may be necessary to make the required statements, in light of the circumstances under which they are made, not materially misleading." For tender offers made by an issuer, Rule 13e-4(j)(1)(ii) similarly requires the issuer not to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

In addition to the foregoing, Section 14(e) of the Exchange Act makes it unlawful for any person in any tender offer to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading. For example, in tender offers for cash consideration subject to only Section 14(e) and Regulation 14E in which no filing requirement exists with the SEC, Section 14(e) would require that the price be disclosed.

*Control*

3. With respect to transactions referred to in Question 1(f)(i) and 1(f)(ii), are shareholders of the class or classes of securities affected by the proposal:

(a) Given a reasonable time in which to consider the proposal?

Yes. In each of these types of transactions, shareholders are given a reasonable time in which to consider the proposal.

**Takeover Bids (Tender Offers)**

With respect to takeover bids, security holders are given 20 business days under Rule 14e-1(a) of Regulation 14E to consider a third-party tender offer proposal. Issuers also must comply with Rule 14e-1(a) and, to the extent an issuer conducts an issuer tender offer subject to Rule 13e-4, the issuer also is required to keep the offer open for at least 20 business days from its commencement under Rule 13e-4(f)(1)(i).

**Other Change of Control Transactions**

Actions or activities involving shareholders and/or issuers other than business combinations that could result in a change of control, such as a contested proxy solicitation involving the election of directors, also may be subject to federal regulation. An issuer or third party may satisfy its disclosure obligations under the SEC's proxy rules to furnish proxy materials to shareholders in connection with a proxy solicitation by posting its proxy materials on a publicly accessible

Internet website (other than the SEC's EDGAR website) and sending its Notice of Internet Availability of Proxy Materials. An issuer must send its Notice of Internet Availability of Proxy Materials to shareholders at least 40 calendar days before the shareholder meeting date while a third party must send its Notice of Internet Availability of Proxy Materials by the later of 40 days before the meeting or the date on which it files its definitive proxy statement with the SEC, provided its preliminary proxy statement is filed no later than 10 calendar days after the issuer files its definitive proxy statement.

To the extent an issuer or third party chooses to mail the proxy statement to security holders, the proxy rules do not specify the number of days before the meeting by which issuers must deliver or otherwise make their proxy materials available for distribution to their beneficial owners. The SEC has interpreted an existing proxy rule as requiring a proxy statement to be mailed sufficiently in advance of the meeting date to allow five business days for processing by banks and brokers (acting on behalf of beneficial owners) and an additional period to provide ample time for delivery of the material, consideration of the material by the beneficial owners, return of their voting instructions, and transmittal of the vote from the bank or broker to the tabulator.<sup>498</sup> To the extent that financial information is incorporated by reference to satisfy line-item disclosure requirements in the proxy statement instead of being disclosed directly in the document, Note D to Schedule 14A requires the proxy statement to be sent to security holders no later than 20 business days prior to the date on which the meeting of security holders is held. The same timeliness standard is applicable in cases where an information statement on Schedule 14C incorporates information by reference. Rule 14c-2(b) of Regulation 14C otherwise requires that the information statement filed on Schedule 14C must be disseminated to security holders 20 calendar days before the corporate action is taken.

In cases where a person makes an acquisition of equity securities registered under Section 12, but is not necessarily engaged in a business combination or may even beneficially own less than a majority of the equity following such acquisition subject to Sections 13(d) or 14(d), additional disclosures will be required if such person has an arrangement or understanding with the issuer to elect or designate a majority of the issuer's directors other than at a meeting of security holders. Prior to the expiration of 10 days before this type of change of control is effectuated, the issuer is required by Section 14(f) and corresponding Rule 14f-1 to file and transmit to all security holders information substantially equivalent to that which would have been transmitted through a proxy statement regarding such new directors had a meeting been held.

(b) Supplied with adequate information to enable them to assess the merits of the proposal?

Yes. As described in the response to Principle 16, security holders receive comprehensive disclosure documents upon which they may rely in order to make an informed voting or

<sup>498</sup>

SEC Release 34-33768 (March 16, 1994).

investment decision when the transaction involves an offering of securities that is registered under the Securities Act.

### **Takeover Bids (Tender Offers)**

In the context of tender offers, security holders will receive a Schedule TO as described in response to Question 17.1(f)(ii). To the extent that securities are offered as consideration, the offeror will need to register the offer and sale of such securities on a registration statement under the Securities Act or claim an exemption. Management of the subject company also is required to make a statement on behalf of the issuer expressing its position with respect to the tender offer. The statement is required to be filed on a Schedule 14D-9 and disseminated to security holders within 10 business days from commencement of a tender offer and must disclose, among other things, whether the issuer is: abstaining from rendering an opinion and thus remaining neutral with respect to the offer; unable to take a position; or recommending that security holders accept or reject the offer and the reason(s) in support of any of the required positions being taken. The directors' fiduciary duty of disclosure under state law requires them, when making a recommendation in respect of a tender offer, to disclose to stockholders all reasonably available material facts.

### **Other Change of Control Transactions**

In the context of other change of control transactions that involve approval by security holders pursuant to a vote, security holders will receive a proxy statement that complies with Schedule 14A. In the event a change of control may be effectuated without a security holder vote by way of consent executed by a majority of the securities in the class outstanding, security holders will receive an information statement that complies with Schedule 14C. To the extent that securities are offered as consideration, the offeror(s) will need to register the offer and sale of such securities on a registration statement under the Securities Act or claim an exemption.

- (c) As far as practicable, given reasonable and equitable opportunities to participate in any benefits accruing to the shareholders under the proposal?

### **Takeover Bids (Tender Offers)**

As discussed in the responses to Questions 17.1(f)(i) and (ii), Section 14(d)(7) of the Exchange Act and corresponding Exchange Act Rule 14d-10 are designed to ensure that target security holders receive fair and equal treatment. In the context of tender offers made by issuers subject to Rule 13e-4, Rule 13e-4(f)(8) similarly requires that the offer be made to all holders in the subject class and that each security holder is eligible to receive the highest form of consideration.



### Other Change of Control Transactions

The proxy rules under the federal securities laws do not require that security holders be given reasonable and equitable opportunities to participate in the benefits of a transaction or receive an equal amount of consideration. Notwithstanding the absence of an express requirement under the federal securities laws to guarantee equal treatment of security holders in the proxy solicitation context, other sources of authority applicable to solicitations potentially resulting in a change of control may provide members of the class an equal opportunity to vote. In order to achieve the desired approval for or result in a transaction subject to security holder vote, a natural incentive also exists to ensure that adoption of the proposal would result in a fair distribution of the benefits among security holders.

In change of control transactions in which an ownership or management transition may be effectuated without a security holder vote of a class of securities registered under Section 12 of the Exchange Act, the issuer may be required to disseminate an information statement complying with Schedule 14C. Instances in which Section 14(c) may require the dissemination of an information statement are those where management may control sufficient shares to assure a quorum and a favorable vote (*e.g.*, majority-owned subsidiary) or where a solicitation of proxies is made of only certain security holders or certain security holders act unilaterally by written consent. While no provision exists in Section 14(c) or corresponding Regulation 14C to offer a reasonable and equal opportunity to participate in any benefits accruing to participants in the transaction or certain security holders, the requirement under Rule 14c-2(b) of Regulation 14C that the information statement complying with Schedule 14C be disseminated at least 20 calendar days before the corporate action is to be taken provides security holders with an opportunity to legally challenge the transaction in a court of competent jurisdiction.

As noted above, in certain acquisitions of securities registered under Exchange Act Section 12 that are subject to the tender offer or beneficial ownership reporting requirements under the federal securities laws, agreements may exist as part of those acquisitions that result in the replacement of a majority of the board of directors. Such transactions may be classified as a change of control transaction and subject the issuer to a disclosure obligation under Section 14(f) of the Exchange Act and corresponding Rule 14f-1. Those regulatory provisions require the issuer to disseminate an information statement that contains information that is the substantial equivalent of information contained in the proxy statement with respect to solicitations involving the election of directors. This information statement must be transmitted to security holders at least 10 calendar days before the designated officers take office.

(d) Given fair and equitable treatment (in particular, minority security holders) in relation to the proposal?

Yes. Please see the responses to Questions 17.1(f)(i) and (ii).

- (e) Not unfairly disadvantaged by the treatment and conduct of directors of any party to the transaction or by the failure of the directors to act in good faith in responding to or making recommendations with respect to the proposal?

Yes. This area of the regulatory framework is addressed principally under state corporate law. DGCL Section 141(a) provides that the business and affairs of a corporation are to be managed or under the control of its board of directors. Delaware common law provides that directors owe fiduciary duties to the corporation and its stockholders. While the DGCL contains statutory provisions that address the rights and equal treatment of stockholders, as discussed in the response to Question 17.1 above, the outlines of management's fiduciary duties towards the corporation and its stockholders have been developed through common law jurisprudence. Most states possess similar judicial precedent.

Two general fiduciary duties imposed on directors are the duty of care and the duty of loyalty. In furtherance of the basic concept contained in DGCL Section 141(a), the duty of care is aimed at a director's responsibility to exercise an appropriate degree of diligence when managing the corporation's business or affairs and requires that a director remain fully informed about the corporation's activities. This can mean that the director should commit time to and regularly attend meetings, pay attention and ask questions at these meetings, stay adequately informed about the corporation, and bring relevant information to the attention of other directors. It is expected that directors will exercise their duty of care in a manner that a person in a like position would reasonably believe appropriate given the circumstances.

The duty of loyalty requires that the best interests of the corporation and its stockholders take precedence over any direct or indirect personal interest not shared by stockholders generally. Directors should watch for and be aware of any interests that could potentially be considered to conflict with the corporation's interests.

Delaware courts have also developed jurisprudence relating to subsets of the duty of loyalty, reflecting the related concepts of good faith and candor. The duty of good faith requires that directors act in the best interests of the corporation and its stockholders, as with the duty of loyalty, but court review centers on the motivations behind board actions and considers the process by which the board considered a matter (similar to the duty of care). The duty of candor may be breached when a board issues deceptive or incomplete communications to shareholders. Closely following the standard of materiality discussed above in the introduction to Question 16, Delaware courts have stated that directors have a duty to disclose all material information that a reasonable stockholder would consider important in deciding how to vote on a corporate action and, in order to be considered material, such information must significantly alter the "total mix" of information made available.

The business judgment rule is an established judicial standard of review ordinarily used by the judiciary if a director's satisfaction of the duty of care is challenged in court. It allows courts to analyze a director's behavior and determine whether a board decision can be successfully

challenged or whether a director should be personally liable.

As discussed under the response to Question 17.1(a)(iii), the DGCL also requires the availability of appraisal rights to stockholders as a result of a merger or consolidation in which the stockholder is required to accept cash or certain other consideration in exchange for the shares previously held. Additionally, as discussed under the response to Question 17.1(g), shareholder derivative suits provide additional means for holding directors accountable for their oversight of a company's affairs.

The federal securities laws also contain requirements designed to address the concern that stockholders could be unfairly disadvantaged in certain related party transactions. Rule 13e-3 under the Exchange Act applies to transactions by an issuer or affiliate of the issuer that have either a reasonable likelihood or purpose of causing a class of the issuer's equity securities to become eligible to terminate registration or reporting under the Exchange Act or causing a class of the issuer's equity securities that are listed on an exchange to no longer be listed. Because the issuer, control person(s), and management have vested interests in the outcome of these types of transactions that may not be shared on a *pro rata* basis with other security holders, there may be a risk that unaffiliated security holders could be treated unfairly or otherwise placed at a disadvantage. The SEC has brought enforcement actions under Rule 13e-3.<sup>499</sup>

Rule 13e-3 is intended to minimize the potential for unfair treatment by imposing procedural and disclosure obligations upon issuers and their affiliates engaged in these types of transactions. Among these are requirements to disclose the purposes of the transaction, whether any alternative means for accomplishing the stated purposes were considered, the reasons for the structure of the transaction and why it is being undertaken at the time, the effects that the transaction would have on the issuer and its unaffiliated security holders, whether or not the filing party believes the transaction is fair to unaffiliated security holders, the factors considered in support of such fairness determination, and whether security holders possess any rights to seek appraisal of their shares outside of the transaction proposed by management or an affiliate of the issuer. In support of a finding of fairness, directors and affiliated persons generally will discuss whether they received a fairness opinion from a financial advisor. Additionally, disclosure is required if there is any requirement that security holders approve the transaction, and this disclosure must include a discussion of whether the transaction requires the approval of at least a majority of unaffiliated security holders; approval by the board of directors and any special committee formed to consider the transaction, including disclosure of whether the transaction was approved by a majority of the directors who are not employees of the subject company; whether or not members of a special committee retained an unaffiliated representative to act

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See, e.g., SEC Release No. 34-69750 (June 13, 2013) and SEC Release No. 34-48703 (October 27, 2003).

solely on behalf of unaffiliated security holders for purposes of negotiating the transaction; and the receipt of other offers.<sup>500</sup>

4. With respect to substantial holdings of voting securities:

(a) Is information about the identity and holdings of persons who hold a substantial (well below controlling) beneficial ownership interest in a company required to be timely disclosed:

(i) In public offering and listing particulars documents?

Yes. Generally, beneficial ownership is defined under Exchange Act Rule 13d-3(a) as persons who may, directly or indirectly, vote or dispose or direct the voting and disposition of a voting class of equity securities registered under Section 12 of the Exchange Act. Beneficial ownership of directors and executive officers of the issuer as a group and any person who is known to the issuer to be the beneficial owner of more than 5% of any class of the issuer's voting securities must be disclosed in registration statements under the Securities Act pursuant to Item 403 of Regulation S-K.

(ii) Once the ownership threshold requiring disclosure has been reached?

Yes. The beneficial ownership reporting requirements under the federal securities laws provide investors and the issuer with information about accumulations of voting classes of equity securities that may have the potential to change or influence control of the issuer. The statutory and regulatory framework establishes a comprehensive reporting system for gathering and disseminating information about the ownership of publicly held equity securities. This framework is established under Sections 13(d) and 13(g) of the Exchange Act.

Section 13(d) of the Exchange Act requires a person who beneficially owns, following an acquisition, more than 5% of a voting class of equity security registered under the Exchange Act

<sup>500</sup> The factors that are important in determining the fairness of a transaction to unaffiliated security holders and the weight, if any, that should be given to them will vary. These factors also will include whether the consideration offered to unaffiliated security holders constitutes fair value in relation to:

- Current market prices;
- Historical market prices;
- Net book value;
- Going concern value;
- Liquidation value;
- Purchase prices paid in previous purchases during the past two years;
- Any report, opinion, or appraisal; and
- Firm offers made by unaffiliated persons during the past two years to engage in certain business combination or control transactions.

to provide certain information to the SEC (and consequently to the public). The percentage of the class beneficially owned and the circumstances surrounding the person's acquisition, in addition to other material information summarized below, is required to be reported on a Schedule 13D filing.

Section 13(d) specifies the information required to be disclosed and gives the SEC the authority to adopt rules and regulations that vary those requirements. Under this authority, the SEC has adopted Regulation 13D-G and Schedule 13D under the Exchange Act, which provide the specific disclosure requirements to be satisfied.

Under Section 13(d) and Schedule 13D, a beneficial owner who is required to report must disclose the background and identity, residence, and citizenship of, and the nature of the beneficial ownership by, such person and all other persons by whom or on whose behalf the purchases have been or are to be effected. The disclosure must also cover the number of shares beneficially owned, the source of funds used to purchase the shares, and if the purpose of the purchase is to acquire control of the issuer, then any plans of the reporting person to liquidate the issuer, to sell its assets, to engage it in a merger, or other specified transactions.

The current statutory deadline requires the Schedule 13D beneficial ownership report containing these disclosures to be filed within 10 days after the acquisition that results in the amount of beneficial ownership exceeding 5%, including any amounts beneficially owned before crossing the statutory 5% threshold. Section 929R of the Dodd-Frank Act amended Section 13(d)(1) of the Exchange Act to authorize the SEC to shorten the initial filing deadline for Schedules 13D. This amendment modified Section 13(d)(1) to enable the Schedule 13D to be lawfully made within such shorter time as the SEC may establish by rule. Section 929R did not require the SEC to exercise this authority. The SEC has not initiated any formal regulatory action to shorten the current statutory 10-day initial reporting period.

Exchange Act Section 13(g) and Regulation 13D-G provide that certain investors may file a Schedule 13G, "short-form" disclosure document, to disclose their ownership interest in equity securities. These Schedule 13G filers include specified institutional investors holding securities in the ordinary course of business and not with a control purpose. The types of institutional investors that may file on Schedule 13G include registered broker-dealers, banks, insurance companies, registered investment companies, registered investment advisers and employee benefit plans and pension funds subject to the Employee Retirement Income Security Act, and related holding companies and groups. Schedule 13G must be filed by these investors within 45 days after December 31 of the year in which the 5% threshold was exceeded.

In addition, Regulation 13D-G permits other classes of investors to file a Schedule 13G. A person is permitted to disclose its ownership on a Schedule 13G if it: (i) has not acquired the securities with any purpose or with the effect of changing or influencing control of the issuer or in connection with or as a participant in any transaction having that purpose or effect; (ii) is not a type of institution described in the preceding paragraph; and (iii) is not the beneficial owner of

20% or more of the class of securities. In this circumstance, the due date for filing is 10 days after the acquisition. Section 13(g) and Regulation 13D-G also authorize a person who has not made an acquisition within the meaning of Section 13(d)(1), yet still has become the beneficial owner of greater than 5% of an equity class registered under the Exchange Act, to file a Schedule 13G.

When two or more individuals or entities come together for the purpose of acquiring, holding, or disposing of a target company's securities, the group is deemed to be a single "person" for purposes of the filing requirement under Sections 13(d) and 13(g). As a result, a Schedule 13D or Schedule 13G must be filed by the members of the "group" when they collectively beneficially own more than 5% of the class of target company securities. Application of this "group" notion is based on the facts and circumstances of any particular situation.

(iii) At least annually (e.g., in the issuer's annual report)?

Yes. Consistent with the disclosure required in registration statements filed under the Securities Act and Exchange Act, as outlined in the response to Question 17.4(a)(i) above, beneficial ownership of directors and executive officers of the issuer as a group and any person who is known to the issuer to be the beneficial owner of more than 5% of any class of the issuer's voting securities must be disclosed in annual reports pursuant to Item 403 of Regulation S-K. As discussed more fully below in the response to Question 17.5, officers and directors of an issuer with a class of equity securities registered under Section 12 of the Exchange Act, and every person who is the beneficial owner of more than 10% of the class of such securities, must file with the SEC an initial ownership report and subsequent ownership reports noting any changes in ownership, and these reports are publicly available upon filing.

(b) Is it mandatory for material changes in such ownership and other required information to be disclosed in a timely manner?

Yes. Sections 13(d)(2) and 13(g)(2) of the Exchange Act, in combination with Exchange Act Rule 13d-2, require that material changes to the information disclosed in the various Schedules be disclosed in an amended filing. Under that rule, the acquisition or disposition of beneficial ownership of securities in an amount equal to 1% or more of the class of securities shall be deemed material, although acquisitions or dispositions of less than those amounts may be deemed material, depending on the facts and circumstances. Other material changes in the facts disclosed must likewise be disclosed. An amendment to a Schedule 13D must be filed promptly. The regulation governing the circumstances under which a Schedule 13G must be amended, including the date by which an amendment to Schedule 13G must be filed, differs from the regulation of amendments to Schedule 13D. For example, under the provisions of Exchange Act Rule 13d-2(b), amendments to Schedule 13G filings must be filed on an annual basis and no later than 45 days following the end of the calendar year in which any change in the information previously reported changes regardless of the materiality of such change. To the extent that the only change in the information relates to a change in the percentage amount of beneficial

ownership caused by a change in the amount of the issuer's outstanding securities, no amendment to the Schedule 13G is required. Schedule 13G filers also remain subject to other regulatory provisions in addition to the requirement to amend on an annual basis, and the circumstances under which such amendments are required and time periods for which such amendments must be filed vary according to the type of beneficial owner eligible to report on Schedule 13G.

- (c) Are these disclosure requirements applicable to two or more persons acting in concert even though their individual beneficial ownership might not have to be disclosed?

Yes. Sections 13(d)(3) and (g)(3) of the Exchange Act provide that when two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a "person." Application of this statutory provision therefore results in an aggregation of the ownership interests between two or more persons acting in concert. Related Exchange Act Rule 13d-5(b)(1) applies to the group immediately upon its formation, assuming statutory coverage, and deems this newly formed "person" to have acquired the beneficial ownership of the group members, thereby subjecting groups to Section 13(d). The rule also operates to help determine when two or more persons should be deemed to be a "group."

Rule 13d-5(b)(1) sets forth a test for whether two or more persons constitute a group. The test is twofold. First, there must be an agreement. The agreement need not be in written form. In determining whether persons agreed to act together, the SEC and the courts look to circumstances such as contacts between persons, parallel action by persons, and whether persons had similar goals. To be deemed to have formed a group, persons must agree to act together for purposes of acquiring, holding, voting, or disposing of the subject securities. Groups formed at a point in time before Section 13(d) applies, as would be the case if the class of equity securities in which the beneficial ownership held by group members exceeded 5% was not yet registered under the Exchange Act, would be subject to Section 13(g) immediately upon registration of the subject class of equity securities under the Exchange Act.

5. With respect to holdings of voting securities by directors and senior management:

- (a) Is information about the beneficial ownership interest and material changes in beneficial ownership in a company required to be timely disclosed?
- (b) Is such information available:
- (i) In public offering and listing particulars documents?
- (ii) At least annually (e.g., in the issuer's annual report)?
- (c) Is the legal infrastructure sufficient to ensure enforcement of and compliance with these requirements?

Yes. Disclosure about the beneficial ownership interest of directors and executive officers in a company, and material changes in those interests, is required pursuant to two distinct reporting

regimes under the federal securities laws: one regime relates to disclosure provided by the issuer on a periodic basis under the issuer's disclosure obligations under the federal securities laws; and the second regime relates to disclosure provided by "insiders" (described below) under Section 16 of the Exchange Act.

### **Issuer Disclosure**

In various disclosure documents described below, issuers are required to disclose, as of the most recent practicable date, in a specified tabular format, as to each class of equity securities of the issuer or any of its subsidiaries or parent companies, the beneficial ownership of securities of all directors and nominees (naming them), each of the five mostly highly compensated executive officers (naming them), and all directors and executive officers as a group (without naming them). The information disclosed must include the title of the class of securities, the name of the beneficial owner, the amount and nature of beneficial ownership, and the percent of the class. This disclosure must specify the amount of shares that are pledged as security and the amount of shares with respect to which the named persons have the right to acquire beneficial ownership.<sup>501</sup>

For purposes of this disclosure, an executive officer broadly includes any officer who performs a policy making function for an issuer, which could include officers of subsidiaries if they perform policy making functions for the issuer. Beneficial ownership is broadly defined as discussed in response to Question 17.4.

This disclosure must be made in a prospectus relating to an offering of the issuer's shares under the Securities Act<sup>502</sup> and in a registration statement under the Exchange Act.<sup>503</sup> In addition, the disclosure must be updated at least yearly, either in the issuer's annual report filed under the Exchange Act or in the issuer's proxy or information statement delivered to shareholders in connection with the election of directors.<sup>504</sup>

As noted elsewhere in this assessment, issuers are subject to SEC enforcement actions and other sanctions with respect to incomplete or misleading disclosures.

<sup>501</sup> Item 403(b) of Regulation S-K.

<sup>502</sup> Form S-1, Item 11(m).

<sup>503</sup> Form 10, Item 4.

<sup>504</sup> Form 10-K, Item 12 and Schedule 14A, Item 6(d).



### Section 16 Reporting Regime

Section 16 of the Exchange Act provides for a stand-alone reporting regime with respect to ownership of an issuer's securities. Section 16 applies to every officer and director of an issuer with a class of equity securities registered under Section 12 of the Exchange Act.<sup>505</sup> Upon becoming a reporting person or upon the Section 12 registration of that security, Section 16(a) requires a reporting person to file an initial ownership report with the SEC disclosing his or her beneficial ownership of all equity securities of the issuer. The insider must report the number of securities in which he or she has a direct or indirect opportunity to profit. To keep this information current, Section 16(a) also requires reporting persons to report changes in such ownership, or the purchase or sale of a SBS agreement involving such equity security, before the end of the second business day following the day on which the subject transaction was executed.

The SEC has adopted various forms and rules to implement this reporting requirement. Insiders are required to report their initial ownership and all changes in ownership on the required forms. The SEC has adopted rules that exempt insiders from reporting some changes in security ownership, such as routine acquisitions pursuant to broad-based, non-discriminatory employee benefit plans. Insiders who are delinquent in their current transaction reporting, or who engage in transactions for which deferred reporting is permitted (*e.g., bona fide* gifts), must file an annual statement to report those previously unreported transactions.

All filings under Section 16 (*i.e.*, the initial statement of ownership, the statement of changes in ownership, and the annual statement, if required) must be filed electronically through the SEC's EDGAR system. These filings are immediately publicly available on filing.

The SEC's Delinquent Filings Program, described in the response to Question 16.5, applies similarly to filings under Section 16. The SEC has brought enforcement actions against insiders who have not complied with their Section 16 filing obligations.<sup>506</sup>

### Cross-Border

6. If public offerings or listings by foreign issuers are significant within the jurisdiction, does the jurisdiction require disclosure in foreign issuers' offering and listing particulars documents of any governance provisions or information relating to the foreign issuer's jurisdiction that may materially affect the fair and equitable treatment of shareholders?

Yes. There are approximately 940 foreign private issuers that have registered a class of securities or a transaction and are filing reports with the SEC under the Exchange Act. Please refer to the

<sup>505</sup> Section 16 also applies to every person who is the beneficial owner (as defined under Exchange Act Rule 13d-3(a)) of more than 10% of the class of securities registered under Section 12. This assessment refers to all persons to whom Section 16 applies as "reporting persons" or "insiders." See also the response to Question 17.4.

<sup>506</sup> See, *e.g.*, SEC Release 34-41428 (May 20, 1999).

response to Question 16.9 for a discussion of the SEC's disclosure regime applicable to foreign private issuers. As noted in that discussion, in September 1999, the SEC substantially revised its disclosure requirements for foreign private issuers to fully incorporate the IOSCO International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers.<sup>507</sup> As a result, in prospectuses under the Securities Act and registration statements under the Exchange Act, foreign private issuers are required to disclose material information relating to shareholder rights as required under those IOSCO standards.

In addition, in prospectuses under the Securities Act and annual reports under the Exchange Act, all issuers, including foreign private issuers, are required to disclose material "risk factors," *i.e.*, those factors that are specific to the company that make an investment speculative or one of high risk. In practice, in providing "risk factor" disclosure, a foreign private issuer may frequently disclose differences in shareholder rights between the foreign jurisdiction and the U.S., or note the existence of provisions of foreign corporate law or of the issuer's chartering document that have a material effect on shareholders' ability to pursue certain remedies or other matters affecting shareholder rights.

Further, in September 2008, the SEC adopted a disclosure requirement applicable to the annual reports of foreign private issuers.<sup>508</sup> Under this new requirement, all foreign private issuers that are listed on a U.S. exchange must provide a concise summary of the significant ways in which the issuer's corporate governance practices differ from the corporate governance practices followed by U.S. companies under the relevant exchange's listing standards.

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<sup>507</sup> SEC Release 34-41936 (September 28, 1999).

<sup>508</sup> SEC Release 33-8959 (September 23, 2008).

**Principle 18      Accounting standards used by issuers to prepare financial statements should be of a high and internationally acceptable quality.**

**Key Questions**

1. Are issuers required to include audited financial statements in:

(a) Public offering and listing documents?

Yes. The SEC requires that the content of issuer registration statements for public offerings of securities under the Securities Act and public listings of securities under the Exchange Act include audited financial statements.<sup>509</sup> The requirements for the form and content of the financial statements are set forth in Regulation S-X,<sup>510</sup> which calls for provision of the balance sheet and profit and loss statement as well as a statement of comprehensive income, a statement of cash flows, and a statement of changes in equity. Regulation S-X also requires that the financial statements for each year presented be audited by an independent public accountant. The auditor must also be registered with the PCAOB.

(b) Publicly available annual reports?

Yes. Under the Exchange Act, an issuer of a class of securities that is registered under the Exchange Act must file annual reports. These requirements are the same as noted above in response to Question 18.1(a).

Companies file their annual reports with the SEC through the EDGAR system. These annual reports are publicly available, free of charge, electronically from the SEC's website. The SEC also provides an ordering service for older documents not available on the website and maintains a Public Reference Room at the SEC's Headquarters.

2. Do the required audited financial statements include:

(a) A balance sheet or statement of financial position?

Yes. The information is required in audited financial statements, as specified in Regulation S-X.

(b) A statement of the results of operations?

Yes. The information is required in audited financial statements, as specified in Regulation S-X.

<sup>509</sup> In responding to this Principle, the term "public companies" is considered to refer to the offerings and listings of corporate issuers. The SEC has separate requirements for more specialized offerings and listings; for example, for those of investment funds (mutual funds), see Principle 26, and for ABS trusts, see Principle 16.2.

<sup>510</sup> See 17 C.F.R. §§ 210 *et seq.*

(c) A statement of cash flow?
Yes. The information is required in audited financial statements, as specified in Regulation S-X.
(d) A statement of changes in ownership equity or comparable information included elsewhere in the audited financial statements or footnotes?
Yes. The information is required in audited financial statements, as specified in Regulation S-X.
3. With respect to the financial statements required in public offering and listing documents and publicly available annual reports:
(a) Are these required to be prepared and presented in accordance with a comprehensive body of accounting standards?
<p>Yes. The financial statements of U.S. public companies are required to be prepared and presented in accordance with U.S. GAAP. U.S. GAAP is a comprehensive body of accounting standards that has evolved and developed since the first Accounting Research Bulletins were issued by the American Institute of Certified Public Accountants (AICPA) in the late 1930s. It comprises standards and interpretations established by the FASB and its predecessors, as modified or supplemented in a limited number of places by rules and guidance from the SEC and its staff. It has been established and continuously improved by a full-time standard setting organization, the FASB, since 1973. In 2009, the FASB adopted the Accounting Standards Codification, which is the source of authoritative GAAP recognized by the FASB. For foreign private issuers, see Question 18.7.</p>
(b) Do these accounting standards require financial statements to
(i) Be comprehensive?
<p>Yes. The financial statements prepared under U.S. GAAP are required to be comprehensive. U.S. GAAP is recognized globally as comprehensive and has evolved from decades of development of the requirements of the standards. These requirements are modified or supplemented in a limited number of places by rules and guidance from the SEC and Staff.</p>
(ii) Be designed to serve the needs of investors?
<p>Yes. U.S. GAAP is intended to provide investors and other users of financial statements a clear, unambiguous picture of the financial position and operation of a company. The FASB's mission is to establish and improve standards of financial accounting in order to provide decision-useful information to investors and other users of financial reports, and one of the FASB's guiding principles is to strive for neutrality of information resulting from its standards. Staff also issues guidance to promote clear, complete, and understandable reports and disclosures for investors. In addition to the requirements of the accounting standards and the SEC's guidance, Staff regularly performs selective reviews of the accounting and disclosure included in the financial</p>

reporting of public companies to determine if necessary information is included and presented in a clear and understandable manner in order to meet the needs of investors, and Staff advises the company via comment letter if improvement is needed. Refer to Question 16.5 for a discussion of the filing review process.

(iii) Reflect consistent application of accounting standards?

Yes. U.S. GAAP and related Staff guidance relating to changes in accounting standards direct that information is to be presented on a consistent basis and prescribe special procedures and disclosures if reclassifications and/or changes in accounting occur.

(iv) Be comparable if more than one accounting period is presented?

Yes. U.S. GAAP and related Staff guidance promote consistency and comparability in period-to-period reporting. Specific guidance is included for presentation and disclosure associated with reclassifications and changes in accounting policies, changes in estimates, changes in reporting entity, and other conditions that affect comparability. The PCAOB's auditing standards also require an auditor to add explanatory language to their report when there has been a material change between periods in accounting principles or in the method of their application.

(c) Are the prevailing accounting standards of an internationally acceptable quality?

Yes. U.S. GAAP is a long-established and continually improving high quality and comprehensive body of accounting standards and related guidance that has long been accepted in capital markets throughout the world for the preparation of financial statements. For example, Japan permits domestic issuers to prepare financial statements in accordance with U.S. GAAP.

The Securities Act and the Exchange Act give the SEC statutory authority to establish financial accounting and reporting standards for publicly held companies. Throughout its history, however, the SEC's practice has been to look to the private sector for this function to the extent that the private sector demonstrates the ability to fulfill the responsibility in the public interest.

Since 1973, the FASB has been the full-time U.S. organization in the private sector for establishing standards of financial accounting. The FASB's standard-setting process allows for due process, which includes broad public exposure, consultation from various advisory groups, task forces and working groups of constituents, as well as input from Staff.

Pursuant to its authority under Section 108 of the Sarbanes-Oxley Act, the SEC has recognized the standards of the FASB as “generally accepted” for the purposes of the federal securities laws.<sup>511</sup>

4. Where unaudited financial statements are used, for example, in interim reports, and interim period financial statements in public offering and listing documents, in full or summary format, are the financial statements presented in accordance with accounting standards that are of a high and internationally acceptable quality?

Yes. Financial statements in interim reports and offering and listing documents are required to be prepared and presented in accordance with Regulation S-X and U.S. GAAP, whether audited or unaudited. In addition, unaudited interim financial statements are required to be reviewed by an independent public accountant registered with the PCAOB.

5. In regard to oversight, interpretation and independence with respect to accounting standards:

- (a) Does the regulatory framework provide for an organization responsible for the establishment and timely interpretation of accounting standards?

Yes. The federal securities laws authorize the SEC to set standards of accounting and financial reporting for companies that file information and reports with the SEC. The SEC historically has looked to private-sector, standard-setting bodies to develop accounting principles and standards for public companies. Pursuant to its authority under Section 108 of the Sarbanes-Oxley Act,<sup>512</sup> the SEC has recognized the standards of the FASB as “generally accepted” for the purposes of the federal securities laws.<sup>513</sup>

Section 108 of the Sarbanes-Oxley Act establishes criteria that must be met in order for the work product of an accounting standard-setting body to be recognized by the SEC as “generally accepted.” Section 108 requires that the SEC determine whether the standard-setting body has the capacity to assist the SEC in fulfilling the requirements of the securities laws. In addition, the standard-setting body must have adopted procedures to ensure prompt issuance, by a majority vote of its members, of changes to accounting principles necessary to reflect emerging accounting issues and changes in business practices.<sup>514</sup>

<sup>511</sup> See the April 25, 2003 SEC policy statement recognizing the FASB as satisfying the criteria in Section 19(b) of the Securities Act, as added by Section 108 of the Sarbanes-Oxley Act. SEC Release No. 33-8221.

<sup>512</sup> Securities Act §19(b).

<sup>513</sup> See the April 25, 2003 SEC policy statement recognizing the FASB as satisfying the criteria in Section 19(b) of the Securities Act, as added by Section 108 of the Sarbanes-Oxley Act. SEC Release No. 33-8221.

<sup>514</sup> Securities Act §19(b)(1)(A)(iv).

The FASB's mission is to establish and improve standards of financial accounting and reporting that foster financial reporting by nongovernmental entities that provides decision-useful information to investors and other users of financial reports.<sup>515</sup> The FASB follows certain guiding principles in conducting its activities. These principles include: to be objective in its decision making; to actively solicit and carefully weigh the views of stakeholders; to issue standards only when the expected benefits exceed the perceived costs; to issue high-quality standards; to manage the process of improving standards in ways that balance the desire to minimize disruption of accounting and financial reporting processes with the need to improve the decision-usefulness of information in financial reports; to provide clear and timely communications; and to review the effects of past decisions and interpret, amend, or replace standards in a timely fashion if such action is indicated.<sup>516</sup>

The FASB is part of a structure that is independent of all other business and professional organizations. Funding is received through an annual accounting support fee assessed against issuers as provided for under Section 109 of the Sarbanes-Oxley Act. The FASB is overseen by the Financial Accounting Foundation which is responsible for selecting the seven full-time FASB members, selecting members of its advisory council, and ensuring adequate funding of its activities. The Financial Accounting Foundation is an independent, non-profit organization that is run by a Board of Trustees of between 14 and 18 members. The FASB is supported by the Financial Accounting Standards Advisory Council, which is responsible for consulting with the FASB as to technical issues on the FASB's agenda and project priorities. The FASB both establishes standards and related guidance and interprets its standards through approving positions of the FASB staff and of its own Emerging Issues Task Force.

- (b) If yes, are the organization's processes open and transparent, and, if the organization is independent, is the standard setting or interpretation process undertaken in cooperation with, or subject to oversight by, the regulator or another body that acts in the public interest?

Yes. The FASB describes itself as "committed to following an open, orderly process for setting standards" and designed its comprehensive due process procedures to permit timely, thorough, and open study and to encourage broad public participation in the standard-setting process.<sup>517</sup> The FASB's standard-setting meetings (including those of the Emerging Issues Task Force) are open to the public, and information about the status of all projects is available on its website. Proposed standards may be developed with input from task forces, working groups, and public roundtables. The FASB exposes its proposed standards and interpretations for public comment for a reasonable period of time. The comments received are discussed in public meetings as the proposed standard is redeliberated by the FASB in light of the public input received. Staff closely

<sup>515</sup> See [www.fasb.org](http://www.fasb.org), Facts about FASB.

<sup>516</sup> See FASB's Rules of Procedure, Amended and Restated through April 15, 2013.

<sup>517</sup> See FASB's Rules of Procedure, Amended and Restated through April 15, 2013.

monitors the standards development work of the FASB described above. Staff also monitors and participates in meetings of the Emerging Issues Task Force.

6. Is there a system for enforcing compliance with accounting standards?

Yes. The SEC can use both formal and informal mechanisms to enforce compliance with accounting standards.

Formal mechanisms include:

- Seek injunctions against future violations of the reporting provisions;
- Seek an administrative cease-and-desist order against future violations;
- Deregister an issuer's securities;
- Suspend trading in the issuer's securities;
- Restrict a company's ability to complete a public offering of its securities;
- Seek civil monetary penalties against the issuer and culpable individuals;
- Bar officers and directors from future work in those capacities; and
- Refer matters to the DOJ for possible criminal prosecution.

Informal mechanisms include:

- Seek supplemental or amended disclosures;
- Seek correction in future filings; and
- Seek restatements.

Staff selectively reviews the financial information contained in prospectuses, listing documents, registration statements, periodic reports, and ongoing material disclosure reports. In addition to these documents, Staff also selectively reviews the financial information contained in proxy statements that are filed by companies. The financial information contained in prospectuses, registration statements, and listing documents is reviewed for compliance with accounting standards and reporting requirements, compliance with auditing standards and reporting requirements, accuracy and completeness of disclosure, timeliness, and other qualities.

Additional information about these selective reviews is provided in the response to Question 16.5. If Staff notes a perceived accounting or disclosure deficiency during the review of



a company's filing, Staff will send a comment letter to the company that sets forth the specific concerns Staff has with the filing. The company has an opportunity to address the Staff's comments in a response letter to Staff.

7. If public offerings or listings by foreign issuers are significant within the jurisdiction, does the regulator permit the use of high quality, internationally acceptable accounting standards by foreign companies that wish to list or offer securities in the country?

Yes. The financial statements of non-U.S. public companies that are foreign private issuers as defined in Rule 405 under the Securities Act or Rule 3b-4 under the Exchange Act may be presented in accordance with (i) U.S. GAAP, (ii) another comprehensive body of accounting standards reconciled to U.S. GAAP, or (iii) IFRS as issued by the IASB without reconciliation to U.S. GAAP. Each company may elect the basis of presentation.

**Principle 19 Auditors should be subject to adequate levels of oversight.**
**Key Questions**

1. Does the regulatory system provide a framework for overseeing the quality and implementation of auditing, independence, and ethical standards, including the quality control environments in which auditors operate?

Yes. Section 101 of the Sarbanes-Oxley Act established the PCAOB as an independent, non-profit, nongovernmental organization "to oversee the audit of companies that are subject to the [U.S.] securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."

Section 103 of the Sarbanes-Oxley Act gave the PCAOB the authority to establish auditing, ethics, independence, and quality control standards for registered public accounting firms, including through the adoption of standards proposed by other professional groups of accountants, pursuant to SEC oversight. The SEC also has authority under the federal securities laws to set auditing standards for the audits of the financial statements of reporting issuers. Section 10A of the Exchange Act requires that auditors of financial statements of issuers within the SEC's jurisdiction perform audit procedures "in accordance with generally accepted auditing standards as may be modified or supplemented from time to time by the Commission." The SEC also has established independence requirements for auditors.

2. Are auditors required to be qualified and competent pursuant to minimum requirements before being licensed to perform audits, and to maintain professional competency?

Yes. Section 102 of the Sarbanes-Oxley Act provides that no auditing firm can prepare, issue, or participate in the preparation or issuance of an opinion with respect to an issuer or broker-dealer that files with the SEC unless that firm is registered with the PCAOB. The PCAOB will not register a firm unless it finds that registration is consistent with the Board's responsibilities under the Sarbanes-Oxley Act to protect the interests of investors and to further the public interest in the preparation of informative, accurate, and independent audit reports. Further, Rule 2-01 of Regulation S-X provides that the SEC will not recognize any person as a certified public accountant who is not duly registered and in good standing under the laws of the place of his or her residence or principal office, which would include requirements to maintain professional competency generally through continuing education.

3. Is there an oversight body that operates in the public interest, has an appropriate membership, an adequate charter of responsibilities and powers, and adequate funding, such that the oversight responsibilities are carried out in a manner independent of the auditing profession?

Yes. Section 101 of the Sarbanes-Oxley Act established the PCAOB "to oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect

the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors.” Section 103 of the Sarbanes-Oxley Act gave the PCAOB the authority to establish auditing, ethics, independence, and quality control standards for registered public accounting firms, including through the adoption of standards proposed by other professional groups of accountants, pursuant to SEC oversight. The SEC also has authority under the federal securities laws to set auditing standards for the audits of the financial statements of reporting issuers. Section 10A of the Exchange Act requires that auditors of financial statements of issuers within the SEC’s jurisdiction perform audit procedures “in accordance with generally accepted auditing standards as may be modified or supplemented from time to time by the [SEC].” The SEC also has established independence requirements for auditors.

The SEC selects the five board members of the PCAOB. Staff oversees the operation and budget of the PCAOB and also closely monitors its standard-setting work as part of the SEC review and approval process for its standards and interpretive guidance. Both the FASB and the PCAOB receive funding through an annual accounting support fee, as provided for under Section 109 of the Sarbanes-Oxley Act.

4. Does the auditor oversight body have an established process for performing regular reviews of audit procedures and practices of firms that audit financial statements of public issuers?

Yes. The PCAOB inspects registered public accounting firms to assess compliance with the Sarbanes-Oxley Act, the rules of the PCAOB, the rules of the SEC, and professional standards, in connection with the firm’s performance of audits, issuance of audit reports, and related matters involving U.S. companies, other issuers, brokers, and dealers. The PCAOB inspects auditors on a statutorily defined schedule.

As required by the Sarbanes-Oxley Act, the PCAOB prepares a written report on each inspection and provides it, in appropriate detail, to the SEC and to certain state regulatory authorities. The PCAOB also makes portions of the reports available to the public; however, certain information is restricted from public disclosure, or its disclosure is delayed, as required by the Sarbanes-Oxley Act.

5. Are there standards and processes for regular assessments by the oversight body to assess whether the auditor is and remains independent, both in fact and in appearance, of the enterprises that it audits?

Yes. Independence of the external auditor both in fact and in appearance is required under the U.S. system. It is comprehensively addressed by the SEC's auditor independence rules adopted in 2000.<sup>518</sup> These rules were amended and strengthened in 2003 following the passage of the Sarbanes-Oxley Act that amended Exchange Act Section 10A.<sup>519</sup> Some of the major areas covered include the general standard of independence, financial interests, employment relationships, business relationships, non-audit services, contingent fees, partner rotation, audit committee administration of the audit engagement, quality controls, definitions, and other matters. The PCAOB also has adopted certain auditor independence requirements.

The PCAOB assesses a firm's independence as part of its regular inspection program. In addition, the PCAOB can require remedial action by firms that are not appropriately maintaining independence from their clients. In addition, the SEC and PCAOB can bring enforcement actions against firms that have violated the SEC's independence rules.

6.

(a) If the oversight process is performed in coordination with similar quality control mechanisms that are in place within the audit profession, does the oversight body maintain control over key issues such as the scope of reviews, access to and retention of audit work papers and other information needed in reviews, and follow up of the outcome of reviews?

Yes. Pursuant to Section 104(d) of the Sarbanes-Oxley Act, the PCAOB's inspection program is required to evaluate the sufficiency of the quality control system of the firm, including the manner of the documentation and communication of that system by the firm and to perform other testing as appropriate in light of the purpose of the inspection and the responsibilities of the PCAOB.

Section 103 of the Sarbanes-Oxley Act directed the PCAOB to adopt auditing standards that require registered firms to retain audit work papers for a period of not less than seven years. Section 104(e) of the Sarbanes-Oxley also gives the PCAOB authority to adopt rules providing for the retention of documents for purposes of inspection to the extent those documents are not required to be retained under Section 103. Cooperation with inspections is required by PCAOB rules, and auditors are not involved in the choice of which audits or firm practices are to be inspected.

<sup>518</sup> SEC Release No. 33-7919 codified in Rule 2-01 of Regulation S-X (17 C.F.R. §210.2-01).

<sup>519</sup> SEC Release Nos. 33-8183 and 33-8183A.

(b)	Are reviews conducted on a recurring basis, and designed to determine the extent to which audit firms have and adhere to adequate quality control policies and procedures that address all significant aspects of auditing?
	<p>Yes. The Sarbanes-Oxley Act requires the PCAOB to conduct inspections annually for firms that regularly provide audit reports for more than 100 issuers and at least triennially for firms that regularly provide audit reports for 100 or fewer issuers. At any time, the PCAOB might also inspect any other registered firm that plays a role in the audit of an issuer, and the PCAOB has a practice of inspecting, in each year, some firms in that category. PCAOB inspection reports directly address the audit firm's quality control systems.</p>
7.	Does the auditor oversight body have the authority to stipulate remedial measures for problems detected, and to initiate and/or carry out disciplinary proceedings to impose sanctions on auditors and audit firms, as appropriate?
	<p>Yes. The PCAOB's inspection reports have two parts. Part I sets forth the procedures used in the inspection and observations related to the inspection. Part II relates to the audit firm's quality control systems. If the PCAOB issues a final inspection report that contains in Part II criticisms of, or potential defects in, a firm's quality control systems, then the firm may submit evidence of remediation within 12 months of the date of the PCAOB report. If the PCAOB determines that the remediation is satisfactory, then the PCAOB shall notify the SEC and any applicable state regulatory authorities. If no evidence of remediation is submitted or if the PCAOB determines the remediation is not sufficient, then the PCAOB will make those findings public.</p> <p>If, during the inspection process, the PCAOB becomes aware that a firm may be engaged in any act, practice, or omission to act that is or may be in violation of the Sarbanes-Oxley Act, the rules of the PCAOB, any statute or rule administered by the SEC, the firm's own quality control policies, or any professional standard, the PCAOB may report such act to the SEC or state regulatory body or open an enforcement investigation pursuant to Section 105 of the Sarbanes-Oxley Act.</p> <p>The PCAOB has authority to investigate and discipline registered public accounting firms and persons associated with those firms for noncompliance with the Sarbanes-Oxley Act; the rules of the PCAOB and the SEC; and other laws, rules, and professional standards governing the audits of public companies, brokers, and dealers. When violations are found, the PCAOB can impose appropriate sanctions. As required by the Sarbanes-Oxley Act, the Board's investigations are confidential and nonpublic. The Sarbanes-Oxley Act also requires that disciplinary proceedings are confidential and nonpublic, unless both the auditor and the PCAOB consent to public proceedings or until there is a final decision imposing sanctions.</p>

**Principle 20      Auditors should be independent of the issuing entity that they audit**
**Key Questions**

1. Does the regulatory framework set standards for the independence of external auditors?

Yes. Independence of the external auditor both in fact and in appearance is required under the U.S. system. It is comprehensively addressed by the SEC's auditor independence rules adopted in 2000.<sup>520</sup> These rules were amended and strengthened in 2003 following the passage of the Sarbanes-Oxley Act that amended Exchange Act Section 10A.<sup>521</sup> Rule 2-01 of Regulation S-X sets forth the general standard of auditor independence which considers whether a relationship or the provision of a services: (i) creates a mutual or conflicting interest between the accountant and the audit client; (ii) places the accountant in the position of auditing his or her own work; (iii) results in the accountant acting as management or an employee of the audit client; or (iv) places the accountant in a position of being an advocate for the audit client. In addition, some of the specific major areas covered include financial interests, employment relationships, business relationships, non-audit services, contingent fees, partner rotation, audit committee administration of the audit engagement, quality controls, definitions, and other matters. The PCAOB also has adopted certain auditor independence requirements.

The PCAOB assesses an audit firm's independence as part of its regular inspection program and can require remedial action of firms that are not appropriately maintaining independence from their clients. In addition, the SEC and PCAOB can bring enforcement actions against audit firms that have violated the SEC's independence rules.

2. Do the standards contain restrictions relating to audit firms and individuals within the audit firm regarding financial, business or other relationships with an entity that the firm audits?

Yes. Rule 2-01(c) of Regulation S-X prohibits financial, business, employment, and other relationships with an entity that the firm audits that would threaten an auditor's independence.

3. Do the standards address the following:

(a) self-interest?

Yes. In addition to the general standard of independence set forth in Rule 2-01(b) of Regulation S-X, which is intended to prevent relationships or services that create a mutual or conflicting interest between the auditor and its client,<sup>522</sup> Rule 2-01(c) sets forth a non-exclusive list

<sup>520</sup> SEC Release No. 33-7919 codified in Rule 2-01 of Regulation S-X (17 C.F.R. §210.2-01).

<sup>521</sup> SEC Releases Nos. 33-8183 and 33-8183A.

<sup>522</sup> See Preliminary Note to Rule 2-01 of Regulation S-X.

of circumstances that are considered inconsistent with the general standard of independence in Rule 2-01(b). Rule 2-01(c) specifies circumstances related to financial relationships, employment relationships, business relationships, and non-audit services, as well as prohibitions on contingent fees and compensation paid to an audit partner for procuring engagements for non-audit work, that could result in an auditor's self-interest being in conflict with the performance of an independent audit.

(b) self-review?

Yes. The general standard of independence is intended to prohibit an auditor from being in the position of auditing his or her own work.<sup>523</sup> Additionally, Rule 2-01(c) prohibits certain non-audit services, business relationships, and employment relationships, including, for example, bookkeeping services, financial information systems design or implementation, appraisal or valuation services, actuarial services, internal audit outsourcing, broker-dealer, investment adviser or investment banking services, and management functions, that could result in the auditor reviewing its own work.

(c) advocacy?

Yes. The general standard of independence is intended to prevent the auditor from being an advocate for the client.<sup>524</sup> Additionally, Rule 2-01(c)(4)(x) prohibits an auditor from providing an expert opinion or other service for the purpose of advocating a client's interests in litigation or in a regulatory or administrative proceeding or investigation. Also, Rule 2-01(c)(4)(ix) prohibits the auditor from providing legal services to its client. Legal services is defined as any service that "under circumstances in which the service is provided, could be provided only by someone licensed, admitted, or otherwise qualified to practice law in the jurisdiction in which the service is provided."

(d) familiarity?

Yes. Rule 2-01(c) addresses the threat of familiarity by requiring the rotation of an audit partner who has performed the services of a lead or concurring partner for an issuer for more than five consecutive years and certain other members of the audit team who have worked on the audits of an issuer for more than seven consecutive years. In addition, Rule 2-01(c)(2) provides restrictions on certain employment relationships and provides for a cooling off period for certain participants in the audit. Rule 2-01(c)(4) also prohibits an auditor from providing management or human resource functions for an audit client.

<sup>523</sup> *Id.*

<sup>524</sup> *Id.*

(e)	intimidation?
	<p>Yes. SEC rules require that the audit committee (and not management) be responsible for the hiring and retention of the auditor. In addition, the auditor is required under Rule 2-07 of Regulation S-X and PCAOB auditing standards to communicate certain audit-related matters to the audit committee. Administering the relationship with the auditor through the audit committee reduces the possibility of intimidation because the auditor has regular, direct communications with the audit committee, which for listed companies is required to be composed of independent directors.</p> <p>Pursuant to SEC rules, an auditor will not be viewed to be independent when an adversarial relationship has been created between the client and its auditor due to litigation or the possibility of litigation that substantially alters the normal relationship between an auditor and its client.</p> <p>Further, Rule 13b2-2 under the Exchange Act prohibits certain persons from taking any action to coerce, manipulate, mislead, or fraudulently influence an auditor engaged in an audit or review of financial statements of an issuer that are required to be filed with the SEC.</p>
4.	Are there regulatory standards that govern the provision of non-audit services to an entity that an audit firm audits?
	<p>Yes. The general standard of independence is intended to prevent the provision of any non-audit services that would impair the independence of the auditor. In addition, Rule 2-01(c)(4) sets forth a non-exclusive list of non-audit services that would impair the independence of the auditor, including bookkeeping services, financial information systems design and implementation, appraisal or valuation services, actuarial services, internal audit outsourcing services, management functions, human resources, broker-dealer, investment adviser or investment banking services, legal services or expert services unrelated to the audit. Rule 2-01(c)(3) prohibits the auditor from having, directly or indirectly, any business relationship with the client or certain persons associated with the client. The PCAOB also has rules governing the provision of certain tax services to audit clients.<sup>525</sup></p> <p>Both the SEC and PCAOB also have rules requiring pre-approval by the audit committee of any non-audit service provided by the auditor.<sup>526</sup></p>

<sup>525</sup> See, e.g., PCAOB Rules 3522 and 3523.

<sup>526</sup> See Rule 2-01(c)(7) of Regulation S-X and PCAOB Rules 3524-3526.



5. Are auditors required to establish and maintain internal systems, governance arrangements and processes for monitoring, identifying and addressing threats to independence, including the rotation of auditors and/or senior member(s) of the audit engagement team, and ensuring compliance with the standards?

Yes. The PCAOB requires auditors to have a system of quality controls that provide, among other things, reasonable assurance that personnel maintain independence in fact and appearance in all required circumstances.<sup>527</sup> Rule 2-01(d) under Regulation S-X provides a safe harbor from certain independence violations so long as the auditor had in place a quality control system that provides reasonable assurance that the accounting firm and its employees do not lack independence. For accounting firms that annually provide audit, review, or attest services to more than 500 issuers, their quality control system must include written independence policies and procedures, an automated system that identifies investments of partners and managerial employees, a system that provides timely information about entities requiring independence, an annual or ongoing training program, an annual internal inspection and testing program, notification of the member of senior management responsible for compliance with independence requirements, written policies and procedures requiring notice when professionals are engaged in employment negotiations, and a disciplinary mechanism.

In addition, Rule 2-01(c)(6) provides that an accountant will not be independent if an audit partner performs the services of a lead partner on an audit engagement for more than five consecutive years or the services of a concurring partner for more than seven consecutive years.

6. From the perspective of public issuers:

(a) Is the external auditor required to be independent in both fact and appearance of the entity being audited?

Yes. The Sarbanes-Oxley Act and Regulation S-X (Article 2, Rule 2-01) contain rigorous independence requirements. The Preliminary Note to Rule 2-01 expressly provides that the rule is designed to ensure that auditors are independent in both fact and appearance. Audit firms need to be registered with the PCAOB to conduct audits of listed issuers and are required to comply with both SEC and PCAOB independence requirements. Rule 2-01 – which is applicable to both Securities Act and Exchange Act registration statements as well as to periodic filings – contains general restrictions on financial and business relationships, employment with the audit client, and providing certain non-audit services to ensure auditor independence and is designed to ensure that auditors are independent in both fact and appearance. The PCAOB also has enacted certain independence requirements.

<sup>527</sup> See QC 20.09, Independence, Integrity and Objectivity, *available at* <http://pcaobus.org/Standards/QC/Pages/QC20.aspx>.

<p>(b) Is there a governance body independent in both fact and appearance of the management of the entity (e.g., audit committee, board of corporate statutory auditors or other body independent of the entity's management) that oversees the process of selection and appointment of the external auditor?</p>
<p>Yes. Listing standards mandated by the Sarbanes-Oxley Act require that the audit committee of the board of directors oversee the process of selection and appointment of the external auditor of a public company. Each national securities exchange has requirements that issuers have audit committees composed of independent directors. These requirements also include certain composition, charter, and responsibility requirements for audit committees.</p>
<p>(c) Are governance standards intended to promote and contribute to the monitoring and safeguarding of the independence of the external auditor?</p>
<p>Yes. Pursuant to Rule 10A-3 under the Exchange Act, national securities exchanges are prohibited from listing any security of an issuer that is not in compliance with the following standards:</p> <ul style="list-style-type: none"> <li>• Each member of the audit committee of the issuer must be independent according to specified criteria in addition to the general director independence requirement in the listing standards;</li> <li>• The audit committee of each issuer must be directly responsible for the appointment, compensation, retention, and oversight of the work of any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review, or attest services for the issuer, and each such registered public accounting firm must report directly to the audit committee;</li> <li>• Each audit committee must establish procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, or auditing matters, including procedures for the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters;</li> <li>• Each audit committee must have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties; and</li> <li>• Each issuer must provide appropriate funding for the audit committee.</li> </ul> <p>Also, the U.S. regulatory framework has a number of specific audit committee requirements for listed issuers. The SEC's rules implementing Sections 10A(h) and 10A(i) of the Exchange Act, as added by Sections 201 and 202 of the Sarbanes-Oxley Act, require that all audit and non-audit services to be provided by the independent accountant must be pre-approved by the issuer's audit committee, subject to a <i>de minimis</i> exception. Information regarding the audit committee's pre-approval responsibilities is required to be disclosed in the issuer's annual report. The auditor</p>

is also required by the PCAOB standards to communicate information to the audit committee regarding the auditor's independence.<sup>528</sup>

- (d) Is prompt disclosure of information about the resignation, removal or replacement of an external auditor required?

Yes. When the auditor has resigned during a current audit, or has declined to stand for re-election after the completion of the audit, or was dismissed by the company being audited, prompt public disclosure of these facts is required. For U.S. companies this occurs by the issuer filing a Form 8-K within four business days of the termination date. Item 304 of Regulation S-K specifies the information required to be disclosed in the Form 8-K and encompasses such matters as whether there were any disagreements with the former auditor on accounting matters, whether the former auditor's report for the last two years involved an adverse opinion or disclaimer of opinion or other qualifications to the opinion, whether the change was recommended or approved by the board of directors or the audit committee, and other matters relating to the change in auditors.

7. Is there an adequate mechanism in place for enforcing compliance with auditor independence standards, for example, to stipulate remedial measures for problems detected and to initiate and carry out disciplinary proceedings to impose sanction on auditors and audit firms as appropriate, or to refuse to accept, or require revision of, audit reports, or for lack of independence?

Yes. The SEC can use both formal and informal mechanisms to enforce compliance with auditor independence standards.

- Formal mechanisms include:
  - Seek injunction from future violations;
  - Seek cease-and-desist order;
  - Censure and/or bar the audit firm and/or individual auditors from auditing listed and/or reporting companies;
  - Restrict a company's ability to complete a public offering of its securities;
  - Refer matters to the DOJ for possible criminal prosecution; and
  - Seek civil monetary penalties against the auditor.

<sup>528</sup>

See PCAOB Rule 3526 – "Communicating with Audit Committee Concerning Independence."

- Informal mechanisms include:
  - Referral of the matter to the PCAOB or state licensing authority;
  - Seek disclosure of additional facts;
  - Seek auditor quality assurance; and
  - Seek re-audit of the issuer's financial statements by a different auditor.

Pursuant to its selective review of filings, Staff also considers the appropriateness of the form of the auditor's report on the financial statements. Staff may issue comments with respect to the auditor's report similar to the process for issuing comments on the content of the financial statements and associated disclosures.

The PCAOB has authority to investigate and discipline registered public accounting firms and persons associated with those firms for noncompliance with the Sarbanes-Oxley Act; the rules of the PCAOB and the SEC; and other laws, rules, and professional standards governing the audits of public companies, brokers, and dealers. When violations are found, the PCAOB can impose appropriate sanctions, including:

- Temporary suspension or permanent revocation of registration;
- Temporary suspension or permanent bar of a person from association with a registered public accounting firm;
- Temporary or permanent limitation on the activities of a firm or person;
- Civil monetary penalties;
- Censure;
- Requiring additional education or training;
- Requiring an independent monitor or consultant;
- Implementation of additional or remedial policies and procedures; and
- Requiring an independent review and report on an engagement.

**Principle 21      Audit standards should be of a high and internationally acceptable quality**
**Key Questions**

1. Does the regulatory framework require that financial statements included in public offering and listing particulars documents and publicly available annual reports be audited in accordance with a comprehensive set of auditing standards?

Yes. The auditing standards used by auditors of public companies in the U.S. are the standards of the PCAOB, as modified or supplemented by the SEC. These standards are comprehensive. Regulation S-X requires that financial statements be audited, and Section 103 of the Sarbanes-Oxley Act requires that audits of public companies be conducted in accordance with standards established by the PCAOB as described above.

2. Are the prevailing auditing standards of a high and internationally acceptable quality?

Yes. The auditing standards and requirements of the U.S. have long been accepted throughout the world's capital markets and are widely recognized as being of high quality. Before the enactment of the Sarbanes-Oxley Act and the establishment of the PCAOB in 2002, auditing standards for registered public companies were established by the AICPA. The AICPA's Auditing Standards Board (ASB) had developed a number of Statements of Auditing Standards through a process that included deliberations in public meetings and public exposure of draft statements.

The Sarbanes-Oxley Act gave the PCAOB authority to establish auditing, ethics, independence, and quality control standards for registered public accounting firms and specified that the PCAOB may establish standards through its own development and/or through the adoption of standards proposed by other professional groups of accountants, all pursuant to SEC oversight.<sup>529</sup> The SEC has authority under the federal securities laws to set auditing standards for audits of reporting issuers.<sup>530</sup>

The PCAOB adopted the auditing and related professional practice standards of the ASB as they existed in April 2003 as interim professional standards. Subsequently, the PCAOB has been reviewing these standards to determine whether they need to be modified, superseded, or adopted as permanent standards. For example, the PCAOB has proposed and adopted auditing standards that address audit documentation (AS No. 3), an audit of internal control over financial reporting that is integrated with an audit of financial statements (AS No. 5), engagement quality review (AS No. 7), risk assessment (AS Nos. 8-15), and communications with audit committees

<sup>529</sup> Sarbanes-Oxley Act Section 103.

<sup>530</sup> Section 10A of the Exchange Act requires that auditors of financial statements of issuers within the SEC's jurisdiction perform audit procedures "in accordance with general accepted auditing standards as may be modified or supplemented from time to time by the Commission."

(AS No. 16). The PCAOB has an active standard-setting agenda that includes projects on the auditor's reporting model, related parties, the auditors' responsibilities with respect to other accounting firms and specialists, and auditing accounting estimates, including fair value measurements.

The PCAOB's standard-setting process allows for due process that includes broad public exposure, consultation from its Standing Advisory Group, *ad hoc* task forces, as well as a review and approval by the SEC of its standards.<sup>531</sup> In developing its standards, the PCAOB also considers the requirements of the relevant standards of the International Auditing and Assurance Standards Board and the Auditing Standards Board of the AICPA and may consider similar requirements where appropriate.

3.

(a) Does the regulatory framework provide for an organization responsible for the establishment and timely updating of auditing standards?

Yes. Section 101 of the Sarbanes-Oxley Act established the PCAOB as an independent, nonprofit, nongovernmental organization "to oversee the audit of companies that are subject to the [U.S.] securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors."

Section 103 of the Sarbanes-Oxley Act gave the PCAOB the authority to establish auditing, ethics, independence, and quality control standards, pursuant to SEC oversight. The SEC also has the authority under the federal securities laws to set independence and auditing standards for the audits of the financial statements of reporting issuers. Section 10A of the Exchange Act requires that auditors of financial statements of issuers within the SEC's jurisdiction perform audit procedures "in accordance with generally accepted auditing standards as may be modified or supplemented from time to time by the Commission."

The SEC selects the five board members of the PCAOB and approves its budget. Staff oversees the operation of the PCAOB and also closely monitors its standard setting work as part of the SEC review and approval process for its standards and interpretive guidance. The PCAOB receives funding through an annual accounting support fee, as provided for under Section 109 of the Sarbanes-Oxley Act.

<sup>531</sup>

Sarbanes-Oxley Act Section 107.

<p>(b) If yes, are the organization's processes open, transparent and subject to public oversight, and, if the organization is independent, is the standard setting and interpretation process undertaken in cooperation with, or subject to oversight by, the regulator or another body that acts in the public interest?</p>	<p>Yes. The PCAOB recognizes that the development of standards should be an open, public process in which investors, the accounting profession, the preparers of financial statements, and others have the opportunity to participate.</p> <p>PCAOB staff is actively involved in drafting proposed standards and in advising the PCAOB in its standard-setting. The PCAOB also encourages comments on proposed standards and recommendations regarding its standard-setting agenda from the public. Exposure drafts of proposed standards are issued for public comment. In addition, Section 103(a)(4) of the Sarbanes-Oxley Act authorizes the PCAOB to convene expert advisory groups as may be appropriate to aid in standard-setting. The PCAOB has convened a Standing Advisory Group to advise it on the establishment of auditing and related professional practice standards.</p> <p>After completing the development process, which ordinarily includes consultation with the Standing Advisory Group and may include other public forums such as roundtable discussions, the PCAOB's staff recommends a proposed standard to the PCAOB in an open public meeting. Proposed standards approved by the PCAOB in an open meeting are published for public consideration and comment. After the PCAOB and its staff evaluate the comments received, the PCAOB's staff recommends to the PCAOB in an open meeting a final standard, revised as necessary based on the evaluation of the comments received. Final standards adopted by the PCAOB are submitted to the SEC for approval and do not become effective unless approved by the SEC.</p> <p>The SEC reviews the rules, issues them for public comments, considers the comments received, and then determines whether to approve the standards.</p>
<p>4. Is there an adequate mechanism in place for enforcing compliance with auditing standards?</p>	<p>Yes. The SEC can use both formal and informal mechanisms to enforce compliance with auditing standards, as discussed in response to Question 20.7, above.</p>

**Principle 22 Credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision.**

### Key Questions

#### Registration:

1.

- (a) Does the jurisdiction have a definition of “credit rating” and/or “credit rating agency” or otherwise define a scope of activities for the purpose of imposing registration and supervision requirements on entities that engage in the business of determining and issuing credit ratings that are used for regulatory purposes?

Yes. The Exchange Act defines “[c]redit [r]ating” as “an assessment of creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments.”<sup>532</sup> The Exchange Act defines “[c]redit [r]ating [a]gency” as “any person (i) engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee, but does not include a commercial credit reporting company; (ii) employing either a quantitative or qualitative model, or both, to determine credit ratings; and (iii) receiving fees from either issuers, investors, or other market participants, or a combination thereof.”<sup>533</sup>

The Exchange Act defines “nationally recognized statistical rating organization” as a credit rating agency that issues credit ratings used by qualified institutional buyers as certified by such qualified institutional buyers, in accordance with Section 15(a)(1)(B)(ix) of the Exchange Act, with respect to: financial institutions, brokers, or dealers; insurance companies; corporate issuers; issuers of ABS; issuers of government securities, municipal securities, or securities issued by a foreign government; or a combination of one or more of the above and is registered as an NRSRO.<sup>534</sup>

- (b) Are CRAs located in the jurisdiction and whose ratings are used for regulatory purposes in the jurisdiction subject to registration (“regulated CRAs”)?

A CRA, whether located in the U.S. or elsewhere, that wishes its credit ratings to be used for regulatory purposes in the U.S. must elect to register with the SEC. The term “nationally recognized statistical rating organization” or “NRSRO” is used in various federal and state statutes and regulations to refer to a CRA registered with the SEC. Once a CRA is registered with

<sup>532</sup> Exchange Act Section 3(a)(60).

<sup>533</sup> Exchange Act Section 3(a)(61).

<sup>534</sup> Exchange Act Section 3(a)(62).



the SEC as an NRSRO, it is subject to continuing oversight by the SEC to monitor compliance with the federal securities laws, including Section 15E of the Exchange Act and the SEC's related rules<sup>535</sup> (collectively, the NRSRO Regulations).

- (c) Do the jurisdiction's registration requirements provide the Regulator with the ability to obtain all information it deems necessary from a CRA seeking registration in order to determine whether the requirements for registration have been fulfilled?

Yes. A CRA applying to be registered with the SEC as an NRSRO must provide the SEC with an initial application on Form NRSRO,<sup>536</sup> which elicits the information the SEC deems necessary to consider an application for registration as an NRSRO. An application is not eligible for approval unless Form NRSRO has been completed properly, following all applicable instructions.

Form NRSRO requires an applicant to provide information about itself and its policies and procedures related to its credit rating business, including the following:

- the class or classes of credit ratings for which the applicant is applying, specifying for each class: the approximate number of credit ratings currently outstanding; the approximate date the applicant began issuing credit ratings for the class; and performance measurement statistics;<sup>537</sup>
- a description of the procedures and methodologies used in determining credit ratings;<sup>538</sup>
- identification of conflicts of interest relating to the issuance of credit ratings;<sup>539</sup>
- policies and procedures to address and manage conflicts of interest and to prevent the misuse of material, nonpublic information;<sup>540</sup>
- the corporate organizational and managerial structure of the applicant and information about its credit rating analysts, credit rating analyst supervisors, and designated

<sup>535</sup> Exchange Act Rules 17g-1 through 17g-10, Form NRSRO, and Form ABS Due Diligence-15E. Amendments to Exchange Act Rules 17g-1, 17g-2, 17g-3, 17g-5, 17g-6, and 17g-7 and Form NRSRO and the addition of Exchange Act Rules 17g-8 through 17g-10 and Form ABS Due Diligence-15E were approved by the SEC on August 27, 2014. See Exchange Act Release No. 34-72936, 79 Fed. Reg. 55078 (Sep. 15, 2014).

<sup>536</sup> Exchange Act Section 15E(a)(1); Exchange Act Rule 17g-1.

<sup>537</sup> Item 6A of Form NRSRO and Exhibit 1 to Form NRSRO.

<sup>538</sup> Exhibit 2 to Form NRSRO.

<sup>539</sup> Exhibit 6 to Form NRSRO.

<sup>540</sup> Exhibits 3 and 7 to Form NRSRO. The applicant's code of ethics, or an explanation of why the applicant does not maintain a code of ethics, must also be disclosed as Exhibit 5 to Form NRSRO.

compliance officer;<sup>541</sup>

- audited financial statements of the applicant or its parent for each of the three prior fiscal years, unaudited revenue information, including the amount of revenue generated from determining and maintaining credit ratings for the most recently concluded fiscal year, and information regarding the total and median annual compensation of credit analysts;<sup>542</sup> and
- information regarding any violations of law or other regulations by the applicant or persons associated with the applicant.<sup>543</sup>

The information required by the Form NRSRO application is designed to assist the SEC in determining whether to grant or deny NRSRO registration. For example, the required financial and analytical staffing information can assist the SEC in determining the adequacy of an NRSRO's financial and managerial resources to produce credit ratings with integrity,<sup>544</sup> as further described in the responses to Questions 3(a) and Question 4(c), below.

To ensure that the SEC receives the most current and accurate information in connection with an application for registration, an applicant is required to promptly notify the SEC if any information submitted in its application is found to be or becomes materially inaccurate prior to the grant or denial of registration. If such circumstances were to occur, the applicant is also required to promptly provide the SEC with a supplement to its Form NRSRO application identifying such information.<sup>545</sup> As part of the application process, OCR staff typically will identify any deficiencies in the application and any further information needed for full consideration of the application.

After receiving an application for registration that complies with the requirements of Form NRSRO, the SEC will either grant such registration by order or institute a proceeding to determine whether the registration should be denied.<sup>546</sup> The applicant will have an opportunity

<sup>541</sup> Exhibits 4, 8, and 9 to Form NRSRO. See the response to Question 4(c) for a discussion of how the SEC uses such information to evaluate the managerial resources of the applicant.

<sup>542</sup> Exhibits 11-13 to Form NRSRO. See the response to Question 4(c) for a discussion of how the SEC uses such information to evaluate the financial resources of the applicant.

<sup>543</sup> Item 8 of Form NRSRO. Item 8 is designed to determine if any condition exists that would permit the suspension or revocation of registration, if granted, under Section 15E(d)(1) of the Exchange Act. See the response to Question 3(a) for a discussion of conditions that could lead to suspension or revocation of registration as an NRSRO.

<sup>544</sup> Section 15E(a)(2)(C)(ii)(I) of the Exchange Act provides that the Commission shall deny the application for registration if the Commission finds, among other things, that "the applicant does not have adequate financial and managerial resources to: consistently produce credit ratings with integrity and to materially comply" with the procedures and methodologies the applicant uses in determining credit ratings; the applicant's policies and procedures to prevent the misuse of material, nonpublic information; and with NRSRO Regulations concerning conflicts of interest, prohibited conduct, and the NRSRO's designated compliance officer.

<sup>545</sup> Exchange Act Rule 17g-1(c).

<sup>546</sup> Exchange Act Section 15E(a)(2)(A).

for a hearing to provide additional information with respect to the potential grounds for denial under consideration. Following the proceeding, the SEC, by order, will grant or deny the application for registration.<sup>547</sup>

- (d) If a CRA's ratings are used for regulatory purposes but the CRA itself is not located in the Regulator's market and the Regulator does not require registration or oversight of the CRA in question, has the Regulator made a reasonable judgment to ensure that the CRA is subject to registration and oversight as required by Principle 22?

Not applicable. In order for a CRA located outside the U.S. to be considered an NRSRO for regulatory purposes in the U.S., the CRA must register as such with the SEC.<sup>548</sup> Currently, two foreign CRAs are registered with the SEC as NRSROs and are thus subject to the NRSRO Regulations and to direct oversight by the SEC.

If credit ratings issued by affiliates of an NRSRO (including affiliates located outside the U.S.) are issued on behalf of the NRSRO, the affiliates would need to be properly identified by the NRSRO on Form NRSRO when Form NRSRO is submitted to the SEC.<sup>549</sup> This permits credit rating affiliates of NRSROs to be included with the NRSRO in a single registration form. The credit ratings of these affiliates are treated as credit ratings issued by the NRSRO, and the affiliates are thus subject to the NRSRO Regulations and to direct oversight by the SEC.<sup>550</sup>

*Ongoing Supervision:*

2.

- (a) Do the jurisdiction's requirements provide the Regulator with the ability to obtain all information about a regulated CRA that the Regulator deems necessary to perform adequate oversight of the regulated CRA?

Yes. The NRSRO Regulations provide the SEC with the ability to obtain all information necessary to perform adequate oversight of NRSROs.

<sup>547</sup> Exchange Act Section 15E(a)(2)(B). See the response to Question 3(a) for a discussion of the grounds for denying an application for registration.

<sup>548</sup> See the responses to Questions 1(c) and 3(a) for a discussion of the registration process.

<sup>549</sup> See Form NRSRO, instructions for Item 3 (requiring the identification on Form NRSRO of credit rating affiliates that issue credit ratings on behalf of the NRSRO or a credit rating agency applying for registration as an NRSRO in one or more of the classes of credit ratings for which the NRSRO is registered or for which a credit rating agency or NRSRO is applying to be registered). As discussed in the response to Question 1(b), a credit rating agency must be registered with the SEC in order to be considered an NRSRO for regulatory purposes in the U.S.

<sup>550</sup> See Form NRSRO, instructions for Item 3 ("Any credit rating determined by a credit rating affiliate identified in Item 3 will be treated as a credit rating issued by [the NRSRO or a credit rating agency applying for registration as an NRSRO] for purposes of Section 15E of the Exchange Act and the Commission's rules thereunder.").

All records maintained by an NRSRO are subject to examination by the SEC.<sup>551</sup> The Exchange Act further requires all NRSROs to “make and keep for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of [the Exchange Act].”<sup>552</sup> Pursuant to that authority, the SEC adopted Exchange Act Rule 17g-2, which requires that NRSROs make, and retain for examination, records of specific types of information that the SEC considers necessary to perform adequate oversight of NRSROs.<sup>553</sup>

The NRSRO Regulations also require each NRSRO to provide certain information to the SEC on

<sup>551</sup> Exchange Act Section 17(b)(1). The statutory language subjects “records” to examination. The term “records” is defined broadly as “accounts, correspondence, memorandums, tapes, discs, papers, books, and other documents or transcribed information of any type, whether expressed in ordinary or machine language.” Exchange Act Section 3(a)(37).

<sup>552</sup> Exchange Act Section 17(a)(1).

<sup>553</sup> Paragraph (a) of Rule 17g-2 under the Exchange Act requires an NRSRO to make and retain the following records: (i) original accounting system entries and general ledger accounts; (ii) the identity of credit analysts that participated in determining (and the identity of any other person that approved) each credit rating and certain other information regarding the determination of such credit rating; (iii) the identity of each person that has paid for the issuance of a credit rating; (iv) the identity of each subscriber to credit ratings and/or credit analysis reports; (v) the types of services and products offered; (vi) procedures and methodologies used to determine credit ratings; (vii) a list of certain rated asset-backed issuances where a credit assessment is made with respect to the underlying assets that are not rated by the NRSRO; and (viii) credit rating actions taken with respect to each outstanding credit rating. Effective June 15, 2015, paragraph (a) of Rule 17g-2 under the Exchange Act will also require an NRSRO to make and retain a record documenting its policies and procedures with respect to “look-back reviews” (see the response to Question 5(a) for more details regarding such policies and procedures). Paragraph (b) of Rule 17g-2 under the Exchange Act requires an NRSRO to retain the following records: (i) significant records underlying annual financial reports; (ii) internal records used to form the basis of a credit rating or other credit analysis report, credit assessment report or private credit rating report; (iii) compliance reports and internal audit information; (iv) marketing materials made available outside of the NRSRO; (v) communications related to credit rating actions; (vi) written communications that contains complaints about the performance of a credit rating analyst with respect to a credit rating action; (vii) internal support for procedures for using the credit ratings of other NRSROs in the determination of the credit rating for an asset-backed issuance; (viii) descriptions of any process for assessing, for purposes of determining a credit rating of an asset-backed issuance, underlying assets that are not rated by the NRSRO but are rated by another NRSRO; and (ix) Form NRSRO. Effective June 15, 2015, paragraph (b) of Rule 17g-2 under the Exchange Act will also require an NRSRO to retain the following records: (i) the internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings; (ii) policies and procedures with respect to the procedures and methodologies used to determine credit ratings; (iii) policies and procedures with respect to credit rating symbols, numbers, or scores; and (iv) standards of training, experience, and competence for its credit analysts. In cases where the records that the NRSRO is required to retain pursuant to Rule 17g-2(a) or (b) under the Exchange Act or any other records of the NRSRO subject to examination under Section 17(b) of the Exchange Act were made in a foreign language, paragraph (f) of Rule 17g-2 under the Exchange Act requires an NRSRO to promptly furnish the SEC with English translations of those records upon request. Paragraph (c) of Rule 17g-2 under the Exchange Act requires that the records be retained for three years after the record is made or received. Effective November 14, 2014, the records documenting an NRSRO’s internal control structure, its policies and procedures with respect to look-back reviews, credit rating methodologies, and universal rating symbols, and its standards of training, experience, and competence for credit analysts must be retained until three years after the record is replaced with an updated record. Exchange Act Rule 17g-2(c) (as amended, effective November 14, 2014).

an ongoing basis. Each NRSRO must update its Form NRSRO annually and certify that the information therein, as updated, continues to be accurate.<sup>554</sup> The NRSRO Regulations also require that material changes be communicated to the SEC as they occur; an NRSRO must promptly file an amendment to its Form NRSRO if any information therein becomes materially inaccurate.<sup>555</sup>

In addition to requiring periodic updates to Form NRSRO, the NRSRO Regulations require each NRSRO to deliver annually certain financial reports and other information to the SEC.<sup>556</sup> Commencing January 1, 2015, such information will include a report containing an assessment by management of the effectiveness during the fiscal year of the internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings.<sup>557</sup> Further, the designated compliance officer at each NRSRO is required to file an annual report with the SEC discussing the NRSRO's compliance with federal securities laws and its own policies and procedures, including a description of any material changes to the code of ethics and conflict of interest policies of the NRSRO and a certification that the report is accurate and complete.<sup>558</sup>

- (b) Are CRAs whose ratings are used for regulatory purposes in the jurisdiction and located in the jurisdiction (i) supervised on an ongoing basis, (ii) subject to examination by the Regulator, and (iii) subject to enforcement of the jurisdiction's requirements?

Yes. All NRSROs, whether located in the U.S. or elsewhere, are supervised on an ongoing basis through an annual examination process and are subject to further examination and enforcement by the SEC when appropriate.<sup>559</sup>

Section 15E(p)(3) of the Exchange Act requires OCR to conduct an examination of each NRSRO at least annually. Each such examination must include, but is not limited to, a review of the following specified areas:

<sup>554</sup> Exchange Act Section 15E(b)(2); Exchange Act Rule 17g-1(f).

<sup>555</sup> Exchange Act Section 15E(b)(1); Exchange Act Rule 17g-1(e).

<sup>556</sup> Exchange Act Rule 17g-3.

<sup>557</sup> Exchange Act Rule 17g-3(a)(7) (effective January 1, 2015).

<sup>558</sup> Exchange Act Section 15E(j)(5).

<sup>559</sup> In addition to supervising NRSROs through the examination process, OCR staff conducts an ongoing monitoring program involving NRSROs. The program is designed to enhance the SEC's understanding of trends and developments in the credit rating industry generally, and with respect to specific NRSROs, thereby assisting the conduct of risk assessment and examinations, and the development of rules and policies regarding NRSROs. OCR's monitoring staff holds meetings with NRSROs, investors, issuers, and other market participants and prepares reports, studies, and memoranda relating to topics of significance to OCR's regulatory mission. Monitoring staff reviews applications for NRSRO registration and ongoing Form NRSRO submissions.

- whether the NRSRO conducts business in accordance with the policies, procedures, and rating methodologies of the NRSRO;
- the management of conflicts of interest of the NRSRO;
- implementation of ethics policies by the NRSRO;
- the internal supervisory controls of the NRSRO;
- the governance of the NRSRO;
- the activities of the designated compliance officer;
- the processing of complaints by the NRSRO; and
- the policies of the NRSRO governing the post-employment activities of former staff of the NRSRO.<sup>560</sup>

Upon completion of the annual examination, OCR examination staff discusses the results of the examination with each NRSRO and issues a letter to each NRSRO identifying any deficiencies and recommending corrective measures. The examination staff also prepares an annual public report summarizing the essential findings of the examinations, the responses of each NRSRO to any material regulatory deficiencies identified by the examinations, and whether the recommendations contained in previous public reports have been appropriately addressed.<sup>561</sup>

The annual examinations are the primary tool by which the SEC supervises NRSROs on an ongoing basis. The examinations are generally intended to monitor compliance with federal securities laws and rules, including the NRSRO Regulations, identify potential violations of such laws and rules, and recommend remedial action when appropriate. During an examination, OCR examination staff typically visits one or more of the NRSRO's offices and interviews the NRSRO's analytical personnel, senior management, compliance personnel, board of directors, business development/marketing personnel, and other personnel. OCR examination staff also reviews, among other things, documents received from the NRSRO (including internal and nonpublic documents), the Form NRSRO submissions, and public disclosures made by the NRSRO. OCR examination staff also may review TCRs sent to the SEC as well as news articles and other sources.

<sup>560</sup> Exchange Act Section 15E(p).

<sup>561</sup> Exchange Act Section 15E(p)(3)(C). See <http://www.sec.gov/news/studies/2013/nrsro-summary-report-2013.pdf> for a copy of the report from 2013. The annual public report discusses the examinations in general, without identifying the NRSROs by name.

In addition to the required annual examinations, the SEC has broad discretion to conduct examinations of NRSROs whenever it considers an examination to be “necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of [the Exchange Act].”<sup>562</sup> Pursuant to this authority, OCR examination staff may also conduct special and targeted examinations based on specifically identified risk areas and to follow up on TCRs sent to the SEC.

OCR examination staff may also refer potential violations of federal securities laws or rules to Enforcement for further investigation. In conducting its investigations, Enforcement may subpoena witnesses and require the production of records.<sup>563</sup> See also Principle 10, Questions 2(a) and 6.

Moreover, the SEC has authority to bring enforcement actions against NRSROs for possible violations of the federal securities laws, rules, and regulations.<sup>564</sup> This includes the ability to censure, place limitations on the activities, functions, or operations of, suspend, or revoke the registration of any NRSRO upon the occurrence of certain events, including the failure “to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity” or the failure “reasonably to supervise, with a view to preventing a violation of the securities laws, an individual who commits such violation.”<sup>565</sup> More broadly, the SEC is authorized to seek an injunction, civil penalty, and/or equitable relief if it appears to the SEC that there has been a violation of the Exchange Act or any of the rules or regulations thereunder.<sup>566</sup> See also Principle 11, Question 1.

<sup>562</sup> Exchange Act Section 17(b)(1).

<sup>563</sup> See, e.g., Exchange Act Section 21.

<sup>564</sup> See, e.g., Exchange Act Section 15E(d) (discussed below); 21(d) (discussed below); 21A (authorizing the imposition of civil penalties for insider trading); 21B (authorizing the imposition of civil penalties in any proceeding instituted pursuant to Section 15E of the Exchange Act); 21C (authorizing the issuance of cease-and-desist orders with respect to violations of the Exchange Act or the rules and regulations thereunder); and 32 (imposing additional penalties for willful violation of the Exchange Act and its rules and regulations). See the response to Question 3(b) for a description of a recent enforcement action against an NRSRO.

<sup>565</sup> Exchange Act Section 15E(d).

<sup>566</sup> Exchange Act Section 21(d).

*Registering Authority:*

## 3. Does the Regulator have the power to:

- (a) Refuse to register a CRA if the registration requirements have not been met, and to withdraw, suspend or condition a registration or authorization in the event of a failure of a regulated CRA to meet relevant requirements?

Yes. The SEC has the authority to deny an application for registration as an NRSRO if certain requirements are not met or if certain findings are made by the SEC. The SEC also has the authority to suspend or revoke the registration of an NRSRO.

OCR staff reviews the information included in the initial application for registration in determining whether to recommend that the SEC grant or deny such registration, and the SEC will grant registration as an NRSRO if the application for registration satisfies the requirements of the NRSRO Regulations.<sup>567</sup> The SEC is required to deny an application for registration if it finds that the applicant does not have adequate financial and managerial resources to: consistently produce credit ratings with integrity; materially comply with the procedures and methodologies that it uses in determining credit ratings; and materially comply with the NRSRO Regulations that are in place to prevent the misuse of material, nonpublic information, to manage conflicts of interest, to prohibit certain unfair, coercive or abusive practices, and to require designation of a compliance officer responsible, among other things, for ensuring compliance with the NRSRO Regulations.<sup>568</sup> The SEC also must deny an application for registration if a condition exists that would subject the applicant, if so registered, to suspension or revocation of its registration.<sup>569</sup>

The SEC has the authority to suspend or revoke the registration of an NRSRO, entirely or with respect to one or more classes of credit ratings for which the NRSRO is registered, for any of the following reasons:

- willful misstatements or omissions on Form NRSRO or any other report required to be filed with the SEC;<sup>570</sup>
- willful violation of or inability to comply with federal securities laws, willful assistance of a violation of federal securities laws, or a failure to reasonably supervise, with a view to

<sup>567</sup> Exchange Act Section 15E(a)(2)(C). See the response to Question 1(c) for details regarding the information required to be included on Form NRSRO.

<sup>568</sup> Exchange Act Section 15E(a)(2)(C). See the response to Question 4(c) for a discussion of specific disclosure items considered in evaluating the resources of an applicant/NRSRO.

<sup>569</sup> Exchange Act Section 15E(a)(2)(C). For example, in September 2010, the SEC denied an application for registration by a CRA for this reason, finding that the SEC could not conclude that the foreign applicant was able to comply with the Exchange Act's recordkeeping, production and examination requirements. See *In the Matter of the Application of Dagong Global Credit Rating Co., Ltd.*, Release No. 62968 (September 22, 2010).

<sup>570</sup> Exchange Act Section 15E(d)(1)(A); Exchange Act Section 15(b)(4)(A).



preventing such violations, a person who violates federal securities laws;<sup>571</sup>

- convictions by the NRSRO or associated persons of certain crimes;<sup>572</sup>
- the finding by a foreign financial regulatory authority of a violation of foreign securities law and certain related actions;<sup>573</sup>
- a final order of certain state or federal authorities finding a violation of law meant to prevent fraudulent, manipulative, or deceptive conduct;<sup>574</sup>
- injunction by any court of competent jurisdiction from acting as or being associated with an NRSRO;<sup>575</sup>
- failure to file the annual amendment and certification of Form NRSRO;<sup>576</sup> or
- failure to “maintain adequate financial and managerial resources to consistently produce credit ratings with integrity.”<sup>577</sup>

(b) Impose adequate measures and sanctions to address a failure of a regulated CRA to meet relevant requirements?

Yes. If an NRSRO fails to meet the relevant regulatory requirements, the SEC has the power to impose sanctions and/or take other measures to remedy such failure.

The manner in which OCR conducts its annual examinations is designed to promote compliance with the NRSRO Regulations. For instance, when OCR examination staff observes that an NRSRO may have failed to comply with the NRSRO Regulations or identifies other concerns in the course of the examination process, such as an NRSRO’s failure to comply with its internal policies, procedures, or rating methodologies, the examination staff develops recommendations, informs the NRSRO of its recommendations, and encourages the NRSRO to undertake remedial actions

<sup>571</sup> Exchange Act Section 15E(d)(1)(A), (B) and (F); Exchange Act Section 15(b)(4)(D) and (E).

<sup>572</sup> Exchange Act Section 15E(d)(1)(B); Exchange Act Section 15(b)(4)(B).

<sup>573</sup> Exchange Act Section 15E(d)(1)(A); Exchange Act Section 15(b)(4)(G).

<sup>574</sup> Exchange Act Section 15E(d)(1)(A); Exchange Act Section 15(b)(4)(H).

<sup>575</sup> Exchange Act Section 15E(d)(1)(A), (C); Exchange Act Section 15(b)(4)(C). The SEC’s authority to suspend or revoke the registration of an NRSRO also applies to an injunction by a court of competent jurisdiction from acting as or being associated with certain other financial industry positions (e.g., an investment adviser, underwriter, broker, or dealer) and entities (e.g., an investment company, bank, or insurance company).

<sup>576</sup> Exchange Act Section 15E(d)(1)(D).

<sup>577</sup> Exchange Act Section 15E(d)(1)(E). See the response to Question 4(c) for a discussion of specific disclosure items considered in evaluating the resources of an applicant/NRSRO.

to address these recommendations. An NRSRO is typically requested to submit a written response within 30 days of the final recommendations of the examination staff. The responses of each NRSRO to any material regulatory deficiencies identified during the annual examinations are summarized in the annual report with respect to such annual examinations that is prepared by the examination staff. Further, during the subsequent annual examination, OCR examination staff assesses, and summarizes in the corresponding report, whether each NRSRO appropriately addressed the recommendations received in conjunction with previous examinations. OCR examination staff has found its interaction with the NRSRO through the annual examination process to be an effective measure to address concerns regarding an NRSRO's compliance with the relevant requirements.<sup>578</sup>

As described above, OCR examination staff may refer potential violations of federal securities laws or rules to Enforcement for further investigation. As also described above, based on the outcome of the investigation, the SEC may bring an action to impose sanctions ranging from fines to suspension or revocation of registration as an NRSRO.<sup>579</sup>

For example, the SEC in April 2012 brought an enforcement action against an NRSRO and its president, charging them with violations of Sections 15E and 17(a) of the Exchange Act and the rules thereunder, in connection with willful and material misrepresentations and omissions in the NRSRO's application, pursuant to Form NRSRO, to the SEC to register as an NRSRO for issuers of ABS and issuers of government, municipal, and foreign government securities. The NRSRO consented to the SEC's order revoking its NRSRO registration with respect to issuers of ABS and issuers of government, municipal, and foreign government securities but providing for the right to re-apply for registration in these classes after 18 months. The president of the NRSRO was barred from association with any NRSRO registered in these two classes of credit ratings, with the right to apply to the SEC for re-entry after 18 months. The SEC's order required the NRSRO to complete a comprehensive review of its policies, procedures, practices, and internal controls that related to the findings set forth in the SEC's order and the findings of the 2012 examination conducted by OCR examination staff. In addition, the settlement required the NRSRO to adopt, implement, and maintain policies, procedures, practices, and internal controls that correct the issues identified in the SEC's order, the 2012 examination, and any deficiencies identified in the NRSRO's comprehensive review and to submit a report to OCR detailing the steps it took to address these issues. The settlement further required the NRSRO and its president to cease and desist from committing or causing future violations.<sup>580</sup>

<sup>578</sup> See Part IV of the 2013 examination summary report (available at <http://www.sec.gov/news/studies/2013/nrsro-summary-report-2013.pdf>) for a discussion of how the recommendations from prior examinations have been addressed.

<sup>579</sup> See the response to Question 2(b) for a discussion of specific enforcement options available to the SEC.

<sup>580</sup> *In the Matter of Egan-Jones Ratings Company and Sean Egan*, Release No. 68703 (January 22, 2013).

*Oversight Requirements: Quality and Integrity*

## 4. Does oversight of regulated CRAs incorporate requirements that address whether:

- (a) Regulated CRAs adopt and implement written procedures and methodologies designed to ensure that they (i) issue initial credit ratings based on a fair and thorough analysis of all information known to the CRA that is relevant to its analysis according to the CRA's published rating methodology, and (ii) except for credit ratings that clearly indicate they do not entail ongoing surveillance, that the regulated CRA updates credit ratings as new information becomes available according to the regulated CRA's published rating methodology for monitoring credit ratings?

Yes. NRSROs are required to disclose the procedures and methodologies used in determining and, where applicable, surveilling credit ratings. NRSROs are also required to "establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings taking into consideration such factors as the Commission may prescribe, by rule."<sup>581</sup> Recordkeeping requirements are designed to ensure that an NRSRO adheres to and properly discloses its procedures and methodologies. The registration process<sup>582</sup> and the ongoing examination of NRSROs also enable the SEC to monitor an NRSRO's ability to produce credit ratings with integrity.

In issuing credit ratings, an NRSRO is required to consider information in its possession that it finds "credible and potentially significant to a rating decision," including information it "receives from a source other than the issuer or underwriter."<sup>583</sup> Each NRSRO must also publicly disclose on Form NRSRO a description of the procedures and methodologies that it uses to determine its credit ratings.<sup>584</sup> The description "must be sufficiently detailed to provide users of credit ratings with an understanding of the processes employed by the [NRSRO] in determining credit ratings" and must include, among other things, a description of the sources of information analyzed in determining credit ratings, "the quantitative and qualitative models and metrics used to

<sup>581</sup> Exchange Act Section 15E(c)(3)(A). The SEC has prescribed by rule certain factors that, effective June 15, 2015, an NRSRO must take into consideration when establishing, maintaining, enforcing, and documenting the internal control structure. For example, with respect to establishing the internal control structure, an NRSRO will be required to take into consideration, among other things, controls reasonably designed to ensure that the NRSRO engages in analysis before commencing the rating of a class of obligors, securities, or money market instruments it has not previously rated to determine whether it has sufficient competency, access to the necessary information, and resources to rate that class. Exchange Act Rule 17g-8(d) (effective June 15, 2015). Consideration of the factors enumerated in Exchange Act Rule 17g-8(d) will provide NRSROs with an opportunity to critically evaluate the effectiveness of their existing internal control structures.

<sup>582</sup> See the responses to Question 1(c) and Question 3(a) for a discussion of the registration process.

<sup>583</sup> Exchange Act Section 15E(v).

<sup>584</sup> Exchange Act Section 15E(a)(1)(B)(ii); Exchange Act Rule 17g-1; Form NRSRO.

determine credit ratings,” and the “procedures for monitoring, reviewing and updating credit ratings, including how frequently credit ratings are reviewed.”<sup>585</sup> Effective June 15, 2015, each NRSRO will also be required to disclose certain information at the time of certain credit rating actions. Such information includes, among other things, the version of the procedure or methodology used to determine the credit rating, a description of the types of data that were relied upon for purposes of determining the credit rating, an assessment of the quality of information available and considered in determining the credit rating, an explanation or measure of the potential volatility of the credit rating, including any factors that are reasonably likely to lead to a change in the credit rating, and information on the sensitivity of the credit ratings to assumptions made by the NRSRO.<sup>586</sup> These requirements are designed to ensure that the process for determining credit rating actions, including how credit ratings are updated as new information becomes available, is disclosed to the users of credit ratings, enabling them to assess whether the process provides for a fair and thorough analysis and to understand how an NRSRO’s credit ratings will be updated over time.<sup>587</sup>

In addition, NRSROs are required to make and retain records “documenting the established procedures and methodologies used by the [NRSRO] to determine credit ratings.”<sup>588</sup> This recordkeeping requirement allows OCR examination staff to review, as part of the examination process, both whether an NRSRO is following its stated procedures and methodologies and whether such NRSRO has accurately disclosed its methodologies and procedures on Form NRSRO so that users of credit ratings can assess this information and understand how the NRSRO determines, monitors, and updates its credit ratings. This recordkeeping requirement helps promote adherence to the procedures and methodologies by the NRSRO.

Moreover, the annual examinations of NRSROs conducted by OCR examination staff include a review of whether each NRSRO “conducts its business in accordance with the policies, procedures, and rating methodologies of the [NRSRO].”<sup>589</sup> As part of this process, OCR

<sup>585</sup> Form NRSRO, instructions for Exhibit 2.

<sup>586</sup> Exchange Act Rule 17g-7(a)(1)(ii) (effective June 15, 2015).

<sup>587</sup> To further promote the integrity and transparency of the procedures and methodologies used to determine credit ratings, the SEC recently approved a new rule, which will become effective on June 15, 2015, requiring NRSROs to establish, maintain, enforce, and document certain policies and procedures with respect to the procedures and methodologies used to determine credit ratings. Such policies and procedures must be reasonably designed to ensure that: (i) the procedures and methodologies are approved by the NRSRO’s board of directors; (ii) the procedures and methodologies are developed and modified in accordance with the NRSRO’s policies and procedures; (iii) material changes to the procedures and methodologies are applied consistently to all current and future credit ratings to which the changed procedures or methodologies apply and, to the extent applicable to surveillance or monitoring procedures and methodologies, are applied to current credit ratings within a reasonable period of time; (iv) material changes to and notice of significant errors in the procedures and methodologies are promptly disclosed; and (v) the version of the procedures and methodologies used with respect to a particular credit rating is disclosed. Exchange Act Rule 17g-8(a) (effective June 15, 2015).

<sup>588</sup> Exchange Act Rule 17g-2(a)(6).

<sup>589</sup> Exchange Act Section 15E(p)(3)(B)(i).

examination staff reviews the documentation of credit rating actions for a selected number of issuers to determine whether the NRSRO followed its policies, procedures, and rating methodologies in each case. The examination staff uses a risk-based approach to determine which rating documentation to review, considering, among other things, information learned during examinations and by reviewing Form NRSRO submissions. The examination staff may also interview the analytical personnel involved in determining or reviewing certain credit ratings that it selects for review.

(b) Regulated CRAs maintain internal records to support their credit ratings?

Yes. The NRSRO Regulations require that NRSROs maintain for examination internal records of specific types of information that the SEC considers necessary to allow examination staff to review whether an NRSRO is following its stated procedures and methodologies and is otherwise complying with the NRSRO Regulations.<sup>590</sup> The records required to be retained, to the extent made or received, include:

- “internal records, including nonpublic information and work papers, used to form a basis of a credit rating;”<sup>591</sup>
- “credit analysis reports, credit assessment reports, and private credit rating reports of the [NRSRO] and internal records, including nonpublic information and work papers, forming a basis for the opinions in these reports;”<sup>592</sup> and
- both internal and external communications “that relate to initiating, determining, maintaining, monitoring, changing or withdrawing a credit rating.”<sup>593</sup>

In addition, the NRSRO Regulations require each NRSRO to make and retain certain records, including “a record documenting the established procedures and methodologies used by the NRSRO to determine credit ratings.”<sup>594</sup> The retention of records related to individual credit rating actions, and the established procedures and methodologies, provides OCR examination staff with the information necessary to ascertain whether an NRSRO is adhering to its established procedures and methodologies for determining each credit rating action.

<sup>590</sup> See Exchange Act Rule 17g-2(a) and (b). See footnote 553 for a complete list of the records required to be maintained under Rule 17g-2 under the Exchange Act.

<sup>591</sup> Exchange Act Rule 17g-2(b)(2).

<sup>592</sup> Exchange Act Rule 17g-2(b)(3).

<sup>593</sup> Exchange Act Rule 17g-2(b)(7).

<sup>594</sup> Exchange Act Rule 17g-2(a)(6). Effective June 15, 2015, NRSROs will be required to retain documentation of policies and procedures with respect to the procedures and methodologies used to determine credit ratings. Exchange Act Rule 17g-2(b)(13) (effective June 15, 2015). See footnote 587 for a description of such policies and procedures.

The NRSRO Regulations also require that records be kept to assist OCR examination staff in obtaining more information if the records discussed above prove to be insufficient. Each NRSRO must make and retain records with respect to each of its current credit ratings showing the identity of the credit analysts who participated in determining the credit rating and any other person that approved the credit rating prior to its issuance.<sup>595</sup> These records assist OCR examination staff in gathering additional information about a particular credit rating by identifying the people in a position to know how the credit rating was determined.

Further, the NRSRO Regulations require that certain records be retained to assist OCR examination staff in identifying potential issues with the credit rating process where further examination may be appropriate. Any written communication received from third parties containing complaints about the performance of a credit rating analyst must be retained by the NRSRO.<sup>596</sup> These records give OCR examination staff the opportunity to review external complaints, and how the NRSRO addresses them, and to follow up further if complaints have not been sufficiently addressed.<sup>597</sup>

Finally, the NRSRO Regulations require an NRSRO to retain external and internal communications received and sent by the NRSRO concerning the initiating, determining, maintaining, monitoring, changing, or withdrawing of a credit rating.<sup>598</sup> Among other things, this requirement enables OCR examination staff to determine whether issuers improperly influence the content of a credit rating or of the relevant press release. Additionally, for those structured finance securities where a quantitative model plays a substantial role in the determination of the credit rating, the NRSRO must make and retain “a record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued.”<sup>599</sup> It may be appropriate for an NRSRO to adjust the credit rating implied by a quantitative model based on qualitative factors identified in an NRSRO’s procedures and methodologies. The requirement to keep a record of the rationale for any such differences is designed to provide OCR examination staff with the information necessary to review these credit rating actions to check, for instance, whether undue commercial influence led to any adjustments.

<sup>595</sup> Exchange Act Rule 17g-2(a)(2).

<sup>596</sup> Exchange Act Rule 17g-2(b)(8).

<sup>597</sup> A review of the NRSRO’s processing of complaints is required as part of the annual examinations. Exchange Act Section 15E(p)(3)(B).

<sup>598</sup> Exchange Act Rule 17g-2(b)(7).

<sup>599</sup> Exchange Act Rule 17g-2(a)(2)(iii).

(c) Regulated CRAs have sufficient resources to carry out high-quality credit assessments?

Yes. The SEC has the authority to assess the resources available to an NRSRO and has the power to sanction an NRSRO if it fails to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity.<sup>600</sup>

OCR examination staff reviews certain information on Form NRSRO and the financial reports submitted by each NRSRO on an annual basis, as well as information obtained during the annual examinations of the NRSRO, in evaluating whether an NRSRO has adequate financial and managerial resources to consistently produce credit ratings with integrity. As noted in the response to Question 1(c), Form NRSRO provides relevant information to the SEC about the managerial resources of each NRSRO. An NRSRO must disclose annually the number of credit analysts and credit analyst supervisors and the required qualifications for each such role.<sup>601</sup> Effective June 15, 2015, each NRSRO must establish, maintain, enforce, and document standards of training, experience, and competence for its credit analysts that are reasonably designed to achieve the objective of producing accurate credit ratings.<sup>602</sup> This information provides OCR examination staff with an understanding of the analytical personnel devoted to the determination and supervision of credit ratings, which the examination staff uses to evaluate the managerial resources available to the NRSRO. An NRSRO must also disclose the employment history and educational background of its designated compliance officer on Form NRSRO.<sup>603</sup> The designated compliance officer is responsible for administering the policies and procedures of the NRSRO to manage conflicts of interest and ensure compliance with the securities laws and the rules and regulations thereunder.<sup>604</sup> The experience and qualifications of the designated compliance officer provide a basis for OCR examination staff to assess his or her ability to effectively carry out these responsibilities and inform the determination regarding whether the NRSRO has adequate managerial resources to consistently produce credit ratings with integrity.

OCR examination staff also considers the financial resources of each NRSRO to evaluate whether it has sufficient resources to consistently produce credit ratings with integrity. Each NRSRO is

<sup>600</sup> See the response to Questions 2(b) and 3(a) for a discussion of when sanctions can be imposed on an NRSRO and how an application for registration must be denied if the applicant has insufficient resources to issue credit ratings with integrity.

<sup>601</sup> Form NRSRO, instructions for Exhibit 8.

<sup>602</sup> Exchange Act Rule 17g-9 (effective June 15, 2015). Such standards must include a requirement for periodic testing of the individuals employed by the NRSRO to participate in the determination of credit ratings on their knowledge of the procedures and methodologies used to determine credit ratings in the classes and subclasses of credit ratings for which the individual participates in determining credit ratings, and a requirement that at least one individual with an appropriate level of experience in performing credit analysis, but not less than three years, participates in the determination of a credit rating.

<sup>603</sup> Form NRSRO, instructions for Exhibit 9.

<sup>604</sup> Exchange Act Section 15E(j).



required to provide audited financial statements for itself or its parent (and, if applicable, unaudited consolidating financial statements) with its initial application for registration and, on an ongoing basis, within 90 days of its fiscal year end.<sup>605</sup> These financial statements provide the examination staff with useful information for determining whether the NRSRO continues to have sufficient financial resources to produce credit ratings with integrity. Also relevant to such a determination and required to be provided together with such financial statements is the unaudited revenue information that specifies the amount of revenue generated from determining and maintaining credit ratings<sup>606</sup> and the total aggregate and mean annual compensation of the NRSRO's credit analysts.<sup>607</sup>

*Oversight Requirements: Conflicts of Interest*

5. Does oversight of regulated CRAs incorporate requirements that address whether:

- (a) Regulated CRA credit rating decisions are independent and free from political or economic pressures and from conflicts of interest arising due to the regulated CRA's ownership structure, business or financial activities, securities or derivatives trading, or the financial interests of the regulated CRA's employees (including securities and derivatives trading by the employees and their compensation arrangements)?

Yes. In order to help promote independent credit rating decisions, the NRSRO Regulations require each NRSRO to establish policies and procedures to manage certain conflicts of interest and prohibit NRSROs from having other conflicts of interest. Further, Section 15E(c)(2) of the Exchange Act provides, in pertinent part, that the SEC may not regulate "the substance of credit ratings or the procedures and methodologies by which any [NRSRO] determines credit ratings."<sup>608</sup>

OCR examination staff reviews an NRSRO's procedures and methodologies to examine whether they are accurately disclosed and followed, and free from conflicts of interest, but does not examine the substance of the credit ratings or their underlying methodologies. NRSROs also are prohibited from representing or implying in any manner whatsoever that they have been designated, sponsored, recommended, or approved, or that their abilities or qualifications have in any respect been passed upon by the U.S. or any agency, officer, or employee thereof.<sup>609</sup>

The Exchange Act also requires each NRSRO to "establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of the business of

<sup>605</sup> Exchange Act Section 15E(k); Exchange Act Rule 17g-3(a)(1) and (2).

<sup>606</sup> Exchange Act Rule 17g-3(a)(3).

<sup>607</sup> Exchange Act Rule 17g-3(a)(4).

<sup>608</sup> Exchange Act Section 15E(c)(2).

<sup>609</sup> Exchange Act Section 15E(f).



such [NRSRO and affiliated persons thereof], to address and manage any conflicts of interest that can arise from such business.”<sup>610</sup> The Exchange Act required the SEC to adopt rules to prohibit or require the management of conflicts of interest related to the issuance of credit ratings.<sup>611</sup> Pursuant to that mandate, the SEC has adopted two categories of rules: one category prohibits outright certain conflicts of interest that the SEC has determined would be difficult to manage because of the risk that they could cause undue influence,<sup>612</sup> and the other category requires certain conflicts of interest to be publicly disclosed and managed.<sup>613</sup>

More specifically, the NRSRO Regulations prohibit NRSROs from having the following conflicts of interest:

- issuing a credit rating solicited by a person that provided the NRSRO with 10% or more of its total net revenue in its most recently ended fiscal year;<sup>614</sup>
- issuing a credit rating with respect to which the related fee was negotiated, discussed, or arranged by a person within the NRSRO who has responsibility for participating in determining credit ratings or developing or approving the related procedures and methodologies;
- issuing a credit rating for an affiliate of the NRSRO;
- issuing a credit rating with respect to a security where the NRSRO or its affiliate made recommendations “about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security;”
- issuing a credit rating for a person where the NRSRO directly owns securities of the person that would be subject to the credit rating;
- issuing a credit rating for a person where an employee of the NRSRO that participated in determining, or is responsible for approving, the credit rating directly owns securities of the person that would be subject to the credit rating;

<sup>610</sup> Exchange Act Section 15E(h)(1).

<sup>611</sup> Exchange Act Section 15E(h)(2).

<sup>612</sup> See Exchange Act Rule 17g-5(c).

<sup>613</sup> See Exchange Act Rule 17g-5(b).

<sup>614</sup> The SEC has granted temporary and conditional exemptions, which will expire on January 1, 2015, from the 10% cap on revenues from any one client pursuant to Exchange Act Rule 17g-5(c)(1) to two smaller NRSROs, finding, among other things, that such an exemption is consistent with the goal of improving ratings quality by fostering accountability, transparency, and competition in the credit rating industry. Both NRSROs have stated in writing their plans to diversify and expand their respective businesses.

- issuing a credit rating for a person where an employee of the NRSRO that participated in determining, or is responsible for approving, the credit rating is an officer or director of the person that would be subject to the credit rating;
- issuing or maintaining a credit rating where an employee of the NRSRO that participated in determining or monitoring the credit rating or is responsible for approving the credit rating received gifts valued over \$25 from the person being rated; and
- effective June 15, 2015, issuing or maintaining a credit rating where a person within the NRSRO who participates in determining or monitoring the credit rating, or developing or approving procedures or methodologies used for determining the credit rating, including qualitative and quantitative models, also (i) participates in sales or marketing of a product or service of the NRSRO or a product or service of an affiliate of the NRSRO or (ii) is influenced by sales or marketing considerations.<sup>615</sup>

The SEC recognizes that certain other conflicts of interest related to the NRSRO's business may arise and the NRSRO Regulations do not prohibit them but require that they be managed. Thus, the following conflicts of interest are permissible only if the NRSRO has publicly disclosed them and has implemented written policies and procedures to address and manage them:

- being paid by obligors, issuers, sponsors of ABS, or underwriters to determine credit ratings for such entities or the securities they issue, sponsor, or underwrite or being paid for other services offered by the NRSRO;
- being paid by subscribers to receive access to credit ratings or other services if such subscribers may use the NRSRO's credit ratings to comply with, and obtain benefits or relief under, statutes or regulations using the term "nationally recognized statistical rating organization" or if such subscribers may own investments or have entered into transactions that could be impacted by a credit rating issued by the NRSRO;
- allowing persons within the NRSRO to have an ownership interest in rated obligors or securities or to have business relationships that are more than arm's length, ordinary course relationships with such obligors or the issuers of such securities; and
- having an affiliate that is a broker or dealer engaged in underwriting activities.

Finally, the NRSRO Regulations require each NRSRO to have policies and procedures in place to provide for an internal review process ("look-back review") in order to determine whether any conflict of interest of a former employee influenced a credit rating action in certain instances. A review is required if a former employee is subsequently employed by an entity rated by the

<sup>615</sup>

Exchange Act Rule 17g-5(c)(8) (effective June 15, 2015).

NRSRO (or by an issuer, underwriter, or sponsor with respect to a security rated by the NRSRO) and the former employee participated in the determination of a credit rating action during the one-year period preceding the date of such credit rating action.<sup>616</sup> OCR examination staff reviews these policies and procedures annually and whenever they are materially modified “to ensure that they are reasonably designed and implemented to most effectively eliminate conflicts of interest.”<sup>617</sup>

- (b) Regulated CRAs (1) identify, and (2) eliminate, or manage and disclose, as appropriate, any actual or potential conflicts of interest that may influence (i) the opinions and analyses regulated CRAs make or (ii) the judgment and analyses of the individuals the regulated CRAs employ who have an influence on ratings decisions?

Yes. As discussed in the response to Question 5(a), certain conflicts of interest are prohibited and others must be identified, managed, and disclosed by the NRSRO. The NRSRO Regulations also require that each NRSRO maintain and enforce written policies and procedures to address and manage any conflict of interest relating to the issuance of credit ratings that is material to an NRSRO.<sup>618</sup>

Each NRSRO must disclose all conflicts of interest that are material to it.<sup>619</sup> However, rather than leave the determination of what constitutes a material conflict of interest entirely to the discretion of the NRSROs, the SEC has specifically identified certain conflicts of interest that commonly arise in the credit rating business and has required each NRSRO to maintain and enforce written policies and procedures to address and manage these conflicts to the extent applicable to such NRSRO.<sup>620</sup> The conflicts of interest identified by the SEC to be managed if applicable to an NRSRO are as follows:

- being paid by obligors, issuers, sponsors of ABS, or underwriters to determine credit

<sup>616</sup> Exchange Act Section 15E(h)(4)(A). Effective June 15, 2015, such policies and procedures must address instances in which such a review determines that a conflict of interest influenced a credit rating by including, at a minimum, procedures reasonably designed to ensure that the NRSRO will promptly determine whether the credit rating must be revised so that it is no longer influenced by a conflict of interest and is solely a product of the documented procedures and methodologies the NRSRO uses to determine credit ratings; and promptly publish a revised credit rating or affirmation of the credit rating, as appropriate. The procedures must also be reasonably designed to ensure that, if the credit rating is not revised or affirmed within 15 calendar days of the date of the discovery that the credit rating was influenced by a conflict of interest, the NRSRO publishes a credit rating action placing the credit rating on watch or review and includes with such publication an explanation that the reason for the credit rating action is the discovery that the credit rating was influenced by a conflict of interest. Exchange Act Rule 17g-8(c) (effective June 15, 2015).

<sup>617</sup> Exchange Act Section 15E(h)(4)(B).

<sup>618</sup> Exchange Act Rule 17g-5(a)(2) and (b)(10).

<sup>619</sup> See Form NRSRO, instructions for Exhibit 6.

<sup>620</sup> Exchange Act Rule 17g-5(a)(2) and (b).

ratings for such entities or the securities they issue, sponsor, or underwrite or for other services offered by the NRSRO;

- being paid by subscribers to receive access to credit ratings or other services if such subscribers may use the NRSRO's credit ratings to comply with, and obtain benefits or relief under, statutes or regulations using the term "nationally recognized statistical rating organization" or if such subscribers may own investments or have entered into transactions that could be impacted by a credit rating issued by the NRSRO;
- allowing persons within the NRSRO to have an ownership interest in rated obligors or securities or to have business relationships that are more than arm's length, ordinary course relationships with such obligors or the issuers of such securities; and
- having an affiliate that is a broker or dealer engaged in underwriting activities.<sup>621</sup>

The annual examinations of each NRSRO conducted by OCR are required to include a review of the NRSRO's management of conflicts of interest.<sup>622</sup> In addition to the disclosure of the conflicts of interest and the related policies and procedures on Form NRSRO,<sup>623</sup> the NRSRO Regulations mandate certain record retention policies designed to ensure adequate information is available to the examiners to determine whether conflicts of interest are being properly managed. NRSROs are required to retain a record of each person who has paid for a credit rating and who has subscribed for a credit rating or credit rating analysis.<sup>624</sup> The twenty largest issuers, subscribers, obligors, and underwriters by revenue are also required to be identified to the SEC annually.<sup>625</sup> This information allows examiners to identify persons that have paid for a large number of credit ratings and may therefore be in a position to exert influence upon the NRSRO. The NRSRO is also required to keep records of the general types of products and services it offers,<sup>626</sup> which can be useful in identifying any potential conflicts of interest that can arise from activities ancillary to an NRSRO's credit rating business. Other information required to be retained by the NRSRO may also assist in the examination of an NRSRO's management of conflicts of interest.<sup>627</sup> For example, both internal and external communications related to the rating process are required to be retained,<sup>628</sup> which could potentially identify any influence

<sup>621</sup> Exchange Act Rule 17g-5(b).

<sup>622</sup> Exchange Act Section 15E(p)(3)(B)(ii). See the response to Questions 2(a) and 2(b) for a discussion of the examination process.

<sup>623</sup> See the response to Question 5(c) for a discussion of these disclosure requirements.

<sup>624</sup> Exchange Act Rule 17g-2(a)(3) and (4).

<sup>625</sup> Exchange Act Rule 17g-3(a)(5).

<sup>626</sup> Exchange Act Rule 17g-2(a)(5).

<sup>627</sup> See footnote 553 for a complete list of the records required to be maintained under Rule 17g-2 under the Exchange Act.

<sup>628</sup> Exchange Act Rule 17g-2(b)(7).

exerted by clients or otherwise by internal sources (e.g., with respect to sales or marketing considerations).

(c) Regulated CRAs disclose actual and potential conflicts of interest arising from the nature of compensation arrangements for producing credit ratings?

Yes. NRSROs are required to publicly disclose actual and potential conflicts of interest on Form NRSRO, including those conflicts arising from the nature of compensation arrangements for producing credit ratings.

The SEC has identified specific conflicts of interest that generally arise from the business of issuing credit ratings, including conflicts relating to credit ratings paid for by the entities being rated (i.e., issuer-paid ratings) or by subscribers who stand to benefit by certain credit rating actions (i.e., subscriber-paid ratings).<sup>629</sup> In particular, the SEC has specified in the NRSRO Regulations that a conflict of interest exists if an NRSRO is paid by obligors, issuers, sponsors of ABS, or underwriters to determine credit ratings for such entities or the securities they issue, sponsor, or underwrite or for other services offered by the NRSRO,<sup>630</sup> or if an NRSRO is paid by subscribers to receive access to credit ratings or other services if such subscribers obtain benefits from the regulatory use of credit ratings or have entered into transactions that could be impacted by a credit rating issued by the NRSRO.<sup>631</sup> The instructions for Form NRSRO list these potential conflicts of interest and require the NRSRO to disclose such conflicts to the extent they apply to its business.<sup>632</sup> Each NRSRO is also required to disclose on Form NRSRO the written policies and procedures maintained and enforced by the NRSRO to manage the conflicts of interest that apply to it.<sup>633</sup> Each NRSRO must update its Form NRSRO annually and certify that the information therein, as updated, continues to be accurate<sup>634</sup> and also must promptly file an amendment to its Form NRSRO if any information therein becomes materially inaccurate.<sup>635</sup>

Effective June 15, 2015, each NRSRO is also required to disclose information relating to conflicts of interest of the NRSRO when taking certain credit rating actions. In particular, an NRSRO will be required to disclose the source of payment for its fees, if applicable, with respect to the credit

<sup>629</sup> Exchange Act Rule 17g-5(b)(1)-(5) and (9). See the response to Question 5(a) and Question 5(b) for more details regarding the conflicts of interest identified by the SEC.

<sup>630</sup> Exchange Act Rule 17g-5(b)(1), (2), (3) and (9).

<sup>631</sup> Exchange Act Rule 17g-5(b)(4) and (5).

<sup>632</sup> Form NRSRO, instructions for Exhibit 6. As discussed in the response to Question 5(b), an NRSRO is also required to disclose any other conflict of interest material to its business, even if it has not been specifically identified in the instructions for Form NRSRO.

<sup>633</sup> Form NRSRO, instructions for Exhibit 7.

<sup>634</sup> Exchange Act Section 15E(b)(2); Exchange Act Rule 17g-1(f).

<sup>635</sup> Exchange Act Section 15E(b)(1); Exchange Act Rule 17g-1(e).

rating and whether the NRSRO was paid for any other services provided during the most recently ended fiscal year to the person paying for the credit rating.<sup>636</sup>

*Oversight Requirements: Transparency and Timeliness*

6. Does oversight of regulated CRAs incorporate requirements that address whether:
- (a) Regulated CRAs distribute their credit ratings in a timely manner?

Yes. Oversight of NRSROs addresses whether NRSROs distribute their credit ratings in a timely manner.

The NRSRO Regulations require each NRSRO to maintain and enforce written policies and procedures reasonably designed to prevent the inappropriate dissemination of a pending credit rating action before issuing the credit rating on the Internet or through another readily accessible means.<sup>637</sup> As applicable to the business model of the NRSRO, these policies may include procedures designed to ensure that a credit rating action is issued in a way that makes it readily accessible to the market place, such as posting the credit rating or an announcement of the credit rating action on the NRSRO's website or through a news or information service used by market participants or making it available to all subscribers simultaneously.

As part of the annual examinations of the NRSROs conducted by OCR, OCR examination staff reviews whether the NRSROs have adequate policies and procedures and internal controls to prevent the inappropriate dissemination of a pending credit rating action and whether the NRSROs are adhering to their established policies and procedures regarding dissemination of credit ratings. Among other things, the examination staff considers requirements with respect to the timely dissemination of credit ratings when assessing the adequacy of such policies and procedures and internal controls. In past examinations, OCR examination staff has made recommendations to several NRSROs to ensure prompt release and dissemination of credit rating actions in accordance with their policies.<sup>638</sup>

- (b) Regulated CRAs disclose credit ratings on a non-selective basis?

Yes. SEC oversight of NRSROs includes requirements that address whether NRSROs disclose credit ratings on a non-selective basis.

The NRSRO Regulations require each NRSRO to maintain and enforce written policies and

<sup>636</sup> Exchange Act Rule 17g-7(a)(1)(ii)(J) (effective June 15, 2015).

<sup>637</sup> Exchange Act Rule 17g-4(a)(3). This rule was adopted pursuant to the mandate in the Exchange Act that each NRSRO maintain and enforce policies and procedures reasonably designed to prevent the misuse of material, nonpublic information by the NRSRO. Exchange Act Section 15E(g).

<sup>638</sup> See Part V.D.4 of the 2012 examination summary report (available at <http://www.sec.gov/news/studies/2012/nrsro-summary-report-2012.pdf>).

procedures reasonably designed to prevent the inappropriate dissemination of a pending credit rating action before issuing the credit rating on the Internet or through another readily accessible means.<sup>639</sup> As discussed in the response to Question 6(a) above, these policies may include procedures designed to ensure that a credit rating action is issued in a way that makes it readily accessible to the market place.<sup>640</sup> Further, when an NRSRO discusses pending credit rating actions with the management of the rated entity, its procedures will need to be reasonably designed to limit the selective disclosure to the appropriate persons within the rated entity in order to comply with this rule.

The NRSRO Regulations also require each NRSRO to “establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings.”<sup>641</sup> OCR is required to examine each NRSRO’s internal supervisory controls on an annual basis.<sup>642</sup> As detailed in the recent report on the annual NRSRO examinations, OCR examination staff observed weaknesses in these controls as they relate to the policies and procedures designed to prevent the inappropriate dissemination of a pending credit rating action before it is distributed on the NRSRO’s website or another readily accessible means. OCR examination staff made recommendations to the applicable NRSROs regarding improvements to their procedures in this regard.<sup>643</sup>

- (c) Regulated CRAs publish sufficient information about their procedures, methodologies and assumptions so that outside parties can understand how a rating was arrived at by the regulated CRA, and the attributes and limitations of such a rating?

Yes. NRSROs are required to publish a description of their procedures and methodologies so that outside parties can understand how a credit rating was determined and the attributes and limitations of each NRSRO’s credit ratings.

<sup>639</sup> Exchange Act Rule 17g-4(a)(3).

<sup>640</sup> In the case of an NRSRO that issues credit ratings under the subscriber-pays business model, such credit ratings will only be disseminated to subscribers. However, in order to be an NRSRO, an entity must issue credit ratings through a readily accessible means for free or for a reasonable fee. See Exchange Act Sections 3(a)(61) and (62). Each NRSRO is required to publicly disclose on Form NRSRO a brief description of how it issues its credit ratings. Form NRSRO, Item 6. This information will inform the public about where, and at what cost, an NRSRO’s credit ratings may be accessed.

<sup>641</sup> Exchange Act Section 15E(c)(3)(A).

<sup>642</sup> Exchange Act Section 15E(p)(3)(B)(iv). See the response to Questions 2(a) and 2(b) for a discussion of the examination process.

<sup>643</sup> See Part V.D.5 of the 2013 examination summary report (available at <http://www.sec.gov/news/studies/2013/nrsro-summary-report-2013.pdf>).

Each NRSRO must publicly disclose on Form NRSRO a description of the procedures and methodologies that it uses to determine its credit ratings.<sup>644</sup> The description “must be sufficiently detailed to provide users of credit ratings with an understanding of the processes employed by the [NRSRO] in determining credit ratings.”<sup>645</sup> Specifically, the disclosure must include, among other things:

- a description of the sources of information used in determining credit ratings;
- how information about verification performed with respect to the collateral backing a structured finance product is relied upon in determining credit ratings;
- how the quality of originators of assets underlying structured finance products factor into the determination of credit ratings;
- the quantitative and qualitative models and metrics used to determine credit ratings;
- the procedures for interacting with management at the rated entity;
- the structure and voting process of the NRSRO’s credit rating committees;
- the procedures for monitoring, reviewing, and updating credit ratings, including how frequently credit ratings are reviewed; and
- the procedures to withdraw a credit rating or suspend maintenance of a credit rating.<sup>646</sup>

These specific items are designed to provide users of credit ratings with useful information to understand how an NRSRO produces credit ratings and to provide a basis for comparing NRSROs. Certain of the required items allow users of credit ratings to understand any limitations of a given credit rating. For instance, the extent to which an NRSRO verifies information (*e.g.*, value of the property or income of the borrower) about the assets underlying a structured finance product will be useful to users of credit ratings in assessing the potential for an NRSRO’s credit ratings to be adversely impacted by inaccurate information about the underlying assets. Additionally, information regarding the process for monitoring and maintaining credit ratings after they are issued allows users of credit ratings to assess any limitations on the accuracy of the credit ratings over time.

<sup>644</sup> Exchange Act Section 15E(a)(1)(B)(ii); Exchange Act Rule 17g-1; Form NRSRO.

<sup>645</sup> Form NRSRO, instructions for Exhibit 2.

<sup>646</sup> Form NRSRO, instructions for Exhibit 2.



As noted above, the instructions for Form NRSRO identify specific items that an NRSRO may address in its procedures, and these must be disclosed to the extent applicable. However, the list of items identified in the instructions is not exhaustive, and each NRSRO is required to disclose a description that is “sufficiently detailed to provide users of credit ratings with an understanding of the processes employed by the [NRSRO] in determining credit ratings.”<sup>647</sup> The NRSRO Regulations also require NRSROs to retain certain records supporting various credit rating actions and with respect to the development of its methodologies to ensure that OCR examination staff has adequate information to review whether an NRSRO has sufficiently described its methodologies and procedures on Form NRSRO.<sup>648</sup>

Each NRSRO is also required to make additional disclosures regarding the general attributes of its credit ratings, by defining the credit rating categories, notches, grades, and rankings it uses.<sup>649</sup> This information is designed to allow users of credit ratings to understand what an NRSRO’s ratings symbols represent.

Effective June 15, 2015, each NRSRO is required to disclose certain information about its procedures, methodologies, and assumptions when taking certain credit rating actions. Such information includes, among other things, the version of the procedure or methodology used to determine the credit rating; the main assumptions and principles used in constructing the procedures and methodologies used to determine credit ratings, including qualitative methodologies and quantitative inputs; the potential limitations of the credit rating, including the types for risks excluded from the credit rating; information regarding the uncertainty of the credit rating, including information on the reliability of the data relied on in determining the credit rating; an explanation or measure of the potential volatility of the credit rating, including any factors that are reasonably likely to lead to a change in the credit rating; and information on the sensitivity of the credit rating to assumptions made by the NRSRO.<sup>650</sup>

Finally, the examination of an NRSRO by OCR examination staff generally includes an assessment of whether the NRSRO has sufficient policies and procedures and internal controls concerning publication of credit ratings and related analysis. Moreover, as discussed in the response to Question 4(a) above, during examinations, OCR examination staff will review documentation of the credit ratings for a selected number of issuers. Generally, the review of these credit rating actions includes assessing whether the NRSRO adequately explains the primary basis and limitations of the NRSRO’s analysis and credit ratings.

<sup>647</sup> Form NRSRO, instructions for Exhibit 2.

<sup>648</sup> Exchange Act Rule 17g-2(a) and (b). See the response to Question 4(a) for a discussion of how the examination process is used to monitor the accuracy and completeness of the required disclosure and more details regarding the information available to the examiners for such purpose.

<sup>649</sup> Form NRSRO, instructions for Exhibit 1.

<sup>650</sup> Exchange Act Rule 17g-7(a)(1)(ii) (effective June 15, 2015).

(d)	Regulated CRAs publish sufficient information about the historical default rates of their credit ratings so that interested parties can understand the historical performance of their credit ratings?
<p>Yes. NRSROs are required to publish information about the historical transition and default rates of their credit ratings so that interested parties can understand the historical performance of their credit ratings.</p> <p>The NRSRO Regulations require each NRSRO to publicly disclose performance measurement statistics with respect to its credit ratings, including ratings transition and default rates within each of the credit rating categories used by the NRSRO.<sup>651</sup> These performance measurement statistics must include historical credit ratings transition and default rates, showing the changes in the credit ratings assigned to obligors and securities over 1-, 3-, and 10-year periods through the most recent calendar year end. The data are required to be provided separately for each class and certain subclasses of credit ratings for which the NRSRO is registered so that interested parties can focus on the information relevant to them.</p> <p>Amendments to the instructions for Exhibit 1 to Form NRSRO, effective January 1, 2015, standardize the production and presentation of the performance measurement statistics, in order to allow users of credit ratings to compare the performance of credit ratings across NRSROs and provide a standardized definition of default for purposes of calculating the default statistics. The amendments also require statistics to be produced for subclasses of structured finance products and for credit ratings where the obligation was paid off or the credit rating was withdrawn for reasons other than a default or the obligation being paid off.<sup>652</sup></p> <p>In addition, under the enhanced credit rating history disclosure requirements effective June 15, 2015, an NRSRO, among other things, is generally required to publicly disclose data necessary to generate statistical information, including default statistics, about the performance of an NRSRO's credit ratings.<sup>653</sup></p>	
<i>Oversight Requirements: Confidential Information</i>	
7.	Does oversight of regulated CRAs incorporate requirements that address whether CRAs protect nonpublic information:
(a)	provided by issuers so that such information is only used for the purposes related to their rating activities; and
<p>Yes. The NRSRO Regulations require NRSROs to take steps to address the protection of nonpublic information provided by issuers so that such information is only used for credit rating</p>	

<sup>651</sup> Exchange Act Section 15E(a)(1)(B)(i); Form NRSRO, instructions for Exhibit 1.

<sup>652</sup> See Form NRSRO, instructions for Exhibit 1 (as amended, effective January 1, 2015).

<sup>653</sup> Exchange Act Rule 17g-7(b) (effective June 15, 2015).

activity purposes. The NRSRO Regulations require each NRSRO to maintain and enforce written policies and procedures reasonably designed to prevent “the inappropriate dissemination within or outside the [NRSRO] of material, nonpublic information obtained in connection with the performance of credit rating services.”<sup>654</sup> The NRSRO Regulations also require that each NRSRO publicly disclose those policies and procedures on Form NRSRO.<sup>655</sup> OCR is required to examine annually each NRSRO’s internal supervisory controls,<sup>656</sup> and OCR examination staff examines policies and procedures with respect to the protection of nonpublic information as part of such examinations.

(b) with respect to pending rating actions?

Yes. The NRSRO Regulations require NRSROs to take steps to address the protection of nonpublic information with respect to pending credit rating actions.

The NRSRO Regulations require each NRSRO to maintain and enforce written policies and procedures reasonably designed to prevent the inappropriate dissemination of a pending credit rating action before issuing the credit rating on the Internet or through another readily accessible means.<sup>657</sup> The NRSRO Regulations also require that each NRSRO publicly disclose those policies and procedures on Form NRSRO.<sup>658</sup> The OCR is required to examine annually each NRSRO’s internal supervisory controls,<sup>659</sup> and OCR examination staff examines policies and procedures with respect to the protection of nonpublic information as part of such examinations.

<sup>654</sup> Exchange Act Rule 17g-4(a)(1). This rule was adopted pursuant to the mandate in the Exchange Act that each NRSRO maintain and enforce policies and procedures reasonably designed to prevent the misuse of material, nonpublic information by the NRSRO. Exchange Act Section 15E(g).

<sup>655</sup> Exchange Act Section 15E(a)(1)(B)(iii) and (a)(3); Form NRSRO, instructions for Exhibit 3.

<sup>656</sup> Exchange Act Section 15E(p)(3)(B)(iv). See the response to Questions 2(a) and 2(b) for a discussion of the examination process.

<sup>657</sup> Exchange Act Rule 17g-4(a)(3). See the response to Question 6(a) and Question 6(b) for more information regarding this rule and how the SEC monitors compliance thereof.

<sup>658</sup> Exchange Act Section 15E(a)(1)(B)(iii) and (a)(3); Form NRSRO, instructions for Exhibit 3.

<sup>659</sup> Exchange Act Section 15E(p)(3)(B)(iv). See the response to Questions 2(a) and 2(b) for a discussion of the examination process.

**Principle 23: Other entities that offer investors analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them.**

### Key Questions

1. Does the regulator periodically consider whether the different types of entities that provide analytical or evaluative services warrant regulation and oversight because of the impact of their activities on the market or because of the degree to which the regulatory system relies on them?

Yes. The SEC and the SROs which it oversees (collectively U.S. Broker-Dealer Regulatory Agencies) do periodically consider whether entities, other than auditors and NRSROs,<sup>660</sup> that provide analytical or evaluative services warrant regulation and oversight tailored to such services, specifically regarding research analysts associated with broker-dealers.<sup>661</sup>

For instance, the Staff stays abreast of developments in the research analyst area primarily by conducting examinations of broker-dealers that produce research; consulting with other U.S. Broker-Dealer Regulatory Agencies regarding the results of their examinations; conducting enforcement investigations; and meeting with interested parties, such as independent analysts and broker-dealers. These activities help identify issues that may require a regulatory response, including bringing enforcement actions when appropriate. For example, in 2012 the SEC charged that a broker-dealer lacked adequate policies and procedures to address the risk that during weekly “huddles” the broker-dealer’s analysts could share material, nonpublic information about upcoming research changes. The broker-dealer settled these charges.<sup>662</sup>

2. Where the regulator identifies the need for regulation and oversight, is the regulation and oversight put into place appropriate to the risks posed by these types of entities?

Yes. In 2002, the SEC, along with other U.S. regulators, began an investigation into the undue influence of investment banking interests on securities research at brokerage firms. These investigations led to settlements with twelve of the leading U.S. broker-dealers (the Global Settlement), which highlighted concerns that conflicts of interest affected the objectivity of research provided to investors. These concerns prompted a number of regulatory responses.

<sup>660</sup> An extensive discussion of the regulation of auditors can be found in response to Principle 19; the same for NRSROs can be found in the response on Principle 22.

<sup>661</sup> Other entities that may provide analytical or evaluative services such as the press or independent research analysts not associated with broker-dealers are not regulated by the SEC. However, the SEC does have anti-fraud authority over such entities which it exercises as appropriate. The provision of analytical or evaluative services may implicate a person’s status as an investment adviser under the Advisers Act. Please see response to Principle 31.6 with respect to an investment adviser’s fiduciary duties under the Advisers Act.

<sup>662</sup> See Exchange Act Release No. 66791 (Apr. 12, 2014).

For instance, in response to concerns about the integrity of research reports and investor confidence in those reports, the SEC adopted Regulation AC (17 C.F.R. 242.500-505). This Regulation requires that research analysts certify that the views they express in their reports accurately reflect their personal views. Research reports also must disclose whether or not the analyst received compensation or other payments in connection with his or her specific recommendations or views. Broker-dealers are also required to obtain periodic certifications of the same items by research analysts in connection with the analyst's public appearances.

Further, the Global Settlement, still partly in force today,<sup>663</sup> required a number of structural changes at the settling firms, such as information barriers between research analysts and investment bankers. Additionally, the U.S. Broker-Dealer Regulatory Agencies have adopted rules regulating research analyst conflicts of interest in order to improve the objectivity of research and provide investors with more useful and reliable information. These rules are detailed extensively in Question 3, below.

The process of calibrating the regulatory framework to evolving market practice is an ongoing part of the SEC mission of investor protection. For example, the U.S. Broker-Dealer Regulatory Agencies are preparing a new research conflicts of interest rule to address concerns identified in the provision of fixed income research.<sup>664</sup>

3. With respect to sell-side securities analysts:

(a) Does regulation contain provisions directed at eliminating, avoiding, managing or disclosing conflicts of interest that can arise from:

(i) Analysts' trading activities or financial interests?

(ii) The trading activities or financial interests of the entities that employ them?

(iii) The business relationships of the entities that employ them?

(iv) The reporting lines for analysts and their compensation arrangements?

Yes. There are regulations in place to address the conflicts covered in Question 2(a)(i) through (iv). In 2003, the SEC adopted Regulation AC to address concerns regarding conflicts of interest. Regulation AC is complemented by other U.S. Broker-Dealer Regulatory Agencies rules aimed at managing analyst conflicts at broker-dealers.

<sup>663</sup> In 2010, the Global Settlement was amended to remove requirements that were duplicative of U.S. Broker-Dealer Regulatory Agency rule requirements. Under the court approved amendments, other key provisions remain in force, including the requirement that firms implement information barriers to prevent prohibited communications between research and investment banking. Among other things, investment bankers are not allowed to discuss proposed transactions or companies that may be potential candidates for transactions with research analysts without a chaperone from the firm's legal or compliance personnel present.

<sup>664</sup> See, e.g., FINRA Regulatory Notice 12-42 (Oct. 2012) available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p187303.pdf>.

As noted in the response to Question 2, above, Regulation AC requires that broker-dealers include in research reports a statement by the analyst certifying that the views expressed in the report accurately reflect his or her personal views and disclosing whether his or her compensation was, or will be, directly or indirectly, related to the specific recommendations or views in the research report. In addition, Regulation AC requires broker-dealers to obtain periodic certifications by analysts in connection with the analyst's public appearances. By requiring these certifications and disclosures, Regulation AC helps to promote the integrity of research and investor confidence in such research.

Section 15D(a) of the Exchange Act (15 U.S.C. 78o-6(a)) requires that the U.S. Broker-Dealer Regulatory Agencies adopt rules reasonably designed to address conflicts that can arise when analysts recommend equity securities in research reports and public appearances in order to, among other things: (i) improve the objectivity of research, (ii) provide reliable information to investors, (iii) foster public confidence in research, and (iv) protect the objectivity and independence of analysts. Section 15D(b) requires, among other things, the adoption of rules reasonably designed to require disclosures of certain conflicts in research reports and analyst public appearances.

In addition, the U.S. Broker-Dealer Regulatory Agencies have adopted rules designed to address equity analyst conflicts of interests (NASD Rule 2711 and NYSE Rule 472). These rules address conflicts of interest that can arise when analysts work at firms that have investment banking or other business relationships with issuers. These rules also address conflicts of interest that can arise when the analyst or the firm owns securities of an issuer that the analyst covers. In particular, the SRO rules contain provisions concerning trading activities, financial interests, business relationships, reporting lines, and compensation, as well as other items, in a manner designed to increase an analyst's independence and manage conflicts.

These rules also place various restrictions on an analyst's personal trading.<sup>665</sup> The provisions in these rules are intended to help ensure that research is not influenced by the prospect of the analyst's personal enrichment. For example, the rules restrict the analyst and his or her household members from purchasing or receiving any securities before an issuer's IPO if the issuer is principally engaged in the same type of business as companies that the analyst follows.<sup>666</sup> In addition, these rules contain provisions that generally restrict an analyst and his or her household members from trading in any securities of an issuer that the analyst follows during certain periods before and after the publication of a research report and from trading in a manner inconsistent with the analyst's most recent published recommendation regarding that security.<sup>667</sup>

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<sup>665</sup> *E.g.*, NASD Rule 2711(g).

<sup>666</sup> *E.g.*, NASD Rule 2711(g)(1).

<sup>667</sup> *E.g.*, NASD Rule 2711(g)(2)-(3).

These rules require prior approval by legal or compliance personnel of certain transactions by persons who oversee research analysts.<sup>668</sup>

In addition to trading restrictions, these rules place substantial disclosure obligations on member firms and analysts.<sup>669</sup> The first category of disclosure obligations is in relation to conflicts of interest arising out of ownership interests, including:

- the nature and amount of a financial interest in the securities of the subject company held by the analyst or a member of his or her household (including any option, right, warrant, future, or long or short position),<sup>670</sup> and
- ownership by the member firm or one of its affiliates of 1% or more of the subject company's equity securities.<sup>671</sup>

These rules also require disclosure if an analyst or his or her household member serves as an officer, director, or advisory board member of the subject company.<sup>672</sup> These rules further require disclosure in research reports if the firm was making a market in the subject company's securities at the time a research report was published.<sup>673</sup>

In addition, these rules generally require various disclosures in research reports regarding investment banking business and compensation as well as other activities. For example, they require that a firm disclose in a research report if:

- the analyst received compensation based upon the firm's investment banking business or from the subject company in the past 12 months;<sup>674</sup>
- the firm or its affiliates (i) managed or co-managed a public offering of securities for the subject company in the past 12 months; (ii) received compensation for investment banking services from the subject company in the past 12 months; or (iii) expects to receive or intends to seek compensation for investment banking services from the subject company in the next 3 months;<sup>675</sup>

<sup>668</sup> *E.g.*, NASD Rule 2711(g)(4).

<sup>669</sup> *E.g.*, NASD Rule 2711(h).

<sup>670</sup> *E.g.*, NASD Rule 2711(h)(1)(A).

<sup>671</sup> *E.g.*, NASD Rule 2711(h)(1)(B).

<sup>672</sup> *E.g.*, NASD Rule 2711(h)(3).

<sup>673</sup> *E.g.*, NASD Rule 2711(h)(8).

<sup>674</sup> *E.g.*, NASD Rule 2711(h)(2)(A)(i).

<sup>675</sup> *E.g.*, NASD Rule 2711(h)(2)(A)(ii).

- the firm received compensation for products or services other than investment banking services in the past 12 months;<sup>676</sup>
- the analyst or an employee who has the ability to influence the substance of a report knows that an affiliate has received compensation for products or services other than investment banking in the past 12 months;<sup>677</sup>
- the firm or the analyst has reason to know that an affiliate received such compensation in the past 12 months;<sup>678</sup> and
- a subject company is, or during the prior 12-month period was, a client of the firm and types of service provided to the subject company.<sup>679</sup>

In addition, these rules mandate certain compensation disclosures in public appearances.<sup>680</sup>

With respect to reporting lines and analyst compensation, these rules place restrictions on relationships with the research department. For example, these rules generally provide that no analyst may be subject to the supervision or control of any investment banking department employee.<sup>681</sup> In addition, these rules generally provide that no personnel engaged in investment banking activities may have influence or control over the compensatory evaluation of an analyst.<sup>682</sup> These rules also require that analyst compensation be reviewed and approved by a committee that reports to a firm's board of directors or to a senior executive officer of the firm.<sup>683</sup> The committee cannot have representation from the firm's investment banking department.<sup>684</sup> Further, these rules delineate specific factors that the committee must consider in its review.<sup>685</sup>

<sup>676</sup> *E.g.*, NASD Rule 2711(h)(2)(A)(iii)(a).

<sup>677</sup> *E.g.*, NASD Rule 2711(h)(2)(A)(iv).

<sup>678</sup> *E.g.*, NASD Rule 2711(h)(2)(A)(v).

<sup>679</sup> *E.g.*, NASD Rule 2711(h)(2)(A)(iii)(b). These rules contain a limited exception for disclosures regarding investment-banking compensation that would reveal material nonpublic information. See, *e.g.*, NASD Rule 2711(h)(2)(C).

<sup>680</sup> *E.g.*, NASD Rule 2711(h)(2)(B).

<sup>681</sup> *E.g.*, NASD Rule 2711(b)(1).

<sup>682</sup> *E.g.*, *Id.*

<sup>683</sup> *E.g.*, NASD Rule 2711(d)(2).

<sup>684</sup> *E.g.*, *Id.*

<sup>685</sup> *E.g.*, *Id.*



(b)	Does regulation contain provisions directed at firm compliance systems and senior management responsibility:
(i)	Requiring written internal procedures or controls to identify and eliminate, manage or disclose actual and potential analyst conflicts of interest?
(ii)	Requiring procedures to eliminate or manage the undue influence of issuers, institutional investors and other outside parties upon analysts?
(iii)	Requiring complete, timely, clear, concise, specific and prominent disclosures of actual and potential conflicts of interest?
<p>Yes. The U.S. Broker-Dealer Regulatory Agency rules discussed in response to the last question establish a comprehensive framework directed at firm compliance systems and senior management. For example, these rules require that firms adopt and implement written supervisory procedures reasonably designed to ensure that the firm and its employees comply with these rules regarding analyst conflicts.<sup>686</sup> A senior officer of the firm must annually attest that the firm has adopted and implemented those procedures.<sup>687</sup> These rules further require specific written policies and procedures reasonably designed to restrict or limit information flow between research department personnel and trading department personnel.<sup>688</sup> The purpose of this rule is to help prevent the firm's conflict of interest in trading ahead of a research report.</p> <p>In addition, these rules help to mitigate potential undue influence of issuers by placing restrictions on communications with the issuer. For example, these rules restrict a firm from sharing draft research reports with the subject company issuer other than as necessary to verify the factual accuracy of information in the draft report.<sup>689</sup> Further, the draft report cannot contain certain information, such as the research rating or the price target.<sup>690</sup> In addition, these rules require that the firm's legal or compliance department be involved in such subject company review. A complete draft of the report must be submitted to legal or compliance personnel before a section of the report is sent to the subject company.<sup>691</sup> Similar restrictions on internal review by non-research department personnel may reduce the possibility of an indirect conflict from the firm's business relationships (e.g., a sales trader representing an institutional investor attempting to influence the outcome).<sup>692</sup> These rules restrict when a firm may notify a subject company of a ratings change and prohibit a firm from offering favorable research, a specific</p>	

<sup>686</sup> E.g., NASD Rule 2711(i).

<sup>687</sup> E.g., *Id.*

<sup>688</sup> See FINRA Rule 5280.

<sup>689</sup> E.g., NASD Rule 2711(c).

<sup>690</sup> E.g., NASD Rule 2711(c)(2)(A).

<sup>691</sup> E.g., NASD Rule 2711(c)(2)(B).

<sup>692</sup> E.g., NASD Rule 2711(b)(2).

rating, or price target to an issuer as consideration or inducement for the receipt of business or compensation.<sup>693</sup>

With respect to other sources of influence that could trigger a material conflict, these rules require disclosure of any other actual, material conflict of interest of the research analyst or member of which the research analysts knows or has reason to know at the time of publication of the research report or at the time of the public appearance.<sup>694</sup> The other specific required disclosures, outlined in detail in the answer to Question 3(a) above, address the potential conflicts the U.S. Broker-Dealer Regulatory Agencies have identified as necessary for the protection of investors. In regard to the manner of disclosure, these rules require prominence of disclosures. In particular, these rules provide that the required disclosures must be presented on the front page of a research report or the front page must refer to the page on which disclosures are found.<sup>695</sup> In addition, these provisions require that the disclosures and references to disclosures be clear, comprehensive, and prominent.<sup>696</sup>

- (c) Does regulation contain provisions directed at integrity and ethical behavior, such as requiring analysts and/or the firms that employ analysts to act honestly and fairly with clients?

Yes. The relevant regulatory system contains provisions directed at integrity and ethical behavior by analysts and the firms that employ them. Regulation AC and the other U.S. Broker-Dealer Regulatory Agency rules help to enhance the integrity of research and facilitate ethical behavior. As noted above, the certifications and disclosures required by Regulation AC help to ensure that analyst views expressed in research reports and public appearances are objective and reliable. Each of the other rule provisions promotes the integrity of research and ethical behavior. In particular-- these rules expressly require that any written or oral communication by an analyst with a current or prospective customer or internal personnel related to an investment banking services transaction be fair, balanced, and not misleading, taking into consideration the overall context in which the communication is made.<sup>697</sup>

Additional rule provisions promote the integrity of research by helping to insulate analysts from investment banking pressures. Investment banking personnel are prohibited from directing an analyst to engage in sales or marketing efforts related to an investment banking transaction or

<sup>693</sup> *E.g.*, NASD Rule 2711(c)(2)(A) and (e).

<sup>694</sup> *E.g.*, NASD Rule 2711(h)(1)(C).

<sup>695</sup> *E.g.*, NASD Rule 2711(h)(10).

<sup>696</sup> *E.g.*, *Id.*

<sup>697</sup> *E.g.*, NASD Rule 2711(c)(7). See also FINRA Rule 2210(d)(1).

communicating with a current or prospective customer about an investment banking transaction.<sup>698</sup> These rules specifically prohibit retaliation for negative research. Specifically, these rules mandate that no firm involved in investment banking activities may retaliate against, or threaten to retaliate against, an analyst for issuing negative research that may adversely affect the firm's investment banking business.<sup>699</sup>

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<sup>698</sup> *E.g.*, NASD Rule 2711(c)(6).

<sup>699</sup> *E.g.*, NASD Rule 2711(j).

**Principle 24     The regulatory system should set standards for the eligibility, governance, organization and operational conduct of those who wish to market or operate a collective investment scheme.**

**Key Questions**

*Eligibility Criteria*

1. Does the regulatory system set standards for the eligibility of those who wish to:

- (a) Market a CIS?
- (b) Operate a CIS?

Yes. Section 203 of the Advisers Act requires a CIS operator to register with the SEC. Generally, the shares of any CIS<sup>700</sup> may be marketed by the CIS itself, its operator (if any), or a broker-dealer. Each of these entities is required to be registered with the SEC.

The federal securities laws impose certain standards for eligibility on persons who market or operate a CIS.

The Advisers Act and the Investment Company Act set forth the criteria for a person's eligibility to serve as an operator of a CIS. The criteria for eligibility to market CIS shares is set forth in (i) the Exchange Act and the Investment Company Act, (ii) rules adopted under the Exchange Act and the Investment Company Act, and (iii) rules adopted by FINRA.<sup>701</sup>

For further information, please see response to Question 24.2 below.

<sup>700</sup> For purposes of the SEC's responses, a CIS does not include a business development company ("BDC"). BDCs generally must make available significant managerial assistance with respect to the companies in which they invest.

<sup>701</sup> FINRA is the primary SRO for broker-dealers. Because the assessment questions focus on the role of the CIS operator rather than the CIS marketing agent, this self-assessment discusses primarily regulatory provisions governing operators. For more information on the role of the CIS marketing agent, please see responses to Principles 29-31.

2.	Do the eligibility criteria for a CIS operator include the following:
(a)	Honesty and integrity of the operator?
(b)	Having appropriate and sufficient human and technical resources to ensure that is capable of carrying out the necessary functions of CIS operator?
(c)	Financial capacity of the CIS or the CIS operator that would allow the launching and operation of the CIS in appropriate conditions?
(d)	Ability to perform specific powers and duties?
(e)	Having or employing an appropriate identification, monitoring and management of risks, based on, among other things, the size, the complexity and the risk profile of the CIS?
(f)	Having internal controls and compliance arrangements sufficient to ensure it can carry out its business diligently, effectively, honestly and fairly?
<p>Yes. The applicable criteria to operate a CIS include several of these factors, as discussed immediately below. Other provisions in the Investment Company Act and Advisers Act also address several of these factors. As described below, these provisions generally relate to approval of the contract between the CIS and the CIS operator by shareholders and directors of the CIS, policies and procedures, examination of the CIS operator and CIS, as well as disclosure of the relevant information to the SEC and to directors and shareholders of the CIS.</p> <p>For example, Section 9(a) of the Investment Company Act addresses the honesty and integrity of the operator by making ineligible certain persons from operating a CIS:</p> <ul style="list-style-type: none"> <li>Any person who, within 10 years, has been convicted of any felony or misdemeanor involving the purchase or sale of any security or arising out of such person's conduct as an underwriter, broker, dealer, CIS operator, municipal securities dealer, government securities broker, government securities dealer, bank, transfer agent, CRA, or entity or person required to be registered under the CEA, or as an affiliated person, salesman, or employee of any CIS, bank, insurance company, or entity or person required to be registered under the CEA;</li> <li>Any person who, by reason of any misconduct, is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an underwriter, broker, dealer, CIS operator, municipal securities dealer, government securities broker, government securities dealer, bank, transfer agent, CRA or entity or person required to be registered under the CEA, or as an affiliated person, salesman, or employee of any CIS, bank, insurance company, or entity or person required to be registered under the CEA, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of any security; or</li> <li>A company any affiliated person of which is ineligible, by reason of either of the</li> </ul>	

above two paragraphs, to serve or act in the foregoing capacities.

Section 9(b) of the Investment Company Act also provides that the SEC may prohibit any person or company from operating a CIS if the person or company:

- Has willfully made or caused to be made in any registration statement, application, or report filed with the SEC under the Act any false or misleading statement with regard to a material fact or has omitted to state any material fact required;
- Has willfully violated, or has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person, of the federal securities laws or the CEA;
- Has been found by a foreign regulatory authority to have: (i) made or caused to be made in any application for registration or report filed with the foreign securities authority, or in any proceeding before it, any false or misleading statement with regard to a material fact or has omitted to state any material fact required; (ii) violated any foreign securities or commodity futures laws; or (iii) aided, abetted, counseled, commanded, induced, or procured the violation by any other person, of the foreign federal securities laws or commodity futures laws;
- Within 10 years has been convicted by a foreign court of a crime that is substantially equivalent to a felony or misdemeanor as described in the first bullet of the previous list (discussing Section 9(a) of the Investment Company Act) regarding automatic ineligibility to operate a CIS; or
- Has been temporarily or permanently enjoined by reason of any misconduct by a foreign court from acting in any of the capacities described in the second bullet of the previous list (discussing Section 9(a) of the Investment Company Act) regarding automatic ineligibility to operate a CIS or a substantially equivalent foreign capacity, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of any security.

Section 9(c) of the Investment Company Act provides that any person who is ineligible, by reason of Section 9(a), to serve or act in the capacities enumerated in Section 9(a), may file with the SEC an application for an exemption from the provisions of Section 9(a). The SEC shall:

by order grant such application, either unconditionally or on an appropriate temporary or other conditional basis, if it is established that the prohibitions of [Section 9](a) as applied to such person, are unduly or disproportionately severe or that the conduct of such person has been

such as not to make it against the public interest or protection of investors to grant such application.<sup>702</sup>

Section 203(e) of the Advisers Act provides that the SEC may prohibit any person or company from operating a CIS if the person or company:

- Has willfully made or caused to be made in any application for registration or report required to be filed with the SEC under the Advisers Act, or in any proceeding before the SEC with respect to registration, any false or misleading statement with regard to a material fact or has omitted to state any material fact required;
- Has within 10 years been convicted by a foreign court of a crime involving the purchase or sale of any security, or other crimes involving dishonesty or arising out of the conduct of a securities business, or any crime punishable by imprisonment for one or more years;
- Is permanently or temporarily enjoined by any court, including a foreign court, from acting as a CIS operator, investment adviser, underwriter, broker, dealer, municipal securities dealer, government securities broker, government securities dealer, transfer agent, CRA, or foreign person performing substantially the same function as any of the above, or entity or person required to be registered under the CEA or equivalent statute, or is unable to comply with any such provision;
- Has willfully violated any provision of the federal securities laws or the CEA or any rule of the MSRB;
- Has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of the federal securities laws or the CEA or any rule of the MSRB or has failed to reasonably supervise another person who commits such a violation, if such other person is subject to his or her supervision;
- Has been found by a foreign financial regulatory authority to have: (i) made or caused to be made in any application for registration or report filed with a foreign securities authority, or in any proceeding before it with respect to registration, any false or misleading statement with regard to a material fact or has omitted to state any material fact required; (ii) violated any foreign securities or commodity futures laws; or (iii) aided, abetted, counseled, commanded, induced, or procured the violation by any other person, of the foreign federal securities or commodity futures laws or has failed to supervise another person who commits such a violation, if such other person is subject to his or her supervision; or

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Investment Company Act, Section 9(c).

- Is subject to any final order of a state securities commission, state banking authority, state insurance commission, a federal banking agency or the NCUA that: (i) bars them from association with an entity regulated by the state or federal agency or from engaging in the business of securities, insurance, banking, savings association activities, or credit union activities; or (ii) constitutes a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative, or deceptive conduct.

The Advisers Act also provides that the SEC may prohibit any person from association with a CIS operator if the person has committed or omitted any act enumerated in bullets 1, 4, 5, 6, or 7 of the list above or has been convicted of any offense specified in the second bullet in the list above or is enjoined from any action as described in the third bullet of the list above. Under this provision, the SEC may, but is not required to, prohibit such persons or companies from operating a CIS. Whether the SEC does so depends on the facts and circumstances of each case.

The CIS's board of directors, particularly the independent directors, and the CIS's shareholders bear primary responsibility for assessing the fitness and competence of a CIS's operator. Under Section 15(c) of the Investment Company Act, the terms of a CIS operator's contract, and any renewal thereof, must be approved by a vote of a majority of the CIS's independent directors and by a vote of a majority of the holders of the CIS's outstanding voting securities.

CIS operators must register with the SEC and, as part of registration, make certain public disclosures. For example, an operator must disclose in Part 2 of its Form ADV (the SEC's registration form for operators) the educational and business background of its employees who provide investment advice. Form ADV Part 2 also requires disclosure of specified financial information about an operator under certain circumstances. The item requires an operator to disclose any financial condition reasonably likely to impair its ability to meet contractual commitments to clients if the operator has discretionary authority over client assets (such as a CIS), among other things. Form ADV Part 2 also requires an operator that has been the subject of a bankruptcy petition during the past 10 years to disclose that fact to clients. In the case of a CIS, an operator generally provides the CIS's board of directors with a copy of the operator's Form ADV. A CIS also must disclose in its registration statement certain information regarding the operator, including the operator's experience as an operator, the operator services that it provides to the CIS, and a description of the compensation that the CIS operator receives.

Under the Investment Company Act and the Advisers Act, the SEC does not assess the qualifications of persons or firms seeking to become CIS operators, except as noted above. The fact that an entity is registered with the SEC as an operator does not represent a determination by the SEC as to the criteria for eligibility to operate CISs. The SEC does not make registration determinations based on those factors, except to the extent noted above. The SEC uses a disclosure-based approach to investment adviser regulation. A primarily disclosure-based approach is similar to the approach in other federal securities laws (*e.g.*, the Securities Act). This



approach provides prospective clients with information to assess the adequacy of an adviser's background and experience.

The lack of federal educational requirements for CIS operators and their employees does not prohibit states from imposing certain educational and professional training requirements upon investment adviser representatives (as defined under the Advisers Act) that have a place of business in that state.<sup>703</sup> Many states also require the registration of the individual persons who are associated with state-registered investment advisers. States may also impose certain educational and professional training requirements upon the representatives of SEC-registered CIS operators who have a place of business in that state.

CISs are subject to minimum capital requirements under the Investment Company Act. No CIS and no principal underwriter of a CIS may publicly offer an investment company's shares unless the CIS meets the applicable minimum capital requirements of at least \$100,000 in net worth. This capital must be provided with a *bona fide* investment purpose, without any present intention to dispose of the investment, and must not be loaned or advanced to the CIS by its promoters.

CISs and their operators also must have written CP&P in place that are reasonably designed to prevent violations of the federal securities laws including, among other things, policies and procedures designed to ensure that the CIS's board is composed of the appropriate number of independent directors. In particular, while the policies and procedures are not required to contain specific elements, the CIS operator must analyze its individual operations and identify conflicts and other compliance factors that create risks for the firm and then design policies and procedures that address those risks. In addition, the CIS's policies and procedures must provide for the oversight of compliance by the CIS operator, principal underwriters, administrators, and transfer agents through which the CIS conducts its activities. The CIS's policies and procedures should cover certain other critical areas, such as: (i) pricing of portfolio securities and CIS shares; (ii) processing of CIS shares; (iii) identification of affiliated persons; and (iv) compliance with CIS governance requirements. For more information on these policies and procedures, please see response to Question 24.6 below.

3. Does the regulatory system provide for effective mechanisms to assess compliance with the criteria referred to in Questions 2(a) to 2(f)?

Yes. The SEC's examination and inspection program, the Advisers Act, the Investment Company Act, and accompanying SEC rules provide for mechanisms to assess compliance with the above criteria. Please see response to Principle 12.

<sup>703</sup> An investment adviser representative is defined in rule 203A-3(a) under the Advisers Act as a supervised person of an investment adviser (i) who has more than five clients who are natural persons (ii) more than 10% of whose clients are natural persons. Certain "qualified clients" are excluded from the thresholds for counting natural persons. An investment adviser representative does not include supervised persons who do not regularly solicit, meet or otherwise communicate with clients, or who provide only impersonal investment advice.

4. Does the regulatory system set standards for the CIS governance seeking to ensure that CIS are organized and operated in the interests of CIS investors, and not in the interests of CIS connected persons?

Yes. CIS operators have a fiduciary duty to act in the best interests of the clients (including the CIS) and to provide investment advice in the clients' best interests. As a fiduciary, operators owe their clients a duty of undivided loyalty and utmost good faith, should not engage in any activity in conflict with the interest of any client, and should take steps reasonably necessary to fulfill their obligations. Fiduciaries must employ reasonable care to avoid misleading clients and must provide full and fair disclosure of all material facts to clients and prospective clients. Operators must eliminate, or at least disclose, all conflicts of interest that might incline them — consciously or unconsciously — to render advice that is not disinterested. If the operator does not avoid a conflict of interest that could affect the impartiality of its advice, the operator must make full and frank disclosure of the conflict. The operator cannot use clients' assets for its own benefit or the benefit of other clients, at least without client consent.

The board of directors of a CIS has overall responsibility for the management of the CIS.

Under the Investment Company Act, independent directors play a major role in the resolution of the conflicts that may arise between a CIS and its operator or other affiliated persons of the CIS. The Investment Company Act requires independent directors of CISs to approve various actions and to monitor certain arrangements, including those relating to potential conflicts of interest, on an ongoing basis.<sup>704</sup> Section 10(a) of the Investment Company Act requires that an open-end or closed-end CIS's board of directors consist of no more than 60% "interested" directors. An "interested" director is one who, among other things: (i) is affiliated with the CIS; (ii) has an immediate family member who is affiliated with the CIS; (iii) is an interested person of any investment adviser of or principal underwriter to such CIS; or (iv) is a person or partner or employee of such a person who has served as legal counsel to the CIS in the past two fiscal years.

For more information on the provisions addressing certain conflicts of interest between a CIS and its operators and the CIS's affiliates, please see response to Questions 24.12 below.

<sup>704</sup> For example, Section 15 of the Investment Company Act, among other things, requires that a CIS operator's contract with the CIS be reviewed and approved by the majority of the CIS's independent directors. Rule 32a-4 under the Investment Company Act provides that an audit committee may select a CIS's independent public accountant, without submitting the choice to shareholders, if, among other things, independent directors comprise the entire committee. In addition, rule 17a-8 under the Investment Company Act requires that CIS directors, including a majority of independent directors, approve mergers between CIS. Section 10(f) of the Investment Company Act and rule 10f-3 thereunder permit certain purchases during an underwriting syndicate involving a principal underwriter that has a close relationship to the CIS and that otherwise would not be permitted if, among other things, the CIS board of directors, including a majority of the independent directors, takes steps to ensure that such purchases are consistent with the protection of investors.

5. Does the authorization/registration of CIS take into account the possible need for international cooperation in the case of CIS marketed across jurisdictions or where promoters, managers or custodians are located in several different jurisdictions?

Yes. Please see responses to Principles 13 and 14 which address cooperation with foreign and domestic authorities.

*Supervision and Ongoing Monitoring*

6. Is the regulator responsible for monitoring ongoing compliance with the standards applicable to CIS and CIS operators? In particular, does the regulator have clear responsibilities and powers with respect to:

(a) Registration or authorization of a CIS?

Yes. CISs generally must be registered with the SEC in order to operate in the U.S.<sup>705</sup> In order to sell its shares to the public, a CIS must register itself under the Investment Company Act, and register the offering of its securities under the Securities Act.

The registration forms for open-end and closed-end CISs (Form N-1A and Form N-2, respectively) each consist of three parts: a prospectus, a statement of additional information (SAI), and a section containing other information (Part C).<sup>706</sup> The prospectus contains the most essential information for investors to make an informed decision about investing in an open-end or closed-end CIS. The SAI contains information that, while important, is not considered as essential to the investor's investment decision as the information contained in the prospectus. Part C contains exhibits to the registration statement, which include the CIS's articles of incorporation and/or bylaws, as well as all material contracts, such as the advisory contract and any distribution contracts.

The SEC's staff conducts selective reviews of CISs registration statements to assess the eligibility of a CIS and its operator. No sales of a CIS's shares may be made before its registration statement is "effective."

All registration statements are public documents.

<sup>705</sup> See Section 8(a) of the Investment Company Act.

<sup>706</sup> A UIT's registration statement under the Investment Company Act consists of nine parts and requires a detailed description of the trust, including: (i) the name (including a complete history of any name changes), address and jurisdiction of organization; (ii) significant aspects of the trust indenture and any contracts into which the trust has entered; (iii) description of the securities being offered; (iv) description of all sales loads, fees, charges and expenses; (v) information regarding the sponsor/depositor, including its history and operations and its officers, directors and employees and their compensation; (vii) distribution and redemption arrangements, including information regarding the principal underwriter(s); (viii) information regarding the trustee, custodian and any other service providers; (h) information regarding portfolio insurance, if applicable; (ix) significant tax consequences of investment in the trust; (x) audited financial statements in accordance with Regulation S-X under the Securities Act; and (k) exhibits, including, but not limited to, the trust indenture and all material contracts.

**Internal Supervision**

Although CISs and CIS operators are not required to employ internal auditors, open-end and closed-end CISs are required to have written policies and procedures, which are reasonably designed to prevent violations of the federal securities laws, and a CCO to administer and oversee the CP&P. CIS CCOs must annually conduct a review of the CIS's CP&P and furnish the board with a written report on the operation of the CIS's policies and procedures and those of its service providers. The report must address, at a minimum: (i) the operation of the policies and procedures of the CIS and each service provider since the last report; (ii) any material changes to the policies and procedures since the last report; (iii) any recommendations for material changes to the policies and procedures as a result of the annual review; and (iv) any material compliance matters since the date of the last report. Additionally, the CCO must meet annually with the independent directors of the CIS without the CIS operator present.

CIS operators also establish and comply with procedures, and systems for applying such procedures, to prevent and detect any violations of the Advisers Act by persons under their supervision. If the federal securities laws are violated by employees who are subject to the supervision of the operator, the SEC can institute administrative proceedings against the operator for failing to reasonably supervise the employees. Section 203(i) also authorizes the SEC to sanction and to impose a civil penalty on any operator that fails reasonably to supervise any employee who commits a violation of the federal securities laws. Please also see the response to Question 24.6(d), below.

**Independent Accountants**

Section 30 of the Investment Company Act requires a CIS to have an independent public accountant to certify the CIS's financial statements that are filed with the CIS's registration statement and sent to shareholders with annual reports. An accountant who certifies financial statements for a CIS must meet certain standards of independence. In addition, Rule 30a-2 under the Investment Company Act requires a CIS's principal executive officer and financial officer to certify the information contained in that company's shareholder reports.

Independent public accountants conduct a required annual audit of a CIS's financial statements. During the audit, the independent public accountant is required to perform a review of the CIS's internal control procedures and render a report to the CIS's board of directors on its findings, including any weakness in controls.<sup>707</sup> The CIS is required to file the independent public accountant's report on internal accounting controls as an exhibit to the CIS's Form N-SAR (the semi-annual report required to be filed with the SEC).<sup>708</sup>

<sup>707</sup> Sub-Item 77 of Form N-SAR.

<sup>708</sup> A UIT is required to file Form N-SAR only annually.

In general, a CIS's independent directors select the CIS's independent public accountant. Many CISs boards of directors establish an audit committee – usually comprised solely of independent directors<sup>709</sup> – which evaluates and recommends the CIS's independent public accountant for approval by the board of directors. The audit committee also meets with the independent accountant to review the scope and anticipated cost of the CIS's audit. Upon completion of the CIS's audit, the audit committee usually has primary responsibility for studying the accountant's report, discussing particular items with the accountant, and reporting to the CIS's board of directors. A CIS must disclose annually on Form N-CSR that its board of directors has determined that the CIS either: (i) has at least one audit committee financial expert serving on its audit committee and, if so, the name of the expert and whether the expert is independent; or (ii) does not have an audit committee financial expert serving on its audit committee. A CIS disclosing that it does not have an audit committee financial expert must explain why it does not have such an expert.<sup>710</sup>

### **The Board**

The board of directors of a CIS has overall responsibility for the management of the CIS. The board of directors' oversight responsibility encompasses a number of specific duties, including: (i) approving the CIS's investment advisory and principal underwriting contracts;<sup>711</sup> (ii) appointing the CIS's custodian and approving the custodian agreement;<sup>712</sup> (iii) approving the CIS's code of ethics relating to personal trading (please refer to response to Question 24.12, below, "Employees Transactions for their Own Accounts"); (iv) approving the independent accountant (please refer to "Independent Accountants", above (discussing the formation of audit committees) and response to Question 24.7, below (discussing the obligation of the board of directors regarding auditors' discovery of illegal acts)); and (v) approving the designation and compensation of the CCO.<sup>713</sup> Certain of these matters also must be approved by a majority of the board's independent directors and by the CIS shareholders. In addition, the CIS board of directors should assess the implementation and effectiveness of risk controls of the operator when approving or reviewing the advisory contract between the CIS and the operator.

Section 10(a) of the Investment Company Act requires that an open-end or closed-end CIS's board of directors consist of no more than 60% "interested" directors. An "interested" director is one who, among other things: (i) is affiliated with the CIS; (ii) has an immediate family member

<sup>709</sup> Rule 32a-4 under the Investment Company Act provides that if the audit committee is composed wholly of independent directors, and the CIS meets other requirements, then the CIS is not required to hold a shareholder vote on the selection of the independent public accountant.

<sup>710</sup> Item 3 of Form N-CSR.

<sup>711</sup> Section 15 of the Investment Company Act.

<sup>712</sup> Rule 17f-1 under the Investment Company Act.

<sup>713</sup> Rule 38a-1 under the Investment Company Act.

who is affiliated with the CIS; (iii) is an interested person of any investment adviser of or principal underwriter to such CIS; or (iv) is a person or partner or employee of such a person who has served as legal counsel to the CIS in the past two fiscal years.

Under the Investment Company Act, independent directors play a major role in the resolution of the conflicts that may arise between a CIS and its operator, or other affiliated persons of the CIS. The Investment Company Act requires independent directors of CISs to approve various actions and to monitor certain arrangements on an ongoing basis.<sup>714</sup>

### **The Trustee**

The trustee of a Unit Investment Trust (UIT) has certain ongoing responsibilities with regard to the trust, including: (i) maintaining the assets of the trust and (ii) ensuring that trust expenses are paid.<sup>715</sup> A trustee is prohibited from resigning until the UIT has been liquidated or a successor trustee has been installed.<sup>716</sup>

#### **(b) Inspections to ensure compliance by CIS operators?**

Yes. OCIE conducts and coordinates the nationwide inspection and examination program for entities that are registered with the SEC. In conducting its inspection and examination program, OCIE reviews CIS operators to ensure that the operators are not ineligible to operate under the federal securities laws. For additional detail regarding OCIE examinations of CIS operators, see responses to Questions 8.1, 12.1 and 24.8.

As discussed in response to Question 24.11 below, the Investment Company Act, the Advisers Act and the rules thereunder require CISs and CIS operators to maintain and preserve certain books and records. All books and records required to be maintained and preserved are subject at any time, or from time to time, to such reasonable periodic, special, and other examinations as the SEC may prescribe. In addition, all records maintained by an operator (whether or not required to be maintained) are similarly subject to such examinations.

<sup>714</sup> For example, Section 15 of the Investment Company Act, among other things, requires that a CIS operator's contract with the CIS be reviewed and approved by the majority of the CIS's independent directors. Rule 32a-4 under the Investment Company Act provides that an audit committee may select a CIS's independent public accountant, without submitting the choice to shareholders, if, among other things, independent directors comprise the entire committee. In addition, rule 17a-8 under the Investment Company Act requires that directors, including a majority of independent directors, approve mergers between CIS. Section 10(f) of the Investment Company Act and rule 10f-3 thereunder permit certain purchases during an underwriting syndicate involving a principal underwriter that has a close relationship to the CIS and that otherwise would not be permitted if, among other things, the board of directors, including a majority of the independent directors, takes steps to ensure that such purchases are consistent with the protection of investors.

<sup>715</sup> Section 26(a)(1) and 26(a)(2) of the Investment Company Act.

<sup>716</sup> Section 26(a)(3) of the Investment Company Act.

OCIE administers an inspection and examination program that covers both CISs and their operators. Inspections are conducted primarily to determine whether CISs and their operators meet eligibility standards and conduct their practices and procedures in compliance with the federal securities laws and regulations as well as to keep the SEC and Staff informed of developments in the industry. OCIE coordinates its examinations with state regulators and federal banking regulators (as well as with other Offices and Divisions of the SEC). OCIE conducts routine or cycle compliance examinations, in which the staff evaluates a registrant's compliance with the federal securities laws. OCIE also conducts cause examinations, based on TCRs, press reports, or other information that suggest violations may have occurred, and OCIE focuses on the transactions or events giving rise to its concerns. As part of its compliance oversight, OCIE may also conduct risk-targeted sweep examinations, in which OCIE typically focuses on a particular practice area (e.g., soft dollar practices) among a number of operators.

During inspections and examinations, OCIE staff generally visits the offices of registrants, interviews management, reviews documents, and analyzes the registrant's operations. SEC examiners usually pay particular attention to the internal controls and compliance program of the CIS and its operator both to better understand their operations and to determine whether significant systemic problems exist.<sup>717</sup> If an SEC examination uncovers material deficiencies or material compliance problems, the independent directors of a CIS may have an obligation to determine the cause thereof, the adequacy of any proposed solutions, whether shareholders have been harmed, and the adequacy of existing procedures to prevent recurring problems.

(c) Investigation of suspected breaches?

Yes. Staff conducts investigations of CISs and their operators when it has reason to believe that a violation of the federal securities laws is about to occur or has already occurred, including suspected violations of the eligibility standards by the CIS or its operator. Because these investigations involve suspected misconduct, they are conducted by Enforcement.

Section 42 of the Investment Company Act gives the SEC broad authority to enforce the Investment Company Act. Section 42(a) authorizes the SEC and Staff to conduct investigations to determine whether any person (including a CIS operator) has violated or is about to violate the Investment Company Act and to determine whether any administrative or judicial action should be instituted against any person or with respect to a particular transaction. For purposes of any investigation or other proceeding under the Investment Company Act, members of the SEC and designated officers are empowered to administer oaths, subpoena witnesses, take evidence, and require production of books and records relevant to the inquiry. When a person refuses to obey a subpoena, Section 42(c) authorizes the SEC to invoke the aid of a court to order compliance. Any person who without cause fails or refuses to answer or produce documents under any

<sup>717</sup> Section 31(b)(3) of the Investment Company Act states that the SEC shall exercise its inspection authority with due regard for the benefits of internal CP&P and the effective implementation and operation thereof.



legitimate SEC inquiry may be found guilty of a misdemeanor and, upon conviction, may be fined not more than \$1,000 or imprisoned for up to one year or both. The SEC has similar investigative authority and power with regard to CIS operators under sections 209(a), (b) and (c) of the Advisers Act.

(d) Remedial action in the event of breach or default?

Yes. For information regarding the powers of the regulator with respect to actions available (statutory or otherwise) in the event of breaches or default by those permitted to market a CIS, please see response to the Question 29.4 below. The remainder of this response addresses the powers of the regulator with respect to actions available (statutory or otherwise) in the event of breaches or default by CIS operators.

**Actions Available Under the Advisers Act**

The Advisers Act and the Investment Company Act authorize the SEC to institute administrative proceedings against CIS operators and their associated persons<sup>718</sup> or to sue any person in federal court for violations of those acts.

**Administrative Proceedings:** Sections 203(e) and (f) of the Advisers Act authorize the SEC to sanction an operator, or a person associated with an operator, if it finds (after notice and an opportunity for a hearing) that the operator or an associated person has engaged in certain willful misconduct and if the sanctions are in the public interest. Specifically, the SEC may “censure, place limitations on the activities, functions, or operations of [an operator or associated person of an operator]” and may suspend the registration of the operator, or prohibit the associated person from acting as such, for a period of not more than 12 months. Additionally, the SEC may revoke the registration of an operator, or bar a person from being associated with any operator. Sections 203(e) and (f) of the Advisers Act list the types of misconduct for which the SEC may sanction operators and their associated persons. Under Section 203(i), the SEC may, upon a proper showing and when in the public interest, impose civil money penalties in proceedings instituted pursuant to sections 203(e) or (f).<sup>719</sup> Administrative proceedings also may

<sup>718</sup> An “associated person” is defined in Section 202(a)(17) of the Advisers Act, which reads, in part, that a “person associated with an investment adviser” includes “any partner, officer, or director of [an investment adviser], or any person directly or indirectly controlling or controlled by such investment adviser, including any employee of such investment adviser.” A “person” is defined as a natural person or a company under Section 202(a)(16) of the Advisers Act.

<sup>719</sup> Under Section 203(i) of the Advisers Act, the SEC may impose civil penalties for each violation according to a three-part scale: (i) if the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and resulted in or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the wrongdoer, a maximum of \$100,000 for a natural person or \$500,000 for any other person; (ii) if fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement is involved, a maximum of \$50,000 for a natural person or \$250,000 for any other person; and (iii) in other cases, a maximum of \$5,000 for a natural person or \$50,000 for any other person. Under Section 203(j) of the Advisers Act, in any proceeding in which the SEC may impose a penalty under Section 203 of the Advisers Act, the SEC may enter an

(continued)



be based on prior injunctions issued by, and/or findings of violations made by, a federal court. Under Section 203(k) of the Advisers Act, the SEC may issue a cease-and-desist order<sup>720</sup> requiring a person to cease violating or causing the violation of the Advisers Act or the rules or regulations thereunder.

**Civil Federal Court Actions:** The SEC is authorized to institute an action seeking an injunction and other equitable relief in federal court against any person who has violated, is violating, or is about to violate the Advisers Act or the rules or regulations thereunder. The SEC similarly may seek an injunction against any person for aiding and abetting a violation of the Advisers Act. The SEC also may seek monetary penalties in federal court from any person who has violated the Advisers Act, the rules or regulations thereunder, or a cease-and-desist order previously entered by the SEC. Upon a proper showing, a court may impose monetary penalties of varying amounts, depending upon the nature of the violation, as described in Section 209(e)(2) of the Advisers Act.<sup>721</sup>

### **Actions Available Under the Investment Company Act**

The federal securities laws also authorize the SEC to institute administrative proceedings against any person or to sue any person in federal court for violations of the Investment Company Act.

**Administrative Proceedings:** The Investment Company Act generally authorizes the SEC to temporarily or permanently bar any person from the CIS industry if it finds that the person engaged in the conduct listed in Section 9(b) (including a violation of the federal securities laws, being convicted of certain types of crimes, being subject to foreign regulatory or court action, or having been convicted by a foreign court of a financial crime) and if the sanctions are in the

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order requiring an accounting and disgorgement (that is, the payment of any unjust enrichment as a result of the violation), including reasonable interest.

<sup>720</sup> A “cease-and-desist” order under either Section 9(f) of the Investment Company Act or Section 203(k) of the Advisers Act is an administrative order that the SEC may issue when it finds that a person has violated, is violating or is about to violate a provision of the Investment Company Act or the Advisers Act or the rules or regulations thereunder. In any cease-and-desist proceeding under either Section 9(f) of the Investment Company Act or Section 203(k) of the Advisers Act, the SEC may enter an order requiring an accounting and disgorgement, including reasonable interest.

<sup>721</sup> Under Section 209(e)(2) of the Advisers Act, a court may assess civil penalties for each violation according to a three-part scale: (i) if the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and resulted in or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the wrongdoer, a maximum of \$100,000 for a natural person or \$500,000 for any other person or the pecuniary gain to the defendant as a result of the violation; (ii) if fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement is involved, a maximum of \$50,000 for a natural person or \$250,000 for any other person or the pecuniary gain to the defendant as a result of the violation; and (iii) in other cases, a maximum of \$5,000 for a natural person or \$50,000 for any other person or the pecuniary gain to the defendant as a result of the violation. The federal courts also possess the power to grant other equitable relief, such as disgorgement, including reasonable interest.

public interest. Under Section 9(d), the SEC may, upon a proper showing and when in the public interest, impose civil money penalties in proceedings instituted pursuant to Section 9(b).<sup>722</sup> The SEC also may order a person to cease and desist from committing or causing a violation of the Investment Company Act or its rules if the SEC finds, after notice and opportunity for a hearing, that the person has violated or is about to violate a provision of the Investment Company Act or the rules thereunder.

**Civil Federal Court Actions:** The Investment Company Act authorizes the SEC to institute an action for an injunction and other equitable relief in federal court against any person who has violated, is violating, or is about to violate the Investment Company Act or the rules or regulations thereunder. The SEC may seek monetary penalties in federal court from any person for violating a cease-and-desist order previously issued by the SEC under Section 9(f) of the Investment Company Act. Upon a proper showing, the court may impose monetary penalties in civil actions according to the three-part scale described in the Investment Company Act.<sup>723</sup>

In addition, the Investment Company Act authorizes the SEC to seek injunctive or other relief against, among others, officers, directors, and operators of a CIS, in a federal court with respect to acts “constituting a breach of fiduciary duty involving personal misconduct in respect” of the CIS for which such persons serve.<sup>724</sup> If the allegations are established, the court may temporarily or permanently enjoin these persons from acting as, among others, officers, directors, and operators of a CIS and award injunctive or other relief as may be reasonable and appropriate.

Finally, the SEC may institute an action in a federal court against, among others, a CIS operator

<sup>722</sup> Under Section 9(d) of the Investment Company Act, the SEC may impose civil penalties for each violation according to a three-part scale: (i) if the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and resulted in or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the wrongdoer, a maximum of \$100,000 for a natural person or \$500,000 for any other person; (ii) if fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement is involved, a maximum of \$50,000 for a natural person or \$250,000 for any other person; and (iii) in other cases, a maximum of \$5,000 for a natural person or \$50,000 for any other person. Under Section 9(e) of the Investment Company Act, in any proceeding in which the SEC may impose a penalty under Section 9 of the Investment Company Act, the SEC may enter an order requiring an accounting and disgorgement, including reasonable interest.

<sup>723</sup> Under Section 42(e) of the Investment Company Act, a court may assess civil penalties for each violation according to a three-part scale: (i) if the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and resulted in or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the wrongdoer, a maximum of \$100,000 for a natural person or \$500,000 for any other person or the pecuniary gain to the defendant as a result of the violation; (ii) if fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement is involved, a maximum of \$50,000 for a natural person or \$250,000 for any other person or the pecuniary gain to the defendant as a result of the violation; and (iii) in other cases, a maximum of \$5,000 for a natural person or \$50,000 for any other person or the pecuniary gain to the defendant as a result of the violation. The federal courts also possess the power to grant other equitable relief, such as disgorgement, including reasonable interest.

<sup>724</sup> Section 36(a) also prohibits a breach of fiduciary duty involving personal misconduct by a UIT’s principal underwriter.

for a breach of fiduciary duty with respect to the receipt of compensation from the CIS.

**Automatic Bar:** Under Section 9(a) of the Investment Company Act, the following persons are automatically barred from serving or acting as, among others, an employee, officer, director, member of an advisory board, principal underwriter, or operator for a CIS: (i) any person who within 10 years has been convicted of certain securities-related crimes (felonies or misdemeanors); (ii) any person who, by reason of any misconduct, is permanently or temporarily enjoined from acting in certain securities-related capacities; and (iii) a company any affiliated person of which is ineligible to serve or act as, among other things, a director by reason of (i) or (ii).<sup>725</sup> If a person serves in such capacity in violation of Section 9(a) of the Investment Company Act, the SEC may institute an administrative proceeding or an action in federal court against the person.

**Criminal Actions:** Any person who willfully violates any provision of the Advisers Act or Investment Company Act or any rule, regulation, or order promulgated by the SEC thereunder is subject to criminal penalties. Upon conviction, the Advisers Act provides for criminal sanctions not to exceed \$10,000 and/or imprisonment for no more than five years. The Investment Company Act contains similar provisions. The DOJ would conduct any criminal investigations and conduct any criminal prosecutions.

7. Does the ongoing monitoring involve review of reports submitted to the regulator with regard to CIS and entities involved in the operation of a CIS (CIS operators, custodians, etc.) on a routine basis or on a risk assessment basis?

Yes. To assure the prompt and orderly processing of CISs filings, the Staff conducts a selective review of registration statements, post-effective amendments, proxy statements, and other periodic reports. The Staff reviews these registration statements and other reports to assess, among other things, the continued eligibility of the CIS and its operator. This practice permits the Staff to use its limited resources more efficiently by eliminating, or at least reducing, Staff review of routine filings by CISs.

Additionally, as noted in response to Question 24.6 above, a CIS must have an independent public accountant, among other things, certify the CIS's financial statements that are filed with the CIS's registration statement and sent to shareholders with annual reports. Among its other audit functions, a CIS's independent public accountant is required, in its audit, to include procedures designed to detect illegal acts, identify related party transactions, and evaluate the

<sup>725</sup> Section 9(c) provides that any person who is ineligible, by reason of Section 9(a), to serve or act in the capacities enumerated in Section 9(a), may file with the SEC an application for an exemption from the provisions of Section 9(a). The SEC shall "by order grant such application, either unconditionally or on an appropriate temporary or other conditional basis, if it is established that the prohibitions of [Section 9](a) as applied to such person, are unduly or disproportionately severe or that the conduct of such person has been such as not to make it against the public interest or protection of investors to grant such application."

CIS's ability to continue as a going concern. Under Section 10A of the Exchange Act and Rule 10A-1 thereunder, if the CIS's independent public accountant detects or becomes aware that an illegal act has occurred, the accountant must promptly notify the CIS's operator and ensure that the CIS's audit committee or directors are also informed. If the accountant determines that the illegal act has a material effect on the CIS's financial statements, that the operator has not taken timely and appropriate remedial action, and that the absence of remedial action is expected to lead to a departure from the standard audit opinion (or resignation from the engagement), the accountant must report its conclusions directly to the CIS's directors. Once the CIS's board of directors has received this report from the independent accountant, the board of directors has one business day to notify OCA that it has received the report (and to provide that Office with either a copy of the report or a summary) and to furnish the independent public accountant making the report with a copy of such notice. If the accountant does not receive a copy of this notice within that one-day period, the accountant is required to provide its report directly to OCA.

Furthermore, Section 24(b) of the Investment Company Act and the rules thereunder require CISs and their underwriters, in connection with a public offering of any security of which the CIS is the issuer, to file copies of all of their advertisements and sales literature with the SEC or with FINRA (if its shares are sold by a FINRA member).

CIS advertisements and sales literature are reviewed by FINRA, if filed with FINRA. CIS and CIS operator advertisements and sales literature may be reviewed by Staff as part of an inspection of the CIS or its operator by the Staff. In such a review Staff assesses if the material is false or misleading. A review does not constitute an approval or authorization of the advertisement or sales literature.

8. Does the ongoing monitoring involve where appropriate performance of on-site inspections of entities involved in operating CIS (CIS operators, custodians, etc.)?

Yes. OCIE examines entities involved in operating CISs by performing onsite examinations or inspections of CISs and their operators. In many cases, examinations are conducted in conjunction with an examination of the CIS's operator, because CIS operators often perform recordkeeping and operational duties, and may perform custodial services for the CIS. The scope of examinations of CISs is tailored to the activities of the CIS and its compliance risks. In formulating the findings of the examination, the examiners may consult with other Staff, including supervisory staff and staff in relevant Offices and Divisions, to ensure that the findings are consistent with SEC rules, regulations, and interpretations. For more information regarding OCIE's inspections and examinations program, please see responses to Question 12.1 above.

9. Do the regulatory authorities proactively perform investigative activities in order to identify suspected breaches with respect to entities involved in the operation of a CIS?

Yes. As discussed in response to Question 24.6 above, Staff conducts investigations of CISs, their operators and other entities involved in the operation of a CIS when it has reason to believe that a violation of the federal securities laws is about to occur or has already occurred.

10. Is the operator of a CIS subject to a general and continuing obligation to report to the regulatory authority or investors, either prior to or after the event, any information relating to material changes in its management or organization or in the by-laws of the CIS or the CIS operator?

Yes. A CIS operator has a general and continuing obligation to report to the SEC, either prior to or after the events, information relating to material changes in its management or organization because (i) that information generally must be described in the operator's Form ADV, and (ii) an operator must keep current the relevant responses on its Form ADV by promptly amending its Form ADV to correct any responses that become materially inaccurate.<sup>726</sup>

A CIS has a general and continuing obligation to report to the SEC, either prior to or after the events, information relating to material changes in their management or organization because (i) that information generally must be described in the CIS's prospectus, and (ii) a CIS generally must amend its registration statement to correct any disclosure that becomes materially inaccurate.<sup>727</sup>

<sup>726</sup> See Form ADV General Instructions at instruction 4.

<sup>727</sup> The Securities Act requires a CIS that is making a continuous offering to maintain a "current" statutory prospectus. Specifically, Section 10(a)(3) of the Securities Act requires that any prospectus used more than nine months after the registration statement's effective date must contain financial and other information as of a date not more than sixteen months prior to such use. A CIS making a continuous offering of its securities can update its prospectus by filing a post-effective amendment to its registration statement that contains updated financial statements and other information. In addition, CIS must amend the registration statement to avoid potential liability. In particular, Section 11 of the Securities Act provides that the CIS itself, its directors (including persons named in the CIS's registration statement as about to become directors of the CIS), all of the persons who sign the CIS's registration statement, any expert who is named as having certified or prepared information in the registration statement, and the underwriter may be liable for any materially false statement or omission in a CIS's registration statement.

11. Does the regulatory system assign clear responsibilities for maintaining records on the organization and business of the CIS operator? Does the regulatory system provide for the keeping of books and records in relation to transactions involving CIS assets and all transactions in CIS shares or units or interests?

Yes. The Investment Company Act and the Advisers Act and the rules thereunder require CISs and CIS operators to maintain and preserve certain books and records.<sup>728</sup> All books and records required to be maintained and preserved are subject at any time, or from time to time, to such reasonable periodic, special, and other examinations as the SEC may prescribe. In addition, all records maintained by an operator (whether or not required to be maintained) are similarly subject to such examinations.

Section 31 of the Investment Company Act and rules 31a-1, 31a-2 and 31a-3 thereunder require CISs, as well as certain majority-owned subsidiaries of CISs, to maintain and keep current the accounts, books, and other documents relating to the CIS's assets. The CIS must keep records for all securities transactions and ledgers for all of the CIS's accounts, such as its income and expense accounts, and records showing the number of shares owned by each shareholder of record.

Rule 31a-1(b)(2)(iv) under the Investment Company Act requires a CIS, as well as certain majority-owned subsidiaries of the CIS, to maintain and keep current separate ledger accounts (or other records) showing, for each shareholder of record of the CIS, the number of shares of capital stock of the CIS held. Alternatively, the ledger accounts (or other records) may be maintained by a transfer agent or registrar. Transfer agents generally are regulated by the SEC under the Exchange Act, and are generally subject to recordkeeping requirements pursuant to Section 17(a)(3) of that act and rules 17Ad-6, 17Ad-7 and 17Ad-9 thereunder. For further information please see responses to Questions 10.4 and 24.11, above.

Investors typically buy CIS shares through registered broker-dealers that, in turn, hold the shares with the CIS's transfer agent in an account. The account commingles all of the CIS's shares that are held by the broker-dealer for all of its customers. Section 17(a)(1) of the Exchange Act and rules 17a-3 and 17a-4 thereunder, and certain applicable rules that have been adopted by SROs, require the broker-dealers to create and maintain records of each customer's ownership of a CIS's shares.

Also, AML rules require an open-end CISs to maintain records of the information that is used to verify each customer's account when the account is opened.<sup>729</sup> This information includes the

<sup>728</sup> See Section 31 of the Investment Company Act and Section 204 of the Advisers Act and the respective rules thereunder.

<sup>729</sup> See rule 0-11 under the Investment Company Act which requires compliance with 31 U.S.C. 5318(l) and the implementing regulation at 31 C.F.R. 103.131. 31 C.F.R. 103.131 requires that a CIS have a written customer

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name, date of birth, address, and identification numbers of the customer. The rule does not require an open-end CIS to obtain any additional information regarding the identities of individual shareholders whose shares are held through an omnibus account that is maintained by, for instance, a broker-dealer. In this case, the shareholder that appears on the open-end CIS's shareholder ledger is the broker-dealer who maintains the account. Information about those customers is kept by the entity that maintains the omnibus account, such as a broker-dealer (which also is subject to AML rules). For further information, please see responses to Questions 10.5 and 10.6, above.

In addition, Rule 204-2 under the Advisers Act requires CIS operators to maintain certain books and records relating to its advisory business, including a memorandum of each order given by a CIS operator for the purchase or sale of any security, of any instruction received by a CIS operator from a CIS concerning the purchase, sale, receipt, or delivery of a particular security, and of any modification or cancellation of any such order or instruction.

Section 17(a)(1) of the Exchange Act and rules 17a-3 and 17a-4 thereunder, and certain rules that have been adopted by SROs, require the broker-dealers that execute CISs portfolio transactions to maintain extensive records of these transactions.

For further information, please see responses to Questions 10.2 and 10.4, above and Question 31.13, below.

#### *Conflicts of Interest and operational conduct*

12. Are there provisions:

- (a) To prohibit, restrict or manage (including if appropriate by disclosure) certain conduct likely to give rise to conflicts of interest between a CIS and its operators or their associates or connected parties?

Yes. There are several provisions that address conflicts of interest.

#### **Principal Transactions between a CIS and its Affiliates**

Section 17(a) of the Investment Company Act prohibits principal transactions between a CIS and its affiliates. Section 17(a) generally prohibits any affiliated person of a CIS (or any affiliated person of an affiliated person<sup>730</sup> of a CIS), acting as principal, from knowingly buying securities or other property from, or selling securities or other property to, the CIS.<sup>731</sup>

identification procedure that specifies the identifying information that will be obtained upon account opening, including, at a minimum, information regarding a customer's name, date of birth, address, and identification number.

<sup>730</sup>

As used herein, the term "affiliate" includes both an affiliated person of a CIS and an affiliated person of an affiliated person of a CIS. The Investment Company Act defines an "affiliated person" of another person as: (i) any person directly or indirectly owning, controlling, or holding with power to vote, 5% or more of the outstanding voting securities of such other person; (ii) any person 5% or more of whose outstanding voting securities are directly

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Section 17(b) of the Investment Company Act authorizes the SEC to grant orders exempting affiliated principal transactions from the prohibitions of Section 17(a) on a case-by-case basis if:

- the terms of the proposed transaction are reasonable and fair and do not involve overreaching by any of the parties to the transaction;
- the proposed transaction is consistent with the policy of each CIS that is a party to the transaction; and
- the proposed transaction is consistent with the general purposes of the Investment Company Act.

In addition, the SEC has adopted several rules that exempt certain types of affiliated principal transactions from these prohibitions. The rules are intended to ensure that the terms of a transaction are fair and, in some cases, require that an independent party (such as a CIS's board of directors) approve the transaction. Entities that are entitled to rely on those rules are not required to obtain exemptive orders from the SEC.

#### **Transactions in which a CIS and its Affiliates Jointly Participate**

Section 17(d) of the Investment Company Act and Rule 17d-1 thereunder together prohibit a CIS's affiliate, acting as principal, from participating in or effecting any transaction in connection with a "joint enterprise or other joint arrangement or profit-sharing plan" in which the CIS is a participant unless the SEC grants an order exempting the transaction before it is effected.<sup>732</sup> In determining whether to grant an exemptive order under these provisions, the SEC will consider:

- whether the CIS's participation in the transaction is consistent with the provisions, policies, and purposes of the Investment Company Act; and

or indirectly owned, controlled, or held with power to vote, by such other person; (iii) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (iv) any officer, director, partner, copartner, or employee of such other person; (v) if such other person is a CIS, any operator thereof or any member of an advisory board thereof; and (f) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

<sup>731</sup> A UIT is created by a sponsor, which is usually a broker-dealer that is registered with the SEC. Prior to the actual sale of UIT units to investors, the sponsor may assemble a securities portfolio and, on a certain date, deposit this portfolio with the UIT's trustee under the terms of a trust indenture. In return, the sponsor receives units of the UIT. Section 17(a)(1) exempts from the prohibitions of Section 17(a) the sponsor's deposit of securities with the trustee and receipt of units from the UIT.

<sup>732</sup> The terms "joint enterprise or other joint arrangement or profit-sharing plan" include any written or oral plan, contract, authorization or arrangement, or any practice or understanding concerning an enterprise or undertaking in which a CIS or a company controlled by it and an affiliate have a joint or a joint and several participation or share in the profits of such enterprise or undertaking.



- whether the CIS is participating on a basis that is different or less advantageous than that of the other participants.

### Soft Dollars

As a fiduciary, a CIS operator has an obligation to seek to obtain “best execution” of a CIS’s transactions. Under Section 28(e) of the Exchange Act, an operator may, consistent with that duty, cause a CIS to pay more than the lowest available commission for executing a securities trade in return for research services and products. To do so, an operator must make a good faith determination that the amount of commission paid is reasonable in relation to the value of the brokerage and research services provided by the broker-dealer viewed in terms of the particular transaction or the operator’s overall responsibilities to its clients. In making this determination, an operator may consider not only the benefit to be derived by the CIS that pays the commissions, but also the benefits derived by the operator’s other accounts. A CIS operator’s burden in substantiating its good faith determination is greater when the operator enters into a soft dollar arrangement with an affiliated broker-dealer, as opposed to an unaffiliated broker or dealer. Not any type of transaction, however, can be used to generate soft dollar benefits. For instance, soft dollar benefits may not be generated by certain types of principal transactions, such as those that occur in the markets for fixed-income securities.<sup>733</sup> Furthermore, soft dollars may not be used for all brokerage and research services. For instance, soft dollars may not be used for hardware, such as telephones or computer terminals, overhead, or products to help the operator meet compliance responsibilities.<sup>734</sup> A CIS must adequately disclose any soft dollar arrangements in its registration statement, and an operator must adequately disclose any soft dollar arrangements in its Form ADV.

In addition, Section 17(e)(1) of the Investment Company Act makes it unlawful for any affiliated person of a CIS (such as its operator), acting as agent, to accept any compensation (other than a regular salary or wages from the CIS) for the purchase or sale of property to or for the CIS (except when acting as a broker or an underwriter as discussed below with respect to the “Use of Affiliated Brokers”). Section 17(e)(1) limits the types of soft dollar benefits that a CIS operator may receive in connection with CIS brokerage transactions to only the research-related benefits that are permitted under Section 28(e) of the Exchange Act. The receipt of research services in connection with the CIS’s payment of commissions is considered to be compensation within the meaning of Section 17(e)(1) because the CIS operator is thereby relieved of the necessity to

<sup>733</sup> Soft dollar benefits may be generated by certain riskless principal transactions so long as the transaction meets certain transparency, disclosure and oversight conditions. See *SEC Guidance on the Scope of Section 28(e) of the Exchange Act*, Exchange Act Rel. No. 45194 (Dec. 27, 2001), available at <http://www.sec.gov/rules/interp/34-45194.htm>.

<sup>734</sup> See *Commission Guidance Regarding Client Commission Practices under Section 28(e) of the Securities Exchange Act of 1934*, Exchange Act Rel. No. 54165 (July 18, 2006), available at <http://www.sec.gov/rules/interp/2006/34-54165.pdf>.

produce the research itself or to purchase the research with its own money.

### **Directed Brokerage**

In a directed brokerage arrangement, a CIS – rather than the operator – instructs its operator to direct transactions to a particular broker, and the CIS receives products and services from the broker directly. Rule 12b-1(h)(1) prohibits a CIS from compensating a broker-dealer for promoting or selling CIS shares by directing brokerage transactions to that broker. The prohibition applies both to directing transactions to selling brokers and to indirectly compensating selling brokers by participation in step-out, and similar, arrangements in which the selling broker receives a portion of the commission. The ban extends to any payment, including any commission, mark-up, mark-down, or other fee (or portion of another fee) received or to be received from the CIS's portfolio transactions effected through any broker or dealer.

### **Lending and Borrowing to or from Affiliates**

Section 17(a) of the Investment Company Act generally prohibits any affiliate of a CIS from borrowing money or other property from the CIS, and Section 21(b) of the Investment Company Act generally prohibits a CIS from lending money or other property to any person that controls or is under common control with the CIS. A CIS, however, is not prohibited from borrowing from an affiliate. Nonetheless, in order to protect a CIS from large, leveraged losses, the Investment Company Act generally restricts the ability of a CIS to borrow.

### **Purchase of an Affiliate's Securities or Securities Underwritten by an Affiliate**

Section 10(f) of the Investment Company Act generally prohibits a CIS from purchasing, during an underwriting, any security when a principal underwriter of the security has certain affiliated relationships with the CIS. The SEC, however, has adopted a rule that exempts certain purchases from that prohibition. Rule 10f-3 permits a CIS that is affiliated with a member of an underwriting syndicate to purchase certain securities underwritten by the syndicate provided that certain conditions that are designed to protect investors have been met (*e.g.*, the CIS's board of directors adopts procedures for purchases made in reliance on the rule and regularly reviews the terms of purchases effected in reliance on the rule in order to determine whether they comply with the procedures). As discussed above, Section 17(d) of the Investment Company Act and Rule 17d-1 thereunder prohibit affiliated joint transactions. Under certain circumstances, a CIS that purchases securities that an affiliated person is selling may be engaged in such a prohibited joint transaction.

In addition, Section 12(d)(3) of the Investment Company Act and Rule 12d-3 thereunder generally prohibit a CIS from purchasing securities issued by its operator and its principal underwriter, *i.e.*, the broker-dealer that is primarily responsible for selling the CIS's shares (CIS principal underwriter).

### **Use of Affiliated Brokers**

Section 17(e)(2) of the Investment Company Act limits the compensation that an affiliate may receive (from any source) when acting as a broker for a CIS. When acting as a broker in connection with the sale of securities to or by the CIS, which is effected on an exchange, an affiliate may not receive compensation in excess of the “usual and customary broker’s commission.”<sup>735</sup> If the sale is effected in connection with a secondary distribution of securities, the compensation cannot exceed 2% of the sales price. For sales effected through other means, the compensation cannot exceed 1% of the sales price.

### **Employees Transacting for their Own Accounts**

Rule 17j-1 under the Investment Company Act generally requires a CIS, its operator, and principal underwriter each to adopt a code of ethics governing the personal securities transactions of its employees. In general, the codes of ethics are designed to ensure that people who have access to information regarding purchases and sales of securities by the CIS (“access persons”) do not use that information, or their ability to influence the CIS’s transactions, for their own personal gain. Rule 17j-1 requires that a CIS’s board of directors, including a majority of the independent directors, approve the CIS’s code, the code of any operator or CIS principal underwriter, and any material changes to the codes. The management of the operator, CIS principal underwriter, or CIS must at least once a year provide the CIS’s board of directors with a written report that describes any issues that arose during the previous year under the code, including, but not limited to, material violations. The management must certify to the CIS’s board of directors that reasonably necessary procedures have been adopted to prevent access persons from violating the code of ethics.

Rule 17j-1 also requires access persons to report personal securities transactions quarterly and to provide initial and annual securities holdings reports to his or her organization. Appropriate management or compliance personnel of the access persons’ organizations are required to review the reports. In addition, the CIS or its operator must review and pre-approve any investment in an IPO or private placement by certain investment personnel of the CIS or CIS operator.

Rule 17j-1 also prohibits an operator, a CIS principal underwriter, and their affiliated persons from engaging in certain fraudulent activities in relation to a CIS. The Rule prohibits such persons in connection with their purchase or sale of securities that are held or are to be acquired

<sup>735</sup> Under rule 17e-1 under the Investment Company Act, a commission will not exceed “usual and customary broker’s commission” if the commission is fair compared to the commission received by other brokers in connection with comparable transactions involving similar securities being purchased or sold on an exchange during a comparable period of time and if the CIS’s board of directors has certain procedures in place designed to monitor the fairness of the commissions.

by the CIS from engaging in any act, practice, or course of business that would operate as a fraud or deceit on the CIS or from engaging in any manipulative practice with respect to the CIS. In addition, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder contain a broad prohibition against any fraudulent activity in connection with the purchase or sale of any security by any person.

In addition, Section 204A of the Advisers Act requires CIS operators to establish, maintain, and enforce written procedures designed to prevent the misuse of material nonpublic information. Rule 204A-1 under the Advisers Act requires CIS operators to adopt codes of ethics. The rule requires an operator's code of ethics to set forth standards of conduct and require compliance with federal securities laws. Codes of ethics must also address personal trading: they must require operators' personnel to report their personal securities holdings and transactions, including those in affiliated CISs, and the codes must require personnel to obtain pre-approval of certain investments. CIS operators are required to keep copies of their codes of ethics and records relating to the code and to describe their codes of ethics to clients.

### **Affiliate's Receipt of Compensation for CIS Transactions**

As discussed above, Section 17(e)(1) of the Investment Company Act makes it unlawful for any affiliated person of a CIS (such as its operator) to receive any compensation (other than a regular salary or wages from the CIS) for the purchase or sale of property to or for the CIS when acting as an agent (except when acting as a broker or underwriter). For example, please refer to the discussion above under the heading "Soft Dollars" discussing the limitations of Section 17(e)(1) with regard to an operator's receipt of non-research related soft dollar benefits.

### **Advisory Fees**

Conflicts of interest may arise when operators set the fees that they charge to a CIS for the services that they provide because an operator has an incentive to charge the highest possible fee.

The SEC does not directly limit or regulate the amount of fees that an operator, or any other entity, can charge to a CIS. The Investment Company Act, however, deems an operator to have a fiduciary duty with respect to the receipt of compensation for services or of payments of a material nature by the CIS or its shareholders to the operator and its affiliates, and the SEC and CIS shareholders can sue the operator for breach of this fiduciary duty. In addition, the Investment Company Act requires a majority of the independent directors of a CIS's board of directors to annually approve the advisory contract. In doing so, the directors generally must evaluate the terms of the contract, including the fees charged by the operator and the

relationship between the nature and quality of the services provided under the contract and the fees charged, consistent with Section 36(b) of the Investment Company Act.<sup>736</sup>

In addition, if an operator charges a fee based on the performance of a CIS, the operator might be encouraged to take undue risks with the assets of the CIS to increase the amount of the fee that it will receive. The Advisers Act provides that a CIS operator may charge a performance fee only, with certain limited exceptions, if the fee also penalizes the operator for poor performance. In particular, a CIS operator may charge a “fulcrum fee,” i.e., a fee that increases or decreases proportionately with the investment performance of the CIS over a specified period of time as compared to an appropriate index of securities or other measure of performance specified by the SEC.

### **CIS Distribution**

Conflicts of interest also may arise when an open-end CIS pays for the marketing of its own shares. A CIS operator that receives an asset-based management fee has an incentive to spend excessive amounts of the open-end CIS’s assets on the marketing efforts because the operator may receive an increased amount of advisory fees due to any increase in open-end CIS assets caused by the sale of additional open-end CIS shares.

Under Section 12(b) of the Investment Company Act and Rule 12b-1, an open-end CIS may only pay for the marketing or distribution of its shares if it complies with certain conditions. For instance, an open-end CIS must adopt a written plan describing all material aspects of the proposed distribution financing. The plan generally must be approved by the open-end CIS’s shareholders, a majority of the open-end CIS’s board of directors, and a majority of the independent directors who have no direct or indirect financial interest in the operation of the plan or in any agreement related to the plan. In addition, an open-end CIS’s board of directors, including a majority of its independent directors, must annually approve the plan.

Shareholder approval is required for any amendment to increase materially the amount spent for marketing or distribution under the plan, and all other material amendments to the written plan must be approved by the open-end CIS’s board of directors and a majority of the independent directors who have no direct or indirect financial interest in the operation of the plan or in any agreement related to the plan. The board of directors must review, at least quarterly, a written report of the amounts spent under the plan and the reasons for these expenditures. An open-end CIS may adopt a plan only if the selection and nomination of independent directors of the open-end CIS is committed to the discretion of the independent directors.

<sup>736</sup>

*Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923 (2d Cir. 1982).

**UIT expenses**

Under the Investment Company Act, the UIT's trust indenture must provide that no payment may be made to the UIT's depositor or principal or affiliate thereof or underwriter except for certain administrative services as prescribed by the SEC. Rule 26a-1 generally limits the amount of any administrative fee paid to the UIT's depositor or principal or affiliate to the costs of the services provided, without profit.

- (b) To require a CIS operator to seek to minimize potential conflicts of interest and ensure that any conflicts that do arise are identified and properly managed by taking appropriate actions (including, where appropriate, through disclosure) so that the interests of investors are not adversely affected?

Yes. The answer below breaks out the various regulatory provisions and discusses them separately. For general information about disclosure of CIS operator conflicts, see response to Question 31.6.

**Direct Prohibition of Particular Transactions under the Law**

As discussed above, Section 17 of the Investment Company Act prohibits affiliated transactions including: (i) principal transactions involving purchases and sales of securities or other property; (ii) borrowing from the CIS and CIS lending; (iii) joint transactions in which a CIS's affiliate acts as principal; (iv) transactions in which a CIS's affiliate acts as agent and receives compensation for the purchase or sale of property for the CIS; and (v) transactions in which a CIS's affiliate acts as broker to the CIS and receives compensation over a specified amount for the purchase or sale of securities for the CIS.

Furthermore, the Advisers Act prohibits a CIS operator from acting as principal for his or her own account without disclosing to his or her client in writing before the completion of the transaction the capacity in which he or she is acting and obtaining the consent of the client to the transaction.

**Code of Ethics**

As discussed above in response to Question 24.12(a), Rule 17j-1 under the Investment Company Act also requires the CIS, its operator, and principal underwriter to adopt codes of ethics governing the personal securities transactions of their employees. A CIS must disclose annually whether it has adopted a code of ethics that applies to the CIS's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, regardless of whether these individuals are employed by the CIS or a third party. If the CIS has not adopted a code of ethics, it must explain why it has not done so. This rule addresses the conflicts of interest that arise when CIS insiders have access to information about the CIS's portfolio transactions. The Advisers Act further requires CIS operators to establish, maintain, and

enforce written policies and procedures reasonably designed, taking into consideration the nature of the CIS operator's business, to prevent the misuse of insider information, and Rule 204A-1 under the Advisers Act requires the CIS operator to adopt codes of ethics similar to those required by Rule 17j-1 under the Investment Company Act.

### **Review and/or Approval of Certain Transactions and Activities by the Regulatory Authority**

The SEC reviews certain filings, including registration and proxy statements, and certain transactions, including affiliated mergers and certain other transactions that involve potential conflicts of interest, in order to determine whether the CIS has made all of the necessary disclosures required.

Section 6(c) of the Investment Company Act and Section 206A of the Advisers Act authorize the SEC by rule, or by order upon application, to exempt, conditionally or unconditionally, any person, security, or transaction from one or more provisions of the Acts or SEC rules. To grant an exemption, the SEC generally must find that the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policies and provisions of the Acts. The exemption process includes notice to the public and an opportunity to request a hearing. Exemptive orders issued by the SEC are publicly available.

As described in response to Question 24.6 above, OCIE conducts and coordinates the nationwide examination program for entities that are registered with the SEC, including CIS operators. If serious potential violations are found, such as those that endanger CIS funds or securities, OCIE staff may refer the matter to Enforcement to consider whether an investigation and possible enforcement action are appropriate.

### **Disclosure by the Operator**

The prohibited affiliated transactions described above are not permitted even if the CIS or operator (or other affiliated persons of the CIS) discloses the conflicts presented by the transactions. The form used to register CIS shares with the SEC requires disclosure regarding the operator's use of affiliated broker-dealers, or any affiliated service provider, and any affiliated transactions that are material to the discussion of the CIS's investment strategies.

An operator must disclose all potential conflicts of interest between the CIS and its operator, even if the operator believes that a conflict has not affected and will not affect the operator's recommendations to the CIS. This obligation to disclose conflicts of interest includes the

obligation to disclose any benefits that the operator may receive from third parties as a result of its recommendations to the CIS.<sup>737</sup> The operator often provides the disclosure to the board of directors of the CIS in connection with the board's approval of the advisory contract. In addition, the CIS may disclose information about certain conflicts of the CIS and its operator to CIS shareholders.<sup>738</sup> Rule 206(4)-6 under the Advisers Act also requires CIS operators to adopt proxy voting policies and procedures, which must include how the CIS operator proposes to address conflicts. CIS operators are required to disclose to the CIS those policies and procedures and how the CIS can obtain information about how the CIS operator has voted CIS proxies, and they are required to keep records of how the CIS operator votes CIS proxies. In addition, a CIS is required to disclose its proxy voting record annually by filing Form N-PX with the SEC. The CIS is also required to inform shareholders of how they may obtain information about the CIS's proxy voting record (this information is disclosed on the CIS's website or in its annual and semi-annual reports).

### **Prior Approval or Ratification of Certain Transactions by the Investors**

The prohibited affiliated transactions described in the response to Question 24.12(a) above generally are not permitted even with prior approval or ratification by investors. Note, however, that the Investment Company Act addresses some potential conflict of interest situations by requiring prior approval by open-end and closed-end CIS shareholders. For example, Section 15 of the Investment Company Act provides that open-end and closed-end CIS shareholders must approve any increase in the operator's fees. In addition, Section 12(b) of the Investment Company Act and Rule 12b-1 thereunder provide that an open-end CIS may pay for the marketing or distribution of its shares only if, among other conditions, a written plan describing all material aspects of the proposed distribution financing is approved by the open-end CIS's shareholders.

### **Recordkeeping by the Operator**

A CIS must keep extensive books and records available for inspection by the Staff. Rule 31a-1 under the Investment Company Act requires a CIS to maintain and keep current the accounts, books, and other documents relating to its business that form the basis for the CIS's financial statements that are required to be filed with the SEC. Rule 31a-2(a)(2) requires the preservation of those records for a period of six years from the end of the fiscal year in which the transaction occurred, the first two years in an easily accessible place. Section 204 of the Advisers Act and Rule 204-2 thereunder require a CIS operator to maintain and preserve specified books and records and make them available to Staff for inspection.

<sup>737</sup> See, e.g., *In the Matter of Dawson-Samberg Capital Mgmt., Inc., et al.*, Advisers Act Rel. No. 1889 (Aug. 3, 2000).

<sup>738</sup> See Form N-1A.



The recordkeeping requirements are designed, in part, to enable the SEC to determine whether conflicts exist and adversely affect the CIS. For example, Rule 17j-1 under the Investment Company Act and Rule 204-2 under the Advisers Act require certain CIS personnel and CIS operators and their advisory representatives to keep records of their personal securities transactions. The recordkeeping requirements also allow the SEC to determine whether a CIS operator is favoring one CIS over another.

As noted above, the SEC has provided, in the form of rules of general application and individual exemptions, limited relief from the affiliated transaction prohibitions. Certain of those rules and orders require the CIS or its operator to maintain certain records for SEC inspection. For example, Rule 17a-7 requires that for every transaction conducted pursuant to the rule, the CIS must preserve written records that describe the transaction and its terms.

### **Independent Review by a Third Party**

**The Board:** The CIS's board, especially the independent directors, is expected to provide general oversight and independent checks on the CIS operator and other service providers to the CIS. In general, this duty requires the board to monitor the conflict of interest transactions involving the CIS. For example, Rule 17a-7 under the Investment Company Act exempts certain affiliated purchase and sale transactions from the prohibition in Section 17(a) (discussed in response to Question 24.12(a)), provided that the board, including a majority of the independent directors, adopts procedures to ensure that the purchase and sale transactions comply with the conditions of the Rule and, each quarter, determines that the transactions during the preceding quarter complied with the Rule. Please also refer to the response to Question 24.6 with respect to "The Board," and Question 24.12(a) with respect to "Principal Transactions between a CIS and its Affiliates."

**Independent Accountants:** The annual financial statements of a CIS must be audited by an independent accountant. Please refer to the response to Question 24.6 with respect to "Independent Accountants." If an open-end or closed-end CIS maintains custody of its own assets, an independent accountant must also verify the assets by actual examination at least three times a year, at least two of which must be chosen by the accountant without prior notice to the operator or CIS.<sup>739</sup>

<sup>739</sup> Rule 17f-2 under the Investment Company Act. Section 26(a) of the Investment Company Act provides that a UIT may not maintain custody of its own assets; rather, it must designate one or more bank custodians.

13.	(a) Does the regulatory system require the CIS operator to comply with operational conduct standards?
(b) In particular, is the CIS operator required to act in the best interest of investors and in accordance with the principle of fair treatment?	<p>Yes. The U.S. Supreme Court has construed Sections 206(1) and (2) of the Advisers Act as establishing a federal fiduciary standard governing the conduct of CIS operators.<sup>740</sup> A CIS operator is a fiduciary whose duty is to serve the best interests of its clients, including an obligation not to subordinate clients' interests to its own. Fiduciary duties are imposed on an adviser by operation of law and apply to the operator's entire relationship with its clients and prospective clients. The fiduciary duty is made enforceable by the anti-fraud provisions of Section 206. Included in the fiduciary standard are the duties of loyalty and care. The duty of loyalty requires an operator to serve the best interests of its clients, which includes an obligation not to subordinate the clients' interests to its own. An operator's duty of care requires it to make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information. For more information about CIS operators' duties, please see response to Question 24.4 above.</p>
14.	Does the regulatory system address the regulatory issues associated with:
(a) Best execution?	<p>Yes. As a fiduciary, an operator has an obligation to seek to obtain "best execution" of a CIS's transactions. Please also refer to response to Question 24.12 under the heading "Soft Dollars."</p>
(b) Appropriate trading and timely allocation of transactions?	<p>Yes. In examinations of CIS and their operators, the SEC gives particular scrutiny to allocation procedures to ensure that they are fair and equitable. Although no special method of allocation is required, the method employed must be fair and reasonable and consistently applied on a timely basis. The SEC has brought several enforcement proceedings against CIS operators for failing to disclose adequately that allocation policies favored certain clients.</p>
(c) Churning?	<p>Yes. CIS operators are subject to the anti-fraud provisions of the Advisers Act with respect to churning.<sup>741</sup></p>

<sup>740</sup> Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-192 (1963).

<sup>741</sup> See, e.g., SEC v. Galleon Capital Management, Litigation Rel. No. 14315 (Nov. 1, 1994), and First Multifund Advisory Corp. et. al., Exchange Act Rel. No. 34-11064 (Mar. 13, 1980).

Additionally, broker-dealers that market CIS shares are subject to rules related to churning. Churning refers to the excessive buying and selling of securities in an account by a broker for the purpose of generating commissions and without regard to the customer's investment objectives. For churning to occur, a broker must exercise control over the investment decisions in an account, either through a formal written discretionary agreement or otherwise. Churning can be a violation of Rule 15c1-7 under the Exchange Act and other federal securities laws.

The SROs have rules prohibiting churning and excessive trading. Excessive trading is the same as churning but without the requirement that the person engaging in the trading do so for the purpose of generating commissions. Churning and excessive trading can violate FINRA Rule 2111, NYSE Rule 408(c), and NYSE Rule 476(a)(6).

(d) Related party transactions?

Yes. The prohibited affiliated transactions described in the response to Question 24.12, above are not permitted even if the CIS or operator (or other affiliated person of the CIS) discloses the conflicts presented by the transactions. Other conflicts between an operator and a CIS that are not specifically prohibited by the Investment Company Act must be disclosed to the board of directors, and they are often disclosed to investors. For example, the form used to register CIS shares with the SEC requires disclosure regarding the operator's use of affiliated broker-dealers, or any affiliated service provider, and any affiliated transactions that are material to the discussion of the CIS's investment strategies. In addition, a CIS is required to disclose information about the nature and extent of all relationships with its affiliates in the CIS's financial statements, which must be filed with the SEC, sent to its investors semi-annually, and audited annually.

(e) Underwriting arrangements?

Yes. Section 22(d) of the Investment Company Act and Rule 22d-1 thereunder generally prohibit a CIS and its principal underwriter or a dealer in its shares from selling its securities at other than the current public offering price described in the CIS's prospectus unless a scheduled variation in sales loads is established, uniformly applied, and disclosed. Furthermore, FINRA generally limits sales loads on CIS shares to a maximum of 8.5%.

Additionally, the Investment Company Act imposes requirements on principal underwriting contracts with CIS that are similar to, but less stringent than, those imposed on advisory contracts. Section 15(b) of the Investment Company Act requires that any principal underwriter for an open-end CIS may sell the CIS's securities only pursuant to a written contract. This contract, in turn, must provide that it may continue in effect for more than two years from execution only if continuance is approved annually by: (i) the board or by shareholders and (ii) the independent directors of the board (Section 15(a)). The contract also must automatically terminate on its assignment.

(f) Due diligence in the selection of investments?
<p>Yes. While there is no explicit SEC rule imposing upon CIS operators a duty to conduct due diligence, a CIS operator does have a fiduciary duty to its clients, which includes the duty to make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information. The duty of care also imposes upon the operators a duty to provide only suitable investment advice. This duty (which is enforceable under the anti-fraud provisions of Section 206 of the Advisers Act) generally requires an operator to determine that the investment advice it gives to a client is suitable for the client, taking into consideration the client's financial situation, investment experience, and investment objectives. All investment advisers, including those that operate CIS, must also disclose to clients, in Item 8 of Form ADV Part 2, their methods of analysis and investment strategies, among other things.</p>
(g) Fees and expenses, in order to ensure that no unauthorized charges or expenses are levied against a CIS or CIS investors and that commission rebates, soft commission arrangements and inducements do not conflict with the CIS operator's duty to act in the best interest of investors?
<p>Yes. The regulation of a CIS's fees and expenses are generally governed by the Advisers Act, Investment Company Act, and the rules thereunder.</p> <p>Please see response to Question 24.4 with respect to a CIS operator's fiduciary duty to a CIS, and Question 24.12 with respect to advisory fees, UIT expenses, and soft dollars.</p>
<i>Delegation</i>
15. Does the regulatory system provide for clear indication of circumstances under which delegation is allowed and is there prohibition of systematic and complete delegation of core functions of the CIS operator to the extent that there is a transformation, gradual or otherwise, into an empty box?
<p>Yes. There is no statutory prohibition on delegation of CIS operator functions to other persons if the contract between the CIS operator and the CIS (advisory contract) permits the delegation.</p> <p>As noted above, delegation is allowed if the advisory contract permits such delegation. If the contract permits delegation and advisory responsibilities are delegated, the delegate would be considered to be an operator of the CIS, and it may perform services for the CIS only pursuant to a written contract (subadvisory contract) that is approved in the same manner as the advisory contract, <i>i.e.</i>, by a majority of the CIS's shareholders and a majority of the CIS's independent directors. In addition, the delegate must be registered with the SEC as an operator under the Advisers Act. As an investment adviser, the delegate would have a fiduciary duty to the CIS and, as discussed below, in the event that the delegate fails to perform its duties satisfactorily, the CIS operator and the delegate may both be accountable. There is no prohibition against the systematic and complete delegation of core functions (<i>i.e.</i>, the advisory responsibilities) of the</p>

CIS operator.

In some instances, a CIS advisory contract may obligate the CIS operator to provide non-advisory services. If the contract provides for delegation, the CIS operator also may delegate the non-advisory services to another person, such as an administrator.

16. If delegation is permitted, is the delegation done in such a way so as not to deprive the investor of the means of identifying the company legally responsible for the delegated functions? In particular:

(a) Is the CIS operator responsible for the actions or omissions, as though they were its own, of any party, to whom it delegates a function, including compliance with the rules of conduct and other operating conditions?

Yes. Whether the CIS operator is responsible for the actions of the delegate depends on the advisory and subadvisory contracts. Usually, the advisory contract will provide that the CIS operator is responsible for all aspects of the advisory relationship, and the subadvisory contract will provide that the CIS operator is responsible for supervising the delegate. In that case, if the delegate fails to perform its duties satisfactorily, the CIS operator and the delegate both may be accountable to the CIS and its shareholders.

If an advisory contract with a CIS (i) provides for the use of a second CIS operator that would not be supervised by the first CIS operator; and (ii) provides that the first CIS operator would not be considered accountable for the actions of the second CIS operator, then the first CIS operator would not be accountable to the CIS and its shareholders for the actions of the second CIS operator. The second CIS operator would be accountable for its actions.

The same principles apply to delegations of administrative functions from CIS operators to administrators.

A CIS operator must designate a person to be CCO. This person should have a position of sufficient seniority and authority within the organization to compel others to adhere to the CP&P. The CIS operator is generally responsible for the actions or omissions of such designee as if they were its own.

(b) Does the regulatory system require the CIS operator to retain adequate capacity and resources and have in place suitable processes to monitor the activity of the delegate and evaluate the performance of the delegate?

Yes. While there are no direct requirements requiring the CIS operator to supervise a sub-adviser (see response to sub-Section (a) above), the SEC can bring an enforcement action against a CIS operator for failure to supervise a delegate if the delegate violates the federal securities laws and is subject to the CIS operator's supervision. Furthermore, the board of directors, when annually renewing the advisory contract with the delegate, examines the effectiveness of the delegate's

internal controls.

- (c) Can the CIS operator terminate the delegation and make alternative arrangements for the performance of the delegated function where appropriate?

Yes. If the delegate is a sub-adviser, Section 15 of the Investment Company Act provides that the CIS operator cannot terminate the contract without approval by either a majority of the CIS directors or a majority of its shareholders. Please see response to Question 24.16(d) below. If the delegate is another service provider, this is a matter of private contract law between the CIS operator and the service provider. Such contracts typically contain a termination clause that requires advance notice of termination.

- (d) Are there requirements for disclosure to investors in relation to the delegation arrangements and the identity of the delegates?

Yes. As noted above, if advisory responsibilities are delegated, the delegate would be considered to be an adviser to the CIS, and it may perform services for the CIS only pursuant to a subadvisory contract that is approved in the same manner as the advisory contract, *i.e.*, by a majority of the CIS's shareholders or a majority of the CIS directors. Disclosure to investors in relation to the delegation arrangements and the identity of the delegates would be made in connection with the shareholder vote approving the subadvisory contract.

In addition, a CIS generally must disclose information about the delegate in its registration statement (including its prospectus) to the same extent that it discloses information about its operator.<sup>742</sup>

- (e) Does the regulatory system allow the regulator to take appropriate actions in case of delegations which may give rise to a conflict of interest between the delegate and the investors?

Yes. The same provisions to prohibit, restrict, or disclose certain conduct likely to give rise to conflicts of interest discussed above in response to Question 24.12 apply equally to delegates of a CIS. As discussed above, particularly in response to Question 11.7, the SEC is empowered to take appropriate actions in case of delegations that may give rise to a conflict of interest between a delegate and investors.

<sup>742</sup>

See, *e.g.*, item 5 of Form N-1A.

17. If delegation is permitted, is the delegation done in such a way so as not to jeopardize the ability of the regulator to effectively access data related to the delegated functions, either directly through the delegate(s) or through the CIS operator?

Yes. As noted above, there is no statutory prohibition on delegation of CIS operator functions to other persons if the contract between the CIS operator and the CIS (*i.e.*, the advisory contract) permits the delegation. If the contract permits delegation and advisory responsibilities are delegated, the delegate would be considered to be an operator to the CIS, and it may perform services for the CIS only pursuant to a written contract (“subadvisory contract”) that is approved in the same manner as the advisory contract, *i.e.*, by a majority of the CIS’s shareholders and a majority of the CIS’s independent directors. In addition, the delegate must be registered with the SEC as an operator under the Advisers Act. There is no statutory prohibition against the systematic and complete delegation of core functions (*i.e.*, the advisory responsibilities) of the CIS operator.

In some instances, a CIS advisory contract may obligate the CIS operator to provide non-advisory services. If the contract provides for delegation, the CIS operator also may delegate the non-advisory services to another person, such as an administrator.

The Investment Company Act, the Advisers Act and the rules thereunder require CISs, CIS operators, and others on behalf of the CIS or CIS operator to maintain and preserve certain books and records.<sup>743</sup> All books and records required to be maintained and preserved are subject at any time, or from time to time, to such reasonable periodic, special, and other examinations as the SEC may prescribe.

For further information please see responses to Questions 24.1 and 24.11 above. In addition, for more information on the SEC’s examination authority, please refer to Question 12.1 above.

<sup>743</sup> See Section 31 of the Investment Company Act and Section 204 of the Advisers Act and the respective rules thereunder.

**Principle 25      The regulatory system should provide for rules governing the legal form and structure of CIS and the segregation and protection of client assets.**

**Key Questions**

*Legal Form/Investors' Rights*

1. Does the regulatory system provide for requirements as to the legal form and structure of CIS that delineate the interests of participants and their related rights?

Yes. The Investment Company Act imposes certain capital structure requirements on CISs. For example, Section 18 of the Investment Company Act requires that all common stock issued by a CIS be voting stock and have equal voting rights. With respect to closed-end CIS, the Investment Company Act provides that such CISs are permitted to have only one class of debt and one class of preferred stock in addition to one class of common stock.

There are no specific requirements as to the legal form of an open-end or closed-end CISs in the Investment Company Act. Under Sections 7(a), (b), and (d) and 8(a) of the Investment Company Act, a CIS must be organized or created either under the laws of the U.S. or a state, or under the laws of a foreign country. An open-end or closed-end CISs generally may be organized as a corporation, a partnership, an association, a joint-stock company, a trust, or any organized group of persons, and most open-end and closed-end CIS are structured as business trusts or as corporations. A Unit Investment Trust (UIT) must be organized under a trust indenture, contract of custodianship or agency, or similar instrument.

Open-end CISs must offer redeemable securities which entitle a CIS investor to redeem the CIS shares for a proportionate cash equivalent of the CIS's NAV upon presentation to the CIS.<sup>744</sup> Closed-end CISs, on the other hand, do not issue redeemable securities.

2. Does the regulatory system provide that the legal form and structure of a CIS, as well as the implications thereof for the nature of risks associated with the CIS, be disclosed to investors in such a way that they are not dependent upon the discretion of the CIS operator?

Yes. Section 8(b) of the Investment Company Act requires an open-end or closed-end CIS to state in its registration statement its classification under Sections 4 and 5 (*i.e.*, whether it is an open-end or closed-end CIS or UIT). All CISs are required to disclose in their registration statements information about the redeemability of their shares, as well as the name of the state or other jurisdiction in which they are organized. In addition, as discussed in response to Question 26.5, a CIS's registration statement contains exhibits, including copies of its organizational documents, such as the articles of incorporation, bylaws, or trust agreement which

<sup>744</sup> Investors in open-end CIS that are exchange-traded funds generally buy and sell their shares on the secondary market, rather than from the CIS.



could include information about legal form and structure. Please also see also response to Question 25.3 below.

3. Is there a regulatory authority responsible for ensuring that the form and structure requirements are observed?

Yes. The responsibility for ensuring that the requirements are observed rests primarily with the CIS and with those who signed its registration statement. Staff generally reviews CIS registration statements to determine whether the CIS has made all of the necessary disclosures required by the registration form, but Staff does not approve or disapprove a CIS registration statement based upon the merits of an investment in the CIS, the qualifications of a CIS operator, or the legal structure and form of the CIS. Please see response to Question 24.2 above. In addition, as described in responses to Question 24.6 above, OCIE conducts and coordinates the nationwide examination program for entities that are registered with the SEC. In addition, enforcement action may be taken if violations are found, such as those that endanger CIS funds or securities.

4. Does the regulatory system provide that where material changes are made to investor rights that do not require prior approval from investors, notice is given to them before the changes take effect?

Yes. The instances in which investor rights are affected materially are subject to shareholder approval, and thus advance notice is provided to shareholders.

Furthermore, in the case of non-material changes, which do not require shareholder approval,<sup>745</sup> open-end CISs and UITs must update their registration statements, including prospectuses, to reflect any material changes that have been made to investor rights so that new shareholders, or existing shareholders making a new investment, are informed of the change.<sup>746</sup> All CIS

<sup>745</sup> Note that the Investment Company Act and the rules thereunder provide shareholders with certain specific rights. Under Section 13 of the Investment Company Act, no CIS may, unless authorized by the vote of a majority of its outstanding voting securities: (i) change from being an open-end CIS to a closed-end CIS or from being a diversified to a nondiversified company; (ii) borrow money, issue senior securities, underwrite securities issued by other persons, purchase or sell real estate or commodities, or make loans to other persons, except in accordance with the recitals of policies contained in the CIS's registration statement; (iii) deviate from any investment policy that is changeable only by shareholder vote; or (iv) change the nature of its business so as to cease to be an investment company. Section 15 of the Investment Company Act generally prohibits any person from acting as an investment adviser (CIS operator) to a CIS except pursuant to a written contract that has been approved by the vote of "a majority of the outstanding voting securities" of the CIS that is cast at the annual meeting or at a special meeting of security holders. Section 16(a) of the Investment Company Act prohibits any person from acting as a director of a CIS unless elected to that office by the holders of the outstanding voting securities of such company, at an annual or a special meeting duly called for that purpose (except that vacancies occurring between such meetings may be filled in any otherwise legal manner if immediately after filling any such vacancy, at least two-thirds of the directors then holding office shall have been elected to such office by the holders of the outstanding voting securities of the company at such an annual or special meeting).

<sup>746</sup> See response to Question 24.10 above. Rule 8b-16 under the Investment Company Act provides that a closed-end CIS need not update its registration statement annually if it provides certain important information to shareholders in the closed-end CIS's annual report to shareholders.

registration statements, including prospectuses, are available on the SEC's website, and many open-end CISs provide updated prospectuses on their websites. A CIS using a summary prospectus must provide updated prospectuses on its website.<sup>747</sup> As a practical matter, open-end CISs generally provide updated prospectuses annually to existing shareholders.

Finally, in certain circumstances a CIS must provide shareholders with at least 60 days' notice prior to changing an investment policy of investing at least 80% of the CIS's assets in the type of investments that are suggested by the CIS's name.<sup>748</sup>

5. Does the regulatory system provide that where material changes are made to investor rights, notice is given to the relevant regulatory authority?

Yes. A CIS that is making a continuous offering of its securities must maintain a current registration statement, including its prospectus. Any material change to the prospectus must be filed with the SEC.<sup>749</sup> Material changes include, among other things, changes in the CIS's investment objectives or fundamental policies, suspension of sales or redemption of shares, termination of an advisory contract, and, in some cases, the resignation of the CIS's independent public accountant. A closed-end CIS (*i.e.*, a CIS that is not making a continuous offer of its securities) discloses material changes in its annual reports to shareholders.<sup>750</sup>

As stated in the response to Question 24.10, CISs have a general and continuing obligation to report to the SEC, either prior to or after the events, information relating to material changes in their management or organization because: (i) that information generally must be described in the CIS's prospectus; and (ii) a CIS generally must amend its registration statement to correct any disclosure that becomes materially inaccurate.<sup>751</sup>

<sup>747</sup> Rule 498(e)(1) under the Securities Act.

<sup>748</sup> Rule 35d-1 under the Investment Company Act provides that if a CIS has a name that suggests that it focuses its investments in a particular investment or investments in an industry or group of industries, then the CIS must invest at least 80% in the particular type of investments suggested by the name. The rule requires that the CIS either: (i) adopt the 80% investment standard as a policy that cannot be changed without prior shareholder approval; or (ii) adopt a policy to provide shareholders with at least sixty days' notice prior to any change in its 80% investment policy.

<sup>749</sup> See response to Question 24.10 above.

<sup>750</sup> See rule 8b-16 under the Investment Company Act, discussed above.

<sup>751</sup> The Securities Act requires a CIS that is making a continuous offering to maintain a "current" statutory prospectus. Specifically, section 10(a)(3) of the Securities Act requires that any prospectus used more than nine months after the registration statement's effective date must contain financial and other information as of a date not more than sixteen months prior to such use. A CIS making a continuous offering of its securities can update its prospectus by filing a post-effective amendment to its registration statement that contains updated financial statements and other information. In addition, CIS must amend the registration statement to avoid potential liability. In particular, section 11 of the Securities Act provides that the CIS itself, its directors (including persons named in the CIS's registration statement as about to become directors of the CIS), all of the persons who sign the CIS's registration statement, any expert who is named as having certified or prepared information in the registration statement, and the underwriter may be liable for any materially false statement or omission in a CIS's registration statement.

6. Does the regulator have powers aimed at ensuring that any restrictions on type or level of investment or borrowing are being complied with?

Yes. As discussed in the responses to Question 24.7, above, Staff reviews the adequacy of disclosures in CIS registration statements and periodic reports. If Staff notes a perceived disclosure or regulatory deficiency during the review of a material amendment to a CIS's registration statement (e.g., that the CIS is not complying with applicable restrictions on investment or borrowing), Staff will send a comment letter to the company or its counsel that sets forth the specific concerns that Staff has with the filing. The CIS has an opportunity to address the Staff's comments by amending the disclosure contained in the filing or by explaining in a response letter to Staff why no amendment to the filing is required.

In addition, OCIE conducts examinations of CISs and CIS operators, among others, to assess whether such entities are complying with the federal securities laws. OCIE reviews a CIS's compliance with its stated investment policy or trading strategy, any authorized investments, and any other required policies during its exams of CISs and CIS operators. Following the completion of an exam, if OCIE has identified rule violations or weaknesses related to a CIS's or CIS operators' compliance, it will typically issue a deficiency letter to the CIS or its operator. In some cases the seriousness of the violations or weaknesses may warrant a referral by examination staff to Enforcement.

As stated in the response to Question 24.6, the SEC is authorized by the Advisers Act and the Investment Company Act to institute administrative proceedings against any person or to sue any person in federal court for violations of these Acts, including, among other things, the failure to follow required restrictions on investment or borrowing.

#### *Separation of Assets/Safekeeping*

7. Does the regulatory system require adequate segregation of CIS assets from the assets of the CIS operator and its managers or other entities?

Yes. To preserve the assets of CIS and protect those assets from abuses, pursuant to Section 17(f) of the Investment Company Act and the rules thereunder, CISs must place their securities and similar investments in the custody of certain eligible custodians ("eligible custodians"). For open-end and closed-end CISs, eligible custodians include: (i) banks subject to federal or state regulation and that generally have capital of at least \$500,000; (ii) members of a national securities exchange (i.e., certain broker-dealers); (iii) securities depositories; (iv) futures commission merchants (FCMs) and commodity clearing organizations; and (v) certain foreign entities subject to certain conditions. In certain circumstances, an eligible custodian may deposit CIS assets with another eligible custodian, such as a registered clearing agency acting as a securities depository. Because a UIT has no board to monitor custody arrangements, Section 26(a) of the Investment Company Act provides that a UIT may not maintain custody of its own assets but must designate one or more banks (that have an aggregate capital of not less than \$500,000) as trustees or custodians.

There is no requirement that a CIS's custodian be legally or functionally independent from the CIS's operator. If a CIS operator or its affiliate acts as a CIS's custodian, however, the CIS is deemed to have "self custody" of its assets. If a CIS is deemed to have self custody, Rule 17f-2 under the Investment Company Act requires, among other things, that: (i) the CIS must deposit the securities and similar investments in the safekeeping of, or in a vault or other depository maintained by, a bank or other company whose functions and physical facilities are supervised by federal or state authorities; (ii) the securities and similar investments must be physically segregated from those of any other person; (iii) the board of directors of the CIS must designate which employees (not more than five persons) are authorized to have access to the assets; and (iv) written notations must document each deposit or withdrawal of securities. In addition, the CIS must employ an independent public accountant to verify, by actual examination, the CIS's assets at least three times during the year (twice without prior notice). A certificate of such accountant, stating that the examination has been made, and describing the nature and extent of the examination, must be sent to the SEC after each examination.

8. Does the regulatory system provide for requirements governing the safekeeping of CIS assets such as:

- (a) the obligation to entrust the assets to custodians and/or depositories that are in appropriate circumstances independent; or
- (b) special legal or regulatory safeguards in cases where the functions of custodian and/or depository are performed by the same legal entity responsible for investment functions (or related entities); or
- (c) adequate protection of client assets from losses or insolvency of the CIS operator and the obligation that, where third party custodians are used, client assets are identified as such to any such custodian and equivalent protection is afforded to the client assets, including when the custodian has entrusted all or some of the assets in its safekeeping to a the third party?

Yes. The SEC has adopted a number of rules that govern the custody of open-end and closed-end CIS assets. One general objective of the rules is to separate the assets of a CIS from the assets of any other person, including its operator (*i.e.*, to entrust assets to custodians that are in appropriate circumstances independent). For more information on the requirements applicable to self-custody arrangements, please refer to response to Question 25.7, above. The requirements that apply to specific eligible custodians are discussed below.

### **Bank**

A CIS may place its securities and similar investments in the custody of a bank that is subject to federal or state regulation and that generally has capital of at least \$500,000.<sup>752</sup> If a CIS uses a

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Section 17(f)(1)(A) of the Investment Company Act.

bank as the eligible custodian of its securities and similar investments, then the cash proceeds from the sale of securities and other cash assets also generally must be kept in the custody of an eligible bank.<sup>753</sup> A CIS that uses a bank custodian may, upon resolution of the CIS's board, maintain limited cash to meet current expenses in another bank and up to \$500 in cash in a petty cash account, subject to certain conditions.<sup>754</sup> The custodial activities of banks are regulated primarily by the appropriate federal or state banking regulator rather than by the SEC.

### **Broker-dealer**

A CIS also may use a member of a national securities exchange (*i.e.*, certain broker-dealers) as its custodian subject to the conditions of Rule 17f-1 under the Investment Company Act. Rule 17f-1 requires, among other things, that the CIS's securities and investments be individually segregated from the securities and investments of any other person and marked to clearly identify them as the property of the CIS to the extent that this is feasible. Rule 17f-1 also requires that the securities and investments be verified by actual examination by an independent public accountant at the end of each annual and semi-annual fiscal period and at least one other time chosen by the accountant during the fiscal year. Such securities and investments also must at all times be subject to inspection by the SEC. Broker-dealers are subject to regulation by FINRA as well as the SEC.

### **Securities Depository**

Rule 17f-4 under the Investment Company Act permits a CIS or any eligible custodian to deposit all or any part of the securities owned by the CIS with a securities depository, which is a system for the central handling of securities where all securities of any particular class or series of an issuer deposited within the system are treated as fungible and may be transferred or pledged by bookkeeping entry without physical delivery of the securities. A securities depository includes a clearing agency that must be registered with the SEC that acts as a securities depository and certain federal agencies that act as depositories for government securities (the Federal Book-Entry System). Rule 17f-4(a) under the Investment Company Act requires that a CIS's custodian must, at a minimum, exercise due care in accordance with reasonable commercial standards in discharging its duty as a securities intermediary to obtain and thereafter maintain financial assets. If the CIS deals directly with a depository, the depository's contract or rules for participants must provide that the depository will meet similar obligations. The custodian also must provide, promptly upon request by the CIS, such reports as are available about the internal accounting controls and financial strength of the custodian. If the fund deals directly with a depository, the depository's contract or written rules for its participants must provide that the depository will provide similar financial reports.

<sup>753</sup> Section 17(f)(5) of the Investment Company Act.

<sup>754</sup> Rule 17f-3 under the Investment Company Act.

**Foreign Entities**

Rule 17f-5 under the Investment Company Act provides that a CIS may maintain its foreign assets with an eligible foreign custodian that is a foreign bank, including a banking institution or trust company that is incorporated or organized under the laws of a non-U.S. country and is regulated by that country's government or an agency of the country's government, or with a majority-owned subsidiary of a U.S. bank or bank holding company. Rule 17f-5 requires, among other things, that a foreign custody manager determine that CIS assets will be subject to reasonable care if maintained with a particular foreign bank.<sup>755</sup> The foreign custody manager must consider all factors relevant to the safekeeping of such assets, including the foreign bank's internal controls, financial strength, and general reputation. In addition, the foreign custody manager must determine that the written custody contract with the foreign bank will provide reasonable care for CIS assets. The rule also states that the contract must contain certain provisions listed in the rule, or that the foreign custody manager must determine that the contract contains other provisions that provide equivalent protection to the provisions listed in the rule.

Rule 17f-7 under the Investment Company Act provides that foreign assets of a CIS may be maintained with an eligible foreign securities depository, which generally includes a securities depository that acts or operates as a system for the central handling of securities or equivalent book-entries in the country where incorporated, or a transnational system for the central handling of securities or equivalent book-entries, if the depository or transnational system is regulated by a foreign financial regulatory authority. Rule 17f-7 requires, among other things, that the depository custody arrangement obligate the primary custodian, generally a U.S. bank or certain foreign banks that contract directly with a CIS to provide custody services for the CIS's foreign assets, to analyze and monitor the custody risks of using the depository, and provide information about the risks and any material changes in the risks to the CIS or its operator. The rule also requires that the eligible foreign securities depository maintain records identifying participants' assets and keeping the depository's own assets separate.

**Futures Commission Merchants**

Rule 17f-6 under the Investment Company Act permits a CIS to maintain assets with an FCM in amounts necessary to effect the CIS's transactions in exchange-traded futures contracts and commodity options. Rule 17f-6 requires, among other things, that the FCM be registered with the appropriate government agency under the CEA and be unaffiliated with the CIS. An FCM must comply with the segregation requirements of the CEA.

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<sup>755</sup> A "foreign custody manager" is defined as the CIS's board of directors or any person serving as the board's delegate in accordance with certain conditions imposed by rule 17f-5 under the Investment Company Act.

**Fidelity Bonds**

Section 17(g) of the Investment Company Act and Rule 17g-1 thereunder generally require that a CIS provide and maintain a bond, issued by a reputable fidelity insurance company, against larceny and embezzlement involving CIS assets. The bond must cover each officer and employee of the CIS who may have access to securities or funds of the CIS, unless the officer or employee has access solely through his or her position as an officer or employee of a bank.

9. Does the regulatory system adequately provide for an orderly winding up of CIS business, if needed?

Yes. A CIS remains subject to all provisions of the Investment Company Act until it is deregistered. To deregister, the CIS must obtain an order from the SEC declaring that it has ceased to be a CIS and that its registration is no longer in effect. The SEC has authority to impose conditions on deregistration that are necessary for the protection of investors. Prior orders have generally been based on a finding that, among other things, the company has distributed substantially all of its assets to shareholders and is winding up its affairs or that the company has sold substantially all of its assets to another CIS or merged into or consolidated with another such CIS.

**Principle 26** Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a CIS for a particular investor and the value of the investor's interest in the CIS.

**Key Questions**

1. Does the regulatory system require that all matters material to the valuation of a CIS are disclosed to investors and potential investors on a timely basis?

Yes.

**Open-end CIS**

Items 11 and 23 of Form N-1A require an open-end CIS to disclose in the prospectus and the SAI information concerning the procedures for valuing the CIS's assets and pricing the CIS's shares and in particular, information about the purchase of CIS shares, the CIS's policy with respect to dividends and distributions, and the tax consequences of buying and selling the CIS's shares. An open-end fund (other than a money market fund) is required to briefly explain the circumstances under which the fund will use fair value pricing and the effects of using fair value pricing.

**Closed-end CIS**

Item 2 of Form N-2 requires a closed-end CIS to identify on the cover page of the prospectus whether any national securities exchange lists the securities offered. Items 5 and 10 of Form N-2 require a closed-end CIS to disclose in its registration statement information concerning the value of the CIS, such as information about the price to the public in each principal underwriter distribution, the CIS's policy with respect to dividends and distributions, and the tax consequences of buying and selling the CIS's shares, and to describe the valuation procedure used by the closed-end CIS in determining the price to the public when it is impracticable to state such a price.

**UIT**

Item 44 of Form N-8B-2 requires information concerning the UIT's value, such as information about the method used to calculate the offering price and the redemption price of securities. Item 46 of Form N-8B-2 requires information concerning the method used to calculate the redemption price.

Regulation S-X also requires a registered CIS to disclose in a note to its balance sheets the methods used in determining the value of its investments.

In addition, please see the response to Question 24.8 for more information on a CIS's responsibility to update its offering documents on a timely basis.



2. Does the regulatory system require that the information referred to in Question 1 above be disclosed to investors and potential investors in an easy to understand format and language having regard to the type of investor?

Yes. Key information is required to appear in “plain English” in a standardized order at the front of an open-end CIS’s prospectus.<sup>756</sup> In particular, the instructions to Form N-1A state that a CIS’s “prospectus should clearly disclose the fundamental characteristics and investment risks of the [f]und, using concise, straightforward, and easy to understand language.” In addition, the instructions also indicate that the prospectus should avoid “including lengthy legal and technical discussions” and “should include only as much information as is necessary to enable an average or typical investor to understand the particular characteristics of the [f]und.” Form N-2 provides that the information in the closed-end CIS prospectus and the “SAI should be organized to make it easy to understand the organization and operation of the [CIS].”<sup>757</sup> It also provides that the information in the prospectus should be “clear, concise, and understandable.” Finally, the requirement to provide information in plain English also applies to UITs as well as other CIS.

3. Does the regulatory system require the use of standard formats for disclosure of offering documents and periodic reports to investors?

Yes. The regulatory system requires the use of standard formats for the submission of offering documents and periodic reports. Please see response to Question 26.5 with respect to offering documents. Please see response to Question 26.9 with respect to annual, semi-annual, and other periodic reports.

4. Does the regulatory system include a general disclosure obligation to allow investors, and potential investors, to evaluate the suitability of the CIS for that investor or potential investor?

Yes. A CIS’s prospectus is intended to include all information that would be material to an investment decision by a prospective investor. A CIS must deliver a prospectus to an investor (a closed-end CIS is not required to deliver a prospectus to an investor purchasing shares in the secondary market). An open-end or closed-end CIS prospectus generally includes information about the CIS’s investment objectives and goals, principal investment strategies, and the principal risks of investing in the CIS. A UIT prospectus contains detailed information concerning the securities comprising the unit of specified securities in which a shareholder will have an interest. An open-end CIS may, but is not required to, describe the types of investors for whom the CIS is intended or the types of investment goals that may be consistent with an investment in

<sup>756</sup> With respect to plain English, see general instruction B.4(c) of Form N-1A and the plain English requirements of Rule 421 under the Securities Act. With respect to the standardized order, see general instruction C.3(a) of Form N-1A.

<sup>757</sup> See Form N-2, General Instruction 1.

the CIS. For additional detail on the contents of a CIS's prospectus, see response to Question 26.5, below.

In addition, the federal securities laws, as well as rules with regard to suitability and disclosure of various SROs, such as FINRA, impose suitability requirements on the entities that recommend to investors that they purchase a CIS's shares.

5. Does the regulatory system specifically require that the offering documents, or other publicly available information, include the following:

(a) The date of issuance of the offering document?

Yes. Rule 423 under the Securities Act generally requires each prospectus used after the effective date of the registration statement to be dated approximately as of such effective date.<sup>758</sup>

### **Open-end CIS**

Item 1 of Form N-1A requires an open-end CIS to include the date of the prospectus on the outside front cover page of the prospectus.<sup>759</sup>

### **Closed-end CIS**

Item 1 of Form N-2 requires a closed-end CIS to include the date of the prospectus on the outside front cover page of the prospectus.

### **UIT**

Item 6 of Form N-8B-2 requires a UIT to include the date of execution and termination of the trust indenture.

<sup>758</sup> Please see response to Question 24.6 for a description of what constitutes the offering document under the federal securities laws. Furthermore, an investor may be sent or given the key information in the form of a summary prospectus as long as the full prospectus is provided on an internet website. A CIS may not incorporate by reference into a prospectus information that is required to be included in the prospectus, except as specifically permitted. A CIS may incorporate by reference any or all of the SAI into the prospectus without delivering to investors the SAI with the prospectus. The SAI must be provided to investors upon request.

<sup>759</sup> If a summary prospectus is used, the approximate date of its first use must be included on the cover page or at the beginning of the document.

(b) Information concerning the legal constitution of the CIS?
<p>Yes.</p> <p><b>Open-end CIS</b></p> <p>Item 15 of Form N-1A requires an open-end CIS to provide in its SAI its date and form of organization and to identify the state or other jurisdiction in which it was organized. Item 28 of Form N-1A requires an open-end CIS to include copies of its articles of incorporation or other corresponding documents as exhibits to its registration statement.</p> <p><b>Closed-end CIS</b></p> <p>Item 8 of Form N-2 requires a closed-end CIS to provide in its prospectus its date and form of organization and to identify the state or other jurisdiction in which it was organized. Item 25 of Form N-2 requires a closed-end CIS to include copies of its articles of incorporation or other corresponding documents as exhibits to its registration statement.</p> <p><b>UIT</b></p> <p>Items 5 and 6 of Form N-8B-2 require UITs to identify the laws that govern the organization of the UIT as well as the dates of execution and termination of any indenture or trust agreement. The indenture or trust agreement also must be filed as an exhibit to the registration statement.</p>
(c) The rights of investors in the CIS?
<p>Yes. A CIS's registration statement sets forth in detail the rights of investors in the CIS. A CIS's registration statement must disclose the rights that are material to an investor's decision to invest in the CIS, as set forth below:</p> <p><b>Open-end CIS</b></p> <p>Item 10 of Form N-1A requires an open-end CIS to provide a description of certain unique, unusual, or material aspects of the capital stock of the CIS in its prospectus. Items 6 and 11 require an open-end CIS to provide a description of shareholder's rights with regard to the purchase and redemption of shares in its prospectus. Items 22 and 23 require additional disclosure in the SAI about shareholders' rights in the CIS including:</p> <ul style="list-style-type: none"> <li>• Information about an open-end CIS's capital stock and other securities, which includes a requirement that an open-end CIS provide, for each class of capital stock, a discussion of the voting rights (including whether the rights of shareholders can be modified by other than majority vote); and</li> </ul>

- Information about the purchase, redemption, and pricing of shares, which describes how the open-end CIS's shares are offered to the public.

### **Closed-end CIS**

Items 9 and 10 of Form N-2 require a closed-end CIS to provide a description of the management of the CIS. Item 10 requires information about the company's capital stock and other securities, which includes a requirement that a closed-end CIS provide a discussion of the voting rights (if the rights of shareholders can be modified by other than majority vote).

### **UIT**

Item 10 of Form N-8B-2 requires the UIT to include shareholder information, including a description of shareholder's rights with regard to the purchase and redemption of shares.

In addition, a CIS's registration statement (including exhibits to the registration statement, such as a CIS's articles of incorporation, bylaws, or trust indenture agreement, which define the rights of security holders) is publicly available to investors.

### **(d) Information on the operator and its principals?**

Yes.

### **Open-end CIS**

Items 5 and 10 of Form N-1A require an open-end CIS to disclose information in the prospectus on the CIS's operator, including the operator's name, address, business experience, and compensation. Item 17 requires additional disclosure in the SAI on the CIS operator. Furthermore, items 5 and 10 require open-end CIS to state the name, title, length of service, and business experience of each member of a portfolio management team. Item 20 further requires an open-end CIS to provide disclosure in its SAI regarding other accounts for which the CIS's portfolio manager is primarily responsible for the day-to-day portfolio management.

### **Closed-end CIS**

Item 9 of Form N-2 requires a closed-end CIS to disclose information in the prospectus on the CIS's operator, including the operator's name, address, business experience, and compensation. Item 20 requires additional disclosure in the SAI on the CIS operator. Item 9 requires closed-end CIS to state the name, title, length of service, and business experience of each member of a portfolio management team. Item 21 further requires a closed-end CIS to provide disclosure in its SAI regarding other accounts for which the CIS's portfolio manager is primarily responsible for the day-to-day portfolio management.

**UIT**

Items 25-30 of Form N-8B-2 require the UIT to include information concerning the organization, personnel, and affiliates of the depositor. Items 31-33 of Form N-8B-2 require the UIT to include information concerning the compensation of officers, directors and certain employees of depositor. This information includes the form of organization and business of the depositor, fees received from the trust, and information concerning controlling shareholders of the depositor or other affiliates and compensation thereof.

**(e) Information on the methodology of asset valuation?**

Yes.

**Open-end CIS**

Items 6, 11, and 23 of Form N-1A require an open-end CIS to disclose in the prospectus and the SAI information concerning the procedures for valuing the CIS's assets and pricing the CIS's shares.

**Closed-end CIS**

Item 2 of Form N-2 requires a closed-end CIS to identify on the cover page of the prospectus whether any national securities exchange lists the securities offered. Item 5 of Form N-2 requires a closed-end CIS to describe the valuation procedure used by the closed-end CIS in determining the price to the public when it is impracticable to state such a price.

**UIT**

Item 44 of Form N-8B-2 requires information concerning the method used to calculate the offering price. Item 46 requires information concerning the method used to calculate the redemption price.

**(f) Procedures for purchase, redemption and pricing of units/shares?**

Yes.

**Open-end CIS**

Items 6, 11, and 23 of Form N-1A require an open-end CIS to disclose in the prospectus and the SAI information concerning the procedures for the purchase, redemption, and pricing of units.

**Closed-end CIS**

Item 2 of Form N-2 requires a closed-end CIS to identify on the cover page of the prospectus whether any national securities exchange lists the securities offered. Item 5 of Form N-2 requires a closed-end CIS to describe the plan of distribution for shares in the CIS, which also includes information on the price of the shares.

**UIT**

Items 15, 16, 17, 35, 38, 44, and 46 of Form N-8B-2 include information concerning the procedures for purchase, redemption, and pricing of the UIT securities. Item 15 requires a description of the procedures with respect to payments from purchasers and items 35 and 38 require a description of where sales will be made as well as a general description of the distribution method. Item 44 requires information concerning the method used to calculate the offering price. Item 17 requires a description of the withdrawal or redemption procedures, and item 46 requires information concerning the method used to calculate the redemption price.

**(g) Relevant, audited financial information concerning the CIS?**

Yes.

**Open-end CIS:** Item 13 of Form N-1A requires an open-end CIS to disclose in its prospectus its financial highlights for the past five years. Item 27 of Form N-1A requires an open-end CIS to provide in its SAI its audited (and, under certain circumstances, unaudited) financial statements.

**Closed-end CIS:** Item 4 of Form N-2 requires a closed-end CIS to disclose in the prospectus its financial highlights for the past 10 years. Item 24 of Form N-2 requires the closed-end CIS to provide its audited (and, under certain circumstances, unaudited) financial statements in its SAI.

**UIT:** Item 54 of Form N-8B-2 requires a UIT to include a chart for the past 10 fiscal years identifying the number of shares, asset value per share, and dividends per share. The financial statements of the UIT are also part of the UIT's prospectus.

**(h) Information on the custodial arrangements (if any)?**

Yes.

**Open-end CIS**

Item 19 of Form N-1A requires an open-end CIS to disclose in the SAI the custodian's name and address and to generally describe the services performed by the custodian. If the custodian is not a commercial bank, trust company, or depository, the open-end CIS must describe the nature of the business of that person.

**Closed-end CIS**

Item 20 of Form N-2 requires a closed-end CIS to disclose in the SAI the custodian's name and address and the nature of that person's business and to generally describe the services performed by the custodian.

**UIT**

Item 48 of Form N-8B-2 requires a UIT to include in the prospectus the name, address, supervising authority, form, and state of organization of the trustee or custodian. Item 49 of Form N-8B-2 requires a UIT to disclose in the prospectus the basis of the trustee's or custodian's fees as well as the aggregate amount for the last fiscal year. In addition, item 50 of Form N-8B-2 requires UITs to state whether the trustee or custodian may create a lien on the UIT's assets.

(i)	The investment policy(ies) of the CIS?
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Yes.

Section 8(b) of the Investment Company Act requires a CIS to disclose in its registration statement its investment strategies regarding: investment diversification, borrowing, the issuance of senior securities, underwriting, concentration of investments within a single industry, investments in real estate and commodities, making loans, and portfolio turnover.

**Open-end CIS**

Items 2, 4, and 9 of Form N-1A requires an open-end CIS to describe in the prospectus its investment objectives and principal investment strategies, including the particular type or types of securities in which the open-end CIS principally invests or will invest. The items do not require that an open-end CIS list every type of market or instrument in which investments are made. Instead they require that the open-end CIS disclose its principal investment strategies. In determining what is a principal investment strategy, an open-end CIS must consider, among other things, the amount of the CIS's assets expected to be committed to the strategy, the amount of the CIS's assets expected to be placed at risk by the strategy, and the likelihood that the CIS may lose some or all of those assets from implementing the strategy. Item 16 of Form N-1A requires an open-end CIS to disclose in the SAI any investment strategy that is not a principal investment strategy.

**Closed-end CIS**

Item 8 of Form N-2 requires a closed-end CIS to describe in the prospectus its investment objectives and policies, including the types of securities in which the closed-end CIS principally invests or will invest. Item 8 of Form N-2 also requires a closed-end CIS to disclose any types of

investments that will be made other than those that constitute its principal portfolio emphasis. This discussion receives less emphasis than the discussion concerning principal portfolio strategies and may be limited or even omitted, if appropriate. Item 17 of Form N-2 requires a closed-end CIS to disclose in the SAI additional information on its investment objectives and policies.

### **UIT**

Item 11 of Form N-8B-2 requires a UIT to describe in the prospectus the kind and type of securities comprising the security holder's UIT interest (*e.g.*, bonds of railroad companies, common stock of industrial companies, preferred stock of public utility holding companies). Item 52 of Form N-8B-2 also requires a description of any UIT policies or indenture or trust agreement provisions governing the selection, substitution, or elimination of securities. Section 26 of the Investment Company Act prohibits the substitution of a UIT's securities with any other security unless the SEC approves the substitution.

#### **(j) Information on the risks involved in achieving the investment objectives?**

Yes.

### **Open-end CIS**

Items 4 and 9 of Form N-1A require an open-end CIS to describe in the prospectus the principal risks of investing in the CIS, and item 16 requires additional detail on risk in the SAI.

An open-end CIS must include in its prospectus a risk/return summary of the principal risks of investing in the CIS. The summary must address the risks to which an open-end CIS's portfolio as a whole is subject and the circumstances that are reasonably likely to affect adversely the CIS's NAV, yield, and total return. An open-end CIS is permitted, but not required, to include disclosure in the narrative risk summary about the types of investors for whom the CIS is intended or the types of investment goals that may be consistent with an investment in the CIS. The summary also must include a bar chart and table illustrating the variability of the open-end CIS's returns. This information must be accompanied by a statement indicating that past performance of the open-end CIS is not necessarily an indication of how the CIS will perform in the future.

### **Closed-end CIS**

Item 8 of Form N-2 requires closed-end CIS to describe the risks associated with an investment in the closed-end CIS. Closed-end CIS shares historically have traded at a discount from the NAV of the shares. Item 8 of Form N-2 also requires a closed-end CIS to disclose in the prospectus whether its common stock has historically traded at an amount less than, equal to, or exceeding NAV. The CIS must also disclose any methods undertaken or to be undertaken to reduce any



discount (such as the repurchase of closed-end CIS shares, ability to convert to an open-end CIS, and guaranteed distribution plans). If the closed-end CIS has no history of trading, it must disclose in the prospectus the tendency of closed-end CIS shares to trade at a discount from NAV.

### **UIT**

There is no explicit requirement in Form N-8B-2 for information on the risks involved in the investment policies of the UIT. As noted above, a UIT invests in a fixed pool of securities.

- (k) The appointment of any external administrator or investment managers or advisers who have a significant and independent role in relation to the CIS (including delegates)?

Yes.

Section 10 of the Investment Company Act requires that at least 40% of the directors of an open-end or closed-end CIS be independent of the CIS operator and other CIS affiliates. Independent directors are charged with various significant oversight requirements, but other officers of the CIS are not required to be independent.

### **Open-end CIS**

Item 17 of Form N-1A requires disclosure in the SAI of specific information on the officers and directors of the open-end CIS. Information about an officer or director includes their name, address, age, positions held with the CIS, principal occupations for the last five years, and the identification of other directorships held by a director. Each director must also disclose the dollar range of equity securities that he or she held in the CIS or in other CISs that are overseen by the director in the same CIS group. The SAI also includes a compensation table for all directors, members of the CIS's advisory board and for each of the three highest paid officers or affiliates that received from the CIS aggregate compensation for the most recently completed fiscal year exceeding \$60,000. Furthermore, item 18 of Form N-1A requires disclosure of the name and address of, and the percentage of voting securities held by, each person who controls the CIS and an explanation of the effect of that control on the voting rights of other shareholders. Items 5, 10, and 19 of Form N-1A require disclosure regarding the CIS operator, CIS sub-operator, principal underwriter, and any other significant service providers.

### **Closed-end CIS**

Item 9 of Form N-2 requires a closed-end CIS to disclose in its prospectus information on: (i) the responsibilities of the board of directors; (ii) the name, principal business address, experience, and services of each operator as well as a description of each operator's compensation; (iii) any person employed by or associated with the operator that provides day-to-day management of

the CIS's portfolio; (iv) the identity of any administrator; (v) the name and principal business address of any custodian, transfer agent, and dividend paying agent; and (vi) control persons. The SAI also includes a compensation table for all directors, members of the CIS's advisory board and for each of the three highest paid officers of affiliates that received from the CIS aggregate compensation for the most recently completed fiscal year exceeding \$60,000.

## UIT

Item 48 of Form N-8B-2 requires information about the trustee or custodian of the UIT, including, among other things, the name and address and form of organization of the trustee and the fees and expenses of trustee for services to the UIT.

- (l) Fees and charges in relation to the CIS, in a way that enables investors to understand their nature, structure and impact on the CIS' performance?

Yes. There are specific requirements that require the offering document to include the fees and charges of an open-end CIS, closed-end CIS, or UIT in a way that enables investors to understand their nature, structure, and impact on the CIS's performance. In particular, most CIS disclose fees and expenses in a table format and also include a fee example, as discussed in more detail below. The following summary describes the requirements for the offering document of an open-end CIS, closed-end CIS, and UIT.

## Open-end CIS

**Prospectus:** The prospectus is the primary means by which information on open-end CIS fees and costs is disclosed to investors.

1. Fee Table (see item 3; instructions 2 and 3 of Form N-1A): An open-end CIS's prospectus is required to have a fee table at the beginning of the prospectus that identifies the amount of the following fees:

- Maximum sales charges ("sales loads")
  - Maximum sales charge imposed on purchases (as a percentage of offering price)
  - Maximum deferred sales charge payable upon redemption (as a percentage of the offering price or NAV at time of redemption)
  - Maximum sales charge imposed on reinvested dividends or other distributions (as a percentage of offering price or other basis as described in fee table)
- Redemption fee – presented as a percentage of amount redeemed.
- Exchange fee – presented as the maximum fee for any exchange or transfer from one CIS to another, as a percentage of amount invested in the new CIS.

- Account fee – presented as the maximum fee that may be charged to a typical shareholder, as a fixed amount or a percentage of the shareholder’s net assets (must explain basis upon which percentage is calculated).
- Management fees or investment advisory fees deducted from open-end CIS assets – presented as a percentage of average net assets.
- Distribution and/or service fees that are deducted from open-end CIS assets under a distribution plan– presented as a percentage of average net assets (*e.g.*, the cost of printing prospectuses for prospective shareholders, compensation of brokers for sale of open-end CIS shares, and shareholder services).<sup>760</sup>
  - Shareholder services expenses deducted from open-end CIS assets other than pursuant to a distribution plan must be disclosed under an appropriate caption or subcaption of “other expenses.”
- Other expenses that are deducted from open-end CIS assets – includes all expenses that must be presented in the statement of operations that a CIS must include in its financial statements, such as accounting, legal, and custody expenses; these expenses must be presented in the fee table as a percentage of average net assets.
  - Other expenses do not include extraordinary expenses as determined under U.S. GAAP. If extraordinary expenses were incurred that materially affected an open-end CIS’s other expenses, a note to the fee table must disclose what the other expenses would have been had the extraordinary expenses been included.

The table is also required to disclose the total of all management and advisory fees, distribution and/or service fees, and other expenses combined. If an open-end CIS’s fees and expenses that are listed in the fee table are subject to a contractual limitation that requires the waiver or reimbursement of the fees and expenses<sup>761</sup> for at least one calendar year, an open-end CIS may add two lines to the fee table: one showing the amount of the reimbursement and the second

<sup>760</sup> Rule 12b-1 under the Investment Company Act prohibits an open-end CIS from using its own assets to pay, directly or indirectly, for any expenses that are primarily intended to result in the sale of its shares without complying with the requirements of the rule. Rule 12b-1 requires all distribution payments (“12b-1 fees”) to be made subject to a written document (a “distribution plan”) that must be approved by the shareholders of the CIS and the CIS’s board of directors, including a majority of its disinterested directors who have no financial interest in the CIS’s distribution arrangements. The distribution plan must describe all material aspects of the proposed financing of distribution. In addition, the CIS’s board must periodically review and monitor the distribution arrangement.

<sup>761</sup> A CIS, often a new CIS, may have a fee waiver arrangement (*e.g.*, the CIS’s operator agrees to waive, or not collect, a portion of its investment advisory fee for a specified period of time) or a reimbursement arrangement (*e.g.*, the CIS’s operator may agree to reimburse the CIS for a portion of its expenses that exceed a specified level for a certain period of time).

showing the CIS's net expenses after subtracting the fee reimbursement from the total CIS operating expenses. The period for which the expense reimbursement or fee waiver arrangement is expected to continue should be disclosed, including the expected termination date.

2. Fee Table Example (item 3): Immediately following the fee table, an open-end CIS must provide an example that illustrates the cost, shown as a dollar amount, of investing in the CIS. The example must assume an investment of \$10,000 over 1-, 3-, 5-, and 10-year periods. If an open-end CIS imposes redemption fees, the CIS must provide two examples, one assuming a full redemption at the end of the period and the other assuming no redemption. Each example must assume that the investment grows by 5% each year and that the expenses remain the same over the time periods. The examples are intended to help investors compare the costs of investing in different CIS.
3. Financial Highlights (item 13): An open-end CIS must provide a tabular summary of its financial history, for each of its past five fiscal years or, if the CIS has been in operation for less than five years, the life of the CIS. Consistent with a CIS's financial statements, the financial highlights must include a ratio of total expenses to average net assets for each period shown.
4. Other: Additional descriptions of some of the fees and expenses that are identified in the fee table are required in the prospectus, (e.g., how sales loads are calculated (item 12(a)), descriptions of any Rule 12b-1 fees (item 12(b)), and the amount of the operator's compensation for the past year as a percentage of net assets of the CIS (item 10(a)(1)(ii)).

**Statement of Additional Information:** An open-end CIS must provide the following fee information in the SAI (delivered to investors upon request). Most of the fee information is more detailed than that presented in the prospectus. In certain cases, different information about a particular fee is given in the SAI (e.g., aggregate dollar amount of fees paid to the operator for the past three fiscal years while the prospectus includes the amount paid as a percentage of average net assets for last fiscal year). Also, the SAI contains some information that is not in the prospectus (e.g., aggregate dollar amount of brokerage commissions paid in the last three fiscal years):

- Any open-end CIS fees and expenses that are paid by persons other than the CIS or its operator (item 19(c)).
- Additional detail concerning the amounts that are paid to an open-end CIS's operator, including the aggregate dollar amounts paid for the last three fiscal years and any credits or waivers that reduced the fees (item 19(a)(3)).
- Additional details of expenses related to any other management-related service agreement, including the total dollar amount paid and by whom for the past three fiscal years (item 19(d)).

- Additional detail relating to any remuneration or other compensation for last three fiscal years that was paid to any person, other than the operator or its employees or officers, who advises an open-end CIS or has the authority to determine what is bought or sold by the CIS (item 19(e)).
- Any dealer reallowances, which are front-end sales loads that are reallocated to dealers in an open-end CIS's shares, presented as a percentage of offering price (item 19(f)).
- Additional details of distribution plans, including the dollar amounts spent on specific kinds of distribution activities (e.g., the cost of printing prospectuses for prospective shareholders and compensation of brokers for sale of an open-end CIS's shares and for shareholder services) (item 19(g)).
- Description of how brokerage transactions in an open-end CIS's portfolio securities are effected, including a general statement about brokerage commissions, markups or markdowns on principal transactions, and the aggregate dollar amount of brokerage commissions paid by the CIS for last three fiscal years (item 21(a)). Brokerage commissions that were paid to any affiliated person of an open-end CIS or an affiliated person of an affiliated person of a CIS in the last three fiscal years must be separately identified (item 21(b)). Brokerage and soft dollar practices, including any commission rebate or recapture arrangements (e.g., an arrangement under which a portion of the commission charged by a broker-dealer for execution of an open-end CIS's securities transactions is used to pay CIS expenses) must also be described including the amount of transactions and related commissions (item 21(c) and (d)).

### **Closed-end CIS**

**Prospectus:** Please note that with respect to closed-end CIS most investors acquire their shares in the secondary market and may not receive a prospectus because the prospectus delivery requirements apply only to the primary offering. For such investors, the primary source of information on fees and expenses will be the annual and semi-annual reports, which include the financial statements of the closed-end CIS. The prospectus for the primary offering, however, does include extensive fee information, which is similar to the fee information provided for open-end CIS.

1. Fee Table (see item 3 of Form N-2): The closed-end CIS prospectus is required to have a fee table at the beginning of the prospectus that identifies the amount of the following fees:

- Maximum sales charges ("sales loads") (as a percentage of offering price).
- Dividend reinvestment and cash purchase plan fees (a note to the fee table should explain the basis on which such fees are imposed).

- Any other transaction fee (maximum or basis on which fees are imposed).
- Management fees or investment advisory fees deducted from the closed-end CIS's assets (as a percentage of average net assets).
- Interest payments on borrowed funds.
- Other expenses that are deducted from the closed-end CIS's assets – includes all expenses that must be presented in the statement of operations that a CIS must include in its financial statements, such as accounting, legal, and custody expenses; these expenses must be presented in the fee table as a percentage of average net assets.

The table is also required to disclose the total of all management and advisory fees, interest payments on borrowed funds, and other expenses combined. If a closed-end CIS's fees and expenses that are listed in the fee table are subject to a contractual limitation that requires the waiver or reimbursement of the fees and expenses<sup>762</sup> for at least one calendar year, a closed-end CIS may add two lines to the fee table: one showing the amount of the reimbursement and the second showing the closed-end CIS's net expenses after subtracting the fee reimbursement from the total closed-end CIS's operating expenses. A footnote to the fee table should describe the contractual arrangement. Otherwise, a closed-end CIS generally must disclose its fees and expenses in the fee table as if there were no reimbursement or waiver arrangement. The net amount of expenses after reimbursement or waiver can be presented in a footnote to the table, provided that the closed-end CIS discloses the period for which the expense reimbursement is expected to continue or whether it may be terminated at any time at the option of the closed-end CIS.

2. Fee Table Example (item 3): Immediately following the fee table, the closed-end CIS must provide an example that illustrates the cost, shown as a dollar amount, of investing in the closed-end CIS. The example must assume an investment of \$1,000 over 1-, 3-, 5- and 10-year periods. The example must assume that the investment grows by 5% each year and that the expenses remain the same over the time periods.

3. Financial Highlights (item 4): A closed-end CIS must provide a tabular summary of its financial history, for each of its past 10 fiscal years or, if the CIS has been in operation for less than 10 years, the life of the closed-end CIS. The financial highlights also must include a ratio of total expenses to average net assets for each period shown as well as the average commission

<sup>762</sup> As discussed above for open-end CIS, CIS may have a fee waiver arrangement (e.g., the CIS's operator agrees to waive, or not collect, a portion of its investment advisory fee for a specified period of time) or a reimbursement arrangement (e.g., the CIS's operator may agree to reimburse the CIS for a portion of its expenses that exceed a specified level for a certain period of time).

rate paid.

4. Other: Additional descriptions of some of the fees and expenses that are identified in the fee table are required in the prospectus, (e.g., description of adviser's compensation (item 9); plan of distribution including a discussion of price and sales loads (item 5)).

**Statement of Additional Information:** A closed-end CIS must provide the following fee information in the SAI. Most of the fee information is more detailed than that presented in the prospectus. In certain cases, different information about a particular fee is given in the SAI (e.g., aggregate dollar amount of fees paid to the operator for the past three fiscal years, while the prospectus includes the amount paid as a percentage of average net assets). Also, the SAI contains some information that is not in the prospectus (e.g., aggregate dollar amount of brokerage commissions paid in the last three fiscal years):

- Any closed-end CIS fees and expenses that are paid by persons other than the closed-end CIS or its operator (item 20).
- Additional detail concerning the amounts that are paid to a closed-end CIS's operator, including the aggregate dollar amounts paid for the last three fiscal years and any credits or waivers that reduced the fees (item 20).
- Additional details of expenses related to any other management-related service agreement, including the total dollar amount paid and by whom for the past three fiscal years (item 20).
- Additional detail relating to any remuneration or other compensation for last three fiscal years that was paid to any person, other than the operator or its employees or officers, who advises the closed-end CIS or has the authority to determine what is bought or sold by the closed-end CIS (item 20).
- Description of how brokerage transactions in the closed-end CIS's portfolio securities are effected, including a general statement about brokerage commissions, markups on principal transactions, and the aggregate dollar amount of brokerage commissions paid by the closed-end CIS for last three fiscal years (item 22). Brokerage commissions that were paid to any affiliated person of a CIS or an affiliated person of an affiliated person of a closed-end CIS in the last three fiscal years must be separately identified (item 22). Brokerage and soft dollar practices, including any commission rebate or recapture arrangements (e.g., an arrangement under which a portion of the commission charged by a broker-dealer for execution of a closed-end CIS's securities transactions is used to pay closed-end CIS expenses) must also be described including the amount of transactions and related commissions (item 22).

**UIT**

The UIT prospectus is delivered in connection with the sale of UIT securities in either a primary or secondary offering.

The UIT prospectus must include the following information (Item 13 of Form N-8B-2) with respect to each load, expense, fee, or charge to which principal payments, underlying securities, distributions, reinvested distributions, or redeemed securities are subject:

- The nature of the load, fee, expense, or charge;
- The amount;
- The identity of the person to whom the amounts are paid and their relationship to the UIT; and
- The nature of the services performed for the load, fee, expense, or charge.

If not otherwise identified, the following must be disclosed (item 13 of Form N-8B-2):

- Total amount of deductions as a percentage of the net amount invested;
- Each different sales charge available as a percentage of the public offering price and as a percentage of the net amount invested;
- Any other charges which may be paid by shareholders in connection with the UIT or its securities;
- Whether the sponsor, underwriter, custodian, trustee, or affiliate may receive profits or other benefits not otherwise disclosed through the sale or purchase of the UIT's securities and a description of the nature and extent of such profits; and
- The percentage that the aggregate annual charges and deductions for maintenance and other expenses of the UIT bear to the dividend and interest income from the UIT's assets during the reporting period of the financial statements.

Note that most UITs disclose the fees and expenses in a table format and also include a fee example similar to the fee table and fee example in the open-end CIS prospectus. This format has been used to comply with the SEC's plain English rule (Rule 461 under the Securities Act). The UIT fee information listed above (provided in response to item 13 of Form N-8B-2) cannot be presented any further back than page three of the prospectus (Form S-6, instruction as to the prospectus 2).



Other information in the prospectus concerning a UIT's fees and expenses includes:

- Table with information concerning all fees received by the depositor in connection with the operation of the UIT during the period covered by any financial statements filed with the UIT's registration statement (e.g., amount of sales loads received, amount of administration fees received, amount of management fees received, amount of other fees received, aggregate gross fees received) (item 26(a) of Form N-8B-2);
- Tables disclosing compensation rendered for services to the UIT for certain of the depositor's officers, directors, employees, and other persons receiving compensation for services to the UIT (items 31, 32, 33 and 34 of Form N-8B-2);
- Table disclosing all fees received by each principal underwriter from the sale of UIT securities during the period covered by the financial statements filed with the registration statement;
- A schedule showing the components of the offering price including any fees or charges that impact the offering price of the securities of the UIT (item 44 of Form N-8B-2);
- A schedule of components showing the calculation of the redemption value of the securities issued by the UIT, including fees or expenses deducted from NAV (item 46 of Form N-8B-2);
- Basis of custodian fees and aggregate amount of custodian fees for the last fiscal year (item 49 of Form N-8B-2); and
- The financial statements of the UIT and the depositor (item 59 of Form N-8B-2; Form S-6, instruction as to the prospectus).

6. Does the regulatory authority have the power to hold back, or intervene, with regard to offering documents? For example, are there regulatory actions available in the event that the information is inaccurate, misleading or false, or does not satisfy the filing/approval requirements?

Yes. As background, note that in order to sell its shares to the public, a CIS must register itself under the Investment Company Act, and register the offering of its securities under the Securities Act. As described in more detail below, the SEC may, among other things, hold back or intervene in an offering if an offering document is found to be unsatisfactory.

First, under Section 8 of the Securities Act, the SEC has the power to issue a "stop order" to suspend the effectiveness of a registration statement if it appears that a registration statement

includes an untrue statement of material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading.

Second, Sections 8A and 10(b) of the Securities Act authorize the SEC to stop an offering after it has commenced by issuing a “cease-and-desist” order and suspending effectiveness of the registration statement or use of the prospectus if it includes any untrue statement of a material fact or omits to state any material fact required to be stated in those documents or necessary to make the statements in those documents not misleading.

Third, Section 485(c) of Regulation C under the Securities Act provides that no amendment to a registration statement shall become effective if, prior to the effective date of the amendment, the SEC determines that the amendment may be incomplete or inaccurate in any material way and furnishes the registrant (such as a CIS) written notice that the effective date of the amendment is to be suspended. Fourth, Section 8(e) of the Investment Company Act provides that, if it appears to the SEC that a registration statement has omitted material facts or contains material misstatements, the SEC shall notify the CIS. If the registration statement is not corrected, the SEC may suspend or revoke the CIS’s registration as an investment company.

In addition, as discussed in response to Question 24.6 above, the SEC has authority to institute a proceeding against a person or entity, or to seek an injunction or other equitable relief in federal court, for violations of the Investment Company Act. A person, such as a CIS or its operator, who makes any materially untrue statement in, or omits any material fact from, issuing documentation would violate Section 34(b) of the Investment Company Act.

The SEC also has authority under Sections 8A and 20 of the Securities Act to bring a cease-and-desist proceeding, injunctive action, or action for monetary penalties against a person or entity for a violation of the Securities Act. For a discussion of liability under the Securities Act, please see response to Question 24.10, above.

7. Does the regulatory system cover advertising material outside of the offering documents? In particular, does it prohibit inaccurate, false or misleading advertising? Are there regulatory actions available to the regulator with regard to advertising material outside of the offering document?

Yes. CIS may use brochures or advertisements and may market through various media, such as television, radio, internet, billboards, and newspapers.

Like offering documents, all marketing materials are subject to the anti-fraud provisions of the federal securities laws and are prohibited from containing material misstatements or omissions.<sup>763</sup> Please see the response to Principles 10 and 12 for more information about the

<sup>763</sup>

See section 17(a) of the Securities Act and section 10(b) of the Exchange Act.

SEC's enforcement and inspection powers. Different disclosure requirements may apply depending on the type of advertisement:

- Rule 135A under the Securities Act permits the distribution of certain "generic advertisements" that may not specifically refer by name to the securities of a particular CIS, the CIS itself, or to any other securities that are required to be registered with the SEC. Generic advertisements are typically used by a CIS operator or distributor to describe the services and benefits of investing in CIS generally rather than focusing on a particular CIS. Generic advertisements must contain the name and address of a registered broker or dealer or other person sponsoring the communication. Generic advertisements also may be used prior to the effectiveness of a CIS's registration statement.
- Rule 482 under the Securities Act permits the distribution of certain marketing materials, called "482 ads," that include performance information. 482 ads are considered "omitting" prospectuses under the Securities Act. A 482 ad need not contain all of the information included in a CIS's prospectus filed as part of its registration statement. A 482 ad may not include, or be accompanied by, an application to purchase a CIS's shares unless the CIS's prospectus also accompanies the 482 ad. A 482 ad that includes performance information must also include "standardized" performance information. Standardized performance information must be calculated in accordance with a formula, and presented for particular periods that have been specified by the SEC. Such a 482 ad also must include a disclaimer to the effect that past performance of the CIS is not necessarily an indication of how the CIS will perform in the future. CISs that advertise performance information must make available to investors total returns that are current to the most recent month-end.
- Supplemental sales literature (*i.e.*, sales literature that is issued after the effectiveness of a CIS's registration statement and that is accompanied or preceded by a prospectus), generally may include any information that is not misleading. Supplemental sales literature may include, or be accompanied by, an application to purchase a CIS's shares. Supplemental sales literature that includes performance information must include standardized performance information, but may also include other performance information (provided that it is not misleading). Supplemental sales literature that includes performance information also must include a disclaimer to the effect that past performance of the CIS is not necessarily an indication of how the CIS will perform in the future.

Advertisements issued electronically (*i.e.*, through the internet) generally are subject to the same requirements as other written marketing materials.

Section 24(b) of the Investment Company Act requires open-end CISs and UITs and their underwriters, in connection with a public offering, to file copies of all of their advertisements and

sales literature with the SEC.<sup>764</sup> If a CIS's shares are sold by a FINRA member broker-dealer, FINRA requires the broker-dealer to file with FINRA any advertisement or sales literature that it uses to market the company. Advertisements and sales literature filed with FINRA are reviewed by FINRA. Advertisements and sales literature filed with the SEC may be reviewed by the Staff as part of an inspection of the open-end CIS or UIT to ensure that the material is not false or misleading.

8. Does the regulatory system require that the offering documents be kept up to date to take account of any material changes affecting the CIS?

Yes. Most open-end CIS, unlike operating companies or closed-end CIS, continuously offer their shares for sale to the public. Each such open-end CIS must, therefore, have at all times a current, effective registration statement. As a result, an open-end CIS amends its registration statement at least annually to include updated financial information (or more frequently, if necessary, to reflect material changes in its operations).

In addition, the Securities Act requires a CIS that is making a continuous offering of its securities to maintain a "current" statutory prospectus. Specifically, Section 10(a)(3) of the Securities Act requires that any prospectus used more than nine months after the registration statement's effective date must contain financial and other information as of a date not more than sixteen months prior to such use. A CIS making a continuous offering of its securities can update its prospectus by filing a post-effective amendment to its registration statement that contains updated financial statements and other information.

Rule 8b-16(b) under the Investment Company Act provides that a closed-end CIS must either amend its registration statement annually or transmit certain important information to shareholders in the closed-end CIS's annual report to shareholders.

9. Does the regulatory system require a report to be prepared in respect of a CIS's activities either on an annual, semi-annual or other periodic basis?

Yes. Sections 30(a) and (b) of the Investment Company Act and Rule 30a-1 thereunder require CIS to file with the SEC a semi-annual report on Form N-SAR.<sup>765</sup> Form N-SAR contains information that may be used by the SEC to aid in monitoring a CIS's operations and to obtain necessary compliance information. Rule 30b1-1 under the Investment Company Act provides that a CIS must file on Form N-SAR not more than sixty days after the close of the fiscal year and the fiscal second quarter. Open-end and closed-end CIS also must file a semi-annual report on Form N-CSR that contains certified shareholder reports.

<sup>764</sup> Rule 24b-3 provides that, if an advertisement is filed with a registered exchange, such as FINRA, it is deemed filed with the SEC.

<sup>765</sup> A UIT files on Form N-SAR annually, rather than semi-annually.

Section 30(e) of the Investment Company Act requires that CIS prepare and send to their shareholders annual and semi-annual reports. The reports must include financial statements for the CIS, including a statement of assets and liabilities (a balance sheet), a statement of operations, a statement of changes in net assets, a schedule of portfolio holdings that shows the amount and value of each security owned by the CIS on that date, and a financial highlights schedule required by the CIS's registration statement. The financial highlights information shows financial results for a single share of a CIS. Only the annual reports must include audited financial statements (accompanied by a certificate of an independent public accountant).

Annual reports typically discuss the relevant market conditions and investment strategies used by the CIS operator that materially affected the CIS's performance during the last fiscal year (alternatively, this information may be included in a CIS's prospectus). Rule 30e-1 under the Investment Company Act requires annual and semi-annual reports to include specified information about any shareholder vote that was taken during the period covered by the report. A CIS may include in its shareholder reports information that is in addition to that which is required, provided that the information is not misleading. CISs often include a letter to shareholders, performance data, and tax information in their shareholder reports.

Additionally, Form N-Q under the Investment Company Act requires open-end and closed-end CISs to file a quarterly report with the SEC that generally discloses the composition of a CIS's portfolio on a delayed basis.

Rule 30e-2 under the Investment Company Act provides that a UIT sponsor must provide semi-annual shareholder reports to shareholders, similar to those issued by an open-end or closed-end CISs, if the UIT's assets substantially consist of securities issued by an open-end or closed-end CIS. In addition, a UIT's trust indenture usually stipulates that there shall be an annual audited financial statement. This annual report provides information regarding the composition of the trust's portfolio, the number and value of units outstanding, cash inflows and outflows, and any disposition of a portfolio security and the proceeds obtained.

10. Does the regulatory system require the timely distribution of periodic reports?

Yes. Section 30(e) of the Investment Company Act and Rule 30e-1 thereunder require CIS to transmit reports to shareholders (*i.e.*, annual and semi-annual reports) within sixty days after the close of the period for which each report is made.

11. Does the regulatory system require that the accounts of a CIS be prepared in accordance with high quality, internationally acceptable accounting standards?

Yes. The financial statements in a CIS's annual and semi-annual reports must be prepared in accordance with U.S. GAAP.<sup>766</sup> Regulation S-X under the federal securities laws requires that an independent public accountant perform an audit of the CIS's financial statements in accordance with PCAOB standards and state that the financial statements are prepared in accordance with U.S. GAAP.

12. Does the regulator have powers to ensure that the stated investment policy or trading strategy, the authorized investments that the CIS is able to undertake or any policy required by regulation, is being followed?

Yes. As discussed in the responses to Question 24.7 above, Staff reviews the adequacy of disclosures in CIS registration statements and periodic reports. If Staff notes a perceived disclosure or regulatory deficiency during the review of a material amendment to a CIS's registration statement (e.g., that the CIS is not following its stated investment policy in accordance with applicable law), Staff will send a comment letter to the company or its counsel that sets forth the specific concerns that the staff has with the filing. The CIS has an opportunity to address Staff's comments by amending the disclosure contained in the filing or by explaining in a response letter to Staff why no amendment to the filing is required.

In addition, OCIE conducts examinations of CISs and CIS operators, among others, to assess whether such entities are complying with the federal securities laws. OCIE reviews a CIS's compliance with its stated investment policy or trading strategy, any authorized investments, and any other required policies during its exams of CISs and CIS operators. Following the completion of an exam, if OCIE has identified rule violations or weaknesses related to a CIS's or CIS operators' compliance, it will typically issue a deficiency letter to the CIS or its operator. In some cases the seriousness of the violations or weaknesses may warrant a referral to Enforcement.

As stated in the response to Question 24.6, the SEC is authorized by the Advisers Act and the Investment Company Act to institute administrative proceedings against any person or to sue any person in federal court for violations of these acts, including, among other things, the failure to follow its stated investment policy.

<sup>766</sup> See rule 4-01(a)(1) of Regulation S-X.

**Principle 27 Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units/shares in a CIS.**

**Key Questions**

*Asset Valuation*

1. Are there specific regulatory requirements in respect of the valuation of CIS assets?

Yes. The regulations relating to the valuation of CIS portfolio securities are included in the Investment Company Act and SEC rules adopted thereunder.<sup>767</sup> In general, these regulations provide that a CIS should value securities for which market quotations are readily available at their current market value and other securities and assets at fair value as determined in good faith by the board of directors of the CIS.<sup>768</sup> In addition, the SEC has addressed many of the issues relating to CIS valuation and pricing in its Accounting Series Releases (ASRs).<sup>769</sup>

Financial statements filed with the SEC generally must be prepared in accordance with GAAP.<sup>770</sup> The FASB Accounting Standards Codification (ASC), which is the source of GAAP,<sup>771</sup> requires investment companies to report investments at fair value.<sup>772</sup> ASC Topic 820 defines fair value as

<sup>767</sup> See Sections 2(a)(41) and 22 of the Investment Company Act and Rules 2a-4 and 22c-1 thereunder.

<sup>768</sup> Money market funds are governed by Rule 2a-7 under the Investment Company Act, which currently permits such funds to price their securities using the amortized cost and/or penny-rounding methods and to periodically compare the amortized cost NAV per share of the fund with the NAV per share determined valuing portfolio securities using market-based factors. Currently, if the market-based price per share and the amortized cost price deviate by more than ½ of 1% of the money market fund's total assets, the money market fund's board of directors must "promptly consider what action, if any, should be initiated by the board of directors." Amendments to Rule 2a-7, which were recently adopted by the SEC, will require institutional prime money market funds (including institutional municipal money market funds) to price their securities based on the fund's market-based NAV per share rounded to the fourth decimal place (e.g., \$1.0000 per share) or an equivalent or more precise level of accuracy for these funds that have a different share price (e.g., \$10.000, or \$100.00 per share). The effect of this amendment is that the NAV of an institutional prime money market fund will generally fluctuate along with the changes in the market-based value of the fund's investments. Other money market funds (i.e., government funds and retail funds) will be permitted to continue to use the amortized cost and/or penny-rounding methods. Money market funds will be required to comply with these Rule 2a-7 amendments by October 2016. See *Money Market Fund Reform; Amendment to Form PF*, Investment Company Act Rel. No. 31166 (July 23, 2014) (2014 Money Market Fund Reform).

<sup>769</sup> See, e.g., ASR No. 113, Financial Reporting Codification (CCH) § 404.04 (Oct. 21, 1969) (ASR 113) (addressing valuation of "restricted securities"); ASR No. 118; Financial Reporting Codification (CCH) § 404.03 (Dec. 23, 1970) (ASR 118) (addressing valuation of securities listed or traded on a national securities exchange, securities that trade in the OTC market, and securities and other assets for which market quotations are not readily available); and ASR No. 219, Investment Company Act Release No. 9786 (May 31, 1977) (ASR 219) (addressing fair valuing debt portfolio securities on an amortized cost basis). ASR 219 was substantially supplemented in the 2014 Money Market Fund Reform release.

<sup>770</sup> See Rule 4-01 of Regulation S-X, which provides that financial statements filed with the SEC which are not prepared in accordance with GAAP, will be presumed to be misleading or inaccurate, despite footnote or other disclosures, unless the SEC has otherwise provided.

<sup>771</sup> See ASC Topic 105, at par. 105-10-05-1.

<sup>772</sup> See ASC Topic 946, at par. 946-10-15-2.

the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. <sup>773</sup>	
2.	Are there regulatory requirements that the NAV of CIS be calculated:
(a)	On a regular basis?
Yes. See the answer to Question 2(b) below.	
(b)	In accordance with high-quality, accepted accounting standards used on a consistent basis?
Yes. Section 22(c) of the Investment Company Act and Rule 22c-1 thereunder provide that shares in an open-end CIS generally may be purchased and redeemed only at a price based on the current NAV of such security, which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security. In addition, Rule 22c-1 requires that an open-end CIS compute its NAV at least once daily from Monday through Friday. Section 23 of the Investment Company Act generally prohibits a closed-end CIS from selling its common stock at a price below current NAV. In addition, as further discussed below in response to Question 27.3, Rule 2a-4 under the Investment Company Act defines current NAV for purposes of calculating the price of shares in an open-end CIS. <sup>774</sup>	
3.	Are there specific regulatory requirements in respect of the fair valuation of assets where market prices are not available?
Yes. As discussed above in response to Principle 27 Question 2, above, open-end CISs are required to price their shares at current NAV and closed-end CISs are generally prohibited from selling their shares at a price below current NAV. Section 2(a)(41) of the Investment Company Act provides that the board of directors of a CIS must determine in good faith the fair value of portfolio securities (and other assets) for which market quotations are not readily available. With respect to open-end CIS, current NAV is defined in Rule 2a-4 under the Investment Company Act to be "an amount which reflects calculations, whether or not recorded in the books of account, made substantially in accordance with," among other things, current market value or, where market quotations for a security are not readily available, "fair value as determined in good faith by the board of directors." The definition for closed-end CISs is similar. Fair value is defined by ASC Topic 820 as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." In addition to defining fair value, ASC Topic 820 also establishes a framework for measuring fair value and	

<sup>773</sup> See ASC Topic 820, at par. 820-10-05-1 through 05-1D, par 20, par. 35-2, and par. 55-1 through 55-2.

<sup>774</sup> See also ASC Topic 946, par. 210-205-20, which defines NAV per share in connection with the presentation of CIS financial statements. Principle 27 Question 1 above contains a discussion concerning the ASC, which is the source of GAAP.



requires disclosures about fair value measurements. ASR 113, ASR 118, and ASR 219 also address fair valuation of particular CIS's portfolio securities. The 2014 Money Market Fund Reform release also contained new guidance on fair valuing thinly traded securities and the use of pricing services to assist in fair valuing securities.

4. Are independent auditors required to check the valuations of CIS assets?

Yes. A CIS's independent auditor plays a significant role in the CIS's valuation process by evaluating the systems and procedures by which the CIS values its portfolio securities as part of the CIS's annual audit.<sup>775</sup> In the case of securities for which market quotations are readily available, the SEC has noted that the independent auditor should verify independently all of the quotations used by the CIS at the balance sheet date.<sup>776</sup> In the case of securities or other assets carried at fair value as determined by the board of directors, which could include illiquid assets or assets subject to suspension, the auditor does not function as an appraiser and is not expected to substitute his or her judgment for that of the CIS's directors. Rather, the SEC believes that the auditor should review all information considered by the board or the operator, read the relevant minutes of directors' meetings, and ascertain the procedures established by the directors.<sup>777</sup>

PCAOB standards also provide that the independent auditor should also obtain an understanding of internal control over the valuation process to plan and perform the audit.<sup>778</sup> For example, PCAOB standards provide that the auditor should determine whether the valuation methods used by a CIS conform with the stated valuation policies and disclosures. In addition, because periodic computations of NAV are based on the fair value of investments, the auditor may evaluate the systems and procedures used by the CIS during the period under audit in determining the fair value of investments. The auditor also may perform some checks on the pricing services or other outside vendors that the CIS uses to value portfolio securities.<sup>779</sup> In some situations, the auditor may determine that it is necessary to obtain an estimate of fair value from more than one pricing source.<sup>780</sup>

<sup>775</sup> See, e.g., AICPA Audit and Accounting Guide: *Investment Companies* (as of May 1, 2013) (AICPA Guide), at par. 2.211, par. 2.212, and par. 2.213.

<sup>776</sup> See ASR 118.

<sup>777</sup> See ASR 118.

<sup>778</sup> See PCAOB, *Auditing Standard No. 12: Identifying and Assessing Risks of Material Misstatement*, and PCAOB, AU Section 328, *Auditing Fair Value Measurements and Disclosures*.

<sup>779</sup> See, e.g., AICPA Guide, at par. 2.220.

<sup>780</sup> See, e.g., PCAOB, AU Section 332, *Auditing Derivatives, Hedging Activities, and Investments in Securities*.

<i>Pricing and Redemption Issues</i>	
5.	Does the regulatory system:
(a)	Require the basis upon which investors may redeem units/shares to be made clear in the constituent documents and/or the prospectus?
<p>Yes. Closed-end CISs do not redeem their shares; however, they can repurchase them in accordance with Section 23 of the Investment Company Act and Rule 23c-1 thereunder. As discussed above in response to Principle 25 Question 5, prospectus disclosure requirements for open-end CIS and UITs require the following information concerning the redemption of units/shares:</p> <p><b>Open-end CIS</b></p> <p>Items 6, 11, and 23 of Form N-1A require an open-end CIS to disclose in the prospectus and the SAI information concerning the procedures for redemption of shares.<sup>781</sup></p> <p><b>UIT</b></p> <p>Item 17 of Form N-8B-2 requires a description of the withdrawal or redemption procedures, and Item 46 requires information concerning the method used to calculate the redemption price.</p>	
(b)	Provide for specific regulatory requirements in respect of the pricing upon redemption or subscription of units/shares in a CIS?
<p>Yes. Rule 22c-1 requires that sales and redemptions must be effected at the current NAV next computed after receipt of an order to purchase or sell. As noted above, closed-end CISs do not redeem their shares, however they can repurchase them. Section 23 of the Investment Company Act generally prohibits a closed-end CIS from selling its common stock at a price below current NAV.</p>	
6.	Does regulation ensure that the valuations made are fair and reliable?
<p>Yes. The board of directors of the CIS is responsible for overseeing the valuation of CIS portfolio securities.<sup>782</sup> CIS boards must approve the valuation criteria and are responsible for continuously</p>	

<sup>781</sup> Recently adopted amendments to Form N-1A require a non-government money market fund to disclose in its prospectus and SAI the potential imposition of a temporary suspension of fund redemptions and/or liquidity fees, as further discussed below. Money market funds also are required to inform shareholders of the actual imposition of any temporary suspension of fund redemptions and/or liquidity fees and the removal of such redemption suspension and/or fees via the fund's website. Funds must comply with these requirements by October 2016.

<sup>782</sup> See ASR 118.

reviewing the appropriateness of the CIS's valuation methods to assure that the valuations of the CIS's portfolio securities are fair and accurate.<sup>783</sup> To the extent necessary, CIS boards may appoint persons to assist them in the determination of such valuations and to make the calculations pursuant to the CIS board's discretion.<sup>784</sup> As required by Rule 38a-1 under the Investment Company Act, the CIS must adopt written policies and procedures to, among other things, regularly review the appropriateness and accuracy of the method used in valuing securities.<sup>785</sup> The CIS's board of directors typically reviews the valuation activities at its periodic meetings to satisfy itself that valuations are being made in conformity with SEC regulations and the written procedures of the CIS. The decisions of the CIS board with respect to the valuation of a CIS's portfolio security should be documented and the supporting data retained for the inspection of the CIS's independent auditors.<sup>786</sup> Additionally, as discussed above in response to Principle 27 Question 4, independent auditors verify the CIS's NAV calculations.

A UIT's valuation procedures are specified in the trust indenture. The sponsor is generally responsible for valuation and pricing of UIT assets.

7. Does regulation require the price of the CIS be disclosed or published on a regular basis to investors or prospective investors?

While the federal securities laws do not require that the prices of a CIS be disclosed or published on a regular basis to investors other than in semi-annual reports, the price of a CIS is generally available in financial publications and websites, and it may also be available on the CIS's or CIS operator's website.<sup>787</sup> Financial publications generally publish pricing information for CISs on a daily basis and for closed-end CISs on a weekly basis.

8. Are there regulatory requirements, rules of practice, and/or rules addressing pricing errors? Are the relevant regulatory authorities able to enforce these rules?

Yes. The SEC may bring an enforcement action against a CIS or a CIS operator if a pricing error violates, or results in violation of, the federal securities laws. The SEC has brought enforcement actions against entities alleging that they did not have adequate oversight or review procedures to determine pricing deviations.<sup>788</sup>

<sup>783</sup> See ASR 118.

<sup>784</sup> See ASR 118.

<sup>785</sup> See *Compliance Programs of Investment Companies and Investment Advisers*, Investment Company Act Rel. No. 26299 (Dec. 17, 2003).

<sup>786</sup> See ASR 118.

<sup>787</sup> Under the 2014 Money Market Fund Reforms, money market funds will be required to disclose on the fund's website the fund's market-based price per share as of the end of the prior business day. Money market funds must comply with this requirement by April 2016.

<sup>788</sup> See, e.g., *In the Matter of the Bank of California, N.A.*, Investment Company Act Rel. No. 19545 (June 28, 1993). See also, e.g., *In the Matter of Morgan Asset Management, Inc.* Investment Company Act Rel. No. 29704 (June

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In addition, there are industry practices, *e.g.*, rules of practice, which exist for addressing pricing errors. Some open-end and closed-end CIS boards of directors have adopted these rules of practice. The standards are voluntary, and other CIS boards have adopted different standards that they consider to be reasonable.

The rules of practice are as follows:

- Financial adjustments may be made if the per share NAV error is greater than US\$0.01. In addition, if the NAV error is less than or equal to 0.5% of the current CIS NAV, then the CIS should determine its net loss or benefit during the error period. If the CIS incurred a net loss, the responsible party should reimburse the CIS. If the CIS had a net benefit, no action needs to be taken.
- If the NAV error is greater than 0.5% of the current CIS NAV, then, under most circumstances, adjustments should be made to compensate shareholders for any losses that they may have experienced as a result of the error.
- Errors of US\$0.01 or less per share generally are deemed immaterial and no retroactive corrective action will be taken.<sup>789</sup>
- If the correction to a shareholder's account is less than \$10 (or another *de minimis* amount), then an account adjustment generally will not be made.

The valuation procedures of a CIS generally provide for the reporting of any material pricing errors to the board of directors and may call for the board to review or approve any corrective action that was taken. Pricing errors that are not considered material should be corrected on a going-forward basis. A CIS typically would not report pricing errors to the SEC unless the error is required to be reflected in its financial statements filed with the SEC.

If a shareholder has a dispute with a CIS about pricing errors, that shareholder may institute an action against the CIS in state or federal court. In addition, a shareholder may choose to privately arbitrate the dispute. The SEC does not institute private actions or arbitrations on behalf of shareholders.

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22, 2011); *In the Matter of Mitchell Hutchins Asset Management Inc.*, Investment Company Act Rel. No. 22805 (Sept. 2, 1997); *Van Kampen American Capital Asset Management, Inc.*, Advisers Act Rel. No. 1525 (Sept. 29, 1995).

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See ASR 219.

9. Does the regulatory system address the general or specific circumstances which there may be suspension or deferral of: routine valuation and pricing; or regular redemption of CIS units or shares?

Yes. Generally, under Section 22(e) of the Investment Company Act, CISs may, but are not required to, suspend redemptions and postpone payment for redemptions already tendered for any period during which the NYSE is closed. A CIS also may suspend redemptions in two other situations. First, a CIS may suspend redemptions for any period during which trading on the NYSE is restricted, as determined by the SEC. Second, a CIS may suspend redemptions for any period during which an emergency exists, as determined by the SEC, as a result of which it is not practicable for the CIS to (i) liquidate its portfolio securities, or (ii) fairly determine the value of its net assets.<sup>790</sup>

The SEC has the authority to adopt rules under the Investment Company Act to establish conditions under which an emergency will be deemed to exist; however, the SEC and its staff have historically dealt with any emergency situations on a case-by-case basis. Orders have been issued to a few CIS to suspend redemptions in specific emergency situations. The SEC may grant such an order, however, only if it determines that the order is necessary for the protection of the CIS's shareholders.<sup>791</sup>

In addition, all CISs are required to include a description of any restrictions on redemptions in their prospectuses.

Rule 22e-3 under the Investment Company Act, which was adopted in 2010 and recently amended, permits money market funds to permanently suspend redemptions in certain circumstances in order to facilitate an orderly liquidation of the fund.<sup>792</sup> In addition, recent

<sup>790</sup> See December 1999 Letter to the ICI Regarding Valuation ([www.sec.gov/divisions/investment/guidance/tyle120899.htm](http://www.sec.gov/divisions/investment/guidance/tyle120899.htm)). In response to the market closure after September 11, for instance, most CIS were closed and did not accept purchase or redemption requests until the markets reopened on Monday, September 17, 2001. More recently, most CIS were closed for two days in 2012 in response to market closure due to Hurricane Sandy.

<sup>791</sup> See, e.g., *In the Matter of The Reserve Fund, on behalf of its two series, the Primary Fund and the U.S. Government Fund*, Investment Company Act Rel. No. 28386 (Sept. 22, 2008) (extraordinary market conditions); *In the Matter of Municipal Lease Securities Fund, Inc.*, Investment Company Act Rel. No. 17245 (Nov. 29, 1989) and 17258 (Dec. 8, 1989) (inability to determine value of assets); *In the Matter of Consolidated Asset Management Fund*, Investment Company Act Rel. No. 16318 (Mar. 17, 1988) (fund becoming subject to undetermined liabilities); *In the Matter of Western Guaranteed Income Trust*, Investment Company Act Rel. No. 16208 (Jan. 11, 1988) (improper accounting and record keeping); *In the Matter of Suspension of Redemption of Open-End Investment Company Shares Because of Current Weather Emergency*, Investment Company Act Rel. No. 10113 (Feb. 7, 1978) (severe weather).

<sup>792</sup> See *Money Market Fund Reform*, Investment Company Act Rel. No. 29132 (Feb. 23, 2010) (2010 Money Market Fund Reform) (allowing, among other things, a money market fund to permanently suspend redemptions and liquidate if the fund's board determines that the deviation between the fund's amortized cost price per share and its market-based NAV per share may result in a material dilution or unfair results to investors or existing shareholders). See also *2014 Money Market Fund Reform* (permitting, among other things, a money market fund to permanently

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amendments to Rule 2a-7 will allow a non-government money market fund's board to temporarily suspend redemptions (i.e., impose redemption gates) in certain circumstances for a limited amount of time and will allow (and in some circumstances require) a non-government money market fund's board to impose a liquidity fee on shareholder redemptions in certain circumstances.<sup>793</sup>

10. Does the regulator have the power to ensure compliance with the rules applicable to asset valuation and pricing?

Yes. The SEC has the power to ensure compliance with the rules applicable to asset valuation and pricing through its examinations of registrants and through enforcement actions. As discussed in the responses to Questions 10.1 and 24.8 above, OCIE conducts examinations of CISs, CIS operators, transfer agents, CIS administrators, and broker-dealers that market CISs, to assess whether such entities are complying with the federal securities laws. OCIE reviews CIS asset valuation and pricing during its examinations of CISs, CIS operators, and third-party administrators that perform certain operational and administrative functions for CISs.

OCIE has conducted risk-targeted examinations focused on the conditions and responsive compliance controls of multiple CISs relating to valuation procedures. OCIE also frequently reviews valuation and pricing practices in regular examinations of CISs.

During an examination of a CIS and its operator or third-party administrator, OCIE may review the CIS's policies and procedures related to asset pricing and NAV calculations and assess the accuracy of the calculations. OCIE also may review the books and records relating to the pricing of CIS assets to assess the appropriateness, reasonableness, and consistency of the valuation processes used to calculate the CIS's NAV. For example, OCIE staff may review:

- whether the CIS's pricing procedures are approved and periodically evaluated by the CIS board;
- whether pricing sources are regularly re-evaluated, including pricing methodology used and accuracy of pricing provided;
- whether the CIS periodically obtains prices from another source, independent of the

suspend redemptions and liquidate if the fund's level of weekly liquid assets falls below 10% of its total assets). The 2014 amendments to Rule 22e-3 will become effective in October 2014.

<sup>793</sup> See *2014 Money Market Fund Reform* (amending Rule 2a-7 to, among other things: (i) allow a non-government money market fund to suspend redemptions temporarily (up to 10 business days in a 90 day-period) if the fund's level of weekly liquid assets falls below 30% of its total assets or to impose a liquidity fee of up to 2% in those same circumstances, if the fund's board determines that it is in the best interests of the fund; and (ii) require a non-government money market fund, if its level of weekly liquid assets falls below 10% of its total assets, to impose a 1% liquidity fee on each shareholder redemption, unless the board determines that such a fee would not be in the best interests of the fund, or determines that a lower or higher fee (not to exceed 2%) would be in the best interests of the fund). Government money market funds are not subject to these fees and gates provisions unless they voluntarily opt into them and disclose so to their investors. Money market funds will be required to comply with these requirements by October 2016.

usual source, to check the accuracy of prices provided by the primary source, and whether the CIS follows-up with appropriate changes if warranted;

- whether the CIS conducts appropriate compliance checks and prepares appropriate documentation of these checks;
- whether the CIS has appropriate procedures to monitor for significant subsequent events that occur after closing prices are determined but before the CIS calculates its NAV, and whether such procedures are followed whenever a significant subsequent event occurs; and
- whether the CIS has controls to avoid or mitigate potential conflicts of interest relating to fair valuation.

Following the completion of an exam, if OCIE has identified rule violations or weaknesses related to asset price and NAV calculations, it will typically issue a deficiency letter informing the CIS or its operator. In some cases the seriousness of the violations or weaknesses may warrant a referral by examination staff to Enforcement.

The SEC recently brought an enforcement action against a CIS operator and distributor and certain of their personnel for overvaluing CIS portfolio assets over a period of time. In settlement, the CIS operator and distributor agreed to, among other things, hire an independent consultant and pay penalties and disgorge profits amounting to \$100,000,000 for distribution to harmed investors.<sup>794</sup> The SEC also has brought other enforcement actions related to inappropriate valuation.<sup>795</sup>

In addition, the SEC vigorously enforces prohibitions on “late trading,” that is the effecting of open-end CIS orders that were placed after an open-end CIS has set its daily NAV. Generally, Rule 22c-1(a) promulgated under Section 22(c) of the Investment Company Act provides that no transactions in shares of the open-end CIS shall be effected at a price based on anything other than the “current net asset value.” Thus, for example, the practice of accepting orders to buy or sell open-end CIS shares after the time as of which the CIS’s portfolio securities are valued for purposes of determining NAV but receiving the previously determined NAV is a violation of Rule 22c-1(a). The SEC has brought several enforcement actions charging both direct and indirect violations of law in this area.

<sup>794</sup> See *Morgan Asset Management Inc.*, Investment Company Act Rel. No. 29704 (June 22, 2011) (<http://www.sec.gov/litigation/admin/2011/34-64720.pdf>).

<sup>795</sup> See, e.g., *In the Matter of KCAP Financial, Inc.*, Exchange Act Rel. No. 68307 (Nov. 28, 2012) (<http://www.sec.gov/litigation/admin/2012/34-68307.pdf>) (closed-end CIS failed to implement sufficient accounting controls over its fair valuation process).

Further, the Sarbanes-Oxley Act and PCAOB rules provide that public accounting firms that prepare or issue or play a substantial role in preparing an audit report for any issuer must be registered with the PCAOB. Registration with the PCAOB will subject the public accounting firm to periodic inspection by the PCAOB. Under these provisions, an accountant that performs an annual audit of a CIS generally is required to register with the PCAOB. The PCAOB conducts inspections of registered CIS auditors to determine compliance with PCAOB standards. These inspections could include a review of asset valuation and pricing within a particular audit. (For further discussion of the PCAOB, please see responses to items in Principles 19 through 21.)

The SEC has examination oversight authority over the PCAOB under the Sarbanes Oxley Act. Pursuant to this authority, the SEC conducts inspections of program areas within the PCAOB. The areas could include PCAOB registrations or inspections.

11. Does the regulatory system require that the regulator:

(a) Be kept informed of any suspension or deferral of redemption rights?

(b) Have the authority to address situations where the CIS operator is failing to honour redemptions or is imposing a suspension of redemptions in a manner that is not consistent with the CIS constitutive documents and prospectus, or the contractual relationship between the CIS participants and the CIS operator, or is otherwise deemed to be in violation with national law?

Yes. Generally, under Section 22(e) of the Investment Company Act, a CIS (other than a money market fund in certain circumstances) cannot suspend the right of redemption or postpone the date of payment of redemption proceeds more than seven days after the tender of the security to the CIS or its agent designated for redemptions. As discussed above in response to Principle 27, Question 9, there are certain limited exceptions (e.g., any period during which the NYSE is closed). If one of those limited exceptions were to apply, a CIS would be allowed to suspend redemptions and would have to attach a sticker to its prospectus that discusses any suspension or deferral of redemption rights. Such an update would be filed with the SEC. If a CIS would like to suspend redemptions for any reason other than those discussed above, however, it must submit a request for an order from the SEC. The SEC may grant such an order, however, only if it determines that the order is necessary for the protection of the CIS's shareholders.

As stated above, Rule 22e-3 under the Investment Company Act permits money market funds to permanently suspend redemptions in order to facilitate an orderly liquidation of the fund. Rule 22e-3 permits all money market funds to suspend redemptions upon breaking a buck or if it is at imminent risk of breaking a buck, if the board, including a majority of independent directors, approves liquidation of the fund, in order to liquidate in an orderly manner.<sup>796</sup> As discussed

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See 2010 Money Market Fund Reform.



above, recent rule amendments, which will become effective in October 2014, will permit a board to suspend redemptions and liquidate a money market fund if at the end of a business day the fund has invested less than 10% of its total assets in weekly liquid assets. The amendments also will allow a non-government money market fund's board to temporarily suspend redemptions (*i.e.*, impose redemption gates) in certain circumstances for a limited amount of time and will allow (and in some circumstances require) a non-government money market fund's board to impose a liquidity fee on shareholder redemptions in certain circumstances. Under these amendments, a money market fund must file a publicly available report with the SEC within one business day of the suspension or imposition of a liquidity fee providing certain factual information about the fee, suspension, or gate. The fund will also have to indicate on its website that a fee or gate was imposed. These requirements become effective in October 2014 and must be complied with by October 2016.<sup>797</sup>

In addition, as discussed above in responses to Questions 10.1, 17.8, and 27.10, OCIE conducts examinations of CISs, CIS operators, transfer agents, CIS administrators, and broker-dealers that market CIS, to ensure such entities are complying with the federal securities law. An examination that uncovers deficiencies or compliance problems with respect to Section 22(e) of the Investment Company Act may lead to a referral to Enforcement for further investigation and possible enforcement action.<sup>798</sup>

Further, as discussed above in Question 26.6, the SEC has a number of options available to intervene in an offering if an offering document is found to be unsatisfactory. This includes, among others, revoking the CIS's registration as an investment company. The SEC also has the authority to institute a proceeding against any person or entity, or seek an injunction or other equitable relief in federal court, for violations of the Investment Company Act. A person, such as a CIS or its operator, who makes materially untrue statements, or omits any material fact from, issuing documentation would violate, among others, Section 34(b) of the Investment Company Act.

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<sup>797</sup> See *2014 Money Market Fund Reform*.

<sup>798</sup> See, *e.g.*, Securities and Exchange Commission v. David B. Welliver and Dblaine Capital LLC, No. 11-CV-3076 (D. Minn. Aug. 13, 2013); In the Matter of David B. Welliver, Advisers Act Release No. 3654 (Aug. 21, 2013).

<b>Principle 28</b>	<b>Regulation should ensure that hedge funds and/or hedge funds managers/advisers are subject to appropriate oversight.</b>
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<b>Key Questions</b>
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<i>Registration/authorization of hedge fund managers/advisers and/or, where relevant, the hedge fund</i>
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1. Does the regulatory system set standards for:
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(a) The registration/authorization and the regulation of those who wish to operate hedge funds (managers/advisers)?
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(b) And/or the registration of the fund?
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<p>Yes.<sup>799</sup> Each investment adviser with assets under management exceeding \$100 million must be registered with the SEC, regardless of the number of clients, unless that adviser can fit within several exemptions that include the following three: (i) adviser solely to one or more “venture capital funds;” (ii) adviser solely to “private funds” with total U.S. assets under management of less than \$150 million; or (iii) a foreign private adviser. Investment advisers qualifying for an exemption may nonetheless elect to register with the SEC, unless they are prohibited from doing so. Managers relying on exemptions (i) and (ii) above (known as “exempt reporting advisers,” or ERAs) continue to be subject to the anti-fraud provisions of the federal securities laws and are subject to examination by the SEC. Hedge funds are generally exempted or excluded from the definition of “investment company” under the Investment Company Act, and therefore, are not registered or regulated as such. See Principles 24 and 29 generally for a discussion of requirements that apply to registered investment advisers regardless of whether their clients are registered or unregistered funds.</p>
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2. Does the regulatory system specify the information contemplated by Key Issue 2 that must be provided to the regulator at the time of the registration/authorization?
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<p>Yes. Hedge fund advisers that are registered with the SEC are subject to the same entry requirements as all other registered investment advisers. See portions of the responses to Questions 24.1 and 24.2 that reference Advisers Act requirements for a discussion of eligibility criteria to operate a CIS. Certain obligations discussed in response to Principle 24 would not</p>
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For purposes of this response, please note that the federal securities laws do not specifically define “hedge funds.” CIS in the U.S. are primarily regulated by the Investment Company Act. Hedge funds and other private pools of capital, however, that are not offered to the public typically rely on one of two statutory exclusions from the definition of an investment company to avoid the regulatory requirements of the Investment Company Act. Section 3(c)(1) of the Investment Company Act excludes any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred investors and who does not make a public offering of such securities. Section 3(c)(7) of the Investment Company Act excludes any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are “qualified purchasers” (as defined by Section 2(a)(51) of the Investment Company Act) and who does not make a public offering of such securities. Qualified purchasers are generally individuals with \$5 million in investments or entities with \$25 million in investments. See Section 3 of the Investment Company Act. “Hedge fund” is defined for purposes of collecting information on Form PF. See response to Question 28.5 below.

apply to hedge funds because they are not registered under the Investment Company Act.

In addition, some specific requirements apply only to advisers to certain private funds. Section 204 of the Advisers Act and Rule 204(b)-1 thereunder require certain investment advisers to file information about the private funds they advise on Form PF, which is designed to assist FSOC in its assessment of systemic risk. For further information please see response to Question 28.5, below.

As noted in response to Question 24.2, investment advisers, including hedge fund managers, register with the SEC by filing Form ADV. ERAs report certain information on Form ADV.<sup>800</sup> Form ADV requires an investment adviser to provide specific information upon registration that provides transparency into the business of the hedge fund manager and on the hedge funds managed. The information in Form ADV must be updated periodically following registration.

The information provided by hedge fund managers upon registration includes:

- Background of organization and ownership – See Form ADV, Part 1A, Item 10 and Schedules A and B (requiring an adviser to identify: (i) direct owners and executive officers; (ii) indirect owners; and (iii) any person that directly or indirectly controls the adviser).
- Assets under management – See Form ADV, Part 1A, Item 5F (requiring an adviser to state its RAUM and to disclose the amount managed on a discretionary and non-discretionary basis). Rule 203(m)-1 under the Advisers Act requires advisers to calculate the value of private fund assets pursuant to instructions in Form ADV, which provide a uniform method of calculating assets under management for regulatory purposes under the Advisers Act. See also Form ADV Part 2A E (requiring an adviser to disclose the amount of client assets managed on a discretionary and non-discretionary basis).
- Services offered – See Form ADV, Part 1A, Items 5G, 5H, 5I, and 6 (requiring an adviser to indicate its advisory and non-advisory activities). See Form ADV, Part 2A, Items 4B, 4C, and 4D (requiring an adviser to disclose the types of advisory services offered, whether (and if so, how) such services are tailored to individual client needs and whether the adviser participates in wrap programs).
- Types of clients – See Form ADV, Part 1A, Item 5D (requiring an adviser to indicate the approximate percentage that each type of client comprises of its total number of clients).
- Fees charged – See Form ADV, Part 1A, Item 5E (requiring an adviser to generally indicate

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In particular, with respect to the Items described below, exempt reporting advisers must complete Items 7 (with accompanying schedules) and 10 of Part 1A.

how it is compensated) and Form ADV, Part 2A, Item 5 (requiring an adviser to describe, among other things, its basic fee schedule) and Item 6 (requiring an adviser to disclose the existence of, and conflicts associated with, performance-based fees).

- Investment related affiliates – See Form ADV, Part 1A, Item 7 (requiring an adviser to disclose its financial industry affiliations) and Form ADV, Part 2A, Item 10.
- Investment strategies utilized – See Form ADV, Part 2A, Item 8 (requiring an adviser to generally indicate its investment strategy).
- Identification of key service providers – See Form ADV, Part 1A, Item 7B and Section 7(B)(1) of Schedule D (requiring information about private fund service providers such as auditors, prime brokers, custodian, administrators and marketers). Fund sub-advisers on whose behalf another adviser reports the information required to be reported by Section 7(B)(1) of Schedule D must instead report the identity of such reporting adviser on Section 7(B)(2) of Schedule D.
- Conflicts of interest – See Form ADV, Part 1A, Items 7 and 8 and Section 7.A of Schedule D (requiring an adviser to disclose its financial industry affiliations and proprietary interest in client transactions), Form ADV, Part 2A, Items 10 and 11 (generally requiring adviser to: (i) disclose conflicts arising from the adviser's or the adviser's affiliates' role in a client transaction; and (ii) explain how the adviser manages the conflict), Form ADV, Part 2A, Item 12 (requiring the adviser to disclose conflicts arising from its discretion in choosing brokers), and Form ADV, Part 2A, Item 14 (requiring adviser to disclose conflicts arising from certain compensation arrangements).

Certain information regarding each hedge fund, including information about leverage, concentration, and liquidity metrics, is not collected on Form ADV at registration due to its confidential nature. However, certain registered hedge fund managers must make this information available to the SEC on Form PF on an ongoing basis following registration. See response to Question 28.5, below.

*Standards for internal organization and operational conduct*

3. Does the regulatory system set (in view of the risk posed) standards for internal organization and operational conduct to be observed on an ongoing basis by the hedge fund manager/adviser, including appropriate risk management and protection and segregation of client money and assets?

Yes. A hedge fund manager registering with the SEC pursuant to the Advisers Act is subject to the same ongoing regulatory requirements as other registered investment advisers. For further information, see responses to Questions 29.2, 29.7, 31.1, 31.5, and 31.16, as well as portions of responses to questions 24.1-24.4, 24.8-24.17 that discuss a variety of Advisers Act requirements imposed on registered investment advisers that pertain to risk management and the protection

and segregation of client assets, such as rules regarding reporting, managing conflicts of interest, and custody of client assets. Certain obligations discussed in response to Principle 24 would not apply to hedge funds because they are not registered under the Investment Company Act.

Registered hedge fund managers with at least \$150 million in private fund assets under management as of the last day of their most recently completed fiscal year are also subject to additional ongoing regulatory requirements through the filing of Form PF. Reporting on Form PF requires certain information, on an aggregate basis, about private funds, including, but not limited to, the amount of assets under management, use of leverage, counterparty credit risk exposure, and trading practices for each private fund managed by the adviser.

*Conflicts of interests and other conduct of business rules*

4. Does the regulatory system set standards for hedge fund managers/advisers to appropriately manage conflicts of interest, and provide full disclosure and transparency to the regulator and investors (including potential investors) about such conflicts and how they manage them?

Yes. A hedge fund manager registering as an investment adviser with the SEC pursuant to the Advisers Act is subject to the same ongoing regulatory requirements as other registered investment advisers. See responses to Questions 29.2, 29.5, 29.6, 31.6, and 31.17-31.18, as well as portions of responses to Questions 24.1-24.4, 24.8-24.17 that contain a detailed discussion of these requirements. Certain obligations discussed in response to Principle 24 would not apply to hedge funds because they are not registered under the Investment Company Act. A hedge fund manager that is not registered with the SEC pursuant to the Advisers Act is still required to manage conflicts of interest as a fiduciary and is subject to certain anti-fraud provisions of the Advisers Act.

*Disclosure to the regulator and to investors*

5. Is the regulator able to obtain from hedge fund managers/advisers appropriate information about their operations and about the funds that they manage that allow it to assess the risks that hedge funds pose to systemic stability?

Yes. As discussed in response to Question 28.2, registered hedge fund managers and hedge fund managers reporting as ERAs must provide specific information on Form ADV that provides transparency into the business of the hedge fund manager or the hedge funds managed. In addition to annual updates on Form ADV, an investment adviser must promptly file additional amendments if certain information on its Form ADV becomes inaccurate. Therefore, all information required at registration (including the information contemplated by Key Issue 2 discussed above) is required to be updated on an ongoing basis.

The SEC has the authority to require advisers, including ERAs, to maintain records and provide reports and has authority to examine such advisers' records. Additionally, the records of private

funds are deemed to be the records of its investment adviser thereby giving the Staff access to private fund records for examination or inspection. See Question 28.8 for a more detailed discussion.

In 2011, the SEC adopted Form PF, which requires certain registered investment advisers that advise private funds to report information to FSOC and the SEC. Advisers Act Rule 204(b)-1 requires registered advisers with at least \$150 million in private fund RAUM to submit regular reports on Form PF. Advisers must file Form PF electronically on a confidential basis. While the primary goal of adopting Form PF was to create a source of data for FSOC to use in assessing systemic risk, the SEC is using the information gathered on Form PF to support its own regulatory programs, including examinations, investigations, and investor protection efforts.

Both the amount of information to be reported and the frequency with which Form PF must be filed depend on the amount of the adviser's private fund RAUM and the types of private funds managed. Most advisers are required to file Form PF once a year, and report only basic information regarding the private funds they advise. This annual filing requirement includes general data such as the types of private funds that an adviser advises (e.g., private equity or hedge funds<sup>801</sup>), and information relating to such funds' size, leverage, types of investors, liquidity, and performance. Advisers managing hedge funds must also report information about fund strategy, counterparty credit risk, and the use of trading and clearing mechanisms.

Large private fund advisers must also provide more detailed information. The content and frequency of this more detailed reporting is different depending on the type of private fund the large adviser manages:

- Advisers with at least \$1.5 billion in hedge fund RAUM must file Form PF quarterly with respect to their hedge funds. Information required to be reported generally includes aggregate information on such funds' exposures, geographical concentration, and turnover by asset class (not position-level information). For each Qualifying Hedge Fund (i.e., \$500 million or more in net assets), additional information relating to each fund's exposures, leverage, risk profile, and liquidity is required.
- Advisers with at least \$1 billion in combined liquidity fund and registered money market fund RAUM must file Form PF quarterly with respect to their liquidity funds. Information required to be reported generally includes each such fund's exposures, geographical concentration, and turnover by asset class (not position-level information), and direct and indirect forms of leverage and liquidity.

<sup>801</sup> For purposes of reporting information, Form PF defines "hedge fund" broadly to include any private fund having any one of three characteristics generally thought to be common for a hedge fund: (i) a performance fee that takes into account market value (instead of only realized gains); (ii) high leverage; or (iii) short selling. Solely for purposes of Form PF, a commodity pool that is reported or required to be reported on Form PF is treated as a hedge fund.

<ul style="list-style-type: none"> <li>Advisers with at least \$2 billion in private equity fund RAUM must file Form PF annually with respect to their private equity funds. Information required to be reported generally relates to each such fund's use of direct and indirect leverage (e.g., use of financing) and investments in financial institutions.</li> </ul>
<p>6. Does the regulatory system, in view of the risk posed, set standards for the proper disclosure by hedge fund managers/advisers or the fund to investors?</p>
<p>Yes. The information filed by a registered hedge fund manager or ERA on Form ADV is publicly available at the time of filing. Furthermore, registered hedge fund managers must provide clients and prospective clients with a brochure containing narrative disclosure of certain information about the firm. For further information regarding the disclosures required to be made to clients and potential clients, see responses to Question 28.2.</p> <p>In addition, all hedge fund managers are prohibited by Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in the hedge fund.</p>
<p><i>Prudential regulation</i></p>
<p>7. Are hedge fund managers/advisers, which are required to register, subject to appropriate ongoing prudential requirements that reflect the risks they pose?</p>
<p>Yes. As noted in response to Principle 6, the FSOC may subject certain nonbank financial companies to oversight by the Federal Reserve and additional prudential standards if it determines that they could pose a threat to the financial stability of the U.S. To date, FSOC has not determined that any hedge funds or hedge fund advisers should be subject to Federal Reserve oversight or additional prudential standards.</p>
<p><i>Supervision and enforcement</i></p>
<p>8.</p>
<p>(a) Does the regulatory system provide for on-going supervision of the hedge fund managers/advisers which are required to register?</p>
<p>(b) Does the regulator have the power to access and inspect the hedge fund managers/advisers and their records and/or the hedge funds?</p>
<p>(c) Does the regulator have the authority to enforce against wrongdoers?</p>
<p>Yes. The SEC's supervision of investment advisers, including hedge fund managers, is primarily performed through a risk-based examination process, with emphasis placed on the highest risk firms and activities at any point in time. OCIE staff works with colleagues throughout the agency to identify high risk issues and to develop models and methodologies to identify the appropriate registrants for risk-based exams. These efforts are designed to focus the SEC's resources on</p>



those firms and practices that pose the greatest potential risk of securities law violations that can harm investors and the markets.

One example of a recent series of examinations related to private funds that is still ongoing is the Presence Exam initiative, which launched at the start of fiscal year 2013. The focus of the initiative is to examine a significant percentage of the advisers registered since the effective date of Title IV of the Dodd-Frank Act, which requires registration of certain advisers to private funds. The five key focus areas of these examinations are: marketing; portfolio management; conflicts of interest; safety of client assets; and valuation. The vast majority of these new registrants are advisers to hedge funds and private equity funds that were not registered or regulated by the SEC prior to the Dodd-Frank Act and have never been examined by the SEC. The staff also will continue to prioritize examinations of private fund advisers where the staff's analytics indicate higher risks to investors, or where there are indicia of fraud, broker-dealer status concerns, or other serious wrongdoing. See Question 12.1(b) for more information about investment adviser examinations including examination focus areas and statistics.

As discussed in response to Question 10.1 and Question 29.7, under Section 204(a) of the Advisers Act, the SEC has the authority to require an investment adviser to maintain records and provide reports, as well as the authority to examine such adviser's records, unless the adviser is "specifically exempted" from the requirement to register pursuant to Section 203(b) of the Advisers Act. Exempt reporting advisers are not "specifically exempted" from the requirement to register pursuant to Section 203(b), and thus the SEC has authority under Section 204(a) of the Advisers Act to require those advisers to maintain records and provide reports and has the authority to examine their records. Additionally, Section 204(b)(2) of the Advisers Act, added by the Dodd-Frank Act, deems the records of private funds to be the records of its investment adviser thereby giving Staff access to private fund records for examination or inspection.

Additionally, through the annual CEO certification requirement and the investment adviser annual review requirements discussed in response to Principle 12, Question 5, firms are required to do annual monitoring of the adequacy of their written supervisory procedures as well as how the procedures are being carried out. OCIE staff review investment advisers' annual compliance reviews as part of examinations of those entities.

The SEC may also use the information provided in Form PF for the purpose of examining SEC-registered investment advisers.

The SEC has broad authority to bring an enforcement action against a registered hedge fund adviser for violations of the federal securities laws (see response to Question 29.4). In addition, all hedge fund managers, whether registered with the SEC or not, are prohibited by Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in the hedge fund.

The SEC may also bring enforcement actions for violations of the federal securities laws against



“regulated” persons or entities that serve as intermediaries. Such intermediaries may include investment advisers to hedge funds. In addition, the SEC may sanction intermediaries and their associated persons for failure reasonably to supervise individuals subject to their supervision who commit violations of the federal securities laws (see response to Question 12.5).

9. Subject to appropriate confidentiality safeguards and national law restrictions, from the point of view of supervision and enforcement, does the regulator have the power to:

(a) Collect where necessary relevant information from hedge fund managers/advisers and/or hedge funds (and through cooperation with other domestic regulators from hedge fund counterparties) also on behalf of a foreign Regulator?

(b) Exchange information on a timely and on-going basis, as deemed appropriate, with other relevant regulators on internationally active funds that may pose systemic or other significant risks?

Yes. The Exchange Act authorizes the SEC to collect information from hedge funds and hedge fund managers on behalf of foreign regulators and to share information in its files with foreign authorities.

Where a hedge fund manager is registered with the SEC, the SEC may perform joint investigations with foreign regulators, pursuant to sections 21(a)(2) and 24(c) of the Exchange Act.

Where a hedge fund manager is registered with the SEC as an investment adviser, or the adviser is not “specifically exempted” from the requirement to register pursuant to Section 203(b) of the Advisers Act, the SEC has the authority to impose and enforce recordkeeping requirements.

The Dodd-Frank Act provides specific confidentiality protections for proprietary information of investment advisers collected on Form PF for the purposes of assessing systemic risk of private funds. A steering committee comprised of senior officials from various Divisions and Offices within the Commission works with other federal agencies that request Form PF data to address the confidentiality obligations under the Dodd-Frank Act. Significantly, in accordance with the Dodd-Frank Act, Form PF data has been made available to FSOC through OFR. The SEC is engaged in an ongoing dialog with OFR regarding the use of Form PF data.

In response to a request from IOSCO, the SEC shared certain aggregated, non-proprietary Form PF data to provide IOSCO with a more complete overview of the global hedge fund market for a report to the FSB.

10. Is the securities' regulator able to obtain from the hedge fund operator/adviser - if necessary working with other regulators - non-public reporting of information on the hedge funds' exposure to counterparties, (which may include prime brokers, banks or OTC derivative counterparties)?

Yes. Form PF requires the reporting of information on counterparty credit exposure in relation to OTC derivatives positions, loans, and loan commitments. Under the Dodd-Frank Act, certain counterparties are required to report transaction information regarding SBS to trade repositories. The SEC will have direct access to information reported to such trade repositories registered with the SEC and is working to secure indirect access to information reported to other trade repositories.

In addition, the Exchange Act requires certain broker-dealers to report on a monthly basis, among other things: (i) overall current exposure; (ii) current exposure (including commitments) listed by counterparty for the 15 largest exposures; (iii) the 10 largest commitments by counterparty; (iv) the firm's maximum potential exposures to the 15 largest counterparties; and (v) the firm's aggregate maximum potential exposure. Counterparties include, among others, hedge funds.

In general, broker-dealer margin requirements with regard to customers, including hedge funds, are set by Regulation T, as promulgated by the Federal Reserve. The margin rules of the SRO that is the DEA of the broker-dealer govern maintenance margin requirements. Further, broker-dealers also may establish "house" initial and maintenance and margin rules that are at least as restrictive as those set by Regulation T and SRO regulations.

Finally, cash loaned to customers for the purpose of buying, carrying, or trading in securities, generally speaking, is reported by broker-dealers in their computation of reserve requirements under the Exchange Act.

## Principle 29 Regulation should provide for minimum entry standards for market intermediaries.

### Key Questions

#### Authorization

1. Does the jurisdiction require that, as a condition of operating a securities business, the market intermediaries (as defined above) are licensed?

Yes, in order to operate a securities business in the U.S., a market intermediary must generally be registered with the appropriate authority, as discussed below.<sup>802</sup>

#### Broker-Dealers

To carry on business as a broker-dealer in the U.S., a person generally must register with the SEC,<sup>803</sup> and become a member of at least one SRO, typically FINRA (formerly known as NASD).<sup>804</sup> A broker is generally defined as “any person engaged in the business of effecting transactions in securities for the account of others”<sup>805</sup> and a dealer as “any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise.”<sup>806</sup>

A broker-dealer registers with the SEC by filing an application for registration on Form BD, which was adopted under the authority of the Exchange Act.<sup>807</sup> Form BD requests extensive information about the background of the applicant, including the type of business in which it proposes to engage, the identity of the applicant’s direct and indirect owners, and other control

<sup>802</sup> Certain persons, such as banks, are excepted from the definition of a broker or dealer. These persons do not have to register as broker-dealers, and generally are not regulated by the SEC. Additionally, certain persons or firms meeting the definition of a broker or dealer may be exempted from the requirement to register with the SEC.

<sup>803</sup> Section 15(a) of the Exchange Act generally requires any broker or dealer that “make[s] use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers’ acceptances, or commercial bills)” to register with the SEC.

<sup>804</sup> See Section 15(a)(8) of the Exchange Act. See response to Question 6.1(a) (broker-dealers that have a public customer business must be members of FINRA unless they limit their transactions to securities traded on an exchange of which they are a member).

<sup>805</sup> Section 3(a)(4)(A) of the Exchange Act. The Exchange Act does not specifically define what is encompassed by “effecting transactions” in securities. To establish that someone is a broker, courts generally require a showing of “a certain regularity of participation in securities transactions at key points in the chain of distribution.” See *Massachusetts Financial Services, Inc. v. Securities Investor Protection Corp.*, 411 F. Supp. 411, 415 (D. Mass. 1976), *aff’d*, 545 F.2d 754 (1st Cir. 1976), *cert. denied*, 431 U.S. 904 (1977). See also *Securities Industry Association v. Board of Governors of the Federal Reserve System*, 468 U.S. 207, 218 (1984) (“a broker executes orders for the purchase or sale of securities solely as agent”).

<sup>806</sup> Section 3(a)(5) of the Exchange Act. Unlike a broker, which acts as agent, a dealer acts as a principal. As discussed in the response to Question 29.2, the definition of “dealer” does not include a “trader,” which is a person who buys and sells securities for his or her own account, either individually or in a fiduciary capacity, but not as part of a regular business.

<sup>807</sup> See Exchange Act Rule 15b1-1.

persons including executive officers, and whether the applicant or any of its control affiliates has been subject to criminal prosecutions, regulatory actions, or civil actions in connection with any investment-related activity.<sup>808</sup> Within 45 days of the filing of a completed application, the SEC will either grant registration or begin proceedings to determine whether it should deny registration.<sup>809</sup> Broker-dealers have an ongoing requirement to promptly update their Forms BD when the information on the Form becomes inaccurate.<sup>810</sup>

An SEC order granting registration generally will not become effective until a broker-dealer has become a member of at least one SRO.<sup>811</sup> SRO rules may impose certain other clear and publicly available criteria consistent with Sections 6(b), 15A(b) and (g) of the Exchange Act and rules and regulations thereunder. Among other things, SRO rules must be “designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, ... to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.”<sup>812</sup> When a firm applies for registration with an SRO, the firm is subject to that SRO’s pre-membership process. The firm may not engage in any securities business without the approval of the SRO upon completion of the pre-membership process. New broker-dealers are generally subject to an examination within six months after they have been approved to do business by an SRO.<sup>813</sup>

In accordance with Section 15A, FINRA has rules that (i) set standards for an application for membership with FINRA; (ii) require registration standards for those persons (persons associated with a broker-dealer) who service customer accounts or otherwise execute transactions in a broker-dealer’s investment banking and securities business; (iii) set standards for fair and reasonable compensation in securities transactions with customers; (iv) dictate standards of conduct outside of compensation such as the suitability of recommended securities transactions, best execution of securities transactions, and the prohibition of front-running customer transactions and the issuance of broker-dealer research to customers; (v) detail requirements for a system of supervision and review of that system of supervision; (vi) set standards for the issuance of research and management of research analysts’ conflicts of interests that may affect the issuance of research; (vii) create financial and operational requirements that supplement the standards set forth in federal securities laws and rules; (viii) create quality of markets conduct rules generally and transaction reporting standards for executions in the OTC market for listed

<sup>808</sup> Form BD also elicits information regarding whether the applicant or any of its control affiliates has been subject to a bankruptcy petition, had a trustee appointed under the SIPA, has been denied a bond, or has any unsatisfied judgments or liens. Form BD is a consolidated form that was established by the Commission, SROs and state regulators to allow an applicant to initiate registration with all relevant regulators using one form.

<sup>809</sup> See Section 15(b)(1). An applicant may consent to a longer time period for a SEC decision.

<sup>810</sup> Exchange Act Rule 15b3-1.

<sup>811</sup> Exchange Act Section 15(b)(8).

<sup>812</sup> Exchange Act Sections 6(b)(5) and 15A(b)(6).

<sup>813</sup> Exchange Act Rule 15b2-2.

and unlisted securities; and (ix) frame the investigative and disciplinary procedures used by FINRA in its examination and enforcement programs.

The Exchange Act also generally prohibits registered broker-dealers from conducting a securities business unless their associated persons who effect or are involved in effecting securities transactions are properly licensed in accordance with the qualification standards of the SROs of which they are members.<sup>814</sup> Most SROs have established various qualification exams and levels of licenses based on an associated person's job functions.<sup>815</sup> For instance, an associated person who is simply involved in selling securities to the public would be required to take one type of exam, whereas an associated person who is actively engaged in the management of the member's investment banking or securities business would generally be designated as a "principal" and would need to take one or more additional exams to qualify for that type of license. The SROs also may require special qualification exams for associated persons with special duties, such as those responsible for financial reporting or supervision of a broker-dealer's options business.<sup>816</sup>

Broker-dealers and their associated persons may also need to register with the securities authority of one or more states, in accordance with the applicable laws of each state.<sup>817</sup>

The broker-dealer registration process is coordinated through the CRD system operated by FINRA.<sup>818</sup>

Simplified Process for FCMs that Engage in Limited Securities Business: The CFMA provided for joint regulation of single stock futures in the U.S. To accommodate this business, the SEC adopted a simplified "notice" broker-dealer registration scheme under Section 15(b)(11) of the Exchange Act for firms already regulated by the CFTC that limit their securities business to SFPs.

Security-based Swap Dealers: The Exchange Act definition of "dealer" does not include certain SBSDs,<sup>819</sup> but Section 15F of the Exchange Act prohibits any person from acting as a SBS

<sup>814</sup> Exchange Act Rule 15b7-1.

<sup>815</sup> See, e.g., NASD Rules 1022 and 1032, and CBOE Rule 3.6A(a).

<sup>816</sup> See, e.g., NASD Rule 1022(b) and 1022(f), and CBOE Rule 3.6A(b).

<sup>817</sup> Section 3(a)(16) of the Exchange Act defines "State" to mean "any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States."

<sup>818</sup> Exchange Act Rule 15b1-1(b). The CRD was developed and is maintained jointly by NASAA and FINRA. CRD is an on-line registration data bank and application processing facility used by FINRA, the other SROs, state regulators, and the SEC in connection with the registration and licensing of broker-dealers and broker-dealers' personnel. CRD was created, in part, to centralize the registration process, allowing applicants to file in one place, rather than filing separately in multiple jurisdictions. *Broker-Dealer Registration and Reporting*, Exchange Act Release No. 41594 (July 2, 1999), 64 Fed. Reg. 37586 (July 12, 1999).

<sup>819</sup> See Section 3(a)(5)(A) of the Exchange Act.

without being registered with the SEC, and it requires that the SEC issue rules to provide for registration of these entities.<sup>820</sup> The Dodd-Frank Act requires the SEC to establish registration and other requirements for SBSDs. In 2011, the SEC proposed rules and forms to establish a registration process for these entities.<sup>821</sup> The SEC has also proposed rules to regulate SBSD conduct.<sup>822</sup> In addition, the SEC has adopted rules jointly with the CFTC to further define the terms “swap dealer” and “security-based swap dealer”<sup>823</sup> and has adopted rules and guidance on cross-border SBS activities for market participants.<sup>824</sup>

Crowdfunding Portals: The JOBS Act requires the SEC to establish registration and other requirements for crowdfunding portals. In 2014, the SEC proposed rules and forms to establish a registration process for these entities, along with limited rules to regulate their conduct.<sup>825</sup> Until the SEC adopts final rules to regulate crowdfunding portals, persons engaged in this type of activity must register as broker-dealers.

### **Investment Advisers**

To carry on business as an investment adviser in the U.S., a person generally must register with the SEC or the securities authority of a state. See response to Question 29.2 for a description of what “triggers” the federal and state registration requirements and the exclusions and exemptions from the federal registration requirements.

### **Municipal Advisors**

To carry on business as a municipal advisor in the U.S., a person generally must register with the SEC.<sup>826</sup> The Exchange Act defines the term “municipal advisor” to mean a person (who is not a

<sup>820</sup> See Section 15F(a) and (d) of the Exchange Act. The definition of “security-based swap dealer” was added to the Exchange Act by the Dodd-Frank Act and focuses on whether a person engages in particular types of activities involving SBSs. The SEC, in a joint rulemaking with the CFTC, and in consultation with the Federal Reserve, adopted new rules and interpretive guidance to further define “security-based swap dealer” and other related terms. See Exchange Act Rules 3a71-1 and 3a71-2.

<sup>821</sup> See Exchange Act Release No. 65543 (Oct. 12, 2011), 76 Fed. Reg. 65784 (Oct. 24, 2011).

<sup>822</sup> See, e.g., Exchange Act Release Nos. 64766 (Jun. 29, 2011), 76 Fed. Reg. 42396 (Jul. 18, 2011), and 68071 (Oct. 18, 2012), 77 Fed. Reg. 70214 (Nov. 23, 2012).

<sup>823</sup> Exchange Act Release No. 66868 (Apr. 27, 2012), 77 Fed. Reg. 30596 (May 23, 2012).

<sup>824</sup> Exchange Act Release No. 72472 (Jun. 25, 2014).

<sup>825</sup> See Exchange Act Release No. 707413 (Oct. 23, 2013), 78 Fed. Reg. 66428 (Nov. 5, 2013).

<sup>826</sup> Section 975 of the Dodd-Frank Act amended Section 15B of the Exchange Act to subject municipal advisors to registration with the SEC and regulation by the MSRB. Thus, as of October 1, 2010, it became unlawful for municipal advisors to provide certain advice to, or solicit, municipal entities or obligated persons without registering with the Commission. In September 2010, the Commission adopted, and subsequently extended, an interim final rule establishing a temporary means for municipal advisors to satisfy the registration requirement. See Exchange Act Release No. 62824 (September 1, 2010), 75 Fed. Reg. 54465 (September 8, 2010).

municipal entity or an employee of a municipal entity) that (i) provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters concerning such financial products or issues, or (ii) undertakes a solicitation of a municipal entity.<sup>827</sup> Subject to certain exemptions, the definition of municipal advisor includes financial advisors, guaranteed investment contract brokers, third-party marketers, placement agents, solicitors, finders, and certain swap advisors that provide municipal advisory services.<sup>828</sup>

The SEC is currently transitioning from an interim temporary registration regime for the registration of municipal advisors to the registration regime provided by the SEC's final rule for the registration of municipal advisors.<sup>829</sup> Currently, new municipal advisors register with the SEC by filing an application for registration on temporary Form MA-T. Effective October 1, 2014, all new municipal advisors will register with the SEC by filing Form MA and will provide information regarding natural persons associated with municipal advisory firms and engaged in municipal advisory activities on such municipal advisory firm's behalf by filing a Form MA-I for each such natural person pursuant to the final registration rule. Municipal advisors already registered under the SEC's temporary registration regime are currently registering with the SEC pursuant to the final registration rule on a staggered basis. Municipal advisor registration pursuant to the final registration rule commenced July 1, 2014 and is scheduled for full implementation by December 15, 2014.

In contrast to temporary Form MA-T, Form MA requires more detailed disclosures by municipal advisors. The disclosures requested by Form MA are based generally on the disclosures required by Form BD for broker-dealers and Form ADV for investment advisers.

Municipal advisory firms register with the SEC pursuant to the final registration rule by filing Form MA with EDGAR.<sup>830</sup> Form MA is a public document made available through the EDGAR website.<sup>831</sup> Form MA requests information about the municipal advisor and persons associated with the advisor, including identifying information, other registrations, information regarding the approximate number of employees it has, how many of those employees engage in municipal advisory activities, the general types of municipal advisory activities in which it engages, general compensation arrangements, and certain information concerning any criminal, regulatory, and civil judicial actions relating to the municipal advisor or any of its associated persons. Within 45

<sup>827</sup> Exchange Act Section 15B(e)(4)(A).

<sup>828</sup> Exchange Act Section 15B(e)(4)(B).

<sup>829</sup> See Exchange Act Release No. 70462 (September 20, 2013), 78 Fed. Reg. 67467 (November 12, 2013).

<sup>830</sup> See Exchange Act Rule 15Ba1-2.

<sup>831</sup> While information required in Form MA generally will not be confidential, some information, such as social security numbers, will be kept confidential (subject to the provisions of applicable law). See Exchange Act Release No. 70462 (Sept. 20, 2013), 78 Fed. Reg. 67468 at 67540 (Nov. 12, 2013).

days of the date a complete Form MA is considered filed, the SEC either will grant registration or institute proceedings to determine whether registration should be denied.<sup>832</sup> A municipal advisor must amend the information in its Form MA at least annually, and more frequently than annually if required by the General Instructions.<sup>833</sup>

Section 15B(b)(2)(L) of the Exchange Act provides that the MSRB shall propose and adopt rules with respect to advice provided to or on behalf of municipal entities or obligated persons by municipal advisors with respect to municipal financial products, the issuance of municipal securities, and solicitations of municipal entities or obligated persons undertaken by municipal advisors. It further provides that these rules shall prescribe means reasonably designed to prevent acts, practices, and courses of business as are not consistent with a municipal advisor's fiduciary duty to its clients; provide continuing education requirements for municipal advisors; provide professional standards; and not impose a regulatory burden on small municipal advisors that is not necessary or appropriate in the public interest and for the protection of investors, municipal entities, and obligated persons, provided that there is robust protection of investors against fraud. The rules of the MSRB require that each municipal advisor must register with the MSRB prior to engaging in municipal advisory activities.<sup>834</sup>

2. Are there minimum standards or criteria that all applicants for licensing must meet before a licence is granted (or denied) and that are clear and publicly available which:

(a) Are fair and equitable for similarly situated intermediaries?

### Broker-Dealers

Yes, there are clear and publicly available minimum standards that all broker-dealer applicants must meet in order to register with the SEC and become a member of an SRO. The standards for registration of broker-dealers with the SEC are set by statute and SEC rules, and they are fair and equitable for similarly situated intermediaries. Broker-dealers applying for registration with the SEC must provide the information required by Form BD, and must comply with the Exchange Act and Rules thereunder. In addition, Section 15(b)(4) of the Exchange Act provides minimum standards or criteria for registration because it describes conduct that can serve as the basis for the SEC to deny, revoke, or suspend a broker-dealer's registration. (For more information, see response to Questions 29.3(a) and (b) below.) Broker-dealers are also subject to initial and ongoing minimum capital requirements through Rule 15c3-1, commonly referred to as the Net Capital Rule. (For more information, see response to Question 30.1 below)

<sup>832</sup> See Section 15B(a)(2). An applicant may consent to a longer time period for an SEC decision.

<sup>833</sup> See Exchange Act Rule 15Ba1-5(a).

<sup>834</sup> See MSRB Rule A-12(a).



The standards for SRO membership are set by SRO rules that have been approved by the SEC under the authority provided by the Exchange Act.<sup>835</sup>

### **Investment Advisers**

Yes, there are clear, publicly available minimum standards that all investment adviser applicants must meet in order to register with the SEC. The standards are fair and equitable for similarly situated entities, and all entities in similar situations are treated the same. The SEC generally registers investment advisers organized in the U.S. and foreign investment advisers (*i.e.*, an investment adviser that is organized under the laws of a non-U.S. jurisdiction) that have \$100 million or more of assets under management<sup>836</sup> or that provide advice to CISs (specifically registered investment companies or business development companies). An investment adviser that has between \$25 million and \$100 million of assets under management must also register with the SEC if it is not required to be registered as an adviser with, and is not subject to examination by, the state securities authority where it maintains its principal office and place of business<sup>837</sup>. Investment advisers that are not registered with the SEC generally must register with the state securities authorities of the state in which they are organized and in each of the states in which they do business as an investment adviser.<sup>838</sup>

In particular, the conduct listed in Section 203(e) of the Advisers Act serves as minimum standards or criteria for registration because that conduct provides the basis upon which the SEC may deny, revoke, or suspend an investment adviser's registration. (For more information, see response to Questions 29.4(a) and (b) below). In addition, under the Investment Company Act, which regulates the operations of CISs, an investment adviser that committed certain wrongful acts is prohibited from advising a CIS unless the SEC grants an order.

Under the Advisers Act, the requirement to register as an investment adviser is triggered by engaging in certain activities. In particular, a person that meets the definition of investment adviser in Section 202(a)(11) of the Advisers Act must register with the SEC if the person is in the

<sup>835</sup> See Section 19(b) of the Exchange Act.

<sup>836</sup> "Assets under management" are defined for purposes of this subsection of the Advisers Act to mean "the securities portfolios with respect to which an investment adviser provides continuous and regular supervisory or management services." See rule 203A-3(d) and Instruction to Item 5.F of Form ADV Part 1A; see also rule 203A-1.

<sup>837</sup> See Section 203A(a) of the Advisers Act. Investment advisers also must register with the SEC if they were granted a SEC rule or order permitting registration, or they meet the requirements of one of the exemptions in rule 203A-2. For example, an investment adviser that has less than \$100 million in assets under management is not prohibited from registering with the SEC if it would be required to register with 15 or more state securities authorities. See Section 203A(a)(2) of the Advisers Act and Rule 203A-2(d) thereunder.

<sup>838</sup> Although state-registered and other unregistered investment advisers are governed primarily by state law, which is not addressed in this response, several provisions of the Advisers Act and SEC rules apply to them. For example, among other provisions, Section 206 of the Advisers Act, which prohibits fraudulent conduct, applies to state-registered advisers, as well as exempt or excluded advisers.

business of providing advice, making recommendations, issuing reports, or furnishing analyses on securities, either directly or through publications.<sup>839</sup>

An investment adviser registers with the SEC by filing an application for registration on Form ADV under the Advisers Act. Form ADV requests extensive information regarding the adviser's background and business practices. Within 45 days after the filing of a Form ADV, the SEC must grant registration or begin proceedings to deny registration.<sup>840</sup> The SEC may deny registration if it finds that the investment adviser has committed certain prohibited acts and that the public interest requires denial.<sup>841</sup>

Form ADV requires an investment adviser to disclose detailed information about itself. Form ADV is a public document, consisting of two parts, both of which are made available through the SEC's website.<sup>842</sup> For more information about Form ADV, see Principles 29.5, 29.6(a), and 29.7(c).

### **Municipal Advisors**

Yes, there are clear and publicly available minimum standards that all municipal advisor applicants must meet in order to register with the SEC. The standards for registration of municipal advisors with the SEC are set by statute and SEC rules, and they are fair and equitable for similarly situated intermediaries. Municipal advisors applying for registration with the SEC must provide the information required by Form MA for the municipal advisory firm and Form MA-I for each natural person associated with the municipal advisory firm and engaged in municipal advisory activities on such firm's behalf and must comply with the Exchange Act and rules thereunder. In addition, Section 15B(c)(2) of the Exchange Act provides minimum standards

<sup>839</sup> Not all persons meeting the definition of "investment adviser" are required to register or be regulated by the SEC, however. The Advisers Act expressly excludes certain persons or firms from the definition of an investment adviser. See Section 202(a)(11)(A)-(G) of the Advisers Act. The Advisers Act also gives the SEC the authority to exclude, by rule or by order, other persons and firms not within the intent of the definition of investment adviser. These persons or firms do not register under the Advisers Act, and generally are not otherwise regulated by the SEC (with the exception of brokers, dealers, and NRSROs). In addition to the exclusions, certain persons meeting the definition of investment adviser may choose not to register with the SEC if the person or firm qualifies for one of the limited exemptions from registration. See Section 203(b)(1)-(7), 203(l), and 203(m) of the Advisers Act. Investment advisers exempt from registration are still subject to certain anti-fraud provisions included in the Advisers Act. See Section 203A(a) of the Advisers Act. If an investment adviser is not registered with the SEC, it generally must register with one or more state securities regulatory authorities.

<sup>840</sup> See Section 203(c)(2) of the Advisers Act.

<sup>841</sup> The SEC may deny an investment adviser's registration under Section 203(e) of the Advisers Act on the same basis that it may revoke an adviser's registration, such as for making false or misleading statements in a Form ADV, or having been convicted of a felony in the past ten years. See response to Question 29.4(b).

<sup>842</sup> Form ADV Part 1A and Part 2A elicit information about the firm and are available publicly. Brochure supplements (Part 2B), however, provide information specific to certain employees of the firm and are not required to be filed with the SEC; therefore, they are not publicly available on its website. Advisers are required to provide brochure supplements to certain prospective and current clients.

or criteria for registration because it describes conduct that can serve as the basis for the SEC to deny, revoke or suspend a municipal advisor's registration. Section 15B(b)(2)(L)(iv) of the Exchange Act also provides that the rules of the MSRB may not impose a regulatory burden on small municipal advisors that is not necessary or appropriate in the public interest and for the protection of investors, municipal entities, and obligated persons, provided that there is robust protection of investors against fraud.

(b) Are consistently applied?

### **Broker-Dealers**

Yes, the standards for SEC registration and regulation of broker-dealers are consistently applied. The standards are set by statute and SEC rules adopted under the authority provided by the statute, and include detailed disclosure on Form BD, recordkeeping, reporting, net capital, and other requirements.

In order for a firm's registration with the SEC to be complete, the firm must be a member of an SRO. SRO rules may impose certain other clear and publicly available criteria, consistent with Sections 6(b), 15A(b) and (g) of the Exchange Act and rules and regulations thereunder.<sup>843</sup>

The SEC oversees the SRO membership and licensing processes and procedures. Rules for admission to an SRO are reviewed by the SEC pursuant to Section 19(b) of the Exchange Act. To effectively evaluate compliance with membership and licensing rules and requirements, OCIE may conduct inspections of the SROs' processes for approving firms' membership, as well as the SROs' processes for licensing individual registered representatives of those member firms, to help ensure, among other things, that the SROs fairly and consistently apply the rules.

### **Investment Advisers**

Yes, the standards for SEC registration and regulation of investment advisers are consistently applied. Every entity that meets the definition of investment adviser and is not prohibited from registering or exempt from registration must register.

### **Municipal Advisors**

Yes, the standards for SEC registration and regulation of municipal advisors are consistently applied. The standards are set by statute and SEC rules adopted under the authority provided by

<sup>843</sup> Among other things, SRO rules must be "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, ... to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest." Exchange Act Sections 6(b)(5) and 15A(b)(6).

the statute. Every person who meets the definition of municipal advisor and does not qualify for a statutory exclusion or regulatory exemption from the municipal advisor definition and is not exempt from registration must register.

(c) Include an initial capital requirement, as applicable?

### **Broker-Dealers**

See response to Question 30.1. Yes, broker-dealers must meet an initial capital requirement. During the pre-membership process the broker-dealer must demonstrate that it has sufficient net capital to fulfill the requirements of the SEC's net capital<sup>844</sup> and early warning<sup>845</sup> rules. Under the SEC's net capital rule, broker-dealers that engage in businesses that present more risk must maintain higher levels of net capital.<sup>846</sup> SROs may also impose net capital or net worth requirements greater than those otherwise required under the SEC's rules.<sup>847</sup>

### **Investment Advisers**

No, the Advisers Act does not impose any minimum initial or ongoing capital requirements upon registered investment advisers. The SEC uses a disclosure-based approach to regulate investment advisers. Staff notes that investment advisers generally act as agent on behalf of their clients; they generally do not trade as principal on their own behalf when conducting their advisory businesses. Accordingly, the operations of investment advisers, unlike other types of market intermediaries, generally do not pose to the securities markets the types of risks that are commonly addressed through capital requirements. Investment advisers that engage in traditional brokerage activities, however, (*e.g.*, transacting in securities) must also register as broker-dealers and would be subject to the capital requirements described above when acting in that capacity.<sup>848</sup>

### **Municipal Advisors**

No, the Exchange Act does not impose any minimum initial or ongoing capital requirements upon registered municipal advisors. The SEC uses a disclosure-based approach to regulate

<sup>844</sup> Exchange Act Rule 15c3-1 sets forth minimum capital requirements for U.S. broker-dealers.

<sup>845</sup> Exchange Act Rule 17a-11 requires that broker-dealers promptly inform the SEC and its DEA if its net capital falls below specified levels.

<sup>846</sup> See Exchange Act Rule 15c3-1 and the response to Principle 30 below.

<sup>847</sup> See, *e.g.*, FINRA Rule 4110(a).

<sup>848</sup> Investment advisers that are also registered as broker-dealers have to meet all broker-dealer requirements, including capital requirements.

municipal advisors. Municipal advisors that engage in traditional brokerage activities (*e.g.*, transacting in securities) must also register as broker-dealers.<sup>849</sup>

- (d) Include a comprehensive assessment of the applicant and all those in a position to control or materially influence the applicant that addresses a demonstration of appropriate knowledge, business conduct, resources, skills, ethical attitude (including a consideration of past conduct)?

### Broker-Dealers

Yes, the standards also provide for a comprehensive assessment of the applicant and all those in a position to control or materially influence the applicant as described in detail below.

Each broker-dealer must disclose the identity of all senior managers and directors on its Form BD, which it files with the SEC. Each broker-dealer that is a corporation must disclose the identity of all shareholders that beneficially own, have the right to vote, or have the power to sell or direct the sale of 25% or more of any class of a voting security of the broker-dealer on Form BD. Each broker-dealer that is a partnership must disclose the identity of all general partners and any limited or special partners that have the right to receive upon dissolution, or have contributed, 25% or more of the partnership's capital on its Form BD. Each broker-dealer that is a trust must disclose the identity of the trust and each trustee on its Form BD. Each broker-dealer that is a LLC must disclose the identity of those members that have the right to receive upon dissolution, or have contributed, 25% or more of the LLC's capital and all elected managers on its Form BD.

Form BD requires additional disclosures about the individuals or entities identified in the preceding paragraph. Criminal, regulatory, civil judicial, bankruptcy, and SIPC actions involving each of those individuals or entities generally are required to be disclosed on Form BD. In addition, negative actions by a bonding company with respect to the applicant for broker-dealer registration must generally be disclosed on Form BD. Form BD also requires the applicant to disclose any unsatisfied judgments or liens against the applicant.

The SROs require that most individuals who work at a broker-dealer register with them using Form U4 and impose qualification requirements on those individuals based on their activities.<sup>850</sup> In order to fulfill SRO requirements, all registered representatives, general sales personnel, and principals, general officers of the firm, and other management personnel involved in the day-to-

<sup>849</sup> Municipal advisors that are also registered as broker-dealers have to meet all broker-dealer requirements, including capital requirements.

<sup>850</sup> See, *e.g.*, NASD Rules 1021 and 1031. Exchange Act Rule 15b7-1 prohibits broker-dealers from engaging in a securities business if its employees are not qualified in accordance with the rules of the SROs of which it is a member.

day operation of the firm's investment banking or securities business must prove themselves to be qualified in the areas in which they will work by passing qualifications examinations.<sup>851</sup> These mandatory examinations test, among other things, the individuals' knowledge of securities industry laws, regulations, and rules; securities products; the operation and interrelation of financial markets; economic theory and kinds of risk; and corporate financing, accounting, and balance sheet analyses; and are both general<sup>852</sup> and specialized.<sup>853</sup> Principals must pass additional examinations that test their knowledge of supervisory rules in areas such as investment banking, trading and market making, retail sales activities, and financial responsibility rules as applicable to that person based on the activities or business lines the principal will be supervising.

The Form U4 requires disclosure of administrative information, as well as information regarding criminal, regulatory, and civil proceedings; customer complaints and arbitrations; terminations; and financial matters.<sup>854</sup> Individuals must submit fingerprints when filing Forms U-4.<sup>855</sup> FINRA reviews the Forms U4 to determine, among other things, if an individual is subject to a statutory disqualification under Section 3(a)(39) of the Exchange Act. Individuals who are subject to a statutory disqualification generally may not associate with a FINRA member in any capacity unless and until the individual is approved under a special eligibility proceeding.<sup>856</sup> In addition, as part of the registration process, FINRA will submit the fingerprints to the FBI for a criminal background check. The SROs also enforce ethical standards through application of their rules requiring member compliance with just and equitable principles of trade.

### Investment Advisers

Under the Advisers Act, the SEC assesses the qualifications of persons or firms seeking to become investment advisers to determine if they have engaged in conduct specified in Section 203(e) of the Advisers Act that may prohibit them from acting as, or being employed by,

<sup>851</sup> See, e.g., NASD Rules 1021(b)(2), 1022(a) through (g) and 1032(a) through (h), and FINRA Rule 1230. SRO registration, in turn, has largely focused on persons who are actively engaged in the investment banking or securities business. Under FINRA rules, for example, registration is permitted – but not required -- for a representative who performs "legal, compliance, internal audit, back-office operations, or similar responsibilities for a member." NASD Rule 1031(a); see also NASD Rule 1060(a)(2) (exempting from registration persons "who are not actively engaged in the investment banking or securities business").

<sup>852</sup> See, e.g., NASD Rules 1022(a) and 1032(a).

<sup>853</sup> See, e.g., NASD Rules 1022(b) and (f) and 1032(c) and (e).

<sup>854</sup> Under FINRA rules, the member firm is responsible for submitting the Form U4 to FINRA via the CRD system. The CRD system also contains information about registered and formerly registered securities industry personnel including the disclosure history (referenced above) that has been reported for such persons.

<sup>855</sup> Persons associated with a broker-dealer that engage in certain activities may not be required to register, but still may be required to submit fingerprints for review. Exchange Act Section 17(f)(2).

<sup>856</sup> If a person is already associated with a broker-dealer, the person could continue to associate with the member as long as the person files a timely application, but would be required to cease that association if his or her application was ultimately denied at the conclusion of the eligibility proceeding.

an investment adviser.

Under the Advisers Act, only an investment adviser, not the persons who are associated with the adviser, must register with the SEC.<sup>857</sup> Under Section 203(f) of the Advisers Act, the SEC may bar, suspend, or place limitations on the activities of persons who are, or are seeking to become, associated with an investment adviser, if an event specified in Section 203(e) has occurred.

Other than with regard to prior misconduct, the SEC uses a disclosure-based approach to investment adviser regulation. A primarily disclosure-based approach is similar to the approach in other federal securities laws (*e.g.*, the Securities Act). This approach provides prospective clients with information to assess the adequacy of an adviser's background and experience. For these purposes, Part 1A of Form ADV, which is an adviser's application for registration, requires the adviser to disclose a variety of census-type information, including identifying information about owners and control persons<sup>858</sup> as well as certain disciplinary information about the firm, these persons, and certain other affiliates. This information is used by the SEC for risk-assessment purposes. Additionally, Part 2 of Form ADV is designed to enable clients and prospective clients to evaluate the risks associated with a particular investment adviser, presented in a format that they are likely to read and understand.<sup>859</sup> Part 2A of Form ADV is a narrative "brochure" that includes plain English disclosures of, among other things, the adviser's business practices, investment strategies, fees, conflicts of interest, financial conditions that reasonably likely would impair the adviser's ability to meet contractual commitments to clients, and disciplinary information. Part 2B requires an adviser to prepare a narrative, plain English "brochure supplement" that contains information about each advisory employee that provides investment advice to certain clients, including educational background, business experience, other business activities, and disciplinary history. The adviser must file its brochure, but not its brochure supplement, with the SEC and must provide both of these disclosure documents to clients and prospective clients. SEC rules require investment advisers to update this information on varying schedules.

<sup>857</sup> An "associated person" is defined in Section 202(a)(17) of the Advisers Act as a "person associated with an investment adviser" includes "any partner, officer, or director of [an investment adviser], or any person directly or indirectly controlling or controlled by such investment adviser, including any employee of such investment adviser." A "person" is defined as a natural person or a company under Section 202(a)(16) of the Advisers Act.

<sup>858</sup> Owners and control persons to be identified includes: all shareholders that beneficially own, have the right to vote, or have the power to sell or direct the sale of 25% or more of any class of a voting security of the investment adviser; for a partnership, all general partners and those limited or special partners that have the right to receive upon dissolution, or have contributed 25% or more of the partnership's capital; for a trust, each trustee on its Form ADV; for a limited liability company, members that have the right to receive upon dissolution, or have contributed, 25% or more of the company's capital and all elected managers; each Chief Executive Officer; each Chief Financial Officer; each Chief Operations Officer; each Chief Legal Officer; each CCO; each director; and any other individuals with similar status or functions. Indirect owners of each owner entity must also be disclosed.

<sup>859</sup> Part 1 requires information about the adviser's business, ownership, clients, employees, business practices (especially those involving potential conflicts with clients), and any disciplinary events of the adviser or its employees. The SEC uses information from this part of the form, which is presented in a check-the-box format, to make its registration determination and to manage its regulatory and examination programs.



Many states also require the registration of the individual persons who are associated with state-registered investment advisers. The states may also impose certain educational and professional training requirements upon the representatives of SEC-registered investment advisers who have a place of business in that state. Under Section 203A(b)(1)(A) of the Advisers Act, a state may not compel the registration of an employee of an SEC-registered investment adviser unless the employee is an investment adviser representative as defined under the Advisers Act who has a place of business in the state. An investment adviser representative is defined in Rule 203A-3(a) under the Advisers Act as a supervised person of an investment adviser (i) who has more than five clients who are natural persons and (ii) more than 10% of whose clients are natural persons. Certain “qualified clients” are excluded from the thresholds for counting natural persons. An investment adviser representative does not include supervised persons who do not regularly solicit, meet, or otherwise communicate with clients, or who provide only impersonal investment advice.

The Advisers Act also requires investment advisers to abide by ethical standards. Section 204A of the Advisers Act requires that investment advisers must maintain and enforce written policies and procedures that are reasonably designed to prevent the misuse of material nonpublic information, which includes the misuse of material nonpublic information about the adviser’s securities recommendations and client securities holdings and transactions. Advisers’ duty of care also requires that they safeguard this sensitive information.<sup>860</sup> The adviser is responsible for preparing, reviewing, and updating these procedures.<sup>861</sup> Advisory contracts also may contain confidentiality provisions.

More information about Section 204A and other statutory provisions and SEC rules that promote ethical conduct, such as a code of ethics rule and a pay-to-play rule, are discussed below in response to Question 29.2(e) and 31.6(b).

### **Municipal Advisors**

Under the Exchange Act, the SEC assesses the qualifications of applicants seeking to become municipal advisors to determine if they have engaged in conduct specified in Section 15B(c) of the Exchange Act that may subject their municipal advisor registration, if they were so registered, to suspension or revocation.<sup>862</sup>

Under Exchange Act Rules 15Ba1-2 and 15Ba-3, only a municipal advisor, not the natural persons

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<sup>860</sup> See Section 204A of the Advisers Act and *Investment Adviser Codes of Ethics*, Advisers Act Rel. No. 2256 (July 2, 2004).

<sup>861</sup> See *Compliance Programs of Investment Companies and Investment Advisers*, Advisers Act Rel. No. 2204 (Dec. 17, 2003).

<sup>862</sup> See Exchange Act Section 15B(a)(2).



who are associated with the municipal advisor and engaged in municipal advisory activities solely on the municipal advisor's behalf, must register with the SEC.<sup>863</sup> The SEC may bar, suspend, censure, or place limitations on the activities of persons who are, or are seeking to become, associated with a municipal advisor, if they have engaged in conduct specified in Section 15B(c)(4) of the Exchange Act.<sup>864</sup>

The SEC uses a disclosure-based approach to municipal advisor regulation. A primarily disclosure-based approach is similar to the approach used in other federal securities laws (*e.g.*, the Advisers Act and the Securities Act). This approach provides prospective clients with information to assess the adequacy of a municipal advisor's background and experience. For these purposes, Form MA, which is a municipal advisor's application for registration, is designed to enable clients and prospective clients to evaluate the risks associated with a particular municipal advisor, presented in a format that they are likely to read and understand.<sup>865</sup> Form MA includes, among other things, the municipal advisor's identifying information, form of organization, information about the municipal advisor's business, other business activities, financial industry and other activities of associated persons, and disciplinary information (*e.g.*, disclosures related to criminal action, regulatory action, and civil judicial action).<sup>866</sup> Form MA-I provides disclosure related to the municipal advisor's associated persons that are engaged in municipal advisory activities on the municipal advisor's behalf, including business experience, other business activities, and disciplinary history (*e.g.*, criminal action, regulatory action, investigation disclosure, termination disclosure, judgment lien disclosure, civil judicial action, customer complaint, and arbitration disclosure).<sup>867</sup>

<sup>863</sup> Exchange Act Section 15B(e)(7) defines "person associated with a municipal advisor" to mean the following persons: (i) any partner, officer, director, or branch manager of such municipal advisor (or any person occupying a similar status or performing similar functions); (ii) any other employee of such municipal advisor who is engaged in the management, direction, supervision, or performance of any activities relating to the provision of advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities; and (iii) any person directly or indirectly controlling, controlled by, or under common control with such municipal advisor.

<sup>864</sup> See Exchange Act Section 15B(c)(4) and Exchange Act Rule 15Bc4-1.

<sup>865</sup> See Form MA.

<sup>866</sup> *Id.*

<sup>867</sup> See Form MA-I.

- (e) Include an assessment of the sufficiency of internal organization and risk management and supervisory systems in place, including relevant written policies and procedures, which also enable ongoing monitoring as to whether the minimum standards are still met?

### Broker-Dealers

Yes, there generally are clear and publicly available minimum standards for broker-dealers that include an assessment of the sufficiency of internal organization and risk management and supervisory systems in place for broker-dealers.

**Internal Controls:** See response to Question 31.1, below. Broker-dealers are required to comply with the SEC's financial responsibility rules (Net Capital Rule, Books and Records Rules, Customer Protection Rule, Hypothecation Rules, etc.). These rules "have existed for many years and have facilitated the prudent operation of broker-dealers."<sup>868</sup> The minimum financial and customer protection requirements – like other financial tests that market participants use in the ordinary course of business to manage risk or to comply with applicable regulations – incorporate many specific numerical thresholds, limits, deductions, and ratios.

Under FINRA's standards for admission, an applicant must have financial controls to ensure compliance with the federal securities laws, the rules and regulations thereunder, and the SRO's rules.<sup>869</sup> An applicant must also have compliance, supervisory, operational, and internal control practices and standards that are consistent with practices and standards regularly employed in the investment banking or securities business, taking into account the nature and scope of the applicant's proposed business.<sup>870</sup> Further, the applicant must have a supervisory system, including written supervisory procedures, internal operating procedures (including operational and internal controls), and compliance procedures designed to detect and prevent, to the extent practicable, violations of the federal securities law, the rules and regulations thereunder, and the SRO's rules.<sup>871</sup>

Explicit delineation of the supervisory hierarchy, including the designation of a direct supervisor for each representative and the assignment of specific supervisory responsibilities to the supervisor, is a necessary part of a firm's supervisory structure.<sup>872</sup> A broker-dealer must also

<sup>868</sup> Exchange Act Release No. 34-68071 (Oct. 18, 2012) ("Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Majority Security-Based Swap Participants and Capital Requirements for Broker-Dealers").

<sup>869</sup> NASD Rule 1014(a)(8).

<sup>870</sup> NASD Rule 1014(a)(9).

<sup>871</sup> NASD Rule 1014(a)(10). See also, NASD Rule 3010, to be replaced in December, 2014 with FINRA Rule 3110.

<sup>872</sup> See *Signal Securities, Inc.*, Exchange Act Release No. 43350 (Sept. 26, 2000); NASD (FINRA) Rule 3010(a)(5) (requiring the assignment of each registered person to a person responsible for supervising their activities).

implement measures to monitor compliance with its policies and procedures.<sup>873</sup> In order to maintain compliance with federal securities laws and rules, a broker-dealer should have a comprehensive compliance system. In addition, under FINRA rules, the broker-dealer must designate a principal to serve as the broker-dealer's CCO and certify annually that the broker-dealer has a process to establish, maintain, test, and modify its supervisory procedures.<sup>874</sup>

The Exchange Act authorizes the SEC to impose sanctions on a firm or any associated person that fails to reasonably supervise a person subject to his or her supervision that commits a violation of the federal securities laws. The SEC's policy regarding failure to supervise is well-established and emphasizes the responsibility of broker-dealers and their supervisory personnel to supervise their employees.<sup>875</sup> Potential liability for failure to supervise is an important component of the federal regulatory scheme for broker-dealers.

**Risk Management:** SRO rules also require a broker-dealer to adopt and maintain a written BCP with procedures that, among other things, are reasonably designed to enable it to meet its existing obligations to customers in the event of an emergency or a significant business disruption.<sup>876</sup>

The standards require an assessment of the sufficiency of internal controls and risk management and supervisory systems in place, including relevant written policies and procedures for the broker-dealer's proposed operations. During the pre-membership process, the SRO will obtain relevant books and records of the firm. Based upon the types of business in which the firm wishes to engage, the SRO will review different types of books and records that are necessary to conduct and supervise those types of activity. Further, the SRO will obtain the firm's supervisory procedures for review. The SRO will also assure that the firm has an adequate number of supervisory personnel, as well as experienced personnel in key areas, to conduct the types of business in which it wishes to engage. Furthermore, FINRA also requires a business plan and an initial interview with the applicable FINRA District Office.

In addition, Exchange Act Rule 15c3-4, which applies to OTC derivatives dealers and ANC Broker-Dealers, requires that a firm establish, document, and maintain a system of internal risk management controls to assist it in managing the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks. See response to

<sup>873</sup> See *Signal Securities, Inc.*, *supra*, quoting *Thomson & McKinnon*, Exchange Act Release No. 8310 (May 8, 1968).

<sup>874</sup> FINRA Rule 3130.

<sup>875</sup> Individual supervisors have a duty, among other things, to investigate warning signs that suggest that misconduct may be occurring and to act upon the results of such investigation. Supervisors may be held accountable for violations by subordinates. For example, an individual may be charged with a failure to supervise if that supervisor failed to follow firm procedures or failed to respond promptly to warning signs.

<sup>876</sup> See FINRA Rule 4370.

Question 31.1 for more information.

### **Investment Advisers**

See response to Question 29.2(d), above.

An investment adviser has an obligation to comply with the federal securities laws, including the Advisers Act, and to conduct its business in accordance with its fiduciary obligations. The Advisers Act imposes requirements relating to certain written policies and procedures and recordkeeping. OCIE staff examines registered investment advisers for compliance with those requirements. See response to Question 29.7.

Under Rule 206(4)-7 of the Advisers Act, registered investment advisers must adopt and implement written CP&P reasonably designed to prevent the violation of the Advisers Act by the investment adviser or any of its supervised persons.<sup>877</sup> Each investment adviser should identify potential conflicts of interest with its clients and other compliance factors creating risks for clients and develop procedures addressing such conflicts and risks. The SEC has indicated that an adviser's CP&P should address, at a minimum, the following:<sup>878</sup>

- Portfolio management processes, including allocation of investment opportunities among clients;
- Trading practices, including best execution, soft-dollar arrangements, and trade aggregation;
- Proprietary trading of the investment adviser and personal trading activities of supervised persons;
- Accuracy of disclosures made to investors, clients and regulators, including advertisements;
- Safeguarding of client assets from conversion or inappropriate use by advisory personnel;
- Creation of required records and their maintenance in a manner that secures them from

<sup>877</sup> The term "supervised persons" is defined as any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser. See Section 202(a)(25) of the Advisers Act.

<sup>878</sup> SEC Release No. IA-2204 (December 17, 2003).

unauthorized alteration or use and protects them from untimely destruction;

- Marketing advisory services, including the use of solicitors;
- Processes to value client holdings and assess fees based on those valuations;
- Safeguards for the privacy protection of client records and information; and
- BCPs.

Rule 206(4)-7(c) requires an investment adviser to designate a single CCO to administer the CP&P. Once the CP&P have been adopted and implemented, an adviser must conduct an annual review to determine their adequacy and effectiveness. Investment advisers must maintain copies of their CP&P for at least five years.

Additionally, Rule 204A-1 under the Advisers Act requires registered investment advisers to adopt codes of ethics setting forth standards of conduct and requiring compliance with federal securities laws. Codes of ethics must address personal trading and must require personnel to report personal securities holdings and transactions, including those in affiliated mutual funds. Codes of Ethics must also require personnel to obtain pre-approval of certain investments. Rule 204-2 under the Advisers Act requires advisers to keep copies of their codes of ethics and related records.

### **Municipal Advisors**

Pursuant to Section 15B of the Exchange Act, municipal advisors are required to register with the SEC and are subject to regulation by the MSRB. A municipal advisor has an obligation to comply with the federal securities laws and to conduct its business in accordance with its fiduciary obligations. The Commission adopted its final rule for the registration of municipal advisors on September 20, 2013.<sup>879</sup> The final registration rule requires all registered municipal advisors to comply with the books and records requirements set out in Exchange Act Rule 15Ba1-8. These rules require a municipal advisory firm to make and keep true, accurate, and current books and records relating to its municipal advisory activities. These books and records requirements will enable ongoing monitoring as to whether minimum standards for municipal advisors are being met. The SEC and FINRA will examine municipal advisors for compliance with applicable SEC and MSRB rules and pursue enforcement actions in appropriate cases.

Accordingly, there generally are clear and publicly available minimum standards for municipal

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<sup>879</sup> See Exchange Act Release No. 34-70462 (Sept. 20, 2013), 78 Fed. Reg. 67468 (Nov. 12, 2013).

advisors, but the MSRB rulemaking required to establish the full regulatory regime for municipal advisors is not complete at this time. The Exchange Act requires that the rules of the MSRB with respect to municipal advisors, at a minimum, prescribe means reasonably designed to prevent acts, practices, and courses of business as are not consistent with a municipal advisor's fiduciary duty to its client, provide continuing education requirements for municipal advisors, and provide professional standards.<sup>880</sup> In 2010, the MSRB extended the application of its core fair dealing rule to municipal advisors in the same manner that it applies to brokers and dealers in municipal securities.<sup>881</sup> The MSRB is completing the development of a regulatory framework for municipal advisors at this time. The MSRB recently proposed new rules governing the supervisory and compliance obligations of municipal advisors.<sup>882</sup>

3. Does the regulator or the SRO subject to the regulator's oversight have in place processes and resources to effectively carry out a review of applications for licence?

### Broker-Dealers

Yes, the SEC and SROs generally have in place processes and resources to effectively carry out a review of applications for registration as a broker-dealer.

See response to Question 29.1 above. A broker-dealer registers with the SEC by filing an application for registration on Form BD, which is filed through the CRD.

When a firm applies for registration with an SRO, the firm is subject to that SRO's pre-membership process. As part of this process, the SRO will require that an applicant submit documents evidencing its ability to comply with applicable requirements. After an SRO admits a broker-dealer to membership, it generally must examine the firm within six months to one year to assure that the broker-dealer is complying with applicable SEC and SRO regulations.

The SEC oversees the SRO membership and licensing processes and procedures. Rules for admission to an SRO are reviewed by the SEC pursuant to Section 19(b) of the Exchange Act. To effectively evaluate compliance with membership and licensing rules and requirements, OCIE may conduct inspections of the SROs' processes for approving firms' membership as well as the SROs' processes for licensing individual registered representatives of those member firms. For example, OCIE may conduct inspections of FINRA district offices that involve a review of FINRA records to determine if it has appropriately granted membership only to firms that meet all of the applicable requirements and to help ensure it has not granted membership to firms that are statutorily disqualified from membership. OCIE also inspects the SROs' disciplinary programs,

<sup>880</sup> See Exchange Act Section 15B(b)(2)(L).

<sup>881</sup> See MSRB Rule G-17, and <http://www.sec.gov/rules/sro/msrb/2010/34-63599.pdf>.

<sup>882</sup> See <http://www.sec.gov/rules/sro/msrb/2014/34-72706.pdf>.

which may include a review of disciplinary actions resulting in the termination of membership or licenses held by a member firm or its individual registered representatives to help ensure the SROs fairly and consistently apply the rules in such actions.

In addition, such oversight by the SEC has included a review of FINRA's procedures to ensure each one actually takes and passes the appropriate tests and requirements necessary to obtain the relevant license or licenses.

OCIE also conducts examinations of member broker-dealer firms that may include an evaluation of the SRO's regulatory efforts. In evaluating the activities within the scope of an examination, OCIE may review the licenses held by the individuals engaged in such activities to identify whether they are appropriately registered.

### **Investment Advisers**

Yes, the SEC and state regulators generally have in place processes and resources to effectively carry out a review of applications for registration as an investment adviser.

The licensing of U.S. investment advisers is the responsibility of the SEC and the state securities regulatory authorities, not an SRO. Although investment advisers generally are not subject to SRO oversight, investment advisers that are also registered as broker-dealers are subject to oversight by FINRA.

Once a prospective registrant submits its initial completed Form ADV, the application is made available to the SEC and many state securities agencies through IARD. Staff reviews the application to ensure that it is complete on its face and that the information submitted appears to meet applicable registration requirements. Typically, any missing, incomplete, or inconsistent disclosures are communicated to the applicant for correction or explanation. Section 203 of the Advisers Act generally requires that the SEC either grant the registration or institute proceedings to determine whether registration should be denied within 45 days after the filing of Form ADV, unless the applicant consents to a longer period of time.

### **Municipal Advisors**

Yes, the SEC generally has in place processes and resources to effectively carry out a review of applications for registration as a municipal advisor.

The registration of municipal advisors is the responsibility of the SEC. Although municipal advisors generally are not subject to SRO examination and enforcement, municipal advisors that are also registered as broker-dealers are subject to oversight by FINRA.

Once a prospective registrant submits its initial completed Form MA, the application is made available to the SEC. Staff reviews the application to ensure that it is complete on its face and

that the information submitted appears to meet applicable registration requirements. Typically, any missing, incomplete, or inconsistent disclosures are communicated to the applicant for correction or explanation. Section 15B(a)(2) of the Exchange Act generally requires that the SEC either grant the registration or institute proceedings to determine whether registration should be denied within 45 days after the filing of Form MA, unless the applicant consents to a longer period of time.

#### *Authority of Regulator*

4. Does the relevant authority have the power to:

- (a) Refuse licensing, subject only to administrative or judicial review, if authorization requirements have not been met?

#### **Broker-Dealers**

Yes, the SEC can refuse licensing of a broker-dealer, subject only to administrative or judicial review, if authorization requirements have not been met.<sup>883</sup>

The SEC may deny registration if it finds that the applicant has not filed a complete Form BD in accordance with related rules adopted under the authority of the Exchange Act. The SEC may also deny registration if it finds the applicant, or any person associated with the applicant, has filed false information with the SEC, or has been convicted within 10 years preceding the application of a financial-related felony or misdemeanor or substantially equivalent crime by a foreign court. The SEC may also deny registration if it finds the applicant, or any person associated with the applicant, is enjoined by a court from participation in the securities business, has willfully violated, or willfully aided the violation of, the federal securities laws, rules issued by the SEC pursuant to those laws, or the CEA, or has failed to reasonably supervise, with a view to preventing such violations, a person subject to the applicant's, or any person associated with the applicant, supervision.

The SEC may similarly deny registration if it finds the applicant is subject to any final order of a state securities commission (or any agency or officer performing like functions), state authority that supervises or examines banks, savings associations, or credit unions, state insurance commission (or any agency or office performing like functions), an appropriate Federal banking agency,<sup>884</sup> or the NCUA, that--

- bars such person from association with an entity regulated by such commission, authority, agency, or officer, or from engaging in the business of securities, insurance, banking, savings association activities, or credit union activities; or

<sup>883</sup> See Exchange Act Section 15(b)(1)(B) (setting forth procedures and grounds for denying registration).

<sup>884</sup> As defined in Section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813(q)).



- constitutes a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative, or deceptive conduct.

The SEC may also deny registration if it finds similar findings have previously been made by a foreign financial regulatory authority.<sup>885</sup> See response to Question 9.1.

Within 45 days of the date of the filing of an application (or within such longer period as to which the applicant consents), the SEC is required either to by order grant the application, or institute proceedings to determine whether registration should be denied.<sup>886</sup> The proceedings must include notice of the grounds for denial under consideration and opportunity for hearing and shall be concluded within 120 days of the date of the filing of the application for registration.<sup>887</sup>

In addition, and subject to an opportunity for a hearing, an SRO may condition or deny membership based on similar findings. It may also deny or condition membership, subject to an opportunity for a hearing, based on, among other things, failure to meet standards of financial responsibility or operational capability.<sup>888</sup>

### Investment Advisers

Yes, the SEC may deny an investment adviser's registration application if the adviser: (i) is "prohibited" from registering with the SEC (see response to Question 29.2, under the heading "Prohibition on Registration"),<sup>889</sup> or (ii) has engaged in conduct specified in Section 203(e) of the Advisers Act (see response to Questions 29.2 and 29.3).

If the SEC does not issue an order granting the registration application, Section 203(c)(2) of the Advisers Act requires the SEC to institute proceedings before the SEC, within 45 days from the date of the filing of an application to register with the SEC as an investment adviser, to determine whether the application should be denied. Section 203(c)(2) of the Advisers Act provides that the proceedings will include the provision of public notice of the grounds under consideration for denial and will provide an opportunity for hearing. The proceedings generally will be concluded within 120 days of the date of the filing of the investment adviser's application to register. At the

<sup>885</sup> See generally Exchange Section 15(b)(4).

<sup>886</sup> See Exchange Act Section 15(b)(1)(B).

<sup>887</sup> See *id.* The SEC may extend the time for concluding the proceeding if it finds good cause and publishes its reasons for doing so, or if the applicant consents.

<sup>888</sup> See, e.g., NASD Rule 1014(c). See also Exchange Act Sections 6(c) and 15A(g).

<sup>889</sup> An investment adviser that is prohibited from registering may apply to the SEC for an order exempting it from the prohibition so that it may register with the SEC. See also our response to Question 29.2, under "Prohibition on Registration," for information about the prohibitions on SEC registration.

conclusion of the proceedings, the SEC by public order will grant or deny the application.

### **Municipal Advisors**

Yes, the SEC can refuse licensing of a municipal advisor, subject only to administrative or judicial review, if authorization requirements have not been met.<sup>890</sup>

The SEC may deny registration if it finds that the applicant has not filed a complete Form MA<sup>891</sup> in accordance with related rules adopted under the authority of the Exchange Act. The SEC may also deny registration if it finds the applicant has filed false information with the SEC, or has been convicted within 10 years preceding the application of a financial-related felony or misdemeanor or substantially equivalent crime by a foreign court. The SEC may also deny registration if it finds the applicant is enjoined by a court from participation in the securities business, has willfully violated, or willfully aided the violation of, the federal securities laws, rules issued by the SEC pursuant to those laws, the CEA or the rules of the MSRB, or has failed to reasonably supervise, with a view to preventing such violations, a person subject to the applicant's supervision.

The SEC may similarly deny registration if it finds the applicant is subject to any final order of a state securities commission (or any agency or officer performing like functions), state authority that supervises or examines banks, savings associations, or credit unions, state insurance commission (or any agency or office performing like functions), an appropriate Federal banking agency,<sup>892</sup> or the NCUA, that--

- bars such applicant from engaging in the business of securities, insurance, banking, savings association activities, or credit union activities; or
- constitutes a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative, or deceptive conduct.

The SEC may also deny registration if it finds similar findings have previously been made by a foreign financial regulatory authority.<sup>893</sup>

<sup>890</sup> See Exchange Act Section 15(B)(a)(2) (setting forth procedures and grounds for denying registration).

<sup>891</sup> Pursuant to Exchange Act Rule 15Ba1-2(c), a Form MA shall be considered filed with the Commission upon submission of a completed Form MA, together with all additional required documents, including all required filings of Form MA-I, to the Commission's EDGAR system. Pursuant to Exchange Act Rule 15Ba1-2(b), a person applying for municipal advisor registration with the Commission as a municipal advisor must complete Form MA-I with respect to each natural person who is a person associated with the municipal advisor and engaged in municipal advisory activities on its behalf.

<sup>892</sup> As defined in Section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813(q)).

<sup>893</sup> See generally Exchange Sections 15B(c)(2) and 15(b)(4).

Within 45 days of the date of the filing of an application (or within such longer period as to which the applicant consents), the SEC is required either to grant the application by order, or institute proceedings to determine whether registration should be denied.<sup>894</sup> The proceedings must include notice of the grounds for denial under consideration and opportunity for hearing, and shall be concluded within 120 days of the date of the filing of the application for registration.<sup>895</sup>

- (b) Withdraw, suspend or apply a condition to a licence where a change in control or other change results in a failure to meet relevant requirements on an ongoing basis?

### Broker-Dealers

Yes, as discussed below, the SEC and SROs generally have authority to withdraw, suspend or condition a broker-dealer's registration and impose sanctions on broker-dealers and their associated persons for violations of applicable federal law and rules thereunder. If a broker-dealer wants to expand or implement new ways of doing business, change control or ownership, or otherwise modify or remove restrictions previously imposed by an SRO in its membership agreement with that SRO, it generally must obtain approval from the SRO prior to implementing such a change.<sup>896</sup> SROs generally may approve, deny or approve with restrictions broker-dealer requests to modify their business.

SROs must have rules that provide that their members shall be appropriately disciplined for violation of the provisions of the Exchange Act, the rules and regulations thereunder, and the rules of the exchange by expulsion, suspension, limitation of activities, functions and operations, fine, censure, being suspended or barred from being associated with a member of any other fitting sanction. Sections 6(b)(7) and 15A(b)(8) of the Exchange Act require that the rules of an SRO must provide for a fair procedure for disciplining members and persons associated with members, denying membership, barring persons from being associated with members, and prohibiting or limiting access to services offered by the exchange or its members.<sup>897</sup> FINRA, pursuant to NASD Rule 1017, requires that prior to implementing certain changes – such as changes in control or ownership of 25% or more for the first time as well as material changes in business, such as the addition of business lines that are material for an individual firm – that its members go through the membership application process. Such applications are subject to the

<sup>894</sup> See Exchange Act Section 15(B)(a)(2).

<sup>895</sup> See *id.* The SEC may extend the time for concluding the proceeding if it finds good cause and publishes its reasons for doing so, or if the applicant consents.

<sup>896</sup> NASD Rule 1017.

<sup>897</sup> See Sections 6(b)(6)-(7) and 15A(b)(7)-(8) of the Exchange Act, 15 U.S.C. 78f(b)(6)-(7) and 78o-3(b)(7)-(8), respectively. See also Sections 6(d) and 15A(h) of the Exchange Act, 15 U.S.C. 78f(d) and 78o-3(h), respectively, which contain additional requirements regarding how an exchange or association may discipline its members.

same standards of review as new membership applications, which are set out in NASD Rule 1014. Pursuant to this review, if it finds the firm fails to meet one of the standards, FINRA can deny the change or approve it with conditions, which are designed to address the reason for failing to meet the standard. For example, if the new control person has regulatory history, the condition may prevent him or her from holding supervisory positions or acting in certain capacities).

In addition, the SEC has direct authority to condition, suspend and revoke a person's registration as a broker-dealer.<sup>898</sup> In addition, if a broker-dealer fails to comply with the federal securities laws, the SEC can impose a wide range of sanctions (including revoking the broker-dealer's registration, or temporarily suspending or permanently barring a person from acting as a broker-dealer). The SEC also can order any person to cease and desist from violating or causing violations of the securities laws and may impose conditions on the operations of such person's business to ensure compliance with the securities laws. The SEC can impose monetary penalties and enter an order requiring an accounting and disgorgement in an administrative action or seek monetary penalties and other equitable relief (e.g., disgorgement) in federal court. For less serious misconduct, the SEC may merely issue a censure.

The federal securities laws authorize the SEC, in its discretion, to institute administrative proceedings against broker-dealers and their associated persons or to sue any person in federal court for violations of the federal securities laws, including the Exchange Act.

Administrative Proceedings: Sections 15(b)(6) and (4) of the Exchange Act, respectively, authorize the SEC to sanction a broker-dealer, or a person associated with a broker-dealer, if it finds (after notice and an opportunity for a hearing) that the broker-dealer or an associated person has engaged in certain willful misconduct and if the sanctions are in the public interest. Specifically, the SEC may "censure, place limitations on the activities, functions, or operations" of a broker-dealer or associated person of a broker-dealer and may suspend the registration of the broker-dealer, or prohibit the associated person from acting as such, for a period of not more than 12 months. Additionally, the SEC may revoke the registration of a broker-dealer, or bar a person from being associated with any broker-dealer. Sections 15(b)(6) and (4) of the Exchange Act identify the types of misconduct for which the SEC may sanction broker-dealers and their associated persons. Under Section 21B of the Exchange Act, the SEC may, upon a proper showing and when in the public interest, impose civil money penalties in proceedings instituted pursuant to Sections 15(b) of the Exchange Act.<sup>899</sup> Proceedings under Sections 15(b)(6) and (4) of

<sup>898</sup> If the SEC finds that a registered broker-dealer has ceased to conduct business as a broker-dealer or is no longer eligible to remain registered with the SEC, the SEC is authorized to cancel the broker-dealer's registration. See Exchange Act Section 15(b)(5).

<sup>899</sup> Under Section 21B of the Exchange Act, the SEC may impose civil penalties against a broker-dealer and its associated persons according to a three-part scale: (i) if the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and resulted in or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the wrongdoer, a maximum for each act or

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the Exchange Act may be based on the entry of an injunction, criminal conviction, or a finding of a willful violation in an administrative proceeding. Under Section 21C of the Exchange Act, the SEC may issue a cease-and-desist order<sup>900</sup> requiring a person to cease violating or causing the violation of the Exchange Act or the rules or regulations thereunder. See response to Question 6.1(c).

Civil Federal Court Actions: The SEC is authorized to institute a federal court action seeking an injunction or other equitable relief under Section 21(d) of the Exchange Act against any person who has violated, is violating, or is about to violate, the Exchange Act, the rules thereunder, any SRO's rules, or the rules of a registered clearing agency in which such person is a participant. The SEC similarly may seek an injunction against any person for aiding and abetting a violation of the Exchange Act. Under Section 21(d)(2) of the Exchange Act, a court may prohibit any person who violated the anti-fraud provision, Section 10(b), from serving as officers and directors of any issuer that has securities registered under Section 12 of the Exchange Act or that is required to file reports with the SEC under the Exchange Act. Upon a proper showing, a court may impose monetary penalties of varying amounts, depending upon the nature of the violation, as described in Section 21(d)(3) of the Exchange Act.<sup>901</sup> In addition, Section 21(d)(5) of the Exchange Act authorizes the SEC to seek any equitable relief that may be appropriate or necessary for the benefit of investors. Further, Section 21(d)(6) provides the civil court authority to prohibit persons from participating in an offering of a "penny stock" as defined in that section.

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omission of \$100,000 for a natural person, or \$500,000 for any other person; (ii) if fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement is involved, a maximum for each act or omission of \$50,000 for a natural person, or \$250,000 for any other person; and (iii) in other cases, a maximum for each act or omission of \$5,000 for a natural person, or \$50,000 for any other person. Under Section 21B(3) of the Exchange Act, in any proceeding in which the SEC may impose a penalty under Section 21B of the Exchange Act, the SEC may enter an order requiring an accounting and disgorgement (that is, the payment of any gains obtained as a result of the violation), including reasonable interest.

<sup>900</sup> A "cease-and-desist" order under Section 21C of the Exchange Act is an administrative order that the SEC may issue when it finds that a person has violated, is violating or is about to violate a provision of the Exchange Act or the rules or regulations thereunder. In any cease-and-desist proceeding under Section 21C of the Exchange Act, the SEC may enter an order requiring an accounting and disgorgement, including reasonable interest.

<sup>901</sup> Under Section 21(d)(3)(B) of the Exchange Act, a court may assess civil penalties for each violation according to a three-part scale: (i) if the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and resulted in or created a significant risk of substantial losses to other persons, a maximum for each act or omission of \$100,000 for a natural person, or \$500,000 for any other person, or the pecuniary gain to the defendant as a result of the violation; (ii) if fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement is involved, a maximum for each act or omission of \$50,000 for a natural person, or \$250,000 for any other person, or the pecuniary gain to the defendant as a result of the violation; and (iii) in other cases, a maximum of \$5,000 for each act or omission for a natural person, or \$50,000 for any other person, or the pecuniary gain to the defendant as a result of the violation. The federal courts also possess the power to grant other equitable relief, such as disgorgement.

### Investment Advisers

Yes, the SEC has the authority to condition, suspend and revoke a person's registration as an investment adviser. If the SEC finds that a registered investment adviser has ceased to conduct business as an investment adviser or is no longer eligible to remain registered with the SEC, the SEC is authorized to cancel the adviser's registration.<sup>902</sup> The SEC periodically seeks to cancel the registrations of investment advisers that appear to no longer conduct business as investment advisers.

In addition, if an investment adviser fails to comply with the federal securities laws, the SEC can impose a wide range of sanctions (including, for serious misconduct, revoking the adviser's registration, and temporarily suspending or permanently barring a person from acting as an investment adviser). The SEC also can order any person to cease and desist from violating or causing violations of the securities laws and may impose conditions on the operations of such person's business to ensure compliance with the securities laws. The SEC can impose monetary penalties and enter an order requiring an accounting and disgorgement in an administrative action or seek monetary penalties and other equitable relief (*e.g.*, disgorgement) in federal court. For less serious misconduct, the SEC may merely issue a censure.

The federal securities laws authorize the SEC, in its discretion, to institute administrative proceedings against investment advisers and their associated persons or to sue such persons in federal court for violations of the federal securities laws, including the Advisers Act.

Administrative Proceedings: Sections 203(e) and (f) of the Advisers Act authorize the SEC to sanction an investment adviser, or a person associated with an investment adviser, if it finds (after notice and an opportunity for a hearing) that the investment adviser or an associated person has engaged in certain willful misconduct and if the sanctions are in the public interest. Specifically, the SEC may "censure, place limitations on the activities, functions, or operations" of an investment adviser or associated person of an investment adviser and may suspend the registration of the investment adviser, or prohibit the associated person from acting as such, for a period of not more than twelve months. Additionally, the SEC may revoke the registration of an investment adviser, or bar a person from being associated with any investment adviser. Sections 203(e) and (f) of the Advisers Act list the types of misconduct for which the SEC may sanction investment advisers and their associated persons based on the entry of an injunction, criminal conviction, or a finding of a willful violation in an administrative proceeding. Under Section 203(k) of the Advisers Act, the SEC may issue a cease-and-desist order<sup>903</sup> requiring a

<sup>902</sup> See Section 203(h) of the Advisers Act. If an investment adviser indicates in its annual updating amendment that it is no longer eligible to register with the SEC, the investment adviser must withdraw from SEC registration within 180 days. See rule 203A-1(b)(2); Form ADV, Instructions for Part 1A, 2(h). If the investment adviser does not withdraw, the SEC may cancel the investment adviser's registration.

<sup>903</sup> A "cease-and-desist" order under Section 203(k) of the Advisers Act is an administrative order that the SEC may issue when it finds that a person has violated, is violating or is about to violate a provision of the Advisers Act or

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person to cease violating or causing the violation of the Advisers Act or the rules or regulations thereunder. Under Section 203(i), the SEC may, upon a proper showing and when in the public interest, impose civil money penalties in proceedings instituted pursuant to Sections 203(e), (f) or (k).<sup>904</sup>

**Civil Federal Court Actions:** The SEC is authorized to institute an action in federal court seeking an injunction and other equitable relief under Section 209(d) of the Advisers Act against any person who has violated, is violating, or is about to violate, the Advisers Act or the rules or regulations thereunder. The SEC similarly may seek an injunction against any person for aiding and abetting a violation of the Advisers Act. Under Section 209(e) of the Advisers Act, the SEC may seek monetary penalties in federal court from any person who has violated the Advisers Act, the rules or regulations thereunder, or a cease-and-desist order previously entered by the SEC pursuant to Section 203(k) of the Advisers Act. Upon a proper showing, a court may impose monetary penalties of varying amounts, depending upon the nature of the violation, as described in Section 209(e)(2) of the Advisers Act.<sup>905</sup>

### **Municipal Advisor**

Yes, the SEC has the authority to condition, suspend, and revoke a person's registration as a municipal advisor.<sup>906</sup> In addition, if a municipal advisor fails to comply with the federal securities laws, the SEC can impose a wide range of sanctions (including revoking the municipal advisor's

the rules or regulations thereunder. In any cease-and-desist proceeding under Section 203(k) of the Advisers Act, the SEC may enter an order requiring an accounting and disgorgement, including reasonable interest.

<sup>904</sup> Under Section 203(i) of the Advisers Act, the SEC may impose civil penalties for each violation according to a three-part scale: (i) if the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and resulted in or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the wrongdoer, a maximum for each act or omission of \$100,000 for a natural person, or \$500,000 for any other person; (ii) if fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement is involved, a maximum for each act or omission of \$50,000 for a natural person, or \$250,000 for any other person; and (iii) in other cases, a maximum for each act or omission of \$5,000 for a natural person, or \$50,000 for any other person. Under Section 203(j) of the Advisers Act, in any proceeding in which the SEC may impose a penalty under Section 203 of the Advisers Act, the SEC may enter an order requiring an accounting and disgorgement (that is, the payment of any gains obtained as a result of the violation), including reasonable interest.

<sup>905</sup> Under Section 209(e)(2) of the Advisers Act, a court may assess civil penalties for each violation according to a three-part scale: (i) if the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and resulted in or created a significant risk of substantial losses to other persons, a maximum for each act or omission of \$100,000 for a natural person, or \$500,000 for any other person, or the pecuniary gain to the defendant as a result of the violation; (ii) if fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement is involved, a maximum for each act or omission of \$50,000 for a natural person, or \$250,000 for any other person, or the pecuniary gain to the defendant as a result of the violation; and (iii) in other cases, a maximum of \$5,000 for each act or omission for a natural person, or \$50,000 for any other person, or the pecuniary gain to the defendant as a result of the violation. The federal courts also possess the power to grant other equitable relief, such as disgorgement.

<sup>906</sup> If the SEC finds that a registered municipal advisor has ceased to conduct business as a municipal advisor or is no longer eligible to remain registered with the SEC, the SEC is authorized to cancel the municipal advisor's registration. See Exchange Act Section 15B(c)(3).



registration, or temporarily suspending or permanently barring a person from acting as a municipal advisor).<sup>907</sup> The SEC also can order any person to cease and desist from violating or causing violations of the securities laws and may impose conditions on the operations of such person's business to ensure compliance with the securities laws.<sup>908</sup> The SEC can impose monetary penalties and enter an order requiring an accounting and disgorgement in an administrative action or seek monetary penalties and other equitable relief (e.g., disgorgement) in federal court.<sup>909</sup> The SEC may also issue a censure.<sup>910</sup>

The federal securities laws authorize the SEC, in its discretion, to institute administrative proceedings against municipal advisors and their associated persons or to sue any person in federal court for violations of the federal securities laws, including the Exchange Act.<sup>911</sup>

FINRA is authorized to conduct examinations of municipal advisors that are also registered as broker-dealers with the Commission and are members of FINRA for compliance with federal securities laws. FINRA generally has authority to impose sanctions on broker-dealers and their associated persons for violations of applicable federal law and rules thereunder. SROs must have rules that provide that their members shall be appropriately disciplined for violation of the provisions of the Exchange Act, the rules and regulations thereunder, and the rules of the association by expulsion, suspension, limitation of activities, functions and operations, fine, censure, being suspended or barred from being associated with a member of any other fitting sanction. Sections 6(b)(7) and 15A(b)(8) of the Exchange Act require that the rules of an SRO must provide for a fair procedure for disciplining members and persons associated with members, denying membership, barring persons from being associated with members, and prohibiting or limiting access to services offered by the exchange or its members.<sup>912</sup>

Administrative Proceedings: Section 15(B)(c)(2) of the Exchange Act, and Exchange Act Rule 15Bc4-1, respectively, authorize the SEC to sanction a municipal advisor, or a person associated with a municipal advisor, if it finds (after notice and an opportunity for a hearing) that the municipal advisor or an associated person has engaged in certain misconduct and if the sanctions are in the public interest. Specifically, the SEC may "censure, place limitations on the activities, functions, or operations" of a municipal advisor or associated person of a municipal advisor and may suspend the registration of the municipal advisor, or prohibit the associated

<sup>907</sup> See Exchange Act Section 15B(c) and Exchange Act Rule 15Bc4-1.

<sup>908</sup> See Exchange Act Sections 21C.

<sup>909</sup> See Exchange Act Sections 21(d)(1), 21(d)(3) and 21(B).

<sup>910</sup> See Exchange Act Section 15B(c)(2) and Exchange Act Rule 15Bc4-1.

<sup>911</sup> See Exchange Act Sections 15B(c) and 27 and Exchange Act Rule 15Bc4-1 ,

<sup>912</sup> See Sections 6(b)(6)-(7) and 15A(b)(7)-(8) of the Exchange Act, 15 U.S.C. 78f(b)(6)-(7) and 78o-3(b)(7)-(8), respectively. See also Sections 6(d) and 15A(h) of the Exchange Act, 15 U.S.C. 78f(d) and 78o-3(h), respectively, which contain additional requirements regarding how an exchange or association may discipline its members.



person from acting as such, for a period of not more than twelve months. Additionally, the SEC may revoke the registration of a municipal advisor, or bar a person from being associated with any municipal advisor. Sections 15(B)(c)(2) and 15(b)(4) of the Exchange Act and Exchange Act Rule 15Bc4-1 identify the types of misconduct for which the SEC may sanction municipal advisors and their associated persons. Under Section 21B of the Exchange Act, the SEC may, upon a proper showing and when in the public interest, impose civil money penalties in proceedings instituted pursuant to Sections 15(B) of the Exchange Act.<sup>913</sup> Proceedings under Sections 15(B)(c)(2) and 15(b)(4) of the Exchange Act and Exchange Act Rule 15Bc4-1 may be based on the entry of an injunction, criminal conviction, or a finding of a willful violation in an administrative proceeding. Under Section 21C of the Exchange Act, the SEC may issue a cease-and-desist order<sup>914</sup> requiring a person to cease violating or causing the violation of the Exchange Act or the rules or regulations thereunder.

Civil Federal Court Actions: The SEC is authorized to institute an action in federal court seeking an injunction or other equitable relief under Section 21(d) of the Exchange Act against any person who has violated, is violating, or is about to violate, the Exchange Act, the rules thereunder, any SRO's rules, or the rules of a registered clearing agency in which such person is a participant. The SEC similarly may seek an injunction against any person for aiding and abetting a violation of the Exchange Act. Under Section 21(d)(2) of the Exchange Act, a court may prohibit any person who violated the anti-fraud provision, Section 10(b), from serving as officers and directors of any issuer that has securities registered under Section 12 of the Exchange Act or that is required to file reports with the SEC under the Exchange Act. Upon a proper showing, a court may impose monetary penalties of varying amounts, depending upon the nature of the violation, as described in Section 21(d)(3) of the Exchange Act.<sup>915</sup> In addition, Section 21(d)(5) of the

<sup>913</sup> Under Section 21B of the Exchange Act, the SEC may impose civil penalties against a municipal advisor and its associated persons according to a three-part scale: (i) if the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and resulted in or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the wrongdoer, a maximum for each act or omission of \$100,000 for a natural person, or \$500,000 for any other person; (ii) if fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement is involved, a maximum for each act or omission of \$50,000 for a natural person, or \$250,000 for any other person; and (iii) in other cases, a maximum for each act or omission of \$5,000 for a natural person, or \$50,000 for any other person. Under Section 21B(e) of the Exchange Act, in any proceeding in which the SEC may impose a penalty under Section 21B of the Exchange Act, the SEC may enter an order requiring an accounting and disgorgement (that is, the payment of any gains obtained as a result of the violation), including reasonable interest.

<sup>914</sup> A "cease-and-desist" order under Section 21C of the Exchange Act is an administrative order that the SEC may issue when it finds that a person has violated, is violating or is about to violate a provision of the Exchange Act or the rules or regulations thereunder. In any cease-and-desist proceeding under Section 21C of the Exchange Act, the SEC may enter an order requiring an accounting and disgorgement, including reasonable interest.

<sup>915</sup> Under Section 21(d)(3)(B) of the Exchange Act, a court may assess civil penalties for each violation according to a three-part scale: (i) if the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and resulted in or created a significant risk of substantial losses to other persons, a maximum for each act or omission of \$100,000 for a natural person, or \$500,000 for any other person, or the pecuniary gain to the defendant as a result of the violation; (ii) if fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement is involved, a maximum for each act or omission of \$50,000 for a natural person, or \$250,000 for any other person, or the pecuniary gain to the defendant as a result of the violation; and

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Exchange Act authorizes the SEC to seek any equitable relief that may be appropriate or necessary for the benefit of investors. Further, Section 21(d)(6) provides the civil court authority to prohibit persons from participating in an offering of a "penny stock" as defined in that section.

- (c) Take effective steps to prevent the employment of persons (or seek the removal of persons) who have committed securities violations or who are otherwise unsuitable, so that they cannot continue to engage in intermediary activities, even if these persons are not separately licensed intermediaries if they can have a material influence on the firm?

### Broker-Dealers

Yes, in general, the SEC and SROs have the authority to sanction persons (including entities) who are found to have violated securities rules and regulations while participating in the securities industry. Persons who are found to have violated securities rules and regulations face sanctions that can jeopardize their continued employment in the securities industry. More specifically, persons who have engaged in certain types of misconduct are subject to a statutory disqualification, and this statutory disqualification becomes an encumbrance to further association or membership within the securities industry. As a result, broker-dealers must obtain approval by the appropriate SRO and subsequently the SEC in order to associate or continue to associate with any persons subject to a statutory disqualification.

Persons who are subject to "statutory disqualification," as defined in Section 3(a)(39) of the Exchange Act, are generally required to undergo a regulatory review before being permitted to become associated with, or to continue their association with, a broker-dealer, or granted membership in, or continue membership in, an SRO. In general, a wide range of events subjects a person to statutory disqualification.<sup>916</sup> Most common among these events are convictions for

(iii) in other cases, a maximum of \$5,000 for each act or omission for a natural person, or \$50,000 for any other person, or the pecuniary gain to the defendant as a result of the violation. The federal courts also possess the power to grant other equitable relief, such as disgorgement.

<sup>916</sup> Section 3(a)(39) of the Exchange Act provides that:

A person is subject to a "statutory disqualification" with respect to membership or participation in, or association with a member of, a self-regulatory organization, if such person--

- A. has been and is expelled or suspended from membership or participation in, or barred or suspended from being associated with a member of, any self-regulatory organization, foreign equivalent of a self-regulatory organization, foreign or international securities exchange, contract market designated pursuant to section 5 of the Commodity Exchange Act (7 U.S.C. 7), or any substantially equivalent foreign statute or regulation, or futures association registered under section 17 of such Act (7 U.S.C. 21), or any substantially equivalent foreign statute or regulation, or has been and is denied trading privileges on any such contract market or foreign equivalent;
- B. is subject to--
  - i. an order of the Commission, other appropriate regulatory agency, or foreign financial regulatory authority--
    - I. denying, suspending for a period not exceeding 12 months, or revoking his registration as a broker, dealer, municipal securities dealer, government securities broker, or government securities

(continued)

any felony or certain enumerated misdemeanors within the last 10 years; temporary or permanent injunctions from violating the securities laws issued by a court of competent jurisdiction; or bars from association with a broker-dealer issued by the Commission, the CFTC, or an SRO. The regulatory review process, which encompasses reviews first by the appropriate SRO and subsequently by the SEC, is designed to ensure that persons with criminal or disciplinary histories either are prohibited from entering the business or are subject to appropriate safeguards (e.g., enhanced supervision or prohibitions on certain activities).<sup>917</sup>

Those persons who are subject to statutory disqualification, but wish to enter, re-enter, or continue in the industry, must apply to the SRO under procedures adopted pursuant to the

- 
- dealer or limiting his activities as a foreign person performing a function substantially equivalent to any of the above; or
  - II. barring or suspending for a period not exceeding 12 months his being associated with a broker, dealer, municipal securities dealer, government securities broker, government securities dealer, or foreign person performing a function substantially equivalent to any of the above;
  - ii. an order of the Commodity Futures Trading Commission denying, suspending, or revoking his registration under the Commodity Exchange Act (7 U.S.C. 1 *et seq.*); or
  - iii. an order by a foreign financial regulatory authority denying, suspending, or revoking the person's authority to engage in transactions in contracts of sale of a commodity for future delivery or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent thereof;
  - C. by his conduct while associated with a broker, dealer, municipal securities dealer, government securities broker, or government securities dealer, or while associated with an entity or person required to be registered under the Commodity Exchange Act [7 U.S.C.A. § 1 *et seq.*], has been found to be a cause of any effective suspension, expulsion, or order of the character described in subparagraph (A) or (B) of this paragraph, and in entering such a suspension, expulsion, or order, the Commission, an appropriate regulatory agency, or any such self-regulatory organization shall have jurisdiction to find whether or not any person was a cause thereof;
  - D. by his conduct while associated with any broker, dealer, municipal securities dealer, government securities broker, government securities dealer, or any other entity engaged in transactions in securities, or while associated with an entity engaged in transactions in contracts of sale of a commodity for future delivery or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent thereof, has been found to be a cause of any effective suspension, expulsion, or order by a foreign or international securities exchange or foreign financial regulatory authority empowered by a foreign government to administer or enforce its laws relating to financial transactions as described in subparagraph (A) or (B) of this paragraph;
  - E. has associated with him any person who is known, or in the exercise of reasonable care should be known, to him to be a person described by subparagraph (A), (B), (C), or (D) of this paragraph; or
  - F. has committed or omitted any act, or is subject to an order or finding, enumerated in subparagraph (D), (E), (H), or (G) of paragraph (4) of section 15(b), has been convicted of any offense specified in subparagraph (B) of such paragraph (4) or any other felony within ten years of the date of the filing of an application for membership or participation in, or to become associated with a member of, such self-regulatory organization, is enjoined from any action, conduct, or practice specified in subparagraph (C) of such paragraph (4), has willfully made or caused to be made in any application for membership or participation in, or to become associated with a member of, a self-regulatory organization, report required to be filed with a self-regulatory organization, or proceeding before a self-regulatory organization, any statement which was at the time, and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or has omitted to state in any such application, report, or proceeding any material fact which is required to be stated therein.

<sup>917</sup> See Exchange Act Rule 19h-1 (concerning processes for admission or continuance notwithstanding a statutory disqualification).

Exchange Act. If the SRO determines that it would be in the public interest to permit the individual to be associated as proposed with one of its members, it typically provides notice to the SEC.<sup>918</sup> The SEC then has the opportunity to review the SRO's determination, and if appropriate, to direct that the SRO not permit the proposed employment.

### **Investment Advisers**

Yes. See response to Questions 29.2 and 29.4(a) and (b).

### **Municipal Advisors**

Yes. See response to Questions 29.2 and 29.4(b).

### *Ongoing Requirements*

5. Are market intermediaries required to update periodically relevant information with respect to their licence and to report immediately to the regulator (or licensing authority) material changes in the circumstances affecting the conditions of the licence?

### **Broker-Dealers**

Yes, a broker-dealer must promptly file an amendment to its Form BD if the information on the form is or becomes inaccurate for any reason.<sup>919</sup> In addition, SROs generally require that registered individuals promptly update their Forms U-4 if the information on that form is or becomes inaccurate.

If a broker-dealer wants to expand or implement new ways of doing business, change control or ownership, or otherwise modify or remove restrictions previously imposed by an SRO in its membership agreement with that SRO, it generally must obtain approval from the SRO prior to implementing such a change.<sup>920</sup> SROs generally may approve, deny or approve with restrictions broker-dealer requests to modify their business.

In addition, broker-dealers that cease doing a securities business are required to withdraw from registration by filing Form BDW (Notice of Withdrawal from Registration) with the CRD.<sup>921</sup> FINRA's bylaws also require registered reps forms (U-4) to be updated within 30 days unless it is a statutorily disqualifying event and then it must be amended within 10 days.

<sup>918</sup> See Sections 6(c)(2) and 15A(g)(2) of the Exchange Act and Rule 19h-1 under the Exchange Act.

<sup>919</sup> See Rule 15b3-1 under the Exchange Act. See also General Instruction A.2 to Form BD.

<sup>920</sup> NASD Rule 1017.

<sup>921</sup> See Section 15(b)(5) of the Exchange Act and Rule 15b6-1 thereunder.

### Investment Advisers

Yes, an investment adviser's Form ADV must be updated each year by filing an annual updating amendment within 90 days of the adviser's fiscal year end.<sup>922</sup> In addition, an investment adviser is obligated to amend its Form ADV to keep it current. If certain material information in an investment adviser's Form ADV becomes inaccurate, it must be amended promptly.<sup>923</sup>

If a registered investment adviser ceases to conduct business as an investment adviser or is otherwise no longer eligible to remain registered with the SEC, the adviser must withdraw its registration by filing with the SEC a Form ADV-W (Notice of Withdrawal from Registration).<sup>924</sup>

### Municipal Advisors

Yes, a municipal advisor's Form MA must be updated each year by filing an annual updating amendment.<sup>925</sup> If certain material events occur and a municipal advisor's Form MA becomes inaccurate, it must be amended promptly.<sup>926</sup> Other corrections or updates, including the required annual update, must be made within 90 days after the end of a municipal advisor's fiscal year (calendar year for sole proprietors).<sup>927</sup>

In general, a registered municipal advisor has a continuing obligation to report to the SEC information relating to material changes in its management or organization because: (i) that information generally must be described in the municipal advisor's Form MA; and (ii) a municipal advisor must keep current responses on its Form MA by promptly amending to correct certain responses that become materially inaccurate.<sup>928</sup>

If a municipal advisor is a corporation that is not a public reporting company, Form MA requires it to disclose the identity of all shareholders that own, beneficially own, have the right to vote, or

<sup>922</sup> See rule 204-1(a); General Instruction 4 of Form ADV.

<sup>923</sup> See rule 204-1(a); General Instruction 4 of Form ADV.

<sup>924</sup> See Rule 203-2 under the Advisers Act.

<sup>925</sup> See Exchange Act Rule 15Ba1-5(a) and General Instructions for the Form MA Series.

<sup>926</sup> See General Instructions for the Form MA Series. For purposes of Form MA, a material event is deemed to have occurred if: information provided in response to Item 1 (Identifying Information), Item 2 (Form of Organization), or Item 9 (Disclosure Information) becomes inaccurate in any way; or information provided in response to Item 3 (Successions), Item 7 (Participation or Interest of Applicant, or of Associate Persons of Applicant, in Municipal Advisory Client or Solicitee Transactions), or Item 8 (Owners, Officers, and Other Control Persons) becomes materially inaccurate.

<sup>927</sup> *Id.*

<sup>928</sup> *Id.*

have the power to sell or direct the sale of 5% or more of any class of a voting security of the municipal advisor.<sup>929</sup> Each municipal advisor that is a partnership must disclose on its Form MA the identity of all general partners and those limited or special partners that have the right to receive upon dissolution, or have contributed 5% or more of the partnership's capital.<sup>930</sup> Each municipal advisor that is a trust must disclose on its Form MA the identity of the trust, each trustee, and persons that directly own 5% or more of a class of the municipal advisor's voting securities, or that has the right to receive upon dissolution, or has contributed, 5% or more of the municipal advisor's capital.<sup>931</sup> Each municipal advisor that is organized as a limited liability company must disclose on its Form MA the identity of those members that have the right to receive upon dissolution, or have contributed, 5% or more of the municipal advisor's capital and all elected managers, if any.<sup>932</sup> Material changes with respect to any of these items require prompt amendment of the municipal advisor's Form MA.<sup>933</sup>

If a registered municipal advisor is no longer required to be registered with the SEC, the municipal advisor must withdraw its registration by filing with the SEC a Form MA-W (Notice of Withdrawal from Registration as a Municipal Advisor).<sup>934</sup>

6. Is the following relevant information about licensed intermediaries available to the public:
- (a) The existence of a licence, its category and status?

### Broker-Dealers

Yes, members of the public may submit a request to the SEC to obtain a copy of completed Forms BD and the non-confidential portion of broker-dealers' annual audited financial statements. The non-confidential portion of broker-dealers' annual audited financial statements also are available on the SEC's website through EDGAR. Form BD indicates the types of business conducted by a broker-dealer, as well as the states and SROs with which it is registered in addition to the SEC.

In addition, FINRA collects, compiles, organizes, indexes, digitally converts and maintains regulatory information from broker-dealers and their registered associated persons, as well as from states and other sources. It maintains this information in the CRD system, including the status of the broker-dealer's registration, and releases certain information derived from CRD to the investing public. This information is available free of charge to the investing public through

<sup>929</sup> See Form MA, Schedule A.

<sup>930</sup> *Id.*

<sup>931</sup> *Id.*

<sup>932</sup> *Id.*

<sup>933</sup> See General Instructions for the Form MA Series.

<sup>934</sup> See Exchange Act Rule 15Ba1-4(a) and General Instructions for the Form MA Series.

FINRA's BrokerCheck system, and is provided pursuant to FINRA Rule 8312 under authority of Exchange Act Section 15A(i).

The CRD system also contains information on persons associated with broker-dealers, such as the types of examinations registered persons have taken and the specific securities licenses they hold, as well as the status of those licenses. As noted above, most of this information is also available through BrokerCheck.<sup>935</sup>

### **Investment Advisers**

Yes, each investment adviser's completed Form ADV is publicly available on the IAPD website (IAPD).<sup>936</sup> On this website, a person can: (i) search for an investment adviser; (ii) view Part 1 and Part 2A of the adviser's current Form ADV; (iii) check the adviser's registration status; (iv) link to a state regulator's website; and (v) link to FINRA's BrokerCheck website for information about broker-dealers and their registered persons. IAPD contains information on all of the investment advisers that currently are registered with the SEC or a state. The website also contains information on all of investment advisers that were registered in the previous two years but are no longer registered.

Form ADV Part 1 contains the information that the SEC reviews to grant, deny, or condition registration. Part 2 of Form ADV provides information about an investment adviser for the use of its clients and prospective clients. As amended in 2010, Part 2 is divided into Part 2A and Part 2B. Part 2A requires an adviser to prepare a narrative "brochure" that includes plain English disclosures of, among other things, that adviser's business practices, investment strategies, fees, conflicts of interest, and disciplinary information. Part 2B requires an adviser to prepare a "brochure supplement" that contains information about each advisory employee that provides investment advice to its clients, including educational background, business experience, other business activities, and disciplinary history. The adviser must deliver the brochure, and updates, to its clients annually, and the brochure supplement about a supervisory employee to a client at the time the employee begins to provide advisory services to that client. In addition, the adviser must file its brochure, but not its brochure supplement, with the SEC to satisfy its registration requirements.

There are no "categories" of licenses that are provided to an investment adviser by the SEC. An investment adviser will either be registered with the SEC, registered with a state securities

<sup>935</sup> FINRA Rule 8312 governs the information it makes available to the public through BrokerCheck, which includes currently approved registrations and certain information reported on the most recently filed Form U4, Form U5, Form U6, Form BD, and Form BDW. With respect to examinations and registered or licensed capacities held by individuals, BrokerCheck provides approved registrations, examinations passed by the person and the date passed. BrokerCheck does not release information regarding examination scores or failed examinations.

<sup>936</sup> See [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov).



commission, or will be unregistered. Since the adoption of rules implementing the Dodd-Frank Act amendments to the Advisers Act, there is also a new category of private fund advisers that are exempt from registration, but must still report to the SEC a subset of the information required by Form ADV (“exempt reporting advisers”). The public may confirm whether a person or firm is registered with the SEC, or is an exempt reporting adviser, either through the SEC’s website, including the IARD system, or by consulting the SEC’s staff, via telephone or e-mail, or by contacting the investment adviser. The public also may confirm whether a person or firm is registered with a state by checking the IARD system, by consulting with the state securities commission, either through the state’s website or via telephone, or by contacting the investment adviser.

### **Municipal Advisors**

There are no “categories” of licenses that are provided to a municipal advisor by the SEC. A municipal advisor will either be registered with the SEC or will be unregistered. The public may confirm whether a municipal advisor is registered with the SEC pursuant to the SEC’s final rule for municipal advisor registration either through the SEC’s EDGAR system, available on the SEC’s website, or by consulting the SEC’s staff, via telephone or e-mail, or by contacting the municipal advisor. The public may confirm whether a municipal advisor is registered with the SEC pursuant to the interim temporary registration regime either through the SEC’s website, or by consulting the SEC’s staff, via telephone or email, or by contacting the municipal advisor.

- (b) The scope of permitted activities and the identity of senior management and names of other authorized individuals who act in the name of the intermediary?

### **Broker-Dealers**

Yes, a broker-dealer is required to disclose the identity of all senior managers and directors on its Form BD. Each broker-dealer that is a corporation must disclose the identity of all shareholders that beneficially own, have the right to vote, or have the power to sell or direct the sale of 25% or more of any class of a voting security of the broker-dealer on Form BD. Each broker-dealer that is a partnership must disclose the identity of all general partners and any limited or special partners that have the right to receive upon dissolution, or have contributed, 25% or more of the partnership’s capital on its Form BD. Each broker-dealer that is a trust must disclose the identity of the trust and each trustee on its Form BD. Each broker-dealer that is a LLC must disclose the identity of those members that have the right to receive upon dissolution, or have contributed, 25% or more of the LLC’s capital and all elected managers on its Form BD.

Form BD requires additional disclosures about the individuals or entities identified in it as described in the preceding paragraph. Criminal, regulatory, civil judicial, bankruptcy, and SIPC actions involving each of those individuals or entities generally are required to be disclosed on Form BD. In addition, negative actions by a bonding company with respect to the applicant for broker-dealer registration must generally be disclosed on Form BD. Form BD also requires the



applicant to disclose any unsatisfied judgments or liens against the applicant.

Form BD requires a broker-dealer to indicate the types of business it conducts. In addition, the SRO pre-membership process determines what types of businesses the SRO will approve the broker-dealer to conduct. The FINRA application process, for example, involves a membership interview between FINRA staff and the primary persons who will own, control and manage the applicant broker-dealer. Approval for membership with FINRA is contingent upon the submission of a written Membership Agreement that will address, among other things, the applicant's proposed business activities.<sup>937</sup>

### Investment Advisers

Yes, a registered investment adviser must list in its Form ADV the names of its executive officers and directors (Chief Executive Officer, Chief Financial Officer, Chief Operations Officer, Chief Legal Officer, CCO, and individuals with similar status or functions).<sup>938</sup> A registered investment adviser is required to identify in its Form ADV every person that directly or indirectly controls the investment adviser, either as a direct owner or an indirect owner.<sup>939</sup> An investment adviser also must provide in its Form ADV certain information about any owner, such as whether it is a domestic or foreign entity.<sup>940</sup> In addition, an investment adviser must state in its Form ADV the general amount of voting control that an owner exercises over the investment adviser (in terms of percentage) and when such voting control was acquired.<sup>941</sup> If this information in its Form ADV becomes *materially* inaccurate, then an investment adviser must promptly amend its Form ADV.<sup>942</sup>

Form ADV also requires a registered investment adviser to disclose the type(s) of services it provides (e.g., financial planning services, portfolio management for individuals and/or small businesses, portfolio management for investment companies, portfolio management for businesses or institutional clients (other than investment companies), pension consulting

<sup>937</sup> See NASD Rule 1017.

<sup>938</sup> See Form ADV, Part 1A, Schedule A.

<sup>939</sup> See Form ADV, Part 1A, Item 10.

<sup>940</sup> See Form ADV, Schedules A and B. Form ADV requires an investment adviser to disclose the identity of all shareholders that beneficially own, have the right to vote, or have the power to sell or direct the sale of 25% or more of any class of a voting security of the investment adviser. Each investment adviser that is a partnership must disclose the identity of all general partners and those limited or special partners that have the right to receive upon dissolution, or have contributed 25% or more of the partnership's capital on its Form ADV. Each investment adviser that is a trust must disclose the identity of the trust and each trustee on its Form ADV. Each investment adviser that is organized as a limited liability company must disclose the identity of those members that have the right to receive upon dissolution, or have contributed, 25% or more of the company's capital and all elected managers on its Form ADV.

<sup>941</sup> *Id.*

<sup>942</sup> See Form ADV, General Instruction 4.

services, selection of other advisers, publication of periodicals or newsletters, security ratings or pricing services, market timing services, or others).

Additional disclosures required on Form ADV Parts 1 and 2 are discussed above in response to Questions 29.2(d) and 29.6(a).

### **Municipal Advisors**

Yes, a registered municipal advisor must list in its Form MA the names of its executive officers and directors (Chief Executive Officer, Chief Financial Officer, Chief Operations Officer, Chief Legal Officer, CCO, and any other individuals with similar status or functions).<sup>943</sup> If this information becomes materially inaccurate, the municipal advisor must promptly file an amendment to its Form MA.<sup>944</sup>

A registered municipal advisor is required to identify in its Form MA every person that directly or indirectly controls the municipal advisor, either as a direct owner or an indirect owner.<sup>945</sup> A municipal advisor also must provide in its Form MA certain information about any owner, such as whether it is a domestic or foreign entity.<sup>946</sup> In addition, a municipal advisor must state in its Form MA the general amount of voting control that an owner exercises over the municipal advisor (in terms of percentage) and when such voting control was acquired.<sup>947</sup> If this information in its Form MA becomes materially inaccurate, then a municipal advisor must promptly amend its Form MA.<sup>948</sup>

Form MA also requires a registered municipal advisor to disclose the type(s) of business it conducts (e.g., advice concerning the issuance of municipal securities, advice concerning the investment of the proceeds of municipal securities, advice concerning municipal escrow investments, advice concerning the investment of other funds of a municipal entity, advice concerning guaranteed investment contracts, advice concerning the use of municipal derivatives, solicitation of investment advisory business from a municipal entity or obligated person, solicitation of business other than investment advisory business from a municipal entity or obligated person on behalf of an unaffiliated person or firm, advice or recommendations concerning the selection of other municipal advisors or underwriters with respect to municipal

<sup>943</sup> See Form MA, Item 8 and Schedule A.

<sup>944</sup> See Exchange Act Rule 15Ba1-5(a) and General Instructions for the Form MA Series.

<sup>945</sup> See Form MA, Schedules A and B.

<sup>946</sup> *Id.*

<sup>947</sup> *Id.*

<sup>948</sup> See Exchange Act Rule 15Ba1-5(a) and General Instructions for the Form MA Series.

financial products or the issuance of municipal securities, brokerage of municipal escrow investments, or others).<sup>949</sup>

### *Investment Advisers*

7. Does the regulatory scheme for investment advisers require that, as applicable:

- (a) If an investment adviser deals on behalf of clients, the capital and other operational controls (explained in Principles 29 to 32) applicable to other market intermediaries also should apply to the adviser?

Yes, to the extent that an investment adviser deals on behalf of customers, the investment adviser would be subject to the broker-dealer regulatory regime, including registration requirements and capital and other operational controls. See response to Question 29.2.

- (b) If the adviser does not deal, but is permitted to have custody of client assets, regulation provides for the protection of client assets, including segregation and periodic or risk-based inspections (either by the regulator or an independent third party) and capital and organizational requirements as explained under Principles 29 to 32?

Yes, regulation provides for protection of client assets. Pursuant to the Advisers Act's broad anti-fraud authority, the SEC adopted rule 206(4)-2, which unless they comply with certain conditions, generally makes it fraudulent for investment advisers to have "custody" of client funds or securities (Client Assets). "Custody" is defined broadly to include more than just physical possession, which, for an investment adviser, is rare. It means holding Client Assets, directly or indirectly, or having any authority to obtain possession of Client Assets.<sup>950</sup> The term includes, for instance, any arrangement (such as a general power of attorney or having the ability to deduct advisory fees from the client's bank account) under which the adviser is authorized or permitted to obtain Client Assets even if the assets are not physically held by the adviser. Custody also results from an adviser acting in any capacity (such as general partner of a limited partnership, managing member of a limited liability company, or trustee of a trust) that gives that adviser or any of its supervised persons legal ownership of or access to Client Assets.

It would not be considered fraudulent for investment adviser to have custody of client assets, if it adheres to the requirements of Rule 206(4)-2. First, Client Assets must be maintained in custodial accounts by a "qualified custodian," which is defined as: (i) a bank as defined in

<sup>949</sup> See Form MA, Item 4.

<sup>950</sup> Investment advisers are deemed to hold Client Assets if the adviser's related person holds Client Assets, directly or indirectly, or has authority to obtain possession of Client Assets, in connection with the investment adviser's advisory services.

Section 202(a)(2) of the Advisers Act or a savings association as defined in Section 3(b)(1) of the Federal Deposit Insurance Act<sup>951</sup> that has deposits insured by the FDIC under the Federal Deposit Insurance Act; (ii) a broker-dealer registered under Section 15(b)(1) of the Exchange Act, holding the client assets in customer accounts; (iii) an FCM registered under Section 4f(a) of the CEA, holding the client assets in customer accounts, but only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; and (iv) a foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets.<sup>952</sup> Under this construct, the Advisers Act custody rule provides advisory clients protection at least as strong as the protections provided under regulatory regimes governing the qualified custodians. For example, where the qualified custodian is a bank, the federal banking laws provide asset protection.

An investment adviser's client, however, also receives the following *additional layers* of protection under Rule 206(4)-2:

First, the qualified custodian must maintain Client Assets either in a separate account for each client under that client's name, or in accounts that contain only the Client Assets, under the adviser's name as agent or trustee for the clients.<sup>953</sup>

Second, if an investment adviser opens an account with a qualified custodian on behalf of a client, either under the client's name or under the adviser's name as agent, the adviser must notify the client in writing of such qualified custodian's name, address, and the manner in which the funds or securities are maintained, promptly when the account is opened and following any changes to this information. If the adviser also sends its own account statements to clients, this notice and subsequent account statements from the adviser must contain a statement urging the client to compare account statements from the custodian with those from the adviser.<sup>954</sup>

Third, an investment adviser must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement, at least quarterly, to each of such adviser's clients for which it maintains funds or securities, identifying the amount of funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period;<sup>955</sup> or

<sup>951</sup> 12 U.S.C. 1813(b)(1).

<sup>952</sup> Advisers Act Rule 206(4)-2(c)(3).

<sup>953</sup> Advisers Act Rule 206(4)-2(a)(1).

<sup>954</sup> Advisers Act Rule 206(4)-2(a)(2).

<sup>955</sup> Advisers Act Rule 206(4)-2(a)(3).

Fourth, if an adviser has custody of Client Assets, unless the adviser solely has custody of Client Assets as a consequence of the adviser's authority to make withdrawals from client accounts to pay its advisory fee,<sup>956</sup> an independent public accountant must verify all of those Client Assets by actual examination at least once during each calendar year at a time that is chosen by the accountant without prior notice or announcement to the adviser and that is irregular from year to year, and must file a certificate on Form ADV-E with the SEC within 120 days of the as-of date chosen by the accountant, stating that it has examined the Client Assets and describing the nature and extent of the examination.<sup>957</sup> If such independent public accountant finds any material discrepancies during the course of such examination, the accountant must notify the SEC within one business day of the finding.<sup>958</sup> Upon the independent public accountant's resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed, the accountant must file Form ADV-E within four business days, accompanied by a statement that includes the date the engagement terminated, an explanation of problems relating to examination scope or procedure that contributed to the termination, and the accountant's contact information.<sup>959</sup>

Fifth and finally, if the adviser or its related person<sup>960</sup> act as qualified custodian, in connection with the adviser's advisory services, the adviser must: (i) have an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB perform the required annual surprise independent verification, unless the related person is "operationally independent" of the adviser;<sup>961</sup> and (ii) obtain, or receive from the related person, an annual report of the internal controls relating to the custody of client assets prepared by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB.<sup>962</sup>

<sup>956</sup> Advisers Act Rule 206(4)-2(b)(3).

<sup>957</sup> Advisers Act Rule 206(4)-2(a)(4)(i).

<sup>958</sup> Advisers Act Rule 206(4)-2(a)(4)(ii).

<sup>959</sup> Advisers Act Rule 206(4)-2(a)(4)(iii).

<sup>960</sup> A "related person" includes any person, directly or indirectly, controlling, controlled by, or under common control with the adviser. Advisers Act Rule 206(4)-2(d)(7).

<sup>961</sup> The surprise independent verification is not required of the adviser if it can demonstrate that the related person qualified custodian is "operationally independent." A related person is presumed not to be operationally independent unless each of the following conditions is met and no other circumstances can reasonably be expected to compromise the operational independence of the related person: (i) client assets in the custody of the related person are not subject to claims of the adviser's creditors; (ii) advisory personnel do not have custody or possession of, or direct or indirect access to client assets of which the related person has custody, or the power to control the disposition of such client assets to third parties for the benefit of the adviser or its related persons, or otherwise have the opportunity to misappropriate such client assets; (iii) advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision; and (iv) advisory personnel do not hold any position with the related person or share premises with the related person. Advisers Act Rule 206(4)-2(d)(5).

<sup>962</sup> Advisers Act Rule 206(4)-2(a)(6).

Advisers to pooled investment vehicles may choose to comply with certain aspects of the rule differently. If the adviser is the general partner of a limited partnership (or holds a similar position with another form of pooled investment vehicle): (i) the adviser is deemed to have complied with the annual surprise independent verification requirement and need not form a reasonable belief regarding delivery of account statements if the pool's financial statements are audited by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB, and the audited statements prepared in accordance with U.S. GAAP are distributed not less than annually to the pool's investors; or (ii) the qualified custodian must send quarterly account statements to each investor in the pool, and the adviser must obtain a surprise examination of the pool's assets.<sup>963</sup>

Rule 204-2 under the Advisers Act requires an adviser that has custody of client assets to keep: (i) a journal or other records showing all purchases, sales, receipts and deliveries of securities (including certificate numbers) for such accounts and all other debits and credits to such accounts; (ii) a separate ledger account for each such client showing all purchases, sales, receipts and deliveries of securities, the date and price of each such purchase and sale, and all debits and credits; (iii) copies of confirmations of all transactions effected by or for the account of any such client; (iv) a record for each security in which any such client has a position, which record shall show the name of each client having any interest in each security, the amount or interest of each such client, and the location of each such security; and, if applicable, (v) a memorandum describing the basis upon which the adviser has determined that the presumption that any related person is not operationally independent under Rule 206(4)-2(d)(5) has been overcome.

We note that, following a number of SEC enforcement actions against investment advisers and broker-dealers alleging fraudulent conduct (including misappropriation or other misuse of investor assets),<sup>964</sup> the SEC undertook a comprehensive review of the rules regarding the safekeeping of investor assets in order to determine changes the SEC might make that would decrease the likelihood that client assets are misused, or would increase the likelihood that fraudulent activities are discovered earlier and client losses are thereby reduced. As part of this review, the SEC adopted amendments to Rule 206(4)-2, Rule 204-2, and related forms intended to provide additional safeguards under the Advisers Act when an adviser has custody of Client Assets.<sup>965</sup> The protections described above reflect the enhancements adopted as a result of these amendments.

<sup>963</sup> Advisers Act Rule 206(4)-2(b)(4). Advisers are not required to comply with Advisers Act Rule 206(4)-2 with respect to CIS clients that are registered under the Investment Company Act because CISs are subject, instead, to a number of custody rules adopted by the SEC under Section 17(f) of that Act. See responses to Questions 25.7, 25.8 and 25.9.

<sup>964</sup> See, e.g., *SEC v. Stanford International Bank*, Litigation Release No. 20901 (Feb. 17, 2009) (complaint alleges that the affiliated bank, broker-dealer, and advisers colluded with each other in carrying out an \$8 billion fraud); *SEC v. Bernard L. Madoff*, Litigation Release No. 20889 (Feb. 9, 2009) (complaint alleges that Madoff and Bernard L. Madoff Investment Securities, a registered investment adviser and broker-dealer, committed a \$50 billion fraud).

<sup>965</sup> Advisers Act Release No. 2968 (Dec. 30, 2009).

- (c) In the case of both (a) and (b), as well as advisers who manage client portfolios without dealing on behalf of clients or holding client assets, does regulation impose relevant requirements that cover record keeping, disclosure and conflicts of interest as explained in Principle 31?

Yes, the Advisers Act imposes requirements covering recordkeeping, disclosure and conflicts of interest. For a discussion of recordkeeping requirements, please see response to Question 31.13.

An investment adviser's fiduciary duty requires it to disclose to its clients and prospective clients any material facts that might cause the adviser, either consciously or unconsciously, to render advice that is not disinterested.<sup>966</sup> An investment adviser must disclose all material potential conflicts of interest between the adviser and its clients, even if the adviser believes that a conflict has not affected and will not affect the adviser's recommendations to its clients.<sup>967</sup>

The SEC also requires a registered adviser to make extensive disclosures in its Form ADV application for registration. Part 1 requires information about the adviser's business, ownership, clients, employees, business practices (especially those involving potential conflicts with clients), and any disciplinary events of the adviser or its employees. The SEC uses information from this part of the form to make its registration determination and to manage its regulatory and examination programs. The SEC recently amended both Part 1A and Part 2 to expand the amount of information collected, and in the case of Part 2, the method by which the information is presented to clients. Part 1A was expanded to increase the following types of information collected about: (i) about advising private funds; (ii) advisory business (including the types of clients they have, their employees, and their advisory activities), particularly those that may present conflicts of interest; (iii) non-advisory activities; and (iv) financial industry affiliations. Part 2A of Form ADV is a narrative "brochure" that includes plain English disclosures of, among other things, the adviser's business practices, investment strategies, fees, conflicts of interest, financial conditions that reasonably likely would impair the adviser's ability to meet contractual commitments to clients, and disciplinary information. Part 2B requires an adviser to prepare a narrative, plain English "brochure supplement" that contains information about each advisory employee that provides investment advice to its clients, including educational background, business experience, other business activities, and disciplinary history. The adviser must file its brochure, but not its brochure supplement, with the SEC and must provide both of these disclosure documents to clients and prospective clients.

The Advisers Act also imposes requirements to mitigate conflicts. For example, investment advisers that exercise voting authority with respect to client securities generally must: (i) adopt written policies and procedures that are reasonably designed to ensure that the adviser votes

<sup>966</sup> See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195-97 (1963). See also Sections 206(1) and (2) of the Advisers Act.

<sup>967</sup> *Id.*

proxies in the best interest of clients; (ii) describe such policies and procedures to clients and provide copies upon request; and (iii) disclose to clients how they may obtain information on how the adviser voted their proxies.<sup>968</sup>

Section 206(3) of the Advisers Act requires an investment adviser, prior to completion of a principal trade, to disclose to its client in writing when it is acting as a principal for its own account, and to obtain the consent of the client.<sup>969</sup>

Rule 204-2 under the Advisers Act requires investment advisers to create and maintain certain records relating to any proprietary trading activities in which they engage as part of their investment advisory business. Rule 204-2 under the Advisers Act requires an investment adviser to keep a record of every transaction in a security in which the investment adviser or any advisory representative of the investment adviser has, or by reason of the transaction acquires, any direct or indirect beneficial ownership, except: (i) transactions effected in any account over which neither the investment adviser nor any advisory representative of the investment adviser has any direct or indirect influence or control; and (ii) transactions in securities that are: direct obligations of the Government of the U.S.; bankers' acceptances, bank certificates of deposit, commercial paper, and high quality short-term debt instruments, including repurchase agreements; or shares issued by registered open-end investment companies.

Additionally, Rule 204A-1 under the Advisers Act requires registered investment advisers to adopt codes of ethics setting forth standards of conduct and requiring compliance with applicable federal securities laws. Codes of ethics must address personal trading and must require personnel to report personal securities holdings and transactions, including those in affiliated mutual funds. Codes of Ethics must also require personnel to obtain pre-approval of certain investments. Rule 204-2 under the Advisers Act requires advisers to keep copies of their codes of ethics and related records.

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<sup>968</sup> Rule 206(4)-6.

<sup>969</sup> Section 204 and Rule 204-2(a)(7) under the Advisers Act require an investment adviser to retain this written communication as part of its records.



**Principle 30**    **There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.**

**Key Questions**

1. Are there initial and ongoing minimum capital requirements for market intermediaries? Are there also liquidity standards? Do the capital and liquidity standards address solvency?

**Broker-Dealers**

Yes. Broker-dealers are subject to initial and ongoing minimum capital requirements through Rule 15c3-1 (commonly referred to as the Net Capital Rule). There are also liquidity standards. The capital and liquidity standards address solvency. The SEC's Net Capital Rule is a net liquid assets test designed to promote liquidity and solvency.

More specifically, pursuant to Exchange Act Section 15(c)(3)(A), "No broker or dealer ... shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security ... in contravention of such rules and regulations as the SEC shall prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers..."

In accordance with the Exchange Act, the SEC promulgated a number of financial responsibility rules, including the Net Capital Rule. The rule allows a broker-dealer to engage in activities that are part of conducting a securities business (e.g., taking securities into inventory) but in a manner that places the firm in the position of holding at all times more than one dollar of highly liquid assets for each dollar of unsubordinated liabilities (e.g., money owed to customers, counterparties, and creditors). The objective of the rule is to require the broker-dealer to maintain sufficient liquidity so that, if it fails financially, it can meet all unsubordinated obligations to customers and have adequate resources to wind-down in an orderly manner without the need for a formal proceeding.

The rule permits proprietary securities positions to count as allowable net capital, subject to standardized or internal model-based haircuts which are deducted from the mark-to-market value of such positions. The standardized haircuts are designed to account for the market risk inherent in these positions and to create a buffer of liquidity to protect against other risks associated with the securities business. The rule does not permit most unsecured receivables to count as allowable net capital, that is, the broker-dealer must take a 100% capital charge. This aspect of the rule severely limits the ability of broker-dealers to engage in certain activities, such as unsecured lending that generate unsecured receivables. In addition, the rule does not permit fixed assets or other illiquid assets to count as allowable net capital, which creates disincentives for broker-dealers to own real estate and other fixed assets that cannot be readily converted into

cash. For these reasons, these liquidity-based standards in the Net Capital Rule incentivize broker-dealers to confine their business activities and devote capital to activities such as underwriting, market making, and advising on and facilitating customer securities transactions.

All broker-dealers are subject to the SEC's Net Capital Rule. Broker-dealers must maintain sufficient net capital at all times.<sup>970</sup> If a firm's net capital falls below the level of net capital it is required to maintain pursuant to the rule, that firm must cease doing a securities business. In 2013, the SEC amended the Net Capital Rule to also require a broker-dealer to cease conducting a securities business if certain insolvency events occur.

The Net Capital Rule requires that a broker-dealer perform two calculations: (i) a computation of the minimum amount of net capital the broker-dealer must maintain; and (ii) a computation of the amount of net capital the broker-dealer is maintaining. The minimum net capital requirement is the **greater** of a fixed-dollar amount specified in the rule and an amount determined by applying one of two financial ratios: the 15-to-1 aggregate indebtedness to net capital ratio (basic method) or the 2% of aggregate debit items ratio (alternative method).

Although all broker-dealers must keep a minimum amount of capital "at all times," new firms calculating net capital under the basic method are subject to more stringent capital requirements than firms that have been in the business for more than one year. The SEC's Net Capital Rule also requires that firms exposed to more risk (such as due to the types of business in which the broker-dealer engages) maintain higher levels of liquid net capital.

In addition, the SROs may prescribe net capital requirements in excess of the requirements of the SEC's Net Capital Rule.<sup>971</sup>

Finally, the SEC has recently proposed a funding liquidity stress test for ANC Broker-Dealers (permitted to use the alternative internal model-based method for computing net capital).<sup>972</sup>

### **Non-Bank Security-Based Swap Dealers**

Section 15F(e) of the Exchange Act, which was added by Section 764 of the Dodd-Frank Act, requires the SEC to adopt rules establishing capital and margin requirements for SBSDs for which

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<sup>970</sup> Broker-dealers are expected to demonstrate moment-to-moment compliance with the Net Capital Rule. See NYSE Interpretation Memorandum No. 99-8 (Aug. 5, 1999).

<sup>971</sup> See, e.g., FINRA Rule 4110.

<sup>972</sup> See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 68071 (Oct. 18, 2012), 77 Fed. Reg. 70213 (Nov. 23, 2012).

there is not a prudential regulator (non-bank SBSBs). Accordingly, the SEC proposed rules in October 2012 to establish capital and margin requirements for non-bank SBSBs.<sup>973</sup> The SEC's proposed capital and margin applicable to non-bank SBSBs are modeled on the capital and margin rules that apply to broker-dealers.

### Investment Advisers

The Advisers Act does not impose any minimum initial or ongoing capital requirements or liquidity standards upon registered investment advisers. Staff notes that investment advisers generally act as agent on behalf of their clients; they do not trade as principal on their own behalf when conducting their advisory businesses. See also response to Question 29.2(c).

2. Are the capital adequacy requirements structured to result in capital addressed to the full range of risks to which market intermediaries are subject, e.g., market, credit, liquidity and operational risks?

Yes. The Net Capital Rule is structured to result in capital addressed to the full range of risks to which market intermediaries are subject, e.g., market, credit, liquidity, and operational risks. As discussed in Question 30.1, the Net Capital Rule is a net liquid assets test designed to promote liquidity.

The Net Capital Rule sets forth minimum dollar amounts that range from \$5,000 (for the least risky type of activity) to \$250,000 (for the most risky type of activity), depending on the different types of activities in which the broker-dealer engages, the perceived relative risk associated with these different types of activities, and whether the broker-dealer holds customer funds or securities. For instance, an established firm that engages only in the business of selling mutual funds on an application-way basis (where the customer's mutual fund is held directly with the fund) could not allow its aggregate indebtedness to all other people to exceed 1,500% of its net capital, and its net capital could not fall below \$5,000. These minimum requirements increase with riskier types of activities.

ANC Broker-Dealers and a type of limited purpose broker-dealer that deals solely in OTC derivatives (OTC derivative dealers) are permitted, with SEC approval, to calculate net capital using internal models as the basis for taking market risk and credit risk charges in lieu of the standardized haircuts for classes of positions for which they have been approved to use models. The Net Capital Rule imposes substantially higher minimum capital requirements for ANC Broker-Dealers and OTC derivatives dealers, as compared to other types of broker-dealers, because, among other reasons, the use of internal models to compute net capital can substantially reduce the deductions for securities and money market positions as compared with the standardized haircuts. Consequently, the higher minimum capital requirements are designed

<sup>973</sup>

Id.

to account for risks that may not be addressed by the internal models.

Larger U.S. broker-dealers generally choose to calculate their net capital based on the alternative method. Pursuant to the alternative method, the broker-dealer must maintain at least the greater of \$250,000 or 2% of aggregate debit items as calculated in the reserve computation under Rule 15c3-3.<sup>974</sup> This method would only be available to firms that hold customer funds and securities, and these debit items tend to increase in accord with the amount of customer business a firm does. The alternative method limits the expansion of customer business of poorly capitalized firms by tying the minimum net capital requirement to the amount of aggregate customer receivables.

As discussed in response to Question 30.1, the Net Capital Rule uses risk factors, or “haircuts,” to adjust a firm’s capital calculation by requiring a broker-dealer to take prescribed percentage deductions (standardized haircuts) from the mark-to-market value of its proprietary positions. The larger a firm’s position or risk, the larger the haircut the firm is required to take when calculating its net capital.

The standardized haircut structure is designed so that broker-dealers will have a sufficient capital based to account for, in addition to market and credit risk, other types of risk, such as operational risk, leverage risk, and liquidity risk. In addition to the requirements to deduct most unsecured receivables from the Net Capital Rule in computing minimum net capital, the Net Capital Rule requires a broker-dealer to take other charges in computing minimum net capital, including charges to cover operational risk and credit risk. For example, broker-dealers are required to take specific capital charges related to failed-to-deliver contracts that are outstanding five business days or longer and to deduct the market value of all short security differences unresolved after discovery in accordance with a schedule set forth in the rule. In addition, the rule requires a broker-dealer to deduct the amount of cash required in each customer’s or non-customer’s account to meet maintenance margin requirements, after application of calls for margin, marks to the market or other required deposits which are outstanding five business days or less.

Pursuant to Exchange Act Rule 17a-11 (commonly called the Early Warning Rule), a broker-dealer

<sup>974</sup> The reserve computation is calculated pursuant to a formula set forth in Exhibit A to Rule 15c3-3. Under the formula, a broker-dealer adds up various credit and debit line items. The credit items include cash balances in customer accounts and funds obtained through the use of customer securities. The debit items include monies owed by customers (e.g., from margin lending), securities borrowed by the broker-dealer to effectuate customer short sales, and required margin posted to certain clearing agencies as a consequence of customer securities transactions. If, under the formula, customer credit items exceed customer debit items, the broker-dealer must maintain cash or qualified securities in that net amount in a “Special Reserve Bank Account for the Exclusive Benefit of Customers.” This account must be segregated from any other bank account of the broker-dealer. Generally, a broker-dealer with a deposit requirement of \$1 million or more must compute its reserve requirement on a weekly basis. The weekly computation determines the required minimum balance the broker-dealer must maintain in the reserve account.

must promptly notify the SEC and its DEA, when, among other things:

- its net capital falls below 120% of its required net capital;
- if the firm computes its net capital using the alternative method, the firm's net capital falls below 5% of aggregate debit items;
- if the firm computes its net capital using the basic method, if the firm's aggregate indebtedness is in excess of 1,200% of its net capital;
- if its net capital falls below the minimum require amount; or
- when the firm fails to make and keep current the books and records required by SEC rules.

SROs also have early warning rules, which in some cases have higher thresholds than the SEC Early Warning Rule.<sup>975</sup> The requirements of the Early Warning Rule, in effect, require broker-dealers to maintain net capital in excess of the early warning thresholds so the broker-dealer will not have to file the required notices. For example, pursuant to the alternative method, while the Net Capital Rule requires most larger broker-dealers to maintain at least the greater of \$250,000 or 2% of aggregate debit items, the Early Warning Rule in effect requires these broker-dealers to maintain capital at least equal to 5% of aggregate debit items.

The conservatism of the Net Capital Rule, coupled with the higher early warning thresholds produces capital buffers that provide added protection for other risks, such as broader operational risks (*e.g.*, reputational and legal risks). This buffer also helps the broker-dealer maintain minimum net capital and remain solvent in times of stress. The Net Capital Rule, in conjunction with the other broker-dealer financial responsibility rules, has existed for many years and has facilitated the prudent operation of broker-dealers. According to the 2013 SIPC Annual Report, since its inception in 1971,<sup>976</sup> SIPC has initiated customer protection proceedings for only 328 broker-dealers, representing less than 1% of the approximately 39,400 broker-dealers that have been SIPC members during the last 43 years. Over the last 10-year period, the annual average number of new cases per year was 2.

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<sup>975</sup> See FINRA Rule 4120.

<sup>976</sup> SIPC was created under SIPA as a non-profit membership corporation. SIPC oversees the liquidation of member broker-dealers that close when the broker-dealer is bankrupt or in financial trouble, and customer assets are missing.

3. Are capital adequacy requirements sensitive to the quantum of risks undertaken; that is, does required capital increase as risk increases, *e.g.*, in the event of large market moves?

Yes, there are capital adequacy requirements sensitive to the quantum of risks undertaken. For example, there are differences in the net capital requirements applicable to broker-dealers based upon the types of business in which each firm engages and the perceived relative risk associated with these different types of activities. As discussed in responses 30.1 and 30.2 above, the Net Capital Rule uses risk factors, or haircuts, to adjust a firm's capital calculation. The larger a firm's position or risk, the larger the haircut the firm is required to take when calculating its net capital.

Pursuant to the basic method of determining a firm's net capital requirement, a firm generally must not allow its aggregate indebtedness to all other people to exceed 1,500% of its net capital (or 800% if the firm has been in business for less than a year) and must maintain at least a minimum dollar amount of net capital as set forth in the Net Capital Rule. The Net Capital Rule sets forth minimum dollar amounts that range from \$5,000 (for the least risky type of activity) to \$250,000 (for the most risky type of activity).

Further, larger U.S. broker-dealers generally choose to calculate their net capital based on the alternative method. Pursuant to the alternative method, the broker-dealer must maintain at least the greater of \$250,000 or 2% of aggregate debit items as calculated in the Reserve Computation under Rule 15c3-3. This method would only be available to firms that hold customer funds and securities, and these debit items tend to increase in accord with the amount of customer business a firm does. Therefore, a broker-dealer's minimum capital requirement would increase to the extent there is a quantum increase in its aggregate customer debit items.

As noted in response to Question 30.2, most often, for both small and large broker-dealers, a broker-dealer's minimum net capital requirement is the financial ratio, rather than the minimum fixed dollar amount.

In addition, the Net Capital Rule requires a broker-dealer to take specific capital charges which are sensitive to the quantum of risks undertaken by a broker-dealer, *i.e.*, that require a broker-dealer to take specific capital charges as the risk of holding a position may increase. For example, the Net Capital Rule requires a broker-dealer to take open contractual commitment charges, such as if a firm is engaged in specific underwriting activity. In addition, broker-dealers are required to take additional capital charges in cases where they hold undue concentrations in specific securities, or where securities that otherwise have a "ready market" held by a broker-dealer may be difficult to sell if markets can absorb only a limited number of such shares (marketplace blockage charge).

All SROs have the ability to set capital requirements for broker-dealers at levels higher than that required pursuant to the SEC's rule. Many SROs also may prevent a firm from expanding its

business or otherwise limit its business to the extent that it fails to maintain sufficient levels of net capital if the SRO has rules in place that permit them to do so.<sup>977</sup> As noted in the response to 30.2, under the Early Warning Rule, a broker-dealer must promptly notify the SEC and its DEA, when, among other things, its net capital falls below a certain threshold.

4. Are capital standards designed to allow an intermediary to absorb some losses and to wind down its business over a relatively short period without loss to its clients or disrupting the orderly functioning of the markets?

Yes, the capital standards are designed to allow a broker-dealer to absorb some losses and to wind down its business over a relatively short period without loss to its clients or disrupting the orderly functioning of the markets. As stated in the response to Question 30.1, the objective of the SEC's broker-dealer Net Capital Rule is to require the broker-dealer to maintain sufficient liquidity so that if it fails financially it can meet all unsubordinated obligations to customers and have adequate resources to wind-down in an orderly manner without the need for a formal proceeding. Therefore, the requirements of the Net Capital Rule should enable a broker-dealer to wind down its business over a relatively short period without loss to its clients or disrupting the orderly functioning of the markets.

Further, the SEC's broker-dealer financial responsibility rules require a broker-dealer to segregate customer securities and monies from proprietary positions and monies so that if a liquidation were to occur, those customer securities and funds would not be available to satisfy claims of creditors of the broker-dealer. More specifically, the SEC's Rule 15c3-3,<sup>978</sup> commonly called the "Customer Protection Rule," requires that every broker-dealer obtain and maintain possession and control of customer securities, and maintain a reserve account that contains (at least) the net dollar amount of cash the broker-dealer owes to its customers. Physical possession or control means the broker-dealer must hold these securities in one of several locations specified in Rule 15c3-3 and free of liens or any other interest that could be exercised by a third party to secure an obligation of the broker-dealer. Permissible locations include a bank, as defined in Section 3(a)(6) of the Exchange Act, and a clearing agency. Customer securities held by the carrying broker-dealer are not assets of the firm. Rather, the carrying broker-dealer holds them in a custodial capacity and the possession and control requirement is designed to ensure that the carrying broker-dealer treats them in a manner that allows for their prompt return.

The reserve account must be titled "Special Reserve Bank Account for the Exclusive Benefit of Customers." The amount of net cash owed to customers is computed pursuant to a formula set forth in Exhibit A to Rule 15c3-3. Under the customer reserve formula, the broker-dealer adds up customer credit items (e.g., cash in customer securities accounts and cash obtained through the use of customer margin securities) and then subtracts from that amount customer debit items

<sup>977</sup> See, e.g., FINRA Rule 4110.

<sup>978</sup> 17 C.F.R. 240.15c3-3.

(e.g., margin loans). If credit items exceed debit items, the net amount must be on deposit in the customer reserve account in the form of cash and/or qualified securities. A broker-dealer cannot make a withdrawal from the customer reserve account until the next computation and even then only if the computation shows that the reserve requirement has decreased. The broker-dealer must make a deposit into the customer reserve account if the computation shows an increase in the reserve requirement. In 2013, the SEC adopted amendments to the Customer Protection Rule to prohibit a broker-dealer from depositing cash in its customer reserve account at an affiliated bank and to limit the amount of cash a broker-dealer can deposit in any one bank to meet its minimum required customer reserve deposit.<sup>979</sup> This limitation on the amount of cash a broker-dealer may deposit in any one bank to meet its customer reserve requirement addresses the risk that the potential impairment of a bank's ability to quickly return the customer reserve deposit to the broker-dealer.

In addition, the customer reserve formula permits the broker-dealer to offset customer credit items only with customer debit items. This means the broker-dealer can use customer cash to facilitate customer transactions such as financing customer margin loans and borrowing securities to make deliveries of securities that customers have sold short. Broker-dealer margin rules require securities customers to maintain a minimum level of equity in their securities accounts.<sup>980</sup> In addition to protecting the broker-dealer from the consequences of a customer default, the equity in a customer's securities account serves to over-collateralize the customers' obligations to the broker-dealer and thereby protect customers whose cash was used to facilitate the broker-dealer's financing of securities purchases and short sales by other customers. For example, if the broker-dealer fails, the customer debits, because they generally are over-collateralized, should be attractive assets for another broker-dealer to purchase or, if not purchased by another broker-dealer, they should be able to be liquidated to a net positive equity. The proceeds of the debits sale or liquidation can be used to repay the customer cash used to finance the customer obligations. This cash plus the funds and/or qualified securities held in the customer reserve account should equal or exceed the total amount of customer credit items (i.e., the total amount owed by the broker-dealer to its customers).

The SEC's Rules 8c-1 and 15c2-1,<sup>981</sup> commonly called the "Hypothecation Rules," require that a broker-dealer segregate customer securities from its own proprietary securities, and prohibit a broker-dealer from hypothecating customers' fully paid securities. In addition, the SROs have rules that restrict a broker-dealer's use of customer securities.<sup>982</sup> These rules serve to reduce the risk that a firm failure will have a widespread detrimental effect on the marketplace and customers and alert the SEC and SROs to a potential failure so that any impact may be

<sup>979</sup> 17 C.F.R. 240.15c3-3(e)(5).

<sup>980</sup> See, e.g., FINRA Rule 4210.

<sup>981</sup> 17 C.F.R. 240.8c-1 and 15c2-1.

<sup>982</sup> See, e.g., FINRA Rules 2150 and 2090.



minimized. Finally, the Net Capital Rule requires broker-dealers to maintain a minimum amount of capital, which is based upon the nature of the broker-dealer's business and whether the broker-dealer handles customer funds and securities. Those broker-dealers that handle customer funds and securities are required to maintain a higher level of net capital. See the response to Question 30.2.

In addition to proposals related to broker-dealer net capital requirements,<sup>983</sup> several developments have occurred since 2009 to facilitate risk-based portfolio margining of securities and futures, as well as SBS and swaps under the regulation of the SEC and CFTC, respectively. For example, the Dodd-Frank Act amended the Securities Investor Protection Act of 1970 (SIPA)<sup>984</sup> to take into account futures and options on futures held in a portfolio margin account carried as a securities account pursuant to an SEC-approved portfolio margining program. As a result, persons who hold futures positions in a portfolio margining account carried as a securities account are now entitled to SIPA protection. Further, Section 713 of the Dodd-Frank Act provided the SEC and CFTC with explicit authority to facilitate portfolio margining by allowing cash and securities to be held in a futures account, and futures and options on futures and related collateral to be held in a securities account, subject to certain conditions. Finally, the SEC and the CFTC have jointly coordinated to facilitate the portfolio margining of credit default swaps that are security-based swaps and swaps regulated by the SEC and CFTC, respectively.

5. Are relevant market intermediaries required to maintain records such that capital levels can be readily determined at any time?

Yes. Broker-dealers are required to make, keep and preserve records regarding their net capital computation under the SEC's recordkeeping rules – Rules 17a-3 and 17a-4.<sup>985</sup> Further, the capital levels of a broker-dealer, and its compliance at all times with minimum capital requirements, is monitored through filings made by the broker-dealer of periodic and annual reports, and through onsite inspections. The broker-dealer's DEA regularly monitors compliance with capital levels; however, the SEC also may review a firm's filings or conduct an onsite inspection. The broker-dealer must also file an audited annual report to the SEC and its DEA.

<sup>983</sup> The SEC proposed rules in 2012 to increase the minimum net capital and "early warning" requirements for ANC Broker-Dealers in response to issues that arose during the 2008 financial crisis, recognizing the large size of these firms and the scale of their custodial responsibilities. The financial crisis demonstrated the risks to financial firms when market conditions are stressed and how the failure of a large firm can accelerate the further deterioration of market conditions. The proposals are designed to bolster the ANC Broker-Dealer net capital rules to ensure that these firms maintain sufficient capital reserves to account for market, credit, operational, and other risks (such as reputational risk).

<sup>984</sup> 15 U.S.C. § 78aaa – 78III.

<sup>985</sup> The SEC recently proposed recordkeeping and reporting requirements for SBSs that are based on the broker-dealer recordkeeping and reporting rules. Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers, Exchange Act Release No. 71958 (Apr. 17, 2014), 79 Fed. Reg. 25194 (May 2, 2014).

6. Are the detail, format, frequency and timeliness of reporting to the regulator and/or the SRO sufficient to reveal a significant deterioration in the capital adequacy position of market intermediaries?

Yes. The detail, format, frequency and timeliness of reporting to the SEC and SROs are sufficient to reveal a significant deterioration in the capital adequacy position of market intermediaries.

Pursuant to Exchange Act Rule 17a-5(a), all broker-dealers must file certain reports with the SEC either once each month or once each quarter, depending on the types of business in which the firm engages and the perceived relative risk of those types of business.<sup>986</sup> The SEC has delegated the responsibility for receiving those reports to each firm's DEA. Each report calculates a broker-dealer's capital levels and the DEA reviews it. Broker-dealers are required to file those reports electronically. The SEC generally is able to access these reports electronically, and receives information regarding these reports in database format from the SROs.

In addition, pursuant to Exchange Act Rule 17a-11 (the Early Warning Rule), a broker-dealer must promptly notify the SEC and its DEA, when, among other things, its net capital falls below a certain threshold. See response to Question 30.2 for a description of the Early Warning Rule. Furthermore, the equity capital of a broker-dealer may not be withdrawn under certain circumstances without written notice to the SEC, the DEA, and, if applicable, the CFTC.

7. Is the financial position of the intermediary subject to audit by independent auditors to provide additional assurance that the financial position reflects the risk that the intermediary undertakes?

Yes. Pursuant to Exchange Act Rule 17a-5(d), each broker-dealer must file an audited annual report with the SEC, the broker-dealer's DEA, SIPC if the broker-dealer is a member, and each SRO of which it is a member unless the SRO waives the requirement by rule. Exchange Act Rule 17a-5(d)(1)(i)(C) requires that the report be audited by "an independent public accountant." Further, Exchange Act Rule 17a-5(f)(1) states that the independent public accountant must be qualified and independent in accordance with § 210.2-01 of Regulation S-X and the independent public accountant must be registered with the PCAOB if required by the Sarbanes-Oxley Act.

Under Rule 17a-5(h), if the independent public accountant determines that a broker-dealer is not in compliance with any of the financial responsibility rules during the course of preparing its reports, the independent public accountant must immediately notify the broker-dealer's chief financial officer of the nature of the non-compliance. If the notice from the accountant concerns an instance of non-compliance that would require a broker or dealer to provide a notification

<sup>986</sup> The SEC recently proposed recordkeeping and reporting requirements for SBSs that are based on the broker-dealer recordkeeping and reporting rules. Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers, Exchange Act Release No. 71958 (Apr. 17, 2014), 79 Fed. Reg. 25194 (May 2, 2014).

under Rule 15c3-1, 15c3-3, or 17a-11, the broker or dealer must provide a notification in accordance with Rules 15c3-1, 15c3-3, or 17a-11, as applicable, and provide a copy of the notification to the independent public accountant.

If the independent public accountant determines that a material weakness exists in the internal controls over compliance of the broker-dealer, the accountant must immediately notify the broker-dealer's chief financial officer of the nature of the material weakness. The broker-dealer must then provide notice in accordance with Rule 17a-11 – the Early Warning Rule – and provide a copy of the notification to the independent public accountant. See the response to Question 30.2 above for a description of the Early Warning Rule.

In 2013, the SEC amended certain reporting, audit, and notification requirements for broker-dealers registered with the SEC.<sup>987</sup> The SEC also adopted amendments that require a broker-dealer that clears transactions or carries customer accounts to agree to allow representatives of the SEC or the broker-dealer's DEA to review the documentation associated with certain reports of the broker-dealer's independent public accountant and to allow the accountant to discuss its findings with the representatives if requested to do so in writing for purposes of an examination of the broker-dealer.<sup>988</sup> Finally, the SEC adopted a new form – Form Custody – that a broker-dealer must file with its DEA that elicits information about the broker-dealer's practices with respect to the custody of securities and funds of customers and non-customers.<sup>989</sup>

8. Does the regulator:

(a) Regularly review market intermediaries' capital levels?

Yes. An SRO inspects a broker-dealer member periodically, depending on the types of business the broker-dealer engages in and the perceived relative risk of those types of business. For instance, SROs inspect broker-dealers that hold customer funds and securities once each year. Other broker-dealers are also subject to onsite examinations by SROs, although they may be examined less frequently. In addition, the SRO reviews a broker-dealer's capital levels when periodic reports are filed.

<sup>987</sup> See Exchange Act Release No. 70073 (July 30, 2013) 78 Fed. Reg. 51910 (Aug. 21, 2013). Among other things, under the amendments, broker-dealers must file one of two new reports with the SEC annually – either a compliance report if the broker-dealer did not claim it was exempt from Rule 15c3-3 throughout the broker-dealer's fiscal year or an exemption report if the broker-dealer did claim it was exempt from Rule 15c3-3 throughout the fiscal year. The amendments also include a requirement that broker-dealer audits be conducted in accordance with standards of the PCAOB in light of explicit oversight authority provided to the PCAOB by the Dodd-Frank Act to oversee these audits. Additionally, the amendments generally provide new notice requirements for independent public accountants and broker-dealers. The amendments also require broker-dealers that are members of SIPC to file their annual reports with SIPC.

<sup>988</sup> See Exchange Act Release No. 70073 (July 30, 2013) 78 Fed. Reg. 51910 (Aug. 21, 2013).

<sup>989</sup> See Exchange Act Release No. 70073 (July 30, 2013) 78 Fed. Reg. 51910 (Aug. 21, 2013).

The SEC may examine a broker-dealer on a routine or cyclical basis based upon some specific perceived risk, or as part of a risk-targeted sweep examination where the SEC may examine a group of broker-dealers focusing on one specific area.

(b) Take appropriate action when these reviews indicate material deficiencies?

Yes, as stated in response to Question 30.2, pursuant to the Early Warning Rule, a broker-dealer must promptly notify the SEC, its DEA, and, under certain circumstances, the CFTC if its net capital falls below a specific threshold amount. See Question 30.9, which explains the actions regulators can take if the reviews indicate material deficiencies. In addition to the notices received under the Early Warning Rule, the SEC and the SROs may also discover material deficiencies during exams or through other means and make take appropriate action as a result of these deficiencies.

9. Does the regulator:

(a) Have specific authority to impose restrictions on an intermediary's regulated business activities and more stringent capital monitoring and/or reporting requirements if an intermediary's capital deteriorates so as to endanger its capacity to fulfil its obligations or when it falls below minimum requirements?

Yes. The Exchange Act and the regulations promulgated thereunder prohibit a broker-dealer from continuing to do a securities business if the firm does not have sufficient net capital.<sup>990</sup> Further, a broker-dealer is restricted from withdrawing capital if certain parameters have been broken.<sup>991</sup> The SROs also have rules that restrict the activities of a broker-dealer in financial difficulty.<sup>992</sup> The SROs have rules that allow the SRO to direct the intermediary to take specific corrective or prophylactic actions, such as reducing their business, imposing higher capital requirements, or requiring the firm to suspend operations.<sup>993</sup> The SEC may also petition the court to place a freeze on the broker-dealer's assets.

(b) Is there evidence that the regulator exercises this authority?

Yes, the SEC and the SROs regularly exercise this authority.

<sup>990</sup> 15 U.S.C. 78o(c)(3) and 17 C.F.R. 240.15c3-1.

<sup>991</sup> 17 C.F.R. 240.15c3-1(e)(2).

<sup>992</sup> See, e.g., FINRA Rule 4120.

<sup>993</sup> Id.

10. Does the prudential framework address risks from outside the regulated entity, for example from unlicensed affiliates and off-balance sheet affiliates?

Yes, the prudential framework addresses risks from outside the regulated entity. The Net Capital Rule requires that a broker-dealer consolidate in a single computation, for purposes of calculating net capital and aggregate indebtedness, the assets and liabilities of any subsidiary or affiliate for which it guarantees, endorses, or assumes directly or indirectly the obligations or liabilities.<sup>994</sup> Under certain circumstances a broker-dealer may be allowed to consolidate the assets and liabilities of any subsidiary or affiliate whose liabilities or obligations it does not guarantee, endorse, or assume. In addition, a broker-dealer must take a capital charge to the extent of any obligations it has assumed with respect to its affiliates.

In addition, Exchange Act Section 17(h) authorizes the SEC to prescribe recordkeeping and reporting requirements for registered broker-dealers, including municipal securities and government securities broker-dealers, concerning policies, procedures, or systems for monitoring and controlling financial and operational risks to the broker-dealer resulting from affiliate activities. These requirements must relate to associated persons of the broker-dealer whose “business activities are reasonably likely to have a material impact on the financial and operational condition” of the broker-dealer, including the broker-dealer’s “net capital, its liquidity, or its ability to finance its operations.” Further, the records must concern the broker-dealer’s “policies, procedures, or systems for monitoring and controlling financial and operational risks to it resulting from the activities” of its material associated persons and should “describe, in the aggregate, each of the financial and securities activities conducted by, and the customary sources of capital and funding” of “associated persons whose business activities are reasonably likely to have a material impact” on the broker-dealer.

Accordingly, Rule 17h-1T sets forth the specific recordkeeping requirements applicable to broker-dealers and provides guidelines to be used in establishing which of the broker-dealer’s affiliates are “material” for purposes of the rules, *i.e.*, whose information is subject to these recordkeeping and reporting requirements. Material associated persons can be licensed or unlicensed. Included in these requirements are risk management policy information, financial data (including consolidating and consolidated financial statements, securities and other financial product position data), and financial instruments with off-balance sheet risk, among other things. Current Rule 17h-2T requires broker-dealers to file quarterly reports concerning these records on Form 17-H. These rules are referred to as the “Risk Assessment Rules.”

The SEC’s Risk Assessment Program is an important source of information for the Staff when concerns arise regarding the financial condition of a broker-dealer, its holding company, or its affiliates. While the Risk Assessment Rules are labeled “Final Temporary Risk Assessment Rules,” they are enforceable on the same terms as final rules adopted by the SEC, and thus, their

<sup>994</sup>

17 C.F.R. 240.15c3-1c.

temporary nature does not affect their enforceability. These rules were both proposed for comment and subsequently adopted as final temporary rules by the SEC. Since 2009, there have been significant enhancements to the staff and resources devoted to the Risk Assessment Program.

Separately, ANC Broker-Dealers must file with the SEC the consolidated and consolidating financial statements for the ANC Broker-Dealer's ultimate holding company (UHC), the UHC's most recent capital measurements computed in accordance with Basel standards, as reported to the UHC's principal regulator; and certain regular risk reports provided to the persons responsible for managing group-wide risk as the SEC may request from time to time.

**Principle 31**     **Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters.**

### Key Questions

#### *Management and Supervision*

1. With regards to an intermediary's internal organization, does the regulatory framework require the following to be considered:
  - (a) An appropriate management and organization structure, including in relation to activities that have been outsourced?
  - (b) Adequate internal controls?
  - (c) Management that is required to bear primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the whole firm?

### Broker-Dealers

Yes. As described in the response to Principle 30 above, and in more detail below, the broker-dealer financial responsibility rules (Net Capital Rule, Customer Protection Rule, Hypothecation Rules, etc.) have existed for many years and have facilitated the prudent operation of broker-dealers. The minimum financial and customer protection requirements – like other financial tests that market participants use in the ordinary course of business to manage risk or to comply with applicable regulations – incorporate many specific numerical thresholds, limits, deductions, and ratios. These rules act as a set of internal controls for a broker-dealer in the conduct and operation of its business by incentivizing a broker-dealer generally to confine its activities to securities activities, as well as by requiring a separation of the broker-dealer's proprietary activities from those of its customers. Some of these rules, including SRO rules, specifically address the outsourcing of certain functions by a broker-dealer.<sup>995</sup>

For example, as stated in the responses to Principle 30, the Net Capital Rule is a net liquid assets test. This standard is designed to promote liquidity; the rule allows a broker-dealer to engage in activities that are part of conducting a securities business (e.g., taking securities into inventory) but in a manner that places the firm in the position of holding at all times more than one dollar

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See, e.g., FINRA Rule 4311 (Carrying Agreements); Outsourcing; Members' Responsibilities When Outsourcing Activities to Third-Party Service Providers (NASD Notice to Members 05-48, July 2005); A Member's Responsibilities Regarding the Outsourcing of Certain Activities (FINRA, August 15, 2006). See also, e.g., Exchange Act Rule 17a-4(i), 17 C.F.R. 240.17a-4(i) (requirements for broker-dealer records kept by a third party storage provider which states "[a]greement with an outside entity shall not relieve such member, broker or dealer from the responsibility to prepare and maintain records as specified in this section or in §240.17a-3.").

of highly liquid assets for each dollar of unsubordinated liabilities (*e.g.*, money owed to customers, counterparties, and creditors). The requirements of the Net Capital Rule incentivize broker-dealers to confine their business activities and devote capital to activities such as underwriting, market making, and advising on and facilitating customer securities transactions. These limits act as an internal control on the operations of a broker-dealer to facilitate its prudent operation.

In addition, the Customer Protection Rule is another rule adopted in 1972 in response to a congressional directive to strengthen the financial responsibility requirements for broker-dealers that hold securities and cash for customers. The Customer Protection Rule functions as an internal control rule to place limits on a broker-dealer's use of customer funds and securities. In particular, the Customer Protection Rule is designed to give more specific protection to customer funds and securities, in effect forbidding brokers and dealers from using customer assets to finance any part of their businesses unrelated to servicing securities customers, *e.g.*, a firm is virtually precluded from using customer funds to buy securities for its own account.

The broker-dealer financial responsibility rules are described in further detail below.

Pursuant to Exchange Act Section 15(c)(3)(A), "No broker or dealer ... shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security ... in contravention of such rules and regulations as the SEC shall prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers including, but not limited to, the acceptance of custody and use of customers' securities and the carrying and use of customers' deposits and credit balances. Such rules and regulations shall ... require the maintenance of reserves with respect to customers' deposits or credit balances...."

Pursuant to Exchange Act Section 17(a), "[e]very ... registered broker or dealer ... shall make and keep for prescribed periods such records, furnish copies thereof, and make and disseminate such reports as the SEC, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors...."<sup>996</sup>

In accordance with these paragraphs, the SEC promulgated a number of rules including the Net Capital Rule, the Early Warning Rule, the Customer Protection Rule,<sup>997</sup> the Hypothecation Rules,<sup>998</sup> the Books and Records Rules,<sup>999</sup> the broker-dealer reporting requirements,<sup>1000</sup> and the

<sup>996</sup> 15 U.S.C. 78q(a).

<sup>997</sup> 17 C.F.R. 240.15c3-3.

<sup>998</sup> 17 C.F.R. 240.8c-1 and 15c2-1.

<sup>999</sup> 17 C.F.R. 240.17a-3 and 17a-4.



Quarterly Count Rule.<sup>1001</sup> Each of these rules is designed to ensure a broker-dealer has appropriate controls in place to protect the interests of their clients and to properly manage risk.

The SEC's Net Capital Rule is discussed more fully above in response to Principle 30. The SEC's Early Warning Rule is discussed more fully above in response to Questions 30.6 and 30.8.

The SEC's Customer Protection Rule requires that every broker-dealer obtain and maintain possession and control of customer securities,<sup>1002</sup> and maintain a separate customer reserve account that contains (at least) the net dollar amount of cash the broker-dealer owes to its customers. The SEC's Hypothecation Rules require that a broker-dealer segregate customer securities from its own proprietary securities, and prohibit a broker-dealer from hypothecating customers' fully paid securities.

The SEC's Books and Records Rules – Rules 17a-3 and 17a-4 – require that a broker-dealer create and maintain certain books and records relating to its business. In addition, Rule 17a-3 requires certain large broker-dealers to document their credit, market, and liquidity risk management controls.

Rule 17a-5 has two main elements: (i) a requirement that broker-dealers file periodic unaudited reports containing information about their financial and operational condition on a FOCUS Report; and (ii) a requirement that broker-dealers annually file financial statements and certain reports and a report covering the financial statements and reports prepared by an independent public accountant registered with the PCAOB in accordance with PCAOB standards. The reporting program established under Rule 17a-5 is designed, among other things, to promote compliance with Rules 15c3-1 and 15c3-3 and to assist the SEC, SROs, and state securities regulators in conducting effective examinations of broker-dealers.

More specifically, under Rule 17a-5, broker-dealers must prepare and file with the SEC annual reports consisting of a financial report and either a compliance report or an exemption report that are prepared by the broker-dealer, as well as certain reports that are prepared by the independent public accountant covering the financial report and the compliance report or the exemption report (collectively, the "annual reports"). A broker-dealer must prepare and file a compliance report if the firm did not claim it was exempt from Exchange Act Rule 15c3-3 throughout the most recent fiscal year. A broker-dealer must prepare and file an exemption report if the firm did claim that it was exempt from Rule 15c3-3 throughout the most recent fiscal year.

<sup>1000</sup> 17 C.F.R. 240.17a-5.

<sup>1001</sup> 17 C.F.R. 240.17a-13.

<sup>1002</sup> Customer securities must be specifically identified and held free and clear of any liens.

The compliance report must contain statements regarding the broker-dealer's compliance with Exchange Act Rules 15c3-1 and 15c3-3(e) and the broker-dealer's internal control over compliance with Rules 15c3-1 (Net Capital Rule), 15c3-3 (Customer Protection Rule), Rule 17a-13 (Quarterly Count Rule), and applicable DEA rules that require broker-dealers to send account statements to customers (collectively, the "financial responsibility rules"). The compliance report must also contain descriptions of each material weakness in the broker-dealer's internal control over compliance and any instances of non-compliance with Rules 15c3-1 and 15c3-3(e). The exemption report must contain statements regarding the broker-dealer's claimed exemptions from Rule 15c3-3. These statements must be made to the broker-dealer's best knowledge and belief, identify and describe any exceptions to the claimed exemptions, and briefly describe the nature of each exception and the approximate dates on which the exceptions occurred.

The SEC's Quarterly Count Rule requires that broker-dealers count positions owed to customers and securities on hand and reconcile those two numbers on a quarterly basis.

In addition, certain regulatory requirements (including the Net Capital and Customer Protection Rules, as well as the Federal Reserve's Regulation T requirements) compel firms to take certain risk-reducing steps. For instance, the Net Capital Rule requires that a firm subtract a "haircut" when calculating net capital to account for the market risk of their proprietary positions. Further, Regulation T serves to reduce a broker-dealer's exposure to credit risk by limiting the amount of margin it may extend to customers on securities. The Customer Protection Rule, in requiring that a broker-dealer promptly obtain customer securities, serves to decrease the firm's exposure to market risk.

The SEC's Risk Assessment rules require that certain broker-dealers that hold customer assets maintain books and records regarding certain affiliated persons and entities. In addition, these rules require that those broker-dealers submit quarterly and annual reports concerning these affiliated persons and entities.

These financial responsibility and reporting rules set forth specific requirements with which a broker-dealer must comply. For instance, a broker-dealer is required to be in capital compliance at all times, and is required to reconcile all securities positions at least once daily. While these rules are fairly specific, the SEC allows broker-dealers flexibility as to how they will comply with those rules. So long as a broker-dealer's risk management procedures and internal controls facilitate a broker-dealer's compliance with the rules, they are considered to be adequate.

In addition, OTC derivatives dealers and ANC Broker-Dealers are required to establish, document, and maintain a system of internal risk management controls to manage the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks.<sup>1003</sup> The internal risk control system must include certain elements, including a risk control unit that

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17 C.F.R. 240.15c3-4.

reports directly to senior management, periodic and annual reviews of the risk management system, and separation of duties for personnel responsible for entering into a transaction and personnel responsible for recording the transaction in the books and records.<sup>1004</sup>

Pursuant to SRO rules, each broker-dealer must implement a supervisory system reasonably designed to achieve compliance with applicable securities laws, regulations and rules. The SROs generally specify that the supervisory system should include designation of one or more persons responsible for reviewing the supervisory system implemented by the member and either take (or advise senior management to take) action to achieve the member's compliance with applicable securities laws and regulations and the SRO's rules or report to management regarding the efforts taken.

SROs also require broker-dealers to appoint a CCO.<sup>1005</sup> SRO rules further require chief executive officers to certify annually that the broker-dealer has in place policies and procedures to establish, review, and modify compliance procedures. The CCO must meet with the compliance officer at least once annually to discuss the compliance processes.

### **Investment Advisers**

An investment adviser is required to disclose information regarding its management and organizational structure on its Form ADV.

Regarding adequate internal controls, see responses to Question 29.2(d) and (e), generally, and the discussion of codes of ethics, particularly. Regarding books and records and custody, see responses to Questions 31.13 and 29.7(b), respectively.

Regarding management bearing responsibility, see response to Question 29.2(e). Rule 206(4)-7 under the Advisers Act requires an investment adviser to adopt and implement written CP&P reasonably designed to prevent the violation of the Advisers Act by the investment adviser or any of its supervised persons. Advisers also have a duty to manage conflicts of interests and certain risks, as discussed more fully in response to Question 8.2. The Rule also requires advisers to

<sup>1004</sup> The SEC has recently proposed certain recordkeeping and reporting rules for SBSDs that are generally based on the corresponding broker-dealer rules. Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers, Exchange Act Release No. 71958 (Apr. 17, 2014), 79 Fed. Reg. 25194 (May 2, 2014). In addition, the SEC has proposed certain rules applicable to supervision and CCOs for security based swap dealers and major security based swap participants. See Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, Exchange Act Release No. 64766 (June 29, 2011), 76 Fed. Reg. 42396 (July 18, 2011). Finally, the SEC has proposed capital, margin and segregation requirements for SBSDs that are generally based on broker-dealer financial responsibility rules and SRO margin rules. See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers. Exchange Act Release No. 68071 (Oct. 18, 2012), 77 Fed. Reg. 70214 (Nov. 23, 2012).

<sup>1005</sup> See FINRA Rule 3130.

designate a single CCO to administer the CP&P. In addition, all supervisors, including senior management, are subject to liability for failure to supervise. Section 203(e)(6) of the Advisers Act provides that a person shall not be deemed to have failed to supervise any person if: (i) the adviser had adopted procedures reasonably designed to prevent and detect violations of the federal securities laws; (ii) the adviser had a system in place for applying the procedures; and (iii) the person had reasonably discharged his or her supervisory responsibilities in accordance with the procedures and had no reason to believe the supervised person was not complying with the procedures.

None of these obligations, or any other requirements under the Advisers Act or rules, are reduced if the adviser outsources activities, such as if the adviser were to engage a vendor for compliance or recordkeeping services. Of course, if an adviser were to engage the services of another SEC-registered adviser, that firm would similarly be subject to the Advisers Act and rules.

2. Does the regulatory framework require market intermediaries to provide all relevant information about the business in a timely, readily accessible way and to regularly report to management? Is such information subject to procedures intended to maintain its security, availability, reliability and integrity?

### **Broker-Dealers**

Yes. As stated above in response to Question 31.1, the SEC has promulgated certain rules designed to ensure that broker-dealers implement internal controls to manage risk. In addition, the Exchange Act requires that a broker-dealer have supervisory procedures in place and a system for applying such procedures. To the extent that segregation of duties and functions is necessary to comply with securities laws, regulations and rules, a broker-dealer's procedures and systems must provide for such segregation of duties and functions. Every broker-dealer is required to periodically inspect all aspects of its business, and must be audited annually by an independent public accountant. In addition, broker-dealers are subject to regulatory examinations by the SEC, the SROs and by state inspectors.

In addition, the management of ANC Broker-Dealers and OTC derivatives dealers subject to Rule 15c3-4 are required to periodically review, in accordance with written procedures, the business activities of the ANC Broker-Dealer or the OTC derivatives dealer for consistency with risk management guidelines.

Further, Rules 17a-3 and 17a-4 specify requirements with respect to the records that a broker-dealer must make and keep current, as well as how long and, the manner in which, these records and other records relating to a broker-dealer's business must be maintained and preserved. The recordkeeping program codified in Rules 17a-3 and 17a-4 is designed, among other things, to promote the prudent operation of broker-dealers and assist the SEC, SROs, and state securities regulators in conducting effective examinations of broker-dealers. Rule 17a-3 requires a broker-dealer to make and keep current certain records. Implicit in the rule is that these required

records be accurate. Rule 17a-4 prescribes the time period that a broker-dealer must preserve records required to be preserved under Rule 17a-3, as well as other records, and generally requires records to be preserved for the first two years in an “easily accessible place.” Further, Rule 17a-4(j) requires broker-dealer to furnish *promptly* to a representative of the SEC legible, true, complete, and current copies of those records of the broker-dealer that are required to be preserved, or any other records of the broker-dealer subject to examination under Section 17(b) of the Exchange Act that are requested by the representative of the SEC. For additional information about the requirement to provide books and records, please see the response to Questions 10.1(a) and 10.4.

In addition, according to SRO rules, internal examinations of certain aspects of the firm’s business must be performed at least once each year.<sup>1006</sup> Pursuant to SRO rules, information regarding internal inspections must be presented to senior management.<sup>1007</sup> The internal inspections may be reported to the firm’s management, but are not required to be reported to outside agencies. However, the firm must be able to evidence to regulators that such internal inspection was performed.

The SEC, SROs, and state regulatory agencies are not required to report the results of examinations to any party, however they generally inform the broker-dealer itself of any examination deficiencies so the broker-dealer can amend its policies to avoid similar future deficiencies.

Accordingly, the broker-dealer regulatory framework requires broker-dealers to provide all relevant information about the business in a timely, readily accessible way, and to regularly report to management. Such information is subject to procedures intended to maintain its security, availability, reliability, and integrity under the broker-dealer books and records rules, SEC and SRO rules.<sup>1008</sup>

### **Investment Advisers**

Regarding disclosure of relevant information about an investment adviser’s business to the SEC

<sup>1006</sup> See, e.g., NASD Rule 3010(c). The SROs have many rules relating to the internal organization and operational conduct of broker-dealers. These rules are referenced throughout this principle. We also note that the NASD and NYSE have merged into FINRA and are in the process of combining their rules into one rulebook. Until the completion of the rulebook consolidation process, the FINRA rulebook includes NASD Rules and Incorporated NYSE Rules in addition to the new consolidated FINRA Rules. NASD, NYSE, and FINRA Rules are referenced throughout this document.

<sup>1007</sup> See, e.g., FINRA Rule 3130.

<sup>1008</sup> The SEC has recently proposed certain recordkeeping and reporting rules for SBSs that are generally based on the corresponding broker-dealer rules. Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers, Exchange Act Release No. 71958 (Apr. 17, 2014), 79 Fed. Reg. 25194 (May 2, 2014).

and to clients in a timely, readily accessible way, see discussions of Form ADV provided in response to Questions 29.2(a), 29.5, and 29.7(c).

Advisers Act Rule 204-2 requires investment advisers to make and keep a variety of records. Generally, all required books and records must be maintained and preserved in an adviser's office for two years after the last entry date and three additional years in an easily accessible place. See response to Question 31.13. Section 204 of the Advisers Act provides that all records of an investment adviser are subject at any time, or from time to time, to such reasonable periodic, special, or other examinations by representatives of the SEC as the SEC deems necessary or appropriate in the public interest or for the protection of investors. For additional information about the requirement to provide books and records, please see the response to Questions 10.1(a) and 10.4.

As to the availability, reliability, and integrity of an adviser's records, see responses to Questions 29.2(d) and (e) with regard to an adviser's CP&P generally. Also as noted above, Rule 206(4)-7 under the Advisers Act requires an investment adviser to designate a single CCO to administer the CP&P.

Finally, see response to Question 31.6 regarding Advisers Act Section 204A and Regulation S-P for additional information about investment advisers' obligations to maintain the security of certain confidential information.

3. Does the regulatory framework require a market intermediary to be subject to an objective, periodic evaluation of its internal controls and risk management processes?

### **Broker-Dealers**

Yes. The SEC's Books and Records Rules – Rules 17a-3 and 17a-4 – require that a broker-dealer create and maintain certain books and records relating to its business. In addition, Rule 17a-3 requires certain large broker-dealers to document their credit, market, and liquidity risk management controls.

Rule 17a-5 has two main elements: (i) a requirement that broker-dealers file periodic unaudited reports containing information about their financial and operational condition on a FOCUS Report; and (ii) a requirement that broker-dealers annually file financial statements and certain reports and a report covering the financial statements and reports prepared by an independent public accountant registered with the PCAOB in accordance with PCAOB standards. The reporting program established under Rule 17a-5 is designed, among other things, to promote compliance with Rules 15c3-1 and 15c3-3 and to assist the SEC, SROs, and state securities regulators in conducting effective examinations of broker-dealers.

More specifically, under Rule 17a-5, broker-dealers must prepare and file with the SEC annual reports consisting of a financial report and either a compliance report or an exemption report

that are prepared by the broker-dealer, as well as certain reports that are prepared by the independent public accountant covering the financial report and the compliance report or the exemption report (collectively, the “annual reports”). A broker-dealer must prepare and file a compliance report if the firm did not claim it was exempt from Exchange Act Rule 15c3-3 throughout the most recent fiscal year. A broker-dealer must prepare and file an exemption report if the firm did claim that it was exempt from Rule 15c3-3 throughout the most recent fiscal year.

The compliance report must contain statements regarding the broker-dealer’s compliance with Exchange Act Rules 15c3-1 and 15c3-3(e) and the broker-dealer’s internal control over compliance with Rules 15c3-1, 15c3-3, Rule 17a-13, and applicable DEA rules that require broker-dealers to send account statements to customers (collectively, the “financial responsibility rules”). The compliance report must also contain descriptions of each material weakness in the broker-dealer’s internal control over compliance and any instances of non-compliance with Rules 15c3-1 and 15c3-3(e). The exemption report must contain statements regarding the broker-dealer’s claimed exemptions from Rule 15c3-3. These statements must be made to the broker-dealer’s best knowledge and belief, identify and describe any exceptions to the claimed exemptions, and briefly describe the nature of each exception and the approximate dates on which the exceptions occurred.

Section 17(b) of the Exchange Act authorizes representatives of the SEC to conduct “reasonable, periodic, special or other exams” of “[a]ll records” of a broker-dealer. These examinations may be conducted at any time or from time to time as the SEC “deems necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the [Exchange Act.]” Staff examines broker-dealers using a risk-based approach and has a large firm monitoring program that monitors certain large broker-dealers.

In addition to SEC examinations, broker-dealers are subject to examinations by SROs, which are also subject to SEC oversight and examination. The SEC coordinates with the SROs and evaluates the SROs coverage of broker-dealers, including whether the SROs have appropriately fulfilled their oversight and examination obligations. SROs, as regulators, are primarily responsible for establishing standards under which their members conduct business and have front line responsibility for overseeing broker-dealers for compliance with federal securities laws as well as SRO rules. More detailed information about SEC and SRO examinations and OCIE’s large firm monitoring program can be found in the response to Question 12.1. Additionally, as discussed in Principle 12, beginning in 2012, the NEP increased its focus on engagement with senior management and boards of large entities registered with the SEC including their affiliates, where appropriate, to discuss how each firm identifies and mitigates conflicts of interest and legal,



compliance, financial, and operational risks. See item 5 in the Introduction to Principle 12 and the thematic review section of 12.1(b) for more information.<sup>1009</sup>

### Investment Advisers

See responses to Questions 29.2(e) and 31.1(c). While an investment adviser's CCO is not required to be independent of the investment adviser, the SEC has made clear that the CCO must have enough seniority and authority within the investment adviser's organization to conduct an independent compliance review and compel others to comply with the CP&P.<sup>1010</sup>

As discussed in response to Question 29.7(b), generally, if an adviser has custody of Client Assets, an independent public accountant must verify all of those Client Assets by actual examination at least once during each calendar year at a time that is chosen by the accountant without prior notice or announcement to the adviser and that is irregular from year to year. That accountant must file a certificate on Form ADV-E with the SEC within 120 days of the as-of date chosen by the accountant, stating that it has examined the Client Assets and describing the nature and extent of the examination.<sup>1011</sup> If the independent public accountant finds any material discrepancies during the course of such examination, the accountant must notify the SEC within one business day of the finding.<sup>1012</sup> Upon the independent public accountant's resignation or dismissal from, or other termination of, the engagement, or upon removing itself or being removed from consideration for being reappointed, the accountant must file Form ADV-E within four business days, accompanied by a statement that includes the date the engagement terminated, an explanation of problems relating to examination scope or procedure that contributed to the termination, and the accountant's contact information.<sup>1013</sup> Additionally, if the adviser or its related person<sup>1014</sup> act as qualified custodian in connection with the adviser's advisory services, the adviser must: (i) have an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB perform the required annual surprise independent verification, unless the related person is "operationally independent" of the adviser;<sup>1015</sup> and (ii) obtain, or receive from the related person, an annual report of the internal

<sup>1009</sup> The SEC has recently proposed certain recordkeeping and reporting rules for SBSDs that are generally based on the corresponding broker-dealer rules. Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers, Exchange Act Release No. 71958 (Apr. 17, 2014), 79 Fed. Reg. 25194 (May 2, 2014).

<sup>1010</sup> Advisers Act Rel. No. 2204 (Dec. 17, 2003).

<sup>1011</sup> Advisers Act Rule 206(4)-2(a)(4)(i).

<sup>1012</sup> Advisers Act Rule 206(4)-2(a)(4)(ii).

<sup>1013</sup> Advisers Act Rule 206(4)-2(a)(4)(iii).

<sup>1014</sup> A "related person" includes any person, directly or indirectly, controlling, controlled by, or under common control with the adviser. See Advisers Act Rule 206(4)-2(d)(7).

<sup>1015</sup> The surprise independent verification is not required if the adviser can demonstrate that the related person qualified custodian is "operationally independent." A related person is presumed not to be operationally independent unless each of the following conditions is met and no other circumstances can reasonably be expected

(continued)



controls relating to the custody of client assets prepared by an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB.<sup>1016</sup>

See also response to Question 31.4.

Pursuant to examination authority under Section 204 of the Advisers Act, OCIE assesses the appropriateness of compliance programs and risk management processes relative to business operations to identify potential weaknesses that raise investor protection concerns. See Question 12.1 for more information on OCIE examinations and the thematic review section of Question 12.1(b) for specific information about the thematic review of investment advisers related to Compliance, Supervision, and Risk Management. Additionally, as discussed in Principle 12, beginning in 2012, the NEP increased its focus on engagement with senior management and boards of large entities registered with the SEC including their affiliates, where appropriate, to discuss how each firm identifies and mitigates conflicts of interest and legal, compliance, financial, and operational risks. See item 5 in the Introduction to Principle 12 and the thematic review section of 12.1(b) for more information.

#### *Organizational requirements*

4. Does the regulatory framework include the assessment of an intermediary's compliance function, taking into account the intermediary's size and business? When the regulator becomes aware of deficiencies are steps taken to require market intermediaries to improve their compliance function?

#### **Broker-Dealers**

Yes. OCIE examiners may review the compliance function during examinations of broker-dealers. When OCIE examiners become aware of deficiencies, they may issue a deficiency letter to the entity describing such deficiencies, request that the entity respond detailing corrective actions taken, and when appropriate, refer the matter to Enforcement for further investigation and potential action. See Principle 12.1 for more information about examinations.

Under Rule 17a-5, broker-dealers must prepare and file with the SEC annual reports consisting of a financial report and either a compliance report or an exemption report that are prepared by the broker-dealer, as well as certain reports that are prepared by the independent public accountant

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to compromise the operational independence of the related person: (i) client assets in the custody of the related person are not subject to claims of the adviser's creditors; (ii) advisory personnel do not have custody or possession of, or direct or indirect access to client assets of which the related person has custody, or the power to control the disposition of such client assets to third parties for the benefit of the adviser or its related persons, or otherwise have the opportunity to misappropriate such client assets; (iii) advisory personnel and personnel of the related person who have access to advisory client assets are not under common supervision; and (iv) advisory personnel do not hold any position with the related person or share premises with the related person. See Advisers Act Rule 206(4)-2(d)(5).

<sup>1016</sup>

See Advisers Act Rule 206(4)-2(a)(6).

covering the financial report and the compliance report or the exemption report (collectively, the “annual reports”). A broker-dealer must prepare and file a compliance report if the firm did not claim it was exempt from Exchange Act Rule 15c3-3 throughout the most recent fiscal year. A broker-dealer must prepare and file an exemption report if the firm did claim that it was exempt from Rule 15c3-3 throughout the most recent fiscal year.

The compliance report must contain statements regarding the broker-dealer’s compliance with Exchange Act Rules 15c3-1 and 15c3-3(e) and the broker-dealer’s internal control over compliance with Rules 15c3-1, 15c3-3, Rule 17a-13, and applicable DEA rules that require broker-dealers to send account statements to customers (collectively, the “financial responsibility rules”). The compliance report must also contain descriptions of each material weakness in the broker-dealer’s internal control over compliance and any instances of non-compliance with Rules 15c3-1 and 15c3-3(e). The exemption report must contain statements regarding the broker-dealer’s claimed exemptions from Rule 15c3-3. These statements must be made to the broker-dealer’s best knowledge and belief, identify and describe any exceptions to the claimed exemptions, and briefly describe the nature of each exception and the approximate dates on which the exceptions occurred. Therefore, the requirements of Rule 17a-5 take into account the broker-dealer’s size and business.

Rule 17a-11(e) requires whenever any broker-dealer discovers, or is notified by an independent public accountant under Rule 17a-12(i)(2) of the existence of any material inadequacy as defined in Rule 17a-12(h)(2), or whenever any broker-dealer discovers, or is notified by an independent public accountant under Rule 17a-5(h), of the existence of any material weakness as defined Rule 17a-5(d)(3)(iii), the broker-or dealer must: (i) give notice of the material inadequacy or material weakness within 24 hours of the discovery or notification of the material inadequacy or the material weakness; and (ii) transmit a report within 48 hours of the notice stating what the broker-dealer has done or is doing to correct the situation.

If a broker-dealer files a notice under Rule 17a-11, as stated above, the broker-dealer must include statements as to what the firm has done to correct the situation.

See also the discussion of SEC and SRO examinations in the response to Question 12.1. Additionally, as discussed in Principle 12, beginning in 2012, the NEP increased its focus on engagement with senior management and boards of large entities registered with the SEC including their affiliates, where appropriate, to discuss how each firm identifies and mitigates conflicts of interest and legal, compliance, financial, and operational risks. See item 5 in the Introduction to Principle 12 and the thematic review section of 12.1(b) for more information.

In addition, under its examination functions, the SEC and SROs have the ability to examine or review whether a broker-dealer has taken steps to correct a self-reported deficiency or otherwise.<sup>1017</sup>

### Investment Advisers

As stated above, OCIE assesses the appropriateness of compliance programs and risk management processes relative to business operations to identify potential weaknesses that raise investor protection concerns. When OCIE examiners become aware of deficiencies, they may issue a deficiency letter to the entity describing such deficiencies, request that the entity respond detailing corrective actions taken, and when appropriate, refer the matter to Enforcement for further investigation and potential action. See Principle 12.1 for more information about OCIE examinations and the thematic review section of 12.1(b) for specific information about the thematic review of investment advisers related to Compliance, Supervision, and Risk Management.

5. Does the regulatory framework require a market intermediary to establish and maintain appropriate systems of client protection, risk management and internal and operational controls, including policies, procedures, and controls relating to all aspects of its day-to-day business intended reasonably to ensure:

(a) The integrity of the firm's dealing practices, including the treatment of all clients in a fair, honest and professional manner?

(b) Appropriate segregation of key duties and functions, particularly those duties and functions which, when performed by the same individual, may result in undetected errors or may be susceptible to abuses which expose the firm or its clients to inappropriate risks?

### Broker-Dealers

Yes. Broker-dealers are subject to a comprehensive set of statutory, SEC, and SRO requirements that are designed to promote business conduct that, among other things, protects investors from abusive practices, including practices that are not necessarily fraudulent. These business conduct obligations cannot be waived or contracted away by customers.

Broker-dealers have a duty of fair dealing towards their customers that is derived from the anti-fraud provisions of the federal securities laws.<sup>1018</sup> Under the so-called "shingle" theory, by virtue

<sup>1017</sup> The SEC has recently proposed certain recordkeeping and reporting rules for SBSs that are generally based on the corresponding broker-dealer rules. Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers, Exchange Act Release No. 71958 (Apr. 17, 2014), 79 Fed. Reg. 25194 (May 2, 2014).

of engaging in the brokerage profession, a broker-dealer impliedly represents to those persons with whom it transacts business that it will deal fairly with them, consistent with the standards of the profession.<sup>1019</sup> This essential representation implies certain duties and proscribes certain conduct, which has been articulated over time.<sup>1020</sup>

Broker-dealers are also required under SRO rules to deal fairly with customers and to “observe high standards of commercial honor and just and equitable principles of trade.”<sup>1021</sup> FINRA Rule 2111 requires a broker-dealer to “have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer’s investment profile.” SRO rules also impose a duty of best execution on broker-dealers.<sup>1022</sup> Other obligations imposed on broker-dealers include engaging in fair and balanced communications with the public;<sup>1023</sup> providing timely and adequate confirmation of transactions;<sup>1024</sup> disclosing conflicts of interest; receiving fair compensation both in agency and principal transactions;<sup>1025</sup> and giving customers the opportunity for redress of disputes through arbitration.

<sup>1018</sup> See *In the Matters of Richard N. Cea, et al.*, Exchange Act Release No. 8662 at 18 (Aug. 6, 1969) (involving excessive trading and recommendations of speculative securities without a reasonable basis); *In the Matter of Mac Robbins & Co. Inc.*, Exchange Act Release No. 6846 (Jul. 11, 1962).

<sup>1019</sup> *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944) (although not expressly referencing the “shingle theory,” held that broker-dealer was under a “special duty, in view of its expert knowledge and proffered advice, not to take advantage of its customers’ ignorance of market conditions” and that failure to disclose substantial mark-ups on OTC securities sold to unsophisticated customers thus constituted fraud).

<sup>1020</sup> See *generally* *Guide to Broker-Dealer Registration*, (April 2008), available at <http://www.sec.gov/divisions/marketreg/bdguide.html>.

<sup>1021</sup> See FINRA Rule 2010 (Standards of Commercial and Principles of Trade).

<sup>1022</sup> See FINRA Rule 5310 (Best Execution and Rule 5310(a) requires a member firm, in any transaction for or with a customer or a customer of another broker-dealer, to use “reasonable diligence” to ascertain the best market for a security and to buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.

<sup>1023</sup> Broker-dealers must ensure that their communications with the public are not misleading under the anti-fraud provisions of the federal securities laws. In addition, FINRA has detailed rules that address broker-dealers’ communications with the public and specifically require broker-dealer communications to be based on principles of fair dealing and good faith; to be fair and balanced; and to provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service. See, e.g., FINRA Rule 2210.

<sup>1024</sup> Exchange Act Rule 10b-10 requires a broker-dealer effecting customer transactions in securities (other than U.S. savings bonds or municipal securities), to provide written notification to the customer, at or before completion of the transaction, disclosing information specific to the transaction, including whether the broker-dealer is acting as agent or principal and its compensation, as well as any third-party remuneration it has received or will receive. See also FINRA Rule 2232 (Customer Confirmations). MSRB Rule G-15 requires similar disclosures from municipal securities brokers and dealers.

<sup>1025</sup> The courts and the Commission have held that under the anti-fraud provisions of the federal securities laws, broker-dealers must charge prices reasonably related to the prevailing market price. See *Charles Hughes*, 139 F.2d at 437 (holding that broker-dealer impliedly represents that price is reasonably related to the prevailing market price); *In the Matter of Duker & Duker*, Exchange Act Release No. 2350 (Dec. 19, 1939). See also *In the Matter of the Application of A.S. Goldmen & Co., Inc.*, Exchange Act Release No. 44328 (May 21, 2001) (“The prices that a broker-

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The anti-fraud provisions of the Exchange Act also broadly prohibit misstatements or misleading omissions of material facts, and fraudulent or manipulative acts and practices, in connection with the purchase or sale of securities.<sup>1026</sup> Exchange Act Section 15(c) prohibits any broker or dealer from effecting any transaction in or inducing or attempting to induce the purchase or sale of any security by means of any manipulative, deceptive, or other fraudulent device or contrivance. Under this prohibition, broker-dealers are precluded from making material omissions or misrepresentations and from any act, practice, or course of business that constitutes a manipulative, deceptive, or other fraudulent device or contrivance.<sup>1027</sup>

Generally, under the anti-fraud provisions, a broker-dealer's duty to disclose material information to its customer is based upon the scope of the relationship with the customer.<sup>1028</sup> Where a broker-dealer processes its customer's orders, but does not recommend securities or solicit customers, then the material information that the broker-dealer is required to disclose to its customer is narrow, encompassing only the information related to the consummation of the transaction.<sup>1029</sup> In such circumstances, the broker-dealer generally does not have to provide information regarding the security or the broker-dealer's economic self-interest in the security.<sup>1030</sup> However, when recommending a security, a broker-dealer may be liable if it does

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dealer charges retail customers for securities must be reasonably related to the prevailing market price of the security ... The prevailing market price typically is the current inter-dealer price, that is, the price at which dealers trade with one another. Where an integrated dealer ... so dominates and controls the market for a security that it effectively can set wholesale prices, however, the best evidence of the security's market price is the firm's contemporaneous cost in acquiring the security, rather than the inter-dealer price. If there are no contemporaneous purchases from other dealers, purchases from retail customers may be used to determine prevailing market price, subject to an imputed markdown being added to the purchase price.") (citations omitted). SRO rules generally require broker-dealer prices for securities and compensation for services to be fair and reasonable taking into consideration all relevant circumstances. See, e.g., NASD Rule 2440 (Fair Prices and Commissions); IM-2440-1 (Mark-Up Policy); IM-2440-2 (Mark-Up Policy for Debt Securities). Generally, this requirement prohibits a member from entering into any transaction with a customer in any security at any price not reasonably related to the current market price of the security or to charge a commission that is not reasonable.

<sup>1026</sup> Exchange Act Section s 10(b) and 15(c).

<sup>1027</sup> See Exchange Act Rules 10b-3, 15c1-2, and 15c1-3.

<sup>1028</sup> See, e.g., *Conway v. Icahn & Co., Inc.*, 16 F.3d 504, 510 (2d Cir. 1994) ("A broker, as agent, has a duty to use reasonable efforts to give its principal information relevant to the affairs that have been entrusted to it.").

<sup>1029</sup> See *Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529, 536 (2d Cir. 1999).

<sup>1030</sup> See, e.g., *Carras v. Burns*, 516 F.2d 251, 257 (4th Cir. 1975) (broker-dealer not required to volunteer advice where "acting only as a broker"); *Canizaro v. Kohlmeyer & Co.*, 370 F. Supp. 282, 289 (E.D. La. 1974), *aff'd*, 512 F.2d 484 (5th Cir. 1975) (holding that broker-dealer that "merely received and executed a purchase order, has a minimal duty, if any at all, to investigate the purchase and disclose material facts to a customer"); *Walston & Co. v. Miller*, 410 P.2d 658, 661 (Ariz. 1966) ("The agency relationship between customer and broker normally terminates with the execution of the order because the broker's duties, unlike those of an investment advisor or those of a manager of a discretionary account, are only to fulfill the mechanical, ministerial requirements of the purchase and sale of the security or future contract on the market.").

not “give honest and complete information.”<sup>1031</sup> A broker-dealer also may be liable if it does not disclose “material adverse facts of which it is aware.”<sup>1032</sup> Broker-dealers are subject to the financial privacy requirements of the SEC’s Regulation S-P, Regulation S-AM, and the identity theft red flags rules of the SEC’s Regulation S-ID. Regulation S-P requires written policies and procedures designed to help insure the security and confidentiality of customer records and information, protect against any anticipated threats or hazards to the security or integrity of those records, and protect those records and information against unauthorized access or use that could result in substantial harm or inconvenience to any customer. Regulation S-AM allows a customer, in certain limited situations, to block affiliates of brokers-dealers from soliciting the customer based on certain financial information of the customer, such as his or her transactions or experiences with the covered person. Regulation S-ID requires a program including written policies and procedures designed to identify relevant types of identity theft red flags, detect the occurrence of those red flags, respond appropriately to the detected red flags, and periodically update the program.

On the state level, broker-dealers are subject to financial privacy and identity theft prevention requirements that may be more protective than those provided by Regulation S-P and Regulation S-ID. For example, most states have laws requiring broker-dealers to notify individuals affected by information security breaches, and some states have adopted “opt-in” regimes, under which personal information about a consumer generally may not be disclosed to a nonaffiliated third party without the consumer’s affirmative consent.<sup>1033</sup> State criminal laws, and civil causes of action under common law and state statutory provisions, provide additional privacy protections.

Generally, broker-dealers must establish policies and procedures (and systems for implementing and monitoring compliance with those policies and procedures) that are reasonably designed to prevent and detect violations of the federal securities laws and regulations, as well as applicable SRO rules. In addition to establishing policies and procedures, broker-dealers must implement measures to monitor compliance with those policies and procedures, including an appropriate

<sup>1031</sup> See, e.g., *De Kwiatkowski v. Bear, Stearns & Co., Inc.*, 306 F.3d 1293, 1302 (2d Cir. 2002) (broker-dealer “is obliged to give honest and complete information when recommending a purchase or sale”); *Vucinich v. Paine, Webber, Jackson & Curtis, Inc.*, 803 F.2d 454, 459-61 (9th Cir. 1986) (vacating directed verdict for broker-dealer where evidence showed broker-dealer may have violated Exchange Act by failing to disclose material facts relating to risk to his unsophisticated customer and may effectively have exercised control over account); *SEC v. R.A. Holman & Co.*, 366 F.2d 456, 458 (2d Cir. 1966) (salespersons failed to disclose that company had significant losses).

<sup>1032</sup> See, e.g., *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1172 (2d Cir. 1970); *SEC v. Hasho*, 784 F. Supp. 1059, 1110 (S.D.N.Y. 1992); *In the Matter of Richmark Capital Corp.*, Exchange Act Release No. 48758 (Nov. 7, 2003) (Commission opinion) (“Release 48758”) (“When a securities dealer recommends stock to a customer, it is not only obligated to avoid affirmative misstatements, but also must disclose material adverse facts of which it is aware. That includes disclosure of “adverse interests” such as “economic self interest” that could have influenced its recommendation.”) (citations omitted).

<sup>1033</sup> See, e.g., Privacy of Consumer Financial Information (Regulation S-P), Exchange Act Release No. 42484.

system of follow-up and review if red flags are detected. Moreover, broker-dealers must comply with specific detailed SRO rules regarding supervision.<sup>1034</sup>

The Exchange Act authorizes the SEC to sanction a broker-dealer or any associated person that fails to reasonably supervise another person subject to the firm's or the person's supervision that commits a violation of the federal securities laws.<sup>1035</sup> The Exchange Act provides that a person will not be liable for failure to supervise if they can show that there were in place reasonable procedures and that systems for applying the procedures had been established and effectively implemented without reason to believe those procedures and systems were not being complied with.<sup>1036</sup> Failure to supervise liability is a critical component of the federal regulatory scheme for broker-dealers.

In addition, as discussed in Question 31.1, above, FINRA Rule 3130 requires broker-dealers to appoint a CCO and have that CCO or equivalent officer certify annually that the broker-dealer has in place policies and procedures to establish, maintain, review, test, and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable FINRA rules, MSRB rules, and federal securities laws and regulations. The chief executive officer must meet with the compliance officer at least once annually to discuss the compliance processes.

Furthermore, as indicated previously in response to Questions 31.1 and 31.2, the SEC has promulgated a number of rules to safeguard customer assets including the Customer Protection Rule,<sup>1037</sup> the Hypothecation Rules,<sup>1038</sup> and the Quarterly Count Rule.<sup>1039</sup>

Rule 17a-3(a)(3) requires that each broker-dealer maintain ledger accounts, that itemize separately as to each customer account, all purchases, sales, receipts and deliveries of securities and commodities, and all other debits and credits to the account. In addition, the SROs have rules that restrict a broker-dealer's use of customer securities.<sup>1040</sup>

<sup>1034</sup> See, e.g., NASD Rules 3010 and 3012; see also FINRA Rules 3110 and 3120 (consolidating and updating NASD Rules 3010 and 3012 as of their effective date, December 1, 2014).

<sup>1035</sup> Exchange Act Section s 15(b)(4)(E) and (b)(6)(A).

<sup>1036</sup> Exchange Act Section s 15(b)(4)(E) and (b)(6)(A).

<sup>1037</sup> 17 C.F.R. 240.15c3-3.

<sup>1038</sup> 17 C.F.R. 240.8c-1 and 15c2-1.

<sup>1039</sup> 17 C.F.R. 240.17a-13. Paragraph (d) of Rule 17a-13 also states that the examination, count, verification, and comparison shall be made or supervised by persons whose regular duties do not require them to have direct responsibility for the proper care and protection of the securities or the making or preservation of the subject records.

<sup>1040</sup> See, e.g., FINRA Rules 4330 and 2150.



Finally, the SIPA is designed to assure that, in the case of a liquidation, customer assets are promptly returned to customers.<sup>1041</sup> Pursuant to SIPA, a SIPC trustee is appointed to administer the liquidation of a broker-dealer that owes cash or securities to customers. In addition, to the extent that the liquidated broker-dealer no longer has certain customer assets, SIPC will make up for that shortfall (up to \$500,000 per customer, \$250,000 of which may be cash) using assessments it has obtained from its broker-dealer members.

### **Investment Advisers**

See responses to Questions 29.2(e), 29.7(b), 29.7(c), and 31.5.

Additionally, Section 206 of the Advisers Act imposes a fiduciary duty on an investment adviser to act in the utmost good faith with respect to its clients. An investment adviser is required to treat all clients fairly where conflicts of interest arise between several of the firm's clients.<sup>1042</sup> Section 204A of the Advisers Act also requires an investment adviser to establish, maintain, and enforce written procedures to prevent the misuse of material nonpublic information by the investment adviser or any person associated with the investment adviser.

Regulation S-P and Regulation S-ID, discussed immediately above with respect to broker-dealers, also applies to investment advisers.

An investment adviser is required to appoint a CCO to monitor and periodically review the adviser's compliance program (see response to Question 29.2(e)). Additionally, pursuant to Section 203(e)(6) of the Advisers Act, advisers are required to supervise employees, which creates a segregation of duties.

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<sup>1041</sup> 15 U.S.C. 78aaa *et seq.*

<sup>1042</sup> See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).



6.	Taking into account Principle 8, does the regulatory framework require a market intermediary:
(a)	To endeavour to address a conflict of interests arising between its interests and those of its clients or between its clients?
(b)	Where the potential for conflicts arises, (i) to have mechanisms in place to manage conflicts of interests that seek to ensure an unbiased decision making process, fair treatment of all its clients and (ii) consider further steps if these prove inadequate, which may include disclosure of the conflict, internal rules of confidentiality, declining to act where a conflict cannot be resolved?
<p><b>Broker-Dealers</b></p> <p>Yes. As discussed in response to Question 31.15, broker-dealers are required under relevant circumstances, such as when making a recommendation, to disclose material conflicts of interest to their customers. The federal securities laws and SRO rules also restrict broker-dealers from participating in certain transactions that may present particularly acute potential conflicts of interest. In other instances, the federal securities laws require broker-dealers to mitigate conflicts by engaging in specified actions.</p> <p>For research analysts, the historical conflict of interest has been between providing independent analysis of a company that the intermediary was also seeking as an investment-banking client. 15 U.S.C. 78o-6 requires the SEC or the SROs to implement rules designed to “foster greater public confidence in securities research, and to protect the objectivity and independence of securities analysts.” This statute lays out certain specific prohibitions that must be in the rules implemented under the statute. These prohibitions are designed to address the most egregious of the conflicts that analysts face, specifically:</p> <ul style="list-style-type: none"> <li>• Restricting pre-publication review of research reports by investment banking personnel or other personnel not directly responsible for research (other than legal/compliance);</li> <li>• Limiting the supervision and compensatory evaluation of analysts to officials other than investment banking personnel;</li> <li>• Prohibiting retaliation against research by investment banking personnel for opinions expressed in research reports;</li> <li>• Establish quiet periods when the intermediary is prohibited from publishing research after it has participated in a public offering of securities;</li> <li>• Establish structural and institutional safeguards that assure that analysts are separated by appropriate informational partitions within the firm “from the review, pressure, or oversight of those whose involvement in investment banking activities might potentially bias their judgment or supervision;” and</li> </ul>	

- Requiring a number of disclosures on research reports and public appearances including analysts' investments in the subject company of the report/appearance and whether the subject company has been a client of the intermediary.

These required prohibitions were implemented in SRO rules (NASD Rule 2711 and NYSE Rule 472), which were approved by the SEC. The SEC also adopted Regulation AC, which addresses analyst conflicts of interest. The SRO rules contain other provisions beyond what is required by statute, such as a prohibition on the promise of favorable research and analyst trading black-out periods. The SEC's Regulation AC – Analyst Certification – (17 C.F.R. 242.500 - 505) requires that intermediaries obtain certification from their analysts that the opinions expressed in research reports and public appearances are the analyst's actual opinions. It also requires a certification that the analyst was not compensated for a specific recommendation or view expressed by the analyst in a research report or public appearance (or provides details as to any such compensation).

Finally, Exchange Act Rules 15c1-5 and 15c1-6 require a broker-dealer to disclose to the customer if it has any control, affiliation, or interest in a security it is offering or with the issuer of such security.

In addition to the discussion above, please see the response to Principle 8.

### **Investment Advisers**

Section 206 of the Advisers Act imposes a fiduciary duty on an investment adviser to act in the utmost good faith with respect to its clients, and to provide full and fair disclosure of all material facts, particularly when the adviser's interests may conflict with its clients.<sup>1043</sup> An adviser must disclose all material facts regarding a conflict or potential conflict so that a client or prospective client can make an informed decision whether to enter into or continue an advisory relationship with the adviser, or take some action to protect himself or herself against the conflict.<sup>1044</sup> As a fiduciary, an adviser owes its clients undivided loyalty, should not engage in any activity in conflict with the interest of any client, and should take the steps reasonably necessary to fulfill his or her fiduciary obligations. Thus, an investment adviser must not only refrain from effecting, on its own behalf, securities transactions which are inconsistent with its fiduciary obligations, it should also be reasonably certain that persons associated with it are not improperly utilizing the information which they obtain in the conduct of the investment advisory business in such

<sup>1043</sup> See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195-197 (1963).

<sup>1044</sup> *Amendments to Form ADV*, Advisers Act Rel. No. 3060 (July 28, 2010).

manner as to adversely affect the interest of clients or limit the adviser's ability to fulfill its fiduciary obligations.<sup>1045</sup>

The Advisers Act also imposes the following specific client obligations:

Code of Ethics: See response to Question 29.7(c) above.

Performance Fees: Section 205(a)(1) of the Advisers Act prohibits an investment adviser from entering into, extending, or renewing any investment advisory contract, or in any way to perform any investment advisory contract that provides for compensation to the investment adviser on the basis of a share of capital gains or capital appreciation of the funds or any portion of the funds of the client (collectively, "a performance fee"), unless: (i) the performance fee is based upon a percentage of assets under management; or (ii) the client is a registered investment company or certain other entities with assets in excess of \$1 million, and the performance fee is a "fulcrum fee";<sup>1046</sup> or (iii) the client is a qualified client.<sup>1047</sup>

Best Execution: As a fiduciary, an investment adviser has an obligation to seek to obtain "best execution" of a client's securities transactions. To comply with this duty, an investment adviser must arrange for clients' securities transactions in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances.

Principal and Agency Cross Trades for Advisory Clients: Section 206(3) of the Advisers Act and Rule 206(3)-2 thereunder address certain transactions involving investment adviser client accounts. In particular, Section 206(3) of the Advisers Act prohibits an investment adviser, acting as principal for his or her own account, from purchasing or selling any security from or to a client, without disclosing to such client in writing before the completion of the transaction the capacity in which he or she is acting and obtaining the consent of the client. Section 206(3) also prohibits an investment adviser, acting as broker for a person other than the client, from knowingly effecting any sale or purchase of any security for the account of the client, without disclosing to such client in writing before the completion of the transaction the capacity in which he or she is acting and obtaining the consent of the client.<sup>1048</sup>

<sup>1045</sup> See *Adoption of Amendment to Rule 204-2 under the Advisers Act of 1940*, Advisers Act Rel. No. 203 (Aug. 11, 1966).

<sup>1046</sup> A "fulcrum fee" is generally described as a fee that is averaged over a specified period of time that increases or decreases proportionately with the investment performance of the client's account in relation to the investment record of an appropriate securities index. See Rules 205-1 and 205-2 under the Advisers Act. We note that BDCs are not subject to the same performance fee limitations as described here for registered investment companies, although they elect to be regulated as investment companies under the Investment Company Act. Advisers Act section 205(b)(3) permits an adviser to charge BDC clients performance fees if they meet certain requirements.

<sup>1047</sup> Rule 205-3(d)(1) under the Advisers Act defines the term "qualified client."

<sup>1048</sup> The prohibitions of Section 206(3) of the Advisers Act do not apply to any transaction with a customer of a broker or a dealer if such broker or dealer is not acting as an investment adviser in relation to the transaction.

Rule 206(3)-2 under the Advisers Act permits an investment adviser to obtain from clients “blanket consents” to certain of the transactions to which Section 206(3) applies. Specifically, Rule 206(3)-2 provides that an investment adviser may effect an “agency cross transaction” for its client, if the client has executed a written consent prospectively authorizing the investment adviser to effect any agency cross transaction for such client. An agency cross transaction is defined under Rule 206(3)-2 as “a transaction in which a person acts as an investment adviser in relation to a transaction in which such investment adviser, or any person controlling, controlled by or under common control with such investment adviser, acts as broker for both such advisory client and for another person on the other side of the transaction.” The written consent may be obtained only after full written disclosure that, with respect to agency cross transactions, the investment adviser or such other person will act as broker for, receive commissions from, and have a potentially conflicting division of loyalties and responsibilities regarding both parties to such transactions. Rule 206(3)-2 requires an investment adviser relying on the rule to send to its client specified information about the agency cross transactions that the client engaged in through the adviser.

Custody of Client Assets: Please see response to Question 29.7(b) for a discussion of the requirements that are applicable to investment advisers that have custody of their clients’ assets.

Cash Payments for Client Solicitations: Rule 206(4)-3 prohibits an investment adviser from paying a cash fee to a solicitor for solicitation activities if the solicitor: (i) is censured, suspended, barred, or whose activities have been limited by SEC order;<sup>1049</sup> or (ii) has been convicted within the previous 10 years of any felony or misdemeanor described in Section 203(e)(2)(A)-(D) of the Advisers Act;<sup>1050</sup> or (iii) who has been found by the SEC to have engaged, or has been convicted of engaging, in any of the conduct specified in paragraphs (1), (5), or (6) of Section 203(e) of the Advisers Act;<sup>1051</sup> or (iv) is subject to an order, judgment, or decree described in Section 203(e)(4) of the Advisers Act.<sup>1052</sup>

Section 206(4)-3 provides that an investment adviser may pay a solicitor that may be a partner,

<sup>1049</sup> These orders are issued under Section 203(f) of the Act.

<sup>1050</sup> This would include, for example, crimes: involving the purchase or sale of any security, bribery, perjury, extortion, counterfeiting, and crimes arising out of conduct of a financial services type of business.

<sup>1051</sup> Paragraph (1) generally includes willfully making or causing to be made false statements in any application for registration or report required to be filed with the Commission or any proceeding before the Commission on registration issues; paragraph (5) generally includes willfully violating any provisions of the federal securities laws, the U.S. CEA and rules thereunder, and any rule of the MSRB; and paragraph (6) generally includes willfully aiding, abetting, counseling, commanding, inducing, or procuring the violation by any other person of such laws, or failing to reasonably supervise another person who commits such a violation.

<sup>1052</sup> This would generally include being permanently or temporarily enjoined by order, judgment, or decree of any court from acting as an investment adviser, underwriter, broker, dealer, or in many other capacities within the financial services industry, or from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security.

officer, director, or employee of a person that controls the investment adviser (e.g., solicitor is an officer of the investment adviser) provided that the status of such solicitor and any affiliation between the investment adviser and the solicitor is disclosed to the client at the time of the solicitation or referral. An adviser also may pay a cash solicitation fee for solicitation activities for the provision of impersonal advisory services only.

Rule 206(4)-3 also provides that an investment adviser may pay a cash solicitation fee for services other than impersonal advisory services if such fee is paid pursuant to a written agreement to which the adviser is a party and the written agreement: (i) describes the solicitation activities to be engaged in by the solicitor on behalf of the investment adviser and the compensation to be received therefore; (ii) contains an undertaking by the solicitor to perform his or her duties under the agreement in a manner consistent with the instructions of the investment adviser and the provisions of the Advisers Act and the rules thereunder; and (iii) requires that the solicitor, at the time of any solicitation activities for which compensation is paid or to be paid by the investment adviser; provide the client with a current copy of the investment adviser's written brochure and a separate written disclosure document. The separate written disclosure document must contain: (i) the name of the solicitor; (ii) the name of the investment adviser; (iii) the nature of the relationship, including any affiliation, between the solicitor and the investment adviser; (iv) a statement that the solicitor will be compensated for his or her solicitation services; (v) the terms of such compensation arrangement, including a description of the compensation paid or to be paid to the solicitor; and (vi) the amount, if any, for the cost of obtaining his or her account if the client will be charged in addition to the advisory fee.

In addition, the investment adviser must receive from the client a signed and dated acknowledgement of receipt of the investment adviser's brochure and the separate written disclosure document, prior to, or at the time of, entering into any written or oral investment advisory contract with such client.

Protection of Material Nonpublic and Sensitive Information: Section 204A of the Advisers Act requires that investment advisers must maintain and enforce written policies and procedures that are reasonably designed to prevent the misuse of material nonpublic information, which includes the misuse of material nonpublic information about the adviser's securities recommendations, and client securities holdings and transactions. Advisers' duty of care also requires that they safeguard this sensitive information.<sup>1053</sup> The adviser is responsible for preparing, reviewing, and updating these procedures.<sup>1054</sup> Advisory contracts also may contain confidentiality provisions.

<sup>1053</sup> See Section 204A of the Advisers Act and *Investment Adviser Codes of Ethics*, Advisers Act Rel. No. 2256 (July 2, 2004).

<sup>1054</sup> See *Investment Adviser Codes of Ethics*, Advisers Act Rel. No. 2256 (describing the Commission's expectations regarding an adviser's review and enforcement of its code of ethics). See also Advisers Act Rule 206(4)-7 (requiring advisers at least annually to review the adequacy and effectiveness of its policies and procedures reasonably designed to prevent the adviser or its personnel from violating the Advisers Act or rules thereunder).

Pay to Play: In 2010, the SEC adopted rule 206(4)-5 under the Advisers Act to curtail so-called “pay to play” practices in which investment advisers make campaign contributions to elected officials of state or municipal governments in order to improperly influence the award of contracts to manage public pension plan assets and other government investment accounts. The rule applies to SEC-registered investment advisers, certain exempt advisers, and certain foreign advisers.

Also see response to Question 31.5 regarding Regulations S-P and S-ID, which are designed to protect clients’ privacy and identities.

7. If DEA is allowed, does the regulatory framework require market intermediaries to use controls, including automated pre-trade controls, which can limit or prevent a DEA client from placing an order that exceeds the intermediary’s existing position or credit limits?

Yes. In November 2010, the SEC adopted Rule 15c3-5 — Risk Management Controls for Brokers or Dealers with Market Access. Rule 15c3-5 is intended to address the risks that can arise as a result of the automated, rapid electronic trading strategies that exist today, and bolster the confidence of investors in the integrity of our markets.

Rule 15c3-5 is applicable to broker-dealers with access to trading securities, by virtue of being an exchange member, an ATS subscriber, or an ATS operator with non-broker-dealer subscribers. Such broker-dealers with market access are required to establish, document, and maintain a system of risk management controls and supervisory procedures that, among other things, are reasonably designed to: (i) systematically limit the financial exposure of the broker or dealer that could arise as a result of market access, and (ii) ensure compliance with all regulatory requirements that are applicable in connection with market access. Specifically, the risk management controls and supervisory procedures are required to be reasonably designed to:

- prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds, or that appear to be erroneous;
- prevent the entry of orders unless there has been compliance with all regulatory requirements that must be satisfied on a pre-order entry basis; and
- prevent the entry of orders that the broker-dealer or customer is restricted from trading, restrict market access technology and systems to authorized persons, and assure appropriate surveillance personnel receive immediate post-trade execution reports.

In addition to Exchange Act Rule 15c3-5, many SROs have sets of rules governing clearly erroneous transactions to provide transparency and finality with respect to clearly erroneous executions.<sup>1055</sup>

#### *Protection of clients*

8. If a market intermediary has control of, or is otherwise responsible for, assets belonging to a client which it is required to safeguard, are there regulations that require proper protection for them (for example, segregation and identification of those assets) by the intermediary? Do these measures facilitate the transfer of positions and assist in the orderly winding up in the event of financial insolvency and the return of client assets?

#### **Broker-Dealers**

Yes, there are regulations for broker-dealers that require proper protection for assets belonging to a client. These measures facilitate the transfer of positions and assist in the orderly winding up in the event of financial insolvency and the return of client assets. As indicated previously in response to Question 31.1, Exchange Act Section 15(c)(3)(A) requires that the SEC promulgate rules imposing financial responsibility requirements on broker-dealers. In accordance with this requirement, the SEC promulgated a number of rules to protect customer assets including the Customer Protection Rule,<sup>1056</sup> the Hypothecation Rules,<sup>1057</sup> and the Quarterly Count Rule.<sup>1058</sup> The SEC's Customer Protection Rule requires a broker-dealer to segregate customer securities and cash from the firm's proprietary business activities. If the broker-dealer fails, these customer assets should be readily available to be returned to customers. The Customer Protection Rule requires that every broker-dealer obtain and maintain possession or control of customer fully paid and excess margin securities. This means the broker-dealer cannot lend or hypothecate these securities and must hold them itself or, as is more common, in a satisfactory control location. Rule 15c3-3 also required that a broker-dealer maintain a reserve account that contains (at least) the net dollar amount of cash the broker-dealer owes to its customers (in accordance with a prescribed formula). The SEC's Hypothecation Rules require that a broker-dealer segregate customer securities from its own proprietary securities, and prohibit a broker-dealer from hypothecating customers' fully paid securities. The SEC's Quarterly Count Rule requires that broker-dealers count positions owed to customers and securities on hand and reconcile those two numbers on a quarterly basis.

Rule 17a-3(a)(3) requires that each broker-dealer maintain ledger accounts, that itemize

<sup>1055</sup> See, e.g., FINRA Rules 11890-11894.

<sup>1056</sup> 17 C.F.R. 240.15c3-3.

<sup>1057</sup> 17 C.F.R. 240.8c-1 and 15c2-1.

<sup>1058</sup> 17 C.F.R. 240.17a-13.

separately as to each customer account, all purchases, sales, receipts and deliveries of securities and commodities, and all other debits and credits to the account.

These requirements – along with the broker-dealer Net Capital Rule – are designed to allow a broker-dealer to self-liquidate in an orderly wind-down where customer cash and securities are quickly returned to customers or transferred to a solvent broker-dealer.

In addition, the SROs have rules that restrict a broker-dealer's use of customer securities.<sup>1059</sup> SIPA also assures that, in the case of the liquidation of a broker-dealer, customer assets are promptly returned to customers.<sup>1060</sup> Pursuant to SIPA, a SIPC trustee is appointed to administer the liquidation of a broker-dealer that owes cash or securities to customers. In addition, to the extent that the liquidated broker-dealer no longer has certain customer assets, SIPC will make up for that shortfall (up to \$500,000 per customer, \$250,000 of which may be cash) using assessments it has obtained from its broker-dealer members.<sup>1061</sup>

### Investment Advisers

Please see response to Question 29.7(b).

9. Does the regulatory framework require market intermediaries to provide for an efficient and effective mechanism to address investor complaints?

Yes, as described below, the SEC regulatory framework requires market intermediaries to provide for an efficient and effective mechanism to address investor complaints. In addition, the SEC established the Office of the Investor Advocate under section 915 of the Dodd-Frank Act, as codified in Section 4(g) of the Exchange Act. The mission of the Office of the Investor Advocate is to promote the interests of investors, including, among other things, assisting retail investors in resolving significant problems they have with the SEC or SROs. In addition, section 919D of the Dodd-Frank Act requires the Investor Advocate to appoint an Ombudsman who will act as a liaison in resolving problems that retail investors may have with the Commission or an SRO. The SEC selected its first Ombudsman in September 2014.

### Broker-Dealers

Exchange Act Rule 17a-3(a)(18) requires broker-dealers to maintain: (i) a record for each written

<sup>1059</sup> See, e.g., FINRA Rule 2150.

<sup>1060</sup> 15 U.S.C. 78aaa *et seq.*

<sup>1061</sup> The SEC recently proposed segregation rules for SBSDs that are generally consistent with the corresponding broker-dealer rules. Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers. Exchange Act Release No. 68071 (Oct. 18, 2012), 77 Fed. Reg. 70214 (Nov. 23, 2012).



customer complaint received regarding an associated person, including the disposition of the complaint, and (ii) a record indicating that each customer has been provided with a notice with the address and telephone number to which complaints may be directed. In addition, SRO rules require broker-dealers to document and respond to all customer complaints.<sup>1062</sup> Pursuant to SRO rules, broker-dealers also must report to the SROs certain specified events related to customer complaints, as well as statistical and summary information on customer complaints.<sup>1063</sup> The information reported by broker-dealers provides the SROs with important regulatory information that assists with the timely identification of potential sales practice and operational problems. Furthermore, Forms BD and U4, are also used to disclose certain disciplinary and complaint information regarding the applicant.<sup>1064</sup> This information is made publicly available through FINRA's BrokerCheck system.<sup>1065</sup>

SROs have an obligation to have rules that are designed to, among other things, prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, and, in general, protect investors and the public interest.<sup>1066</sup> In furtherance of this obligation, SROs' arbitration rules are generally designed to effectively facilitate the resolution of disputes involving members, associated persons of members, and customers.<sup>1067</sup> Today, substantially all disputes are heard in arbitration, and the vast majority of brokerage-related arbitration claims are handled through the forum of one SRO, FINRA.

As part of the account opening process, members typically require their customers to agree to resolve any future disputes through arbitration. SRO rules typically grant investors the right to require SRO members and associated persons of members to arbitrate any eligible dispute upon a customer's request, even without a pre-dispute arbitration agreement.<sup>1068</sup> In addition, SROs' rules generally require their members to comply with certain requirements when using such agreements (e.g., requiring specific content, and requiring firms to alert customers to the existence of such agreements).<sup>1069</sup>

<sup>1062</sup> See, e.g., Incorporated NYSE Rule 401A.; see also FINRA Rule 4513.

<sup>1063</sup> See, e.g., FINRA Rule 4530.

<sup>1064</sup> See Form BD Instructions; Form U4 Instructions.

<sup>1065</sup> BrokerCheck is a free tool to help investors research the professional backgrounds of brokerage firms and brokers currently or formerly registered with FINRA or a national securities exchange, as well as current or former investment adviser firms and representatives. It is available at [www.finra.org](http://www.finra.org).

<sup>1066</sup> Exchange Act §§6(b)(5) and 15A(b)(6), 15 U.S.C. 78f(b)(5) and 78o-3(b)(6).

<sup>1067</sup> See FINRA Rule 12000 Series for the Code of Arbitration Procedure for Customer Disputes and FINRA Rule 13000 Series for the Code of Arbitration Procedure for Industry Disputes. FINRA also conducts arbitrations on behalf of other SROs. See, e.g., Exchange Act Release No. 56208 (Aug. 6, 2007), 72 C.F.R. 45077 (Aug. 10, 2007) (order approving changes to NYSE arbitration rules to conform to the arbitration rules for the National Securities Dealers Association, Inc. (NASD) (now known as FINRA), to reflect the NASD's regulation of mutual NYSE and NASD members).

<sup>1068</sup> See, e.g., FINRA Rule 12200.

<sup>1069</sup> See, e.g., FINRA Rule 2268.

The SEC reviews SRO rules pursuant to Section 19(b) of the Exchange Act, including arbitration rules, before they can become effective. Section 19(b)(2)(C)(i) of the Exchange Act requires the SEC to approve a rule change if it finds that the change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder. Section 19(b)(2)(C)(ii) requires the SEC to disapprove a proposed rule change if it does not make the finding discussed above. In addition, the SEC has the authority to conduct inspections of FINRA's dispute resolution forum.

SRO rules also require that each carrying agreement shall expressly authorize and direct the carrying firm to: (i) furnish promptly to the introducing firm and the introducing firm's DEA (or, if none, to its appropriate regulatory agency or authority) any written customer complaint received regarding the conduct of the introducing firm or firms and its associated persons; and (ii) notify the complaining customer, in writing, that it has received the complaint and that such complaint has been furnished to the introducing firm and its DEA (or, if none, to its appropriate regulatory agency or authority).<sup>1070</sup> SRO rules also require that each member shall keep and preserve in each office of supervisory jurisdiction either a separate file of all written customer complaints that relate to that office (including complaints that relate to activities supervised from that office) and action taken by the member, if any, or a separate record of such complaints and a clear reference to the files in that office containing the correspondence connected with such complaints.<sup>1071</sup>

### Investment Advisers

As discussed below, an investment adviser is a fiduciary and must act with utmost good faith with respect to its clients and must act in the interests of its clients. An investment adviser's client may sue the investment adviser under state law (and, under certain circumstances, federal law) for failure to meet any obligation of the investment advisory contract between the investment adviser and the client. In addition, Section 215 of the Advisers Act provides an investment adviser's client with a private right of action for violations of the Advisers Act,<sup>1072</sup> under which a client may sue to void its advisory contract and for restitution. Other provisions of the federal securities laws also provide for private rights of action that would be available to an advisory client (e.g., Rule 10b-5 provides a private right of action when there is fraud in connection with the sale of a security). In addition, many advisory contracts contain provisions relating to arbitration of claims.

<sup>1070</sup> See, e.g., FINRA Rule 4311(g)(1).

<sup>1071</sup> See, e.g., FINRA Rule 4513.

<sup>1072</sup> See *Transamerica Mortgage Advisors, Inc. et al. v. Harry Lewis*, 444 U.S. 11 (1979).

10. Does the regulatory framework require market intermediaries to identify and verify the client's identity using reliable, independent data, including persons who beneficially own or control securities?

Yes, as described below, the BSA establishes the basic framework for AML obligations imposed on financial institutions. Among other things, it authorizes the Secretary of the Treasury to issue regulations requiring financial institutions (including broker-dealers) to keep records and file reports on financial transactions that may be useful in investigating and prosecuting money laundering and other financial crimes. FinCEN, a bureau within Treasury, has regulatory responsibilities for administering the BSA.<sup>1073</sup>

Rule 17a-8 under the Exchange Act requires broker-dealers to comply with the reporting, recordkeeping, and record retention rules adopted under the BSA.

The PATRIOT Act, enacted in 2001, amended and strengthened the BSA by, among other things, imposing a number of AML obligations directly on broker-dealers, including:

- AML compliance programs;
- CIPs;
- monitoring, detecting, and filing reports of suspicious activity;
- due diligence on foreign correspondent accounts, including prohibitions on transactions with foreign shell banks;
- due diligence on private banking accounts;
- mandatory information-sharing (in response to requests by federal law enforcement); and
- compliance with "special measures" imposed by the Secretary of the Treasury to address particular AML concerns.

More specifically, Section 326 of the PATRIOT Act amended the BSA to require financial institutions, including broker-dealers, to establish written CIPs. Treasury's implementing rule requires a broker-dealer's CIP to include, at a minimum, procedures for:

- obtaining customer identifying information from each customer prior to account opening;

<sup>1073</sup>

See <http://www.fincen.gov> for more information about FinCEN and the Treasury regulations under the BSA.

- verifying the identity of each customer, to the extent reasonable and practicable, within a reasonable time before or after account opening;
- based on the broker-dealer's risk assessment of a new account opened by a customer that is not an individual, obtaining information about individuals with authority or control over such account in order to verify the customer's identity;
- making and maintaining a record of information obtained relating to identity verification;
- determining within a reasonable time after account opening or earlier whether a customer appears on any list of known or suspected terrorist organizations designated by Treasury; and
- providing each customer with adequate notice, prior to opening an account, that information is being requested to verify the customer's identity.

The CIP rule provides that, under certain defined circumstances, broker-dealers may rely on the performance of another financial institution to fulfill some or all of the requirements of the broker-dealer's CIP. The required circumstances include: (i) the broker-dealer's reliance must be reasonable under the circumstances; (ii) the other financial institution must be subject to an AML compliance program rule and be regulated by a federal functional regulator; and (iii) the other financial institution must enter into a contract requiring it to certify annually to the broker-dealer that it has implemented an AML program and will perform the specified requirements of the broker-dealer's CIP.<sup>1074</sup>

Section 312 of the PATRIOT Act amended the BSA to, among other things, impose special due diligence requirements for correspondent accounts for certain non-U.S. persons. Under Treasury's regulations implementing that provision, a broker-dealer is required to establish a risk-based due diligence program for any "correspondent accounts" maintained for foreign financial institutions. The due diligence program, which is required to be a part of the broker-dealer's overall AML program, must include appropriate, specific, risk-based policies, procedures, and controls reasonably designed to enable the broker-dealer to detect and report, on an ongoing basis, any known or suspected money laundering conducted through or involving any foreign correspondent account. Treasury's regulations also impose enhanced due diligence requirements on correspondent accounts opened for certain foreign banks. These enhanced due diligence procedures require broker-dealers to, among other things, (i) obtain information, as

<sup>1074</sup> In 2014, FinCEN issued a notice of proposed rulemaking on customer due diligence requirements for financial institutions, which would impose an explicit customer due diligence obligation on broker-dealers, among others, including an obligation to obtain beneficial ownership information on account holders. See Customer Due Diligence Requirements for Financial Institutions, 79 Fed. Reg. 45151 (August 4, 2014).

appropriate, from the foreign bank about the identity of any person with authority to direct transactions through any correspondent account that is a payable-through account, as well as the source and beneficial owner of funds or other assets in a payable-through account; and (ii) determine, for any correspondent account established or maintained for a foreign bank whose shares are not publicly traded, the identity of each owner of the foreign bank and the nature and extent of each owner's ownership interest.

In addition, Section 312 of the PATRIOT Act imposes special due diligence requirements on financial institutions, including broker-dealers, which establish, maintain, administer or manage a private banking account or a "correspondent account" in the U.S. for a "non-United States person." Treasury's regulations provide that a broker-dealer is required to maintain a due diligence program that includes policies, procedures, and controls that are reasonably designed to detect and report any known or suspected money laundering or suspicious activity conducted through or involving a "private banking account"<sup>1075</sup> that is established, maintained, administered or managed in the U.S. by the broker-dealer. In addition, the regulations set forth certain minimum requirements for the required due diligence program with respect to private banking accounts and require enhanced scrutiny to any such accounts where the nominal or beneficial owner is a "senior foreign political figure."<sup>1076</sup>

Broker-dealers providing private banking accounts must take reasonable steps to:

- determine the identity of all nominal and beneficial owners of the private banking accounts;
- determine whether any such owner is a "senior foreign political figure" and therefore subject to enhanced scrutiny that is reasonably designed to detect transactions that may involve the proceeds of foreign corruption;
- determine the source of funds deposited into the private banking account and the purpose and use of such account;
- review the activity of the account as needed to guard against money laundering; and
- report any suspicious activity, including transactions involving senior foreign political

<sup>1075</sup> The regulations define a "private banking account" as an account that: (i) requires a minimum deposit of assets of at least \$1,000,000; (ii) is established or maintained on behalf of one or more non-U.S. persons who are direct or beneficial owners of the account; and (iii) has an employee assigned to the account who is a liaison between the broker-dealer and the non-U.S. person. See 31 C.F.R. 1010.605(m).

<sup>1076</sup> The definition of "senior foreign political figure" extends to any member of the political figure's immediate family, and any person widely and publicly known to be a close associate of the foreign political figure as well as any entities formed for the benefit of such persons (such persons are commonly referred to as PEPs, or Politically Exposed Persons). See 31 C.F.R. 1010.605(p).

figures that may involve proceeds of foreign corruption.

Additionally, under Treasury regulations, broker-dealers are prohibited from opening and maintaining correspondent account for foreign shell banks.<sup>1077</sup> Broker-dealers that offer foreign correspondent accounts must take reasonable steps to ensure the account is not being used to indirectly provide banking services to foreign shell banks. Broker-dealers must identify the owners of foreign banks whose shares are not publicly traded and record the name and address of a person in the U.S. that is authorized to be an agent to accept service of legal process.<sup>1078</sup>

In addition to AML obligations, broker-dealers are subject to the books and records requirements under Exchange Act Rule 17a-3. Exchange Act Rule 17a-3(a)(9) requires each broker-dealer to make and keep current a record in respect of each cash and margin account with such broker-dealer indicating (i) the name and address of the beneficial owner of such account, and (ii) except with respect to exempt employee benefit plan securities as defined in Exchange Act Rule 14a-1(d), but only to the extent such securities are held by employee benefit plans established by the issuer of the securities, whether or not the beneficial owner of securities registered in the name of such broker-dealers, or a registered clearing agency or its nominee objects to disclosure of his or her identity, address and securities positions to issuers, and (iii) in the case of a margin account, the signature of such owner; provided, that, in the case of a joint account or an account of a corporation, such records are required only in respect of the person or persons authorized to transact business for such account.

Exchange Act Rule 17a-3(a)(17)(i)(A) requires that for each account with a natural person as a customer or owner, the broker-dealer make an account record including the customer's or owner's name, tax identification number, address, telephone number, date of birth, employment status (including occupation and whether the customer is an associated person of a member, broker or dealer), annual income, net worth (excluding value of primary residence), and the account's investment objectives. In the case of a joint account, the account record must include personal information for each joint owner who is a natural person; financial information for the individual joint owners may be combined. The account record shall indicate whether it has been signed by the associated person responsible for the account, if any, and approved or accepted by a principal of the broker-dealer.

SROs also have "Anti-Money Laundering Compliance Program," "Customer Account Information," "Know Your Customer," and "Suitability" rules.<sup>1079</sup>

<sup>1077</sup> See 31 C.F.R. 1010.630(a)(1).

<sup>1078</sup> See 31 C.F.R. 1010.630(a)(2).

<sup>1079</sup> See, e.g., FINRA Rules 3310, 4512, 2090 and 2111.

### Investment Advisers

Investment advisers must conduct financial transactions for their clients through financial institutions that are subject to BSA requirements, including customer identification requirements.<sup>1080</sup> Also, as noted in response to Question 29.7(b), custody of an investment adviser's clients' funds and securities must be maintained at these financial institutions. See also response to Question 31.5 regarding Regulations S-P and S-ID.

11. Does the regulatory framework require market intermediaries to obtain and retain information from a client about their circumstances and investment objectives relevant to the services to be provided?

### Broker-Dealers

Yes. Broker-dealers must obtain and retain certain information regarding customers that open accounts, including the customer's employment status, net worth, annual income, and investment objectives.<sup>1081</sup> Firms are required to update this customer account record information at least once every three years.<sup>1082</sup> In addition, pursuant to Exchange Act Rule 17a-3(a)(9), a broker-dealer must obtain a record in respect of each cash and margin account with such member, broker or dealer indicating the name and address of the beneficial owner of the account.<sup>1083</sup> Furthermore, broker-dealers generally have an obligation to recommend only those specific investments or overall investment strategies that are suitable for their customers. The concept of suitability appears in specific SRO rules<sup>1084</sup> and has been interpreted by the courts as an obligation under the anti-fraud provisions of the federal securities laws.

The SROs have implemented rules to require that broker-dealer members obtain information from their clients upon establishing the relationship or opening an account. FINRA Rules 4512, 2090, and 2360 specifically delineate certain additional information that must be obtained from the customer, including information regarding the customer's financial circumstances and investment objectives.

<sup>1080</sup> See *Financial Crimes Enforcement Network; Withdrawal of the Notice of Proposed Rulemaking; Anti-Money Laundering Programs for Investment Advisers*, 73 Fed. Reg. 65568 (Nov. 4, 2008) (withdrawing its 2003 proposed AML rule for investment advisers and stating "[i]nvestment advisers must conduct financial transactions for their clients through other financial institutions that are subject to BSA requirements, and their clients' assets must be carried at these financial institutions. Thus, as FinCEN continues to consider the extent to which BSA requirements should be imposed on investment advisers, their activity is not entirely outside the current BSA regulatory regime.").

<sup>1081</sup> 17 C.F.R. 240.17a-3(a)(17); 17 C.F.R. 240.17a-4(e)(5).

<sup>1082</sup> Exchange Act Release No. 44992 (November 2, 2001).

<sup>1083</sup> 17 C.F.R. 240.17a-3(a)(9).

<sup>1084</sup> See, e.g., FINRA Rule 2111.

### Investment Advisers

Investment advisers under the Advisers Act owe their clients the duty to provide only suitable investment advice. To fulfill this suitability obligation, an investment adviser must make a reasonable determination that the investment advice provided is suitable for the client based on the client's financial situation and investment objectives.<sup>1085</sup>

12. Does the regulatory framework require a market intermediary to “know its customer” before providing specific advice to a client?

### Broker-Dealers

Yes. Broker-dealers generally have an obligation to recommend only those specific investments or overall investment strategies that are suitable for their customers. The concept of suitability appears in specific SRO rules and has been interpreted by the courts as an obligation under the anti-fraud provisions of the federal securities laws. In addition, Exchange Act Rule 17a-3(a)(17) requires broker-dealers to obtain basic information about customers that open accounts including name, address, taxpayer identification number, employment status, net worth, annual income, and investment objectives.

In addition to their suitability obligations,<sup>1086</sup> FINRA Rule 2090 requires broker-dealers to use reasonable diligence, when opening and maintaining customers' accounts, to “know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer.”<sup>1087</sup> Essential facts include those that are necessary to (i) effectively service the customer's account; (ii) act in accordance with any special handling instructions for the account; (iii) understand the authority of any person acting on behalf of the customer; and (iv) comply with applicable laws, regulations, and rules.<sup>1088</sup>

Other FINRA rules specifically delineate certain additional information that must be obtained from the customer, including information regarding the customer's financial circumstances and investment objectives. For example, FINRA Rule 4512 requires broker-dealers to maintain specific information for each customer account, such as the customer's name and, residence. In addition, FINRA Rule 2360 requires, among other things, that a broker-dealer must gather

<sup>1085</sup> See *Status of Investment Advisory Programs under the Investment Company Act of 1940*, Investment Company Act Rel. No. 22579 (Mar. 24, 1997).

<sup>1086</sup> FINRA's know-your-customer obligations apply to broker-dealers regardless of whether they have made a recommendation. See FINRA Notice 11-02, SEC Approves Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations (Oct. 7, 2011) (“The know-your-customer obligation arises at the beginning of the customer-broker relationship and does not depend on whether the broker has made a recommendation”).

<sup>1087</sup> FINRA Rule 2090.

<sup>1088</sup> FINRA Rule 2090, Supplementary Material .01.



information about the customer, the customer's financial situation and investment objectives prior to approving a customer's account for options trading. Furthermore, before recommending any options transaction, a broker-dealer must have reasonable grounds to believe that (i) the recommended transaction is not unsuitable for the customer, and (ii) the customer has knowledge and experience in financial matters such that the customer reasonably may be expected to be capable of evaluating and financially bearing the risks of the transaction.<sup>1089</sup>

### Investment Advisers

In order for an investment adviser to provide to its clients investment advice that is suitable to the client, the investment adviser would need to know the financial circumstances and investment objectives of the client. While an investment adviser and its client usually negotiate the terms of their relationship and the client therefore may choose only to disclose information that the client feels is appropriate,<sup>1090</sup> as noted above in response to Question 31.10, investment advisers must conduct financial transactions for their clients, and maintain their clients' assets with, financial institutions that are subject to BSA requirements, including customer identification and "know your customer" requirements. See also response to Question 29.7(b) regarding custody of client assets and Question 31.5 regarding Regulation S-ID.

13. Does the regulatory framework require market intermediaries to keep records containing the information above for a reasonable number of years? Is the market intermediary required to maintain those books and records in such a way that allows the supervisor to be able to find all the relevant facts relating to a particular transaction?

### Broker-Dealers

Yes, the regulatory framework requires broker-dealer to keep records containing the information above for a reasonable number of years. Exchange Act Section 17(a) states, "Every [...] registered broker or dealer [...] shall make and keep for prescribed periods such records, furnish copies thereof, and make and disseminate such reports as the SEC, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors...." In accordance with this paragraph, the SEC promulgated a number of rules including Rules 17a-3 and 17a-4.

<sup>1089</sup> FINRA Rule 2360(b)(19).

<sup>1090</sup> In addition, AML regulation in the U.S. has resulted in another form of "know your customer" requirements. The PATRIOT Act amended the BSA to require that Treasury, along with the SEC and other federal regulators, adopt regulations setting forth minimum standards for financial institutions with regard to the identification and verification of customers in connection with the opening of accounts. Broker-dealers and certain CIS are required to implement CIPs. Investment advisers currently are not included in the definition of "financial institution," but FinCEN, a bureau within the Treasury, has indicated publicly that it is considering whether and to what extent it should impose requirements under the BSA, including CIPs, on investment advisers. See Fed. Reg. Doc. E8-26205 (Oct. 29, 2008).

Rules 17a-3 and 17a-4 specify requirements with respect to the records that a broker-dealer must make and keep current, as well as how long and, the manner in which, these records and other records relating to a broker-dealer's business must be maintained and preserved.

In particular, Rule 17a-3 requires a broker-dealer to make and keep current certain books and records. The required records include, among other records: blotters containing an itemized daily record of all purchases and sales of securities; ledgers reflecting all assets and liabilities, income and expense, and capital accounts; a securities record or ledger reflecting separately for each security as of the clearance dates all "long" or "short" positions; a memorandum of each brokerage order; a memorandum of each purchase or sale of a security for the account of the broker-dealer; and copies of confirmations.

Rule 17a-4 requires a broker-dealer to preserve additional records if the broker-dealer makes or receives the type of record. The categories of records include, among other records, check books, bank statements, bills receivable or payable, communications relating to the broker-dealer's business as such, and written agreements. The rule also establishes retention periods for all records required to be made and kept current under Rule 17a-3 and preserved under Rule 17a-4, and prescribes, among other things, how the records must be retained, including requirements for firms that preserve their records electronically. The length of time a broker-dealer must preserve records depends on the type of record. For example, broker-dealers must retain blotters containing all purchases and sales of securities for not less than six years. Other records, such as confirmations and communications related to the broker-dealer's "business as such" must be preserved for three years. For the first two years, these records must be kept in "an easily accessible place."

The recordkeeping program codified in Rules 17a-3 and 17a-4 is designed, among other things, to promote the prudent operation of broker-dealers and assist the SEC, SROs, and state securities regulators in conducting effective examinations of broker-dealers. As the SEC has stated:

In combination, Rules 17a-3 and 17a-4 require broker-dealers to create, and preserve in an accessible manner, a comprehensive record of each securities transaction they effect and of their securities business in general. These rules impose minimum recordkeeping requirements that are based on standards a prudent broker-dealer should follow in the normal course of business. The requirements are an integral part of the investor protection function of the Commission, and other securities regulators, in that the preserved records are the primary means of monitoring compliance with

applicable securities laws, including anti-fraud provisions and financial responsibility standards.<sup>1091</sup>

Exchange Act Rule 17a-5, the SEC's broker-dealer reporting requirements, requires that each broker-dealer submit financial statements audited by an independent accountant at least once each year.<sup>1092</sup>

### Investment Advisers

The Advisers Act imposes extensive recordkeeping requirements on registered investment advisers. Generally, Rule 204-2 under the Advisers Act requires an adviser to maintain business accounting records as well as records that relate to the fiduciary nature of its business. For example, advisers must maintain, among other things:

- General and auxiliary ledgers reflecting asset, liability, reserve, capital, income and expense accounts;
- A memorandum of any order given and instructions received by the adviser from clients for the purchase, sale, delivery or receipt of securities (including terms and conditions of any order, who recommended and placed the order, the account and date of entry, and who executed the order);
- Trial balances, financial statements, any internal audit papers relating to adviser's business;
- Original or copies of certain communications sent to or received by the adviser (including responses to requests for detailed investment advice, placement or execution of securities orders, receipt or delivery of securities or funds);
- A list of and documents relating to the adviser's discretionary client accounts (including powers of attorney or grants of authority);
- Copies of publications and recommendations the adviser distributed to 10 or more persons, a record of the factual basis, and reasons for the recommendation;

<sup>1091</sup> See *Commission Guidance to Broker-Dealers on the Use of Electronic Storage Media under the Electronic Signatures in Global and National Commerce Act of 2000 with Respect to Rule 17a-4(f)*, 66 Fed. Reg. at 22917.

<sup>1092</sup> The SEC has recently proposed certain recordkeeping and reporting rules for SBSs that are generally based on the corresponding broker-dealer rules. *Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers*, Exchange Act Release No. 71958 (Apr. 17, 2014), 79 Fed. Reg. 25194 (May 2, 2014).

- A record of certain securities transactions in which the adviser or advisory representatives have a direct or indirect beneficial ownership interest.

Additional records must be maintained in certain circumstances (*e.g.*, if an investment adviser has custody of client assets). Generally, all required books and records must be maintained and preserved in an adviser's office for two years after the last entry date and three additional years in an easily accessible place.<sup>1093</sup> Records may be stored on computer, magnetic disk or tape, subject to certain conditions ensuring safekeeping and accessibility.

Finally, Section 204 of the Advisers Act provides that all records of an investment adviser are subject at any time, or from time to time, to such reasonable periodic, special, or other examinations by representatives of the SEC as the SEC deems necessary or appropriate in the public interest or for the protection of investors.

14. Does the regulatory framework require market intermediaries to provide to the client a written contract of engagement or account agreement or a written form of the general and specific conditions of doing business through the market intermediary?

### Broker-Dealers

Yes. Written contracts are required for certain types of accounts (*e.g.*, margin accounts, options accounts and discretionary accounts). However, most broker-dealers have a customer sign a customer agreement, despite the fact that they are not required to do so.

Rule 15c3-3(j)(2)(ii) requires a broker-dealer to obtain a customer's prior written affirmative consent to having free credit balances in the customer's securities account included in the Sweep Program after being notified: (i) of the general terms and conditions of the products available through the Sweep Program; and (ii) that the broker-dealer may change the products available under the Sweep Program.<sup>1094</sup>

Rule 17a-3(a)(9) requires a firm to obtain the signature of the account owner with respect to a margin account. Under Rules 8c-1 and 15c2-1 of the Exchange Act, broker-dealers are required to obtain a customer's written consent in order to hypothecate securities under circumstances that would permit the commingling of customers' securities and to give written notice to a pledgee that, among other things, a security pledged is carried for the account of a customer. Written consent and signatures for the purposes of Rules 8c-1, 15c2-1 and 17a-3 are generally obtained by broker-dealers when a customer executes a margin agreement.

<sup>1093</sup> See Advisers Act rule 204-2(e).

<sup>1094</sup> A Sweep Program is defined under Rule 15c3-3(a)(17) as a service provided by a broker-dealer where it offers its customers the option to automatically transfer free credit balances in the securities account of the customer to either a money market mutual fund or an FDIC-insured bank account.

SRO rules require that a customer opening an options account agree in writing that the account shall be handled in accordance with the rules of the exchange, the rules of the options clearing corporations, that the customer will not violate position, and exercise limits set forth in the FINRA rules. FINRA rules require that a broker-dealer obtain the prior written consent of the customer before exercising any discretionary authority over an account.<sup>1095</sup>

### Investment Advisers

The investment advisory contract forms the basis for the relationship between the investment adviser and its clients. Section 205 of the Advisers Act and the rules thereunder contain a number of provisions relating to items required to be or prohibited from inclusion in an investment advisory contract. For example, an advisory contract must provide, in substance, that the contract may not be assigned by the adviser without client consent; and the contract must not provide for compensation to the adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client.

15. Does the regulatory framework require a market intermediary to disclose or make available information to its client so that the client can make an informed investment decision?

### Broker-Dealers

**Generally:** The anti-fraud provisions of the Exchange Act broadly prohibit misstatements or misleading omissions of material facts, and fraudulent or manipulative acts and practices, in connection with the purchase or sale of securities (e.g., §§10(b) and 15(c) of the Exchange Act). Exchange Act Section 15(c) prohibits any broker or dealer from effecting any transaction in or inducing or attempting to induce the purchase or sale of any security by means of any manipulative, deceptive, or other fraudulent device or contrivance. Under this prohibition, broker-dealers are precluded from making material omissions or misrepresentations and from any act, practice, or course of business that constitutes a manipulative, deceptive, or other fraudulent device or contrivance.

Generally, under the anti-fraud provisions, a broker-dealer's duty to disclose material information to its customer is based upon the scope of the relationship with the customer.<sup>1096</sup> Where a broker-dealer processes its customer's orders, but does not recommend securities or solicit customers, then the material information that the broker-dealer is required to disclose to its

<sup>1095</sup> See FINRA Rule 4512.

<sup>1096</sup> See, e.g., *Conway v. Icahn & Co., Inc.*, 16 F.3d 504, 510 (2d Cir. 1994) ("A broker, as agent, has a duty to use reasonable efforts to give its principal information relevant to the affairs that have been entrusted to it.").

customer is narrow, encompassing only the information related to the consummation of the transaction.<sup>1097</sup> In such circumstances, the broker-dealer generally does not have to provide information regarding the security or the broker-dealer's economic self-interest in the security.<sup>1098</sup> However, when recommending a security, a broker-dealer may be liable if it does not "give honest and complete information."<sup>1099</sup> A broker-dealer also may be liable if it does not disclose "material adverse facts of which it is aware."<sup>1100</sup> For example, in making recommendations, courts have found broker-dealers should have disclosed: acting as a market maker for the recommended security; trading as principal with respect to the recommended security; revenue sharing with respect to a recommended mutual fund; and "scalping" a recommended security. In addition, if a broker-dealer recommends mutual funds with different classes, it must disclose the various class expenses and fees and how they will impact the expected return on investment.

**Penny Stock Disclosures:** Prior to effecting transactions in penny stocks for a customer, a firm must provide customer a standardized disclosure document about the risks associated with penny stocks and obtain from the customer a manually signed and dated written acknowledgement of receipt of the document. The text of the disclosure document is set forth in Schedule 15G. Penny stocks are low-priced shares of small companies not traded on U.S. exchanges or NASDAQ.

<sup>1097</sup> See *Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529, 536 (2d Cir. 1999).

<sup>1098</sup> See, e.g., *Carras v. Burns*, 516 F.2d 251, 257 (4th Cir. 1975) (broker-dealer not required to volunteer advice where "acting only as a broker"); *Canizaro v. Kohlmeyer & Co.*, 370 F. Supp. 282, 289 (E.D. La. 1974), *aff'd*, 512 F.2d 484 (5th Cir. 1975) (broker-dealer that "merely received and executed a purchase order, has a minimal duty, if any at all, to investigate the purchase and disclose material facts to a customer"); *Walston & Co. v. Miller*, 410 P.2d 658, 661 (Ariz. 1966) ("The agency relationship between customer and broker normally terminates with the execution of the order because the broker's duties, unlike those of an investment advisor or those of a manager of a discretionary account, are only to fulfill the mechanical, ministerial requirements of the purchase and sale of the security or future contract on the market.").

<sup>1099</sup> See, e.g., *De Kwiatkowski v. Bear, Stearns & Co., Inc.*, 306 F.3d 1293, 1302 (2d Cir. 2002) (broker-dealer "is obliged to give honest and complete information when recommending a purchase or sale"); *Vucinich v. Paine, Webber, Jackson & Curtis, Inc.*, 803 F.2d 454, 459-61 (9th Cir. 1986) (vacating directed verdict for broker-dealer where evidence showed broker-dealer may have violated Exchange Act by failing to disclose material facts relating to risk to his unsophisticated customer and may effectively have exercised control over account); *SEC v. R.A. Holman & Co.*, 366 F.2d 456, 458 (2d Cir. 1966) (salespersons failed to disclose that company had significant losses).

<sup>1100</sup> See, e.g., *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1172 (2d Cir. 1970); *SEC v. Hasho*, 784 F. Supp. 1059, 1110 (S.D.N.Y. 1992); *In the Matter of Richmark Capital Corp.*, Exchange Act Release No. 48758 (Nov. 7, 2003) (Commission opinion) ("Release 48758") ("When a securities dealer recommends stock to a customer, it is not only obligated to avoid affirmative misstatements, but also must disclose material adverse facts of which it is aware. That includes disclosure of "adverse interests" such as "economic self interest" that could have influenced its recommendation.") (citations omitted).

**Disclosure of Credit Terms in Margin Transactions:** Prior to extending credit to a customer a broker-dealer generally must provide a written statement to the customer describing the terms of the credit arrangement.<sup>1101</sup> In addition, the broker-dealer must provide the customer with quarterly account statements.

**Day Trading Risk Disclosure Statement:** FINRA Rule 2270, which applies to firms that are promoting a day-trading strategy, and to new accounts opened by all non-institutional customers at those firms, requires such firms to deliver a risk disclosure statement, discussing the unique risks posed by day trading, to all non-institutional customers before opening an account for such customers.

The rule mandates that the disclosure statement include several factors that a customer is advised to consider before engaging in day trading, including that:

- the customer may lose all of the funds that he or she uses for day trading;
- day trading usually requires significant resources; and
- day trading on margin or short selling may result in losses beyond the customer's initial investment.

Additionally, the disclosure statement would include a provision stating that day trading is inappropriate for persons of limited resources and limited investment or trading experience, as well as inadvisable for customers with low risk tolerance.

Firms are permitted to develop an alternative risk disclosure statement, provided such statement is substantially similar to the statement mandated by the rule, and is filed with and approved by FINRA's Advertising Department.

**Options Disclosure Document and Options Clearing Corporation Prospectus:** Under SRO rules, a firm must deliver to its customer the current Options Disclosure Document at or prior to the time a customer's account is approved for options trading.<sup>1102</sup> The firm also must deliver to each customer who was previously furnished the Options Disclosure Document a copy of any amendment to the Options Disclosure Document no later than the time of the delivery to the customer of a trade confirmation, in the category of options to which the amendment pertains. In addition, a firm must deliver a current prospectus of the Options Clearing Corporation to each customer who requests one.

<sup>1101</sup> Exchange Act Rule 10b-16.

<sup>1102</sup> FINRA Rule 2360.

**Security Futures Risk Disclosure Statement:** Under SRO rules, a firm must deliver to its customer the current Security Futures Risk Disclosure Statement at or prior to the time a customer's account is approved for trading security futures.<sup>1103</sup> The firm also must deliver each new or revised security futures risk disclosure statement to every customer having an account approved for such trading or, in the alternative, no later than the time a trade confirmation is delivered to each customer that enters into a security futures transaction.

**Prospectus Delivery:** If a broker-dealer is participating in a distribution that is registered under the Securities Act, the broker-dealer must: (i) in an IPO, deliver a preliminary prospectus to purchasers 48 hours prior to sending a confirmation, if the issuer has not previously filed certain periodic financial condition reports;<sup>1104</sup> (ii) take reasonable steps to provide a preliminary prospectus to any person who requests one in writing between filing and effectiveness; (iii) take reasonable steps to provide a final prospectus to any person who requests in writing during the period between effectiveness and the termination of the distribution or the expiration of the applicable period under Section 4(a)(3) of the Securities Act; and (iv) make available copies of the preliminary prospectus before effectiveness, and final prospectus after effectiveness during similar periods to its associates who may be selling the offering. In addition, if the broker-dealer is the managing underwriter for the offering, it is subject to additional obligations to help ensure that all broker-dealers participating in the distribution get sufficient copies of the preliminary and final prospectus on a timely basis so that they can meet their delivery requirements.

**Disclosure of Control of Issuer:** Broker-dealers controlling, controlled by, or under common control with, an issuer of a security must disclose such control in writing to customers for whom it effects transactions in such security. This disclosure must take place at or before the completion of the applicable transaction.

**Disclosure of Interest:** Broker-dealers participating in the distribution of, or otherwise financially interested in, the distribution of a security must disclose such participation or interest in writing to customers for whom it effects transactions in such security. This disclosure must take place at or before the completion of such transaction.

**Additional Disclosure Requirements:** There are additional SRO rules that require other specific disclosures including, for example:

- FINRA Rule 2261. Disclosure of Financial Condition
- FINRA Rule 2262. Disclosure of Control Relationship with Issuer
- FINRA Rule 2263. Arbitration Disclosure to Associated Persons Signing or Acknowledging Form U4

<sup>1103</sup> FINRA Rule 2370.

<sup>1104</sup> See 17 C.F.R. 240.13a-1 *et seq.* 17 C.F.R. 15d-1 *et seq.*



- FINRA Rule 2264. Margin Disclosure Statement
- FINRA Rule 2265. Extended Hours Trading Risk Disclosure
- FINRA Rule 2266. SIPC Information
- FINRA Rule 2267. Investor Education and Protection
- FINRA Rule 2268. Requirements When Using Predispute Arbitration Agreements for Customer Accounts
- FINRA Rule 2269. Disclosure of Participation or Interest in Primary or Secondary Distribution

In addition, there are other disclosure requirements under other SEC rules and regulations. For example, Rule 15c3-3(j)(2)(ii) requires broker-dealers to disclose to customers the terms and conditions of a Sweep Program where customers' free credit balances may be swept. In addition, for example, Rules 605 and 606 of Regulation NMS require disclosure of order execution information and order routing information.<sup>1105</sup>

The disclosure requirements are designed to help investors obtain information material to their investment decision.

### **Investment Advisers**

Except as noted below, the federal securities laws generally do not specifically require registered investment advisers to provide their clients with particular documents.<sup>1106</sup> Rather, those delivery requirements would apply to the extent that an investment adviser is also a registered broker-dealer or a bank.

In addition to any information that the adviser is required to provide to clients under applicable law and regulations, an investment adviser's duty to provide documents to its clients generally will depend upon the investment adviser's contractual relationship with each client (*i.e.*, the investment adviser's duties as described in the advisory contract).<sup>1107</sup> For instance, if an advisory client maintains a discretionary account with an adviser (*i.e.*, the investment adviser is authorized to make investment decisions for the client without consulting with the client), the advisory contract typically designates the adviser to receive all required documents that are provided by the issuers of the securities that the client holds in the discretionary account. In contrast, if the client has a non-discretionary account with the investment adviser, and the client's assets are held with a broker-dealer in the name of the client, the advisory contract typically designates the

<sup>1105</sup> 17 C.F.R. 242.605-606.

<sup>1106</sup> See, *e.g.*, Section 4 of the Securities Act (governing prospectus delivery obligations of issuers, underwriters and dealers), Rule 14b-1 under the Exchange Act (obligations of registered broker-dealers in connection with the prompt forwarding of certain proxy communications to beneficial owners of securities).

<sup>1107</sup> An investment adviser's fiduciary duty, which requires disclosure of certain information, is discussed below in response to Question 31.18 and above in response to Question 29.7(c).

client to receive all required documents. Whether an investment adviser has an obligation to provide non-required documents similarly depends on the terms of the contract between the investment adviser and the client.

Finally, as a general matter, the SEC has stated that, consistent with its fiduciary duty to its clients, an investment adviser must disclose all material facts regarding conflicts of interest so that a client can make an informed decision whether to enter into or continue an advisory relationship with the adviser, or take some action to protect himself or herself against the conflict.<sup>1108</sup>

For more information please see response to Questions 29.2, 29.5, 29.6(b), 29.7(c) (describing certain disclosure requirements of Parts 1A, 2A and 2B of Form ADV, including certain disclosures an adviser must make about its financial condition), and 29.7(b) (describing the obligations of an investment adviser that has custody of client assets).

Please note that the advisory contract may require the investment adviser to provide the client with additional information. The investment advisory contract also dictates the types of information that must be provided to the client by the adviser.

16. Does the regulatory framework require market intermediaries to provide a client with statements of account, at least annually?

### Broker-Dealers

Yes, a broker-dealer is generally required to send its customers written trade confirmations, account statements, and other reports disclosing activities and transactions it has taken on the customer's behalf.<sup>1109</sup> In particular, Exchange Act Rule 10b-10 requires the disclosure of, among other things, the date, time, identity, and number of securities bought or sold; the capacity of the broker-dealer (*e.g.*, agent or principal); yields on debt securities; and under specified circumstances, the amount of compensation the broker-dealer will receive from the customer and any other parties.

SRO rules require that a broker-dealer send each customer an account statement at least quarterly showing their security positions, as required by applicable SRO rules of which the broker-dealer is member.<sup>1110</sup> The account statements must include a description of any

<sup>1108</sup> See *Amendments to Form ADV*, Advisers Act Rel. No. 3060 (July 2010). See also *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 191-192 (1963) ("The Investment Advisers Act of 1940 thus reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship, as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.").

<sup>1109</sup> See, *e.g.*, 17 C.F.R. 240.10b-10, NASD Rule 2232.

<sup>1110</sup> See, *e.g.*, NASD Rule 2340.

securities positions, money balances and account activity since the firm issued the prior account statement. In addition, each account statement is required to include a statement that advises the customer to report promptly any inaccuracy or discrepancy in that person's account to his or her brokerage firm. Such statement also must advise the customer that any oral communications should be re-confirmed in writing to further protect the customer's rights, including rights under SIPA. The industry practice is to send monthly account statements to customers with activity in their accounts during that month.

In addition, Exchange Act Rule 15c3-3 requires that a broker-dealer inform a customer that transacts in or holds SFPs as to whether the customer's SFP assets will be held in a securities account or in a futures account and what protections apply to that account. The rule also requires, a broker-dealer holding customer funds must provide at least once every three months each customer with a written statement with or as part of the statement of account, informing the customer of the amount due to the customer by the broker-dealer on the date of the statement, and that the funds are payable on demand of the customer.

### **Investment Advisers**

The Advisers Act generally does not require an investment adviser to send account statements to its clients. An investment adviser may use a broker-dealer to effect trades and the broker-dealer would be responsible for generating such documents. However, many investment advisers do send monthly or quarterly account statements to their clients.

Rule 206(4)-2 under the Advisers Act requires an investment adviser that has custody of client assets to have a reasonable belief, after due inquiry, that the qualified custodian – regardless of whether it is a broker-dealer, bank, FCM or foreign financial institution – that maintains the client assets sends each client, not less frequently than once every three months, an itemized statement showing the client's funds and securities in the adviser's custody or possession at the end of such period, and all debits, credits, and transactions in such client's account during such period. For more information about Rule 206(4)-2, see response to Question 29.7(b).

Investment advisers that are also registered broker-dealers are required under the Exchange Act to provide their customers with account statements.

17. Does the regulatory framework require market intermediaries to provide a client with information about any fees and commissions associated with the client's transactions?

### Broker-Dealers

Yes. Broker-dealers must provide customers with adequate notice prior to their implementation or change of a service fee.<sup>1111</sup> Consequently, broker-dealers should provide written notice to customers of all service charges (i) when accounts are opened, and (ii) at least 30 days prior to the implementation or change of any service charge.

In addition, as discussed in Question 31.16 above, a broker-dealer is generally required to send its customers written trade confirmations,<sup>1112</sup> account statements,<sup>1113</sup> and other reports disclosing activities and transactions it has taken on the customer's behalf. In particular, Exchange Act Rule 10b-10 requires the disclosure of, among other things, the date, time, identity, and number of securities bought or sold; the capacity of the broker-dealer (*e.g.* agent or principal); yields on debt securities; and under specified circumstances, *the amount of compensation the broker-dealer will receive from the customer and any other parties.*

### Investment Advisers

Investment advisers are in the business of providing advice about securities to clients for compensation. While their services may include arranging a purchase or sale through a registered broker-dealer, advisers generally do not, themselves, transact in securities for clients or receive commissions or transaction-based compensation for securities transactions. Persons who are in the business of effecting securities transactions generally are regulated by the SEC as "brokers" or "dealers" under the Exchange Act and are discussed immediately above.

Investment adviser compensation arrangements are required to be disclosed extensively in Form ADV. Part 1A of Form ADV requires investment advisers to disclose the nature of their compensation arrangements (*e.g.*, fixed fee, percentage of assets under management). It also requires investment advisers to indicate whether it (or a related person) has any sales or proprietary interest in, or receives other types of benefits (such as soft dollars) for securities transactions that may be effected for the client's account.

Part 2A of Form ADV requires additional disclosures about how an adviser is compensated for its services. In addition to providing its fee schedule and indicating whether fees are negotiable, investment advisers must (i) describe whether and how often it deducts fees from clients' assets

<sup>1111</sup> See FINRA Regulatory Notice 11-08, "Markups, Commissions and Fees" (Feb. 2011); see also FINRA Notice 92-11, "Fees and Charges for Services."

<sup>1112</sup> 17 C.F.R. 240.10b-10, FINRA Rule 2232.

<sup>1113</sup> Rule 15c3-3(j)(1), NASD Rule 2340, FINRA Rule 2860(b)(15).

or bills clients for fees incurred (ii) describe any other types of fees or expenses clients may pay in connection with their advisory services, such as custodian fees or mutual fund expenses, and that clients will incur brokerage and other transaction costs, if applicable; (iii) disclose whether clients either may or must pay fees in advance, and how to obtain a refund of a pre-paid fee (and how that refunded amount is determined) if the advisory contract is terminated before the end of the billing period; (iv) disclose if the adviser or any of its supervised persons accept compensation for the sale of securities or other investment products, including asset-based sales charges or service fees from the sale of mutual funds. The form also requires extensive disclosures regarding the conflicts of interest that arise where the adviser or its supervised persons are compensated for purchases or sales of certain investment products, particularly the adviser's procedures for addressing such conflicts.

Finally, an adviser must disclose if it or any of its supervised persons accept performance-based fees or manage side-by-side both accounts that are charged a performance-based fee and accounts that are charged another type of fee (such as an hourly or flat fee or an asset-based fee). Investment advisers also must explain and describe how they manage the conflicts of interest that the adviser or its supervised persons face by managing these accounts at the same time, including that the adviser or its supervised persons have an incentive to favor accounts for which it or its supervised persons receive a performance-based fee.

18. Does the regulatory framework require market intermediaries to act with due care and diligence in the best interests of its clients and their assets and in a way that helps preserve the integrity of the market?

### Broker-Dealers

Yes. Under the anti-fraud provisions of the federal securities laws and SRO rules, including SRO rules relating to just and equitable principles of trade and high standards of commercial honor, broker-dealers are required to deal fairly with their customers. While broker-dealers are generally not subject to a fiduciary duty under the federal securities laws, courts have found broker-dealers to have a fiduciary duty under certain circumstances.<sup>1114</sup> Moreover, broker-dealers are subject to statutory, SEC and SRO requirements that are designed to promote business conduct that protects customers from abusive practices, including practices that may be unethical but may not necessarily be fraudulent. The federal securities laws and rules and SRO rules address broker-dealer conflicts in one of three ways: express prohibition, mitigation, or

<sup>1114</sup> Generally, courts have found that broker-dealers that exercise discretion or control over customer assets, or have a relationship of trust and confidence with their customers, are found to owe customers a fiduciary duty similar to that of investment advisers. See, e.g., *United States v. Skelly*, 442 F.3d 94, 98 (2d Cir. 2006); *United States v. Szur*, 289 F.3d 200, 211 (2d Cir. 2002); *Associated Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc.*, 3 F.3d 208, 212 (7th Cir. 1993); *MidAmerica Fed. Savings & Loan Ass'n v. Shearson/American Express Inc.*, 886 F.2d 1249, 1257 (10th Cir. 1989); *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 953-954 (E.D. Mich. 1978), *aff'd*, 647 F.2d 165 (6th Cir. 1981).

disclosure.

An important aspect of a broker-dealer's duty of fair dealing is the suitability obligation, which, as discussed above in response to Question 31.12, generally requires a broker-dealer to make recommendations that are consistent with the interests of its customer.<sup>1115</sup> Broker-dealers also are required under certain circumstances, such as when making a recommendation, to disclose material conflicts of interest to their customers, in some cases at the time of the completion of the transaction. SROs also impose a duty of best execution on broker-dealers.<sup>1116</sup> The federal securities laws and FINRA rules restrict broker-dealers from participating in certain transactions that may present particularly acute potential conflicts of interest. At the state level, broker-dealers and their agents must register with or be licensed by the states in which they conduct their business.

### Investment Advisers

Several obligations of due care and acting in the best interest of clients flow from an investment adviser's fiduciary duties. They are discussed above in response to questions in Principle 29. For example:

1. *Full Disclosure of Material Facts.* Under the Advisers Act, an adviser has an affirmative obligation of utmost good faith and full and fair disclosure of all facts material to the client's engagement of the adviser to its clients, as well as a duty to avoid misleading them. Accordingly, the duty of an investment adviser to refrain from fraudulent conduct includes an obligation to disclose (i) material facts to its clients whenever failure to do so would defraud or operate as a fraud or deceit upon any client. This includes an obligation to disclose all actual or potential conflicts of interest; (ii) a financial condition of the adviser that is reasonably likely to impair the adviser's ability to meet contractual commitments to clients; and (iii) certain disciplinary events of the adviser (and certain of its officers) occurring within the past 10 years, which are presumptively material.<sup>1117</sup>
2. *Suitable Advice.* Advisers owe their clients a duty to provide only suitable investment advice. This duty generally requires an adviser to make a reasonable inquiry into the client's financial situation, investment experience and investment objectives, and to make a

<sup>1115</sup> The concept of suitability appears in specific SRO rules such as FINRA Rule 2111 and has been interpreted as an obligation under the anti-fraud provisions of the federal securities laws.

<sup>1116</sup> See, e.g., FINRA Rule 5310.

<sup>1117</sup> Form ADV explicitly requires these disclosures: See, e.g., Item 11 of Part 1A; Item 9 of Part 2A; Item 18 of Part 2A; Item 3 of Part 2B.

reasonable determination that the advice is suitable in light of the client's situation, experience and objectives.<sup>1118</sup>

3. *Reasonable Basis for Recommendations.* An investment adviser must have a reasonable, independent basis for its recommendations.<sup>1119</sup>
4. *Best Execution.* Where an investment adviser has responsibility to direct client brokerage, it has an obligation to arrange the execution of transactions for clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances.<sup>1120</sup> In assessing whether this standard is met, an adviser should consider the full range and quality of a broker's services when placing brokerage, including, among other things, execution capability, commission rate, financial responsibility, responsiveness to the adviser, and the value of any research provided.<sup>1121</sup>
5. *Proxy Voting.* Advisers Act Rule 206(4)-6 requires, among other things, each registered investment adviser that has voting authority over client securities to adopt and implement policies and procedures reasonably designed to ensure that client securities are voted in the best interest of clients. The SEC has stated that if an adviser has delegated authority to vote client proxies, it has a fiduciary duty to vote the proxies in the best interest of its clients and cannot subrogate the client's interests to its own.

19. Can the regulator demonstrate that it has in place a supervision program, including internal processes that seek to monitor compliance by market intermediaries with these requirements?

Yes. The SEC has a robust examination program which examines SEC regulated entities for compliance with the federal securities laws and SRO rules. See the response to Questions 10.1(a), 10.2(a), 10.4, 10.6, 12.1, and 12.5 for more details on the SEC's examination authority and process.

### **Broker-Dealers**

Yes. As stated above in response to Questions 31.1 and 31.2, the SEC has promulgated certain

<sup>1118</sup> The SEC has instituted enforcement actions against advisers that provided unsuitable investment advice. See *In the Matter of George E. Brooks & Associates, Inc.*, Advisers Act Rel. No. 1746 (Aug. 17, 1998); *In the Matter of Philip A. Lehman*, Advisers Act Rel. No. 1896 (Sept. 7, 2000).

<sup>1119</sup> See, e.g., *In the Matter of Alfred C. Rizzo*, Advisers Act Rel. No. 897 (Jan 11, 1984); *In the Matter of Baskin Planning Consultants, Ltd.*, Advisers Act Rel. No. 1297 (Dec. 19, 1991).

<sup>1120</sup> The SEC has brought enforcement actions against advisers alleging failure to seek best execution. See, e.g., *In the Matter of Renberg Capital Management, Inc.*, Advisers Act Rel. No. 2064 (Oct 1, 2002); *In the Matter of Portfolio Advisory Services, LLC*, Advisers Act Rel. No. 2038 (June 30, 2002).

<sup>1121</sup> See Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Exchange Act Release No. 23170 (Apr. 23, 1986).

rules designed to ensure that broker-dealers implement internal controls to manage risk. Included among these rules is the requirement that an independent public accountant perform a yearly review of each broker-dealer's accounting system, internal accounting controls, procedures for safeguarding securities, and certain specified practices and procedures, and report any material inadequacies found in the course of that review. To the extent that a firm's risk identification and management were found to be inadequate, the independent public accountant performing the audit would have a duty to report that fact in its audit. Furthermore, broker-dealers and their supervisory personnel have an obligation under the Exchange Act reasonably to supervise persons subject to their supervision with a view to preventing violations of the securities laws. Thus, broker-dealers may be found liable for failing to supervise their associated persons who make unsuitable recommendations. Ultimately, the test is whether the supervision was reasonable under the circumstances.

In addition, the SROs require that a broker-dealer conduct periodic internal inspections.<sup>1122</sup> SROs conduct periodic examinations of broker-dealers and Staff conducts risk-based examinations as well. For instance, SROs inspect broker-dealers that hold customer funds and securities once each year. Other broker-dealers are also subject to onsite examinations by SROs, however they may be examined less frequently. For additional information regarding the SEC's broker-dealer examination program, see the responses to Questions 10.1, 12.1, and 12.3.

Pursuant to SRO rules, each broker-dealer must implement a supervisory system reasonably designed to achieve compliance with applicable securities laws, regulations and rules.<sup>1123</sup> The SROs generally specify that the supervisory system should include designation of one or more persons responsible for reviewing the supervisory system implemented by the member and either take (or advise senior management to take) action to achieve the member's compliance with applicable securities laws and regulations and the SRO's rules or report to management regarding the efforts taken.<sup>1124</sup>

Finally, an OTC derivatives dealer or an ANC Broker-Dealer is required to establish, document, and maintain a system of internal risk management controls to manage the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks.<sup>1125</sup> The internal risk control system must include certain elements, including a risk control unit that reports directly to senior management, periodic and annual reviews of the risk management system, and separation of duties for personnel responsible for entering into a transaction and personnel responsible for recording the transaction in the books and records.

<sup>1122</sup> See, e.g., NYSE Rule 342(b)(2), NASD Rule 3010(c).

<sup>1123</sup> See, e.g., NYSE Rule 342, NASD Rule 3010(b).

<sup>1124</sup> See, e.g., NYSE Rule 342.30(a) to (c), NASD Rule 3010(a)(8), FINRA Rule 3130.

<sup>1125</sup> 17 C.F.R. 240.15c3-4.



**Investment Advisers**

In addition, see response to Question 29.1(e), which describes requirements under Rule 206(4)-7(c) under the Advisers Act for an investment adviser to designate a CCO for purposes of regularly self-monitoring and conducting an annual review to determine the adequacy and effectiveness of the firm's CP&P. See also response to Question 31.1 regarding responsibilities of senior management.

**Principle 32      There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.**

**Key Questions**

1. Does the regulator have clear plans for dealing with the eventuality of a firm's failure, including a combination of activities to restrain conduct, to ensure assets are properly managed and to provide information to the market as necessary?

**Broker-Dealers**

Although each broker-dealer failure is unique and presents different issues, Staff has established a well-developed and tested process for dealing with firm failures. First, Staff will generally collect as much information as possible before taking any action. Usually, Staff and the firm's DEA know that the firm is approaching financial difficulty because the firm has filed notice of its financial difficulties pursuant to Exchange Act Rule 17a-11. Staff may then collect the financial reports filed by the relevant broker-dealer, contact the broker-dealer's DEA, and, if the firm is an introducing firm, contact the firm's clearing firm. Further, Staff may attempt to initiate an onsite inspection, since these examinations can be conducted at any time.<sup>1126</sup>

To the extent that it becomes apparent that a broker-dealer is in or is approaching financial difficulty, Staff must contact SIPC to inform it of the status of the situation so that SIPC can assess whether it should initiate a liquidation proceeding,<sup>1127</sup> (alternatively, if SIPC elects not to commit its funds, the SEC may petition a U.S. district court to order SIPC to act<sup>1128</sup>). Once SIPC determines that a member broker-dealer has failed or is in danger of failing to meet its obligations to customers and the firm is either insolvent or not in compliance with the SEC's financial responsibility rules, SIPC may file an application in court to initiate a proceeding to liquidate the broker-dealer. If SIPC's application is granted, the court appoints a trustee for the broker-dealer.<sup>1129</sup>

Under SIPC's oversight, the trustee begins working to restore securities and cash to customers as soon as possible. The trustee and its staff close the broker-dealer's offices and take control of the broker-dealer's books and records. In a failed broker-dealer with accurate records, the

<sup>1126</sup> 15 U.S.C. § 78q(b).

<sup>1127</sup> 15 U.S.C. § 78eee(a)(1). SIPC is a non-profit member corporation that was created by Congress by SIPA. SIPC oversees the liquidation of member broker-dealers that close when the broker-dealer is bankrupt or in financial trouble, and customer assets are missing. SIPC, About SIPC: SIPC Mission, *available at* <http://www.sipc.org/about-sipc/sipc-mission>.

<sup>1128</sup> 15 U.S.C. § 78ggg(b).

<sup>1129</sup> 15 U.S.C. § 78eee(b)(1).

trustee and SIPC may arrange to have some or all customer accounts transferred to another broker-dealer. Customers whose accounts are transferred are notified promptly of the move.<sup>1130</sup> The trustee prepares claim forms for the court's approval, and then publishes notice of the case and mails the claim forms to customers who had an account with the broker-dealer within the previous 12 months. The trustee then works to recover assets belonging to the broker-dealer and its customers.

Under a SIPA liquidation, customers of a failed broker-dealer receive all securities (such as stocks and bonds) that already are registered in their names or are in the process of being registered. After this first step, the firm's remaining customer assets are then divided on a *pro rata* basis with securities and cash shared in proportion to the size of claims. If sufficient assets are not available in the firm's customer accounts to satisfy claims within these limits, the reserve funds of SIPC are used to supplement the distribution, up to a ceiling of \$500,000 per customer, including a maximum of \$250,000 for cash claims (increased from \$100,000 for cash claims by the Dodd-Frank Act).<sup>1131</sup> In this way, SIPA seeks to protect investors from the loss of securities or cash left with a failed broker-dealer.

### **Non-Broker-Dealer SBSDs**

SBSDs that are not dually registered as broker-dealers are subject to a different liquidation regime than SBSDs that are dually registered as broker-dealers. Non-broker-dealer SBSDs are subject to the stockholder liquidation provisions of the U.S. Bankruptcy Code (instead of SIPA's liquidation provisions).<sup>1132</sup> SIPC is not involved in liquidations under the U.S. Bankruptcy Code. Instead, a trustee is appointed who works directly with the court. Generally, customer claims for customer property are given priority above other claims,<sup>1133</sup> with customer securities converted to cash as soon as practicable.<sup>1134</sup>

### **Investment Advisers**

The cessation of operations of an investment adviser does not pose the same risks as could be posed by a broker-dealer's cessation of operations because an investment adviser generally acts as agent on behalf of its clients; it does not trade as principal on its own behalf when conducting its advisory businesses. It is worth noting that an investment adviser is required under rule

<sup>1130</sup> 15 U.S.C. § 78eee(f). In addition, to the extent that a broker-dealer is a publicly traded company, it has an ongoing obligation to inform its shareholders and the marketplace of material information, including material information about the firm's failure. 17 C.F.R. 240.10b-5.

<sup>1131</sup> Pub. L. 111-203 § 929H(a) (amending 15 U.S.C. § 78fff-3).

<sup>1132</sup> Pub. L. 111-203 § 763(d) (adding Exchange Act § 3E(g), which subjects non-broker-dealer SBSDs to Title 11, Chapter 7, Subchapter III of the U.S. Bankruptcy Code).

<sup>1133</sup> 11 U.S.C. § 752.

<sup>1134</sup> 11 U.S.C. § 748.

206(4)-7, and as a fiduciary obligation to its clients to include in its CP&P a BCP because it must take steps to protect its clients' interests from being placed at risk as a result of the adviser's inability to provide advisory services after, for example, a natural disaster or, in the case of some smaller firms, the death of the owner or key personnel.

See also responses to Questions 29.2(c) and 30.1 regarding capital requirements, as well as 29.7(c) regarding safekeeping of advisory clients' assets.

2. Are there early warning systems or other mechanisms in place to give the regulator notice of a potential default by a market intermediary and time to address the problem and to take corrective actions?

### Broker-Dealers

Yes. As noted in response to Question 30, a broker-dealer is required to satisfy its net capital requirement at all times.<sup>1135</sup> Exchange Act Rule 17a-11 (commonly called the "early warning rule") requires a broker-dealer to notify the SEC promptly (but within 24 hours) if the broker-dealer's net capital falls below 120% of the minimum net capital requirement,<sup>1136</sup> and to notify the SEC the same day if the firm fails to make and keep current the books and records required by SEC rules.<sup>1137</sup> Pursuant to Rule 17a-11, a broker-dealer must promptly notify the SEC's main office and the Regional Office of the SEC in whose region it has its principal place of business, as well as its DEA, and, if applicable, the CFTC.<sup>1138</sup> In addition, if a stockholder, partner, sole proprietor, employee or affiliate wants to withdraw equity capital, redeem or repurchase stock, or obtain an unsecured advance or loan from a broker-dealer, the broker-dealer generally must first give the SEC notice.<sup>1139</sup> The SEC has approved DEA rules requiring broker-dealers to provide early warning of similar financial responsibility issues.<sup>1140</sup>

Rule 17a-5 requires a broker-dealer, among other things, to file with the SEC and the broker-dealer's DEA unaudited financial reports either monthly or quarterly, and audited financial reports annually.<sup>1141</sup> All broker-dealers must include their net capital computations in the financial report (commonly called the "FOCUS Report"). Although the other required contents of

<sup>1135</sup> 17 C.F.R. 240.15c3-1(a).

<sup>1136</sup> 17 C.F.R. 240.17a-11(c)(3).

<sup>1137</sup> 17 C.F.R. 240.17a-11(d).

<sup>1138</sup> 17 C.F.R. 240.17a-11(g).

<sup>1139</sup> 17 C.F.R. 240.15c3-1(e)(1).

<sup>1140</sup> See, e.g., FINRA Rule 4120(a) ((requiring a carrying or clearing FINRA member to provide written notice promptly (but in any event within 24 hours) if, among other things, the firm's net capital is less than 150% of its minimum net capital requirement)).

<sup>1141</sup> 17 C.F.R. 240.17a-5.

the FOCUS Report vary by broker-dealer type, all FOCUS Reports must at least also include the firm's Statement of Financial Condition, Statement of Income (Loss), and Ownership Equity and Subordinated Liabilities Maturing or Proposed to Be Withdrawn Within the Next Six Months.

In addition, broker-dealers must submit to periodic examinations by Staff and the broker-dealer's DEA,<sup>1142</sup> and are subject to an annual audit by an independent public accountant.<sup>1143</sup> If the broker-dealer's independent public accountant discovers a material weakness in the firm's accounting system, the accountant must notify the broker-dealer. Generally, if the broker-dealer fails to notify the SEC and its DEA within 24 hours or the independent public accountant disagrees with statements contained in the notice, the independent public accountant must inform the SEC and the DEA of the material weakness within one business day thereafter.<sup>1144</sup>

Finally, as noted in response to Question 30.4, Exchange Act Rule 15c3-3 requires a broker-dealer to maintain a separate customer reserve account that contains at least the net dollar amount of cash the broker-dealer owes to customers. If a broker-dealer fails to make a required deposit in its reserve bank account or special account, the broker-dealer must immediately notify the SEC and its DEA.<sup>1145</sup>

### **Non-Broker-Dealer SBSDs**

Section 15F(f) of the Exchange Act, which was added by Section 764 of the Dodd-Frank Act, requires the SEC to adopt rules governing reporting for SBSDs, including reports regarding such firms' transactions, positions, and financial condition.<sup>1146</sup> Accordingly, the SEC proposed rules in April 2014 to establish a reporting and notification program for SBSDs that would be modeled on the reporting rules that apply to broker-dealers.<sup>1147</sup>

### **Investment Advisers**

See responses to Question 29.2(c) and Question 30.1.

<sup>1142</sup> 15 U.S.C. § 78q(b).

<sup>1143</sup> 17 C.F.R. 240.17a-5(d).

<sup>1144</sup> 17 C.F.R. 240.17a-5(h).

<sup>1145</sup> 17 C.F.R. 240.15c3-3(i).

<sup>1146</sup> 15 U.S.C. § 78o-10(f).

<sup>1147</sup> See Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers, Exchange Act Release No. 71958 (Apr. 17, 2014); 79 Fed. Reg. 25194 (May 2, 2014).

3. Does the regulator have the power to take appropriate actions: In particular, can it:
- (a) Restrict activities by the intermediary with a view to minimizing damage and loss to investors?

### Broker-Dealers

Yes. The SEC, SIPC, and a firm's DEA have the authority to restrict the activities of a broker-dealer that is in or approaching financial distress. The Exchange Act and the regulations promulgated thereunder prohibit a broker-dealer from continuing to conduct a securities business if the firm does not have sufficient net capital.<sup>1148</sup> A broker-dealer's stockholders and partners are not allowed to withdraw equity capital from the broker-dealer if, among other things, the broker-dealer's net capital falls below 120% of the minimum net capital requirement.<sup>1149</sup>

The SEC has also approved DEA rules restricting a broker-dealer if it is in or approaching financial difficulty, such as limits on business expansions.<sup>1150</sup>

### Non-Bank SBSDs

Section 15F(e) of the Exchange Act, which was added by Section 764 of the Dodd-Frank Act, requires the SEC to adopt rules establishing capital and margin requirements for non-bank SBSDs.<sup>1151</sup> Section 3E of the Exchange Act, which was added by Section 763 of the Dodd-Frank Act, requires the SEC to adopt rules establishing segregation requirements for SBSDs.<sup>1152</sup> Accordingly, the SEC proposed rules in October 2012 to establish capital and margin requirements for non-bank SBSDs, and segregation requirements for SBSDs.<sup>1153</sup> The SEC's proposed capital, margin, and segregation rules applicable to SBSDs are modeled on the capital, margin, and segregation rules that apply to broker-dealers. (See response to Question 30.)

<sup>1148</sup> 17 C.F.R. 240.15c3-1.

<sup>1149</sup> 17 C.F.R. 240.15c3-1(e)(2).

<sup>1150</sup> See, e.g., FINRA Rule 4120(b) (prohibiting a carrying or clearing FINRA member from expanding its business if the broker-dealer's net capital would be less than 150% of its minimum net capital requirement for more than 15 consecutive business days and FINRA or the member firm has known this condition for at least 5 consecutive business days).

<sup>1151</sup> 15 U.S.C. § 78o-10(e).

<sup>1152</sup> 15 U.S.C. § 78o-5.

<sup>1153</sup> SEC, Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 68071 (Oct. 18, 2012), 77 Fed. Reg. 70214 (Nov. 23, 2012).

**Investment Advisers**

The Advisers Act does not expressly provide for the SEC to take action if an investment adviser encounters financial difficulty. See responses to Question 29.2(c) and Question 30.1. The SEC has the power to take action, however, if an investment adviser's financial difficulties are related to a violation of the federal securities laws. The SEC can then request that a federal court appoint a monitor, receiver, or other administrator.<sup>1154</sup>

- (b) Require the intermediary to take specific actions, for example, moving client accounts to another intermediary?

**Broker-Dealers**

Yes. The SEC, SIPC, and a firm's DEA have the authority to require broker-dealers to take specific actions if they are in or approaching financial distress. As discussed in response to Question 23.1, during a broker-dealer liquidation, the SIPC-supervised trustee may arrange to have some or all customer accounts transferred to another broker-dealer.<sup>1155</sup>

The SEC has also approved DEA rules requiring broker-dealers to take specific corrective or prophylactic actions if a broker-dealer is in or approaching financial difficulty, such as requirements to affirmatively reduce the broker-dealer's business.<sup>1156</sup>

**SBSDs**

As discussed above, non-broker-dealer SBSDs are subject to the stockholder liquidation provisions of the U.S. Bankruptcy Code,<sup>1157</sup> which means that the bankruptcy trustee is directed to convert securities to cash as soon as practicable (rather than move client assets to another broker-dealer).<sup>1158</sup>

<sup>1154</sup> It is well-established that a court has the authority to grant any form of ancillary relief where necessary and proper to effectuate the purposes of the federal securities laws. *SEC v. Materia*, 745 F.2d 197, 200 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985). Included in the court's equitable powers is the authority to appoint receivers. See, e.g., *SEC v. First Fin. Group*, 645 F.2d 429, 439 (5th Cir. 1981).

<sup>1155</sup> 15 U.S.C. § 78fff-2(f).

<sup>1156</sup> See, e.g., FINRA Rule 4120(c) (requiring a carrying or clearing FINRA member to reduce its business if, among other things, its net capital would be less than 125% of its minimum net capital requirement).

<sup>1157</sup> Public Law 111-203 § 763(d) (adding Exchange Act § 3E(g), which subjects non-broker-dealer SBSDs to Title 11, Chapter 7, Subchapter III of the U.S. Bankruptcy Code).

<sup>1158</sup> 11 U.S.C. § 748.

**Investment Advisers**

See response to Question 32.3(a) with respect to investment advisors.

- (c) Request appointment of a monitor, receiver, curator or other administrator or, in the absence of such power, can the regulator apply to the relevant authorities to take possession or control of the assets held by the intermediary or by a third party on behalf of the intermediary?

See response to Question 32.1.

- (d) Apply other available measures intended to minimize client, counterparty and systemic risk in the event of intermediary failure, such as client and settlement insurance schemes or guarantee funds?

**Broker-Dealers**

SIPC maintains a SIPC Fund, which constitutes an insurance program for member broker-dealers' customers. Generally, if a broker-dealer goes out of business and is not able to meet its obligations to customers, then customers' cash and securities held by the broker-dealer are returned to customers on a *pro rata* basis. If sufficient funds are not available at the firm to satisfy customer net equity claims, the reserve funds of SIPC are used to supplement the distribution, up to a ceiling of \$500,000 per customer, including a maximum of \$250,000 for cash claims.

The SIPC Fund is funded by an annual assessment from SIPC's members, which is deposited in the SIPC Fund to reach the fund target.<sup>1159</sup> Assessments in 2013 were \$417,721,699.<sup>1160</sup> SIPC currently assesses each member at the rate of .0025% of net operating revenues from the broker-dealer's securities business. In addition, if the need arises, the SEC has the authority to lend SIPC up to \$2.5 billion, which the SEC, in turn, would borrow from the U.S. Treasury.<sup>1161</sup> SIPC's 2013 Annual Report states that "[of] the more than 625,200 claims satisfied in completed or substantially completed cases as of December 31, 2013, a total of 352 were for cash and securities whose value was greater than the limits of protection afforded by SIPA. The 352 claims, a net increase of one during 2013, represent less than .001% of all claims satisfied. The unsatisfied portion of claims, \$47.3 million, increased \$100,000 during 2013. These remaining

<sup>1159</sup> The SIPC Fund's fund target is \$2.5 billion in 2014. SIPC, The SIPC Fund, <http://www.sipc.org/about-sipc/the-sipc-fund>.

<sup>1160</sup> SIPC, 2013 Annual Report (Apr. 30, 2014), available at <http://www.sipc.org/Content/media/annual-reports/2013-annual-report.PDF>.

<sup>1161</sup> 15 U.S.C. § 78ddd(f).



claims approximate .003% of the total value of securities and cash distributed for accounts of customers in those cases.”<sup>1162</sup>

As an additional customer safeguard, Exchange Act Rule 15c3-3 requires broker-dealers to have physical possession and control of all fully paid and excess margin securities carried for their customers. (Possession or control means, for example, that the securities cannot be subject to a lien or hypothecated.) To the extent a broker-dealer determines, generally through a legally mandated weekly comparison, that it does not have possession or control of all fully paid and excess margin securities, the firm must initiate procedures to retrieve securities from non-control locations (e.g., recall them from a bank to which they had been hypothecated).<sup>1163</sup>

In addition, a broker-dealer must maintain a “Special Reserve Bank Account for the Exclusive Benefit of Customers” (a Reserve Account) separate from its other bank accounts.<sup>1164</sup> A U.S. broker-dealer must have a written agreement with the bank that the Reserve Account funds are not to be used directly or indirectly as security for a loan and must maintain a “no-lien letter” from the bank acknowledging this limitation.<sup>1165</sup> The Reserve Account cannot contain less than the amount computed under the SEC reserve formula.<sup>1166</sup>

### Investment Advisers

The Advisers Act does not provide for the SEC to take actions intended to minimize customer, counterparty or systemic risk in the event of intermediary failure, such as customer and settlement insurance schemes or guarantee funds.

4. Can the regulator demonstrate that it has the power and practical ability to take these actions against an intermediary?

### Broker-Dealers

The SEC has exercised its power to take action in response to capital failures on numerous occasions. When The Bear Stearns Companies, Inc. (Bear Stearns) and Lehman Brothers Holdings, Inc. (Lehman) failed, their broker-dealer subsidiaries were subject to net capital,

<sup>1162</sup> SIPC, 2013 Annual Report (Apr. 30, 2014), available at <http://www.sipc.org/Content/media/annual-reports/2013-annual-report.PDF>.

<sup>1163</sup> 17 C.F.R. 240.15c3-3.

<sup>1164</sup> 17 C.F.R. 240.15c3-3(e).

<sup>1165</sup> 17 C.F.R. 240.15c3-3(f).

<sup>1166</sup> 17 C.F.R. 240.15c3-3(e). The calculation generally computes credits corresponding to cash obligations owed by the broker-dealer to customers or in connection with customer transactions less debits corresponding to obligations owed by customers or in connection with customer transactions to the broker-dealer. 17 C.F.R. 240.15c3-3a.

customer protection, and bankruptcy rules and regimes that are designed to allow the broker-dealers to unwind without harming customers or causing market disruptions.<sup>1167</sup> The Bear Stearns broker-dealer was able to be transferred to JP Morgan without any losses to customers. The vast majority of the Lehman broker-dealer was liquidated with minimal disruption to customers.

The SEC is also willing to take action in response to net capital violations even when they do not result in the broker-dealer's insolvency. For example, when MidSouth Capital, Inc. failed to satisfy its minimum required net capital requirement seven times over a three-year period, the SEC ordered that the broker-dealer be censured and cease and desist from continuing and future violations, and suspended the broker-dealer's CEO from being associated with certain SEC-registered entities for six months, as well as imposing a \$15,000 penalty on the CEO.<sup>1168</sup>

5. Do the regulator's processes and procedures for addressing financial disruption include communication and cooperation with other regulators, both domestic and foreign, where appropriate, and is there evidence that contact arrangements are in place and that such cooperation occurs?

There are numerous processes in place to ensure that the SEC communicates and cooperates with both domestic and foreign regulators as needed. One example of domestic cooperation is the composition of the seven-member Board of Directors of SIPC. SIPA requires that one director be a Treasury employee appointed by the Secretary of the Treasury and one director be a Federal Reserve employee appointed by the Federal Reserve Board. The President appoints the remaining five directors, with three members coming from the securities industry and two members coming from the general public with no association with the securities industry for the previous two years.<sup>1169</sup>

The SEC works closely with SIPC. The SEC is required to immediately notify SIPC if it is aware of facts that lead it to believe that a broker-dealer is in or is approaching financial difficulty.<sup>1170</sup> The SEC is permitted to participate as a party in any SIPC proceeding.<sup>1171</sup> Staff also holds periodic meetings with SIPC staff to discuss matters that concern or require the attention of the SEC. In the course of day-to-day operations, SEC and SIPC staffs communicate regularly by telephone.

<sup>1167</sup> The holding companies and certain other affiliates were not subject to similar requirements, nor were these firms part of a bank holding company that had access to direct government financing of less liquid assets.

<sup>1168</sup> In re: MidSouth Capital, Inc., Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, Section 203(f) of the Advisers Act of 1940 and Section 9(b) of the Investment Company Act of 1940, Making Findings and Imposing Remedial Sanctions and a cease-and-desist Order (Apr. 18, 2012), available at <https://www.sec.gov/litigation/admin/2012/34-66828.pdf>.

<sup>1169</sup> 15 U.S.C. § 78ccc(c)(2).

<sup>1170</sup> 15 U.S.C. § 78eee(a)(1).

<sup>1171</sup> 15 U.S.C. § 78eee(c).

In addition, the SEC receives monthly reports from SIPC concerning the status of the SIPC Fund and current liquidations.

The SEC also works with domestic and foreign regulators on broker-dealer liquidations and has processes in place for quickly contacting other regulators' key decision makers. For example, the SEC and the CFTC worked together on the MF Global Inc. (MF Global) liquidation since MF Global was registered with the SEC as a broker-dealer and with the CFTC as an FCM. The decision to refer MF Global to SIPC was made jointly by the SEC and the CFTC Chairs and their respective staffs in the early morning hours between MF Global's disclosure of the shortfall in customer funds (around 2:30 a.m.) and the referral to SIPC (at approximately 5:30 a.m.).<sup>1172</sup>

Title II of the Dodd-Frank Act contemplates expanding cooperation between domestic regulators by providing an alternative insolvency regime for the "orderly liquidation" of large financial companies, including certain large broker-dealers. In the case of a broker-dealer, the Federal Reserve and the SEC, in consultation with the FDIC, are authorized to issue a written orderly liquidation recommendation to the Secretary of the Treasury.<sup>1173</sup> As required by the Dodd-Frank Act, the SEC and the FDIC, in consultation with SIPC, are working together to develop regulations relating to certain aspects of the resolution of broker-dealers for which the FDIC has been appointed receiver under Title II.<sup>1174</sup>

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<sup>1172</sup> CFTC, Timeline of Events: CFTC and MF Global Bankruptcy, available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/mfglobaltimeline111511.pdf>.

<sup>1173</sup> Pub. L. 111-203 § 205.

<sup>1174</sup> Pub. L. 111-203 § 205(h).

**Principle 33     The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.**

**Key Questions**

*Exchanges or Trading Systems, Subject to Regulation*

1. Does the establishment of an exchange or trading system require authorization?

**Exchanges and Associations**

Yes. In the U.S., an exchange<sup>1175</sup> must register with the SEC as a national securities exchange,<sup>1176</sup> or be exempt from registration based on limited volume, before it may begin operations.<sup>1177</sup>

Section 19(a) of the Exchange Act sets forth the SEC's responsibilities and obligations upon the filing of an exchange application. Specifically, the SEC must publish notice of the application for public comment and thereafter, within 90 days of publication,<sup>1178</sup> the SEC must by order grant the registration or institute proceedings to determine whether the application should be denied. Section 19(a)(1) of the Exchange Act provides that the SEC "shall grant such registration if it finds that the requirements of this title and the rules and regulations thereunder with respect to the applicant are satisfied." The SEC must deny a registration if it cannot make this finding. Once registered, a national securities exchange becomes an SRO.<sup>1179</sup>

Section 6(a) of the Exchange Act provides the general requirements for the content of an exchange application. Specifically, Section 6(a) of the Exchange Act provides that an applicant must include the rules of the exchange<sup>1180</sup> as well as such other information that the SEC may, by

<sup>1175</sup> The term "exchange" is defined in Section 3(a)(1) of the Exchange Act as "any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange."

<sup>1176</sup> A national securities exchange is a securities exchange that has registered with the SEC under Section 6 of the Exchange Act. See 15 U.S.C. 78f.

<sup>1177</sup> Section 5 of the Exchange Act prohibits any broker, dealer, or exchange from using any facility of an exchange to effect any transaction in a security unless such exchange is either registered as a national securities exchange under Section 6 of the Exchange Act or exempt from registration.

<sup>1178</sup> The SEC has the authority to extend the time for consideration for up to 90 days if it finds good cause for such extension and publishes its reasons for so finding or for such longer period as to which the applicant consents. See Section 19(a)(1)(B) of the Exchange Act, 15 U.S.C. 78s(a)(1)(B).

<sup>1179</sup> Section 3(a)(26) of the Exchange Act, 15 U.S.C. 78c(a)(26) defines an SRO as, among other things, any national securities exchange or registered securities association.

<sup>1180</sup> The term "rules of an exchange" is defined in Section 3(a)(27) as "the constitution, articles of incorporation, bylaws, and rules, or instruments corresponding to the foregoing, of an exchange...and such stated policies, practices, and interpretations of such exchange ... as the SEC, by rule, may determine to be necessary or appropriate in the public interest or for the protection of investors to be deemed to be rules of such exchange..." The SEC exercised its rulemaking authority to adopt Rule 19b-4 under the Exchange Act, which, among other things, defines

(continued)

rule, prescribe. The SEC adopted Rule 6a-1 and Form 1 to set forth the additional materials that must be submitted as part of an exchange application. Rule 6a-1 provides, among other things, that an application for registration as a national securities exchange or exemption from registration based on limited volume shall be made on Form 1. In addition to the “rules of an exchange,” Form 1 requires that an applicant include the following in its registration application: (i) written rulings, settled practices having the effect of rules, and interpretations of the rules of the exchange; (ii) information about operators of any electronic trading system that is used to effect transactions; (iii) current financial statements for any subsidiary or affiliate of the applicant; (iv) the manner of operation of the trading system, including, among other things, the means of access; the procedures for entering and displaying quotes; procedures of execution, reporting and clearing and settling transactions; and fees; (v) all membership forms; (vi) all forms relating to members’ financials, including minimum net capital requirements; (vii) listing applications; (viii) audited financial statements of the applicant prepared according to GAAP; (ix) lists of officers, governors and members of all standing committees; (x) for exchanges with one or more owners, shareholders or partners that are not also members of the exchange, lists of shareholders that either own 5% or more of a class of voting shares, or if a partnership, then all general partners and those limited/special partners that have a right to receive upon dissolution or have contributed 5% or more of the capital; (xi) the applicant’s criteria for membership and the conditions and process for suspension or termination of membership; (xii) a list of all members; and (xiii) a schedule for all securities listed on the exchange, all securities traded on the exchange pursuant to unlisted trading privileges, all securities exempt from registration and traded on the exchange, and other securities traded on the exchange.

### **Alternative Trading Systems**

In order to accommodate traditional market structures and provide sufficient flexibility to ensure that new markets promote fairness, efficiency, and transparency, the SEC adopted Exchange Act Regulation ATS in 1998.<sup>1181</sup> Under Regulation ATS, an entity that falls within the definition of an exchange may register as an exchange or as a broker-dealer and comply with Regulation ATS. If the entity chooses to register as an exchange, it must meet all requisite statutory and regulatory

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the phrase “stated policies, practices or interpretations.” Specifically, a “stated policy, practice or interpretation” means generally any material aspect of the operation of the facilities of the SRO or any statement made available to the membership, participants, or specified persons thereof that establishes or changes any standard, limit, or guideline with respect to the rights, obligations or privileges of specified persons or the meaning, administration, or enforcement of an existing rule. See Rule 19b-4(b), 17 C.F.R. 240.19b-4(b).

<sup>1181</sup> See Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 40760 (December 8, 1998), 63 Fed. Reg. 70843, 70881 (December 22, 1998) (“Regulation ATS Release”). See also Exchange Act Rules 300-303, 17 C.F.R. 242.300-303. Rule 300 of Regulation ATS defines an “alternative trading system” as any organization, association, person or group of persons, or system: (i) that constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of Section 240.3b-16 of this chapter; and (ii) that does not: (a) set rules governing the conduct of subscribers other than the conduct of such subscribers’ trading on such organization, association, person or group of persons, or system; or (b) discipline subscribers other than by exclusion from trading.

obligations discussed above applicable to exchanges. If an entity chooses to be an ATS, it must register as a broker-dealer, fulfill all of the registration requirements as described in the response to Question 9.1(a) above, be a member of an SRO, (e.g., FINRA) and comply with certain reporting and record-keeping requirements set forth under Regulation ATS. The reporting and access requirements vary depending on the ATS' activities and trading volume. Similar to any other broker-dealer, an ATS must have sufficient clearing capabilities in place by either becoming a member of a registered clearing agency, or being affiliated with a member of a registered clearing agency through which the ATS can clear and settle trades.

The SEC continues to study and consider regulatory initiatives concerning ATSs.<sup>1182</sup> Most recently, Staff launched a new website devoted to market structure data and analysis.<sup>1183</sup> Staff recently posted a white paper that describes ATS trading activity on the website.<sup>1184</sup> Staff also published a review of current economic literature on fragmentation in the equity markets on the new website.<sup>1185</sup> This literature review addressed several topics, including dark, or undisplayed, liquidity. The purpose of these efforts is to generate a sound empirical basis for conclusions on whether problems exist that require regulatory action and, if so, what potential solutions to the problems should look like. Additional data concerning ATS trading activity has become available as a result of a FINRA rule that the SEC recently approved. The rule requires registered ATSs to report to FINRA aggregate weekly trading volume on a security by security basis; FINRA will then make the trading data for equity securities publicly available.<sup>1186</sup>

### Security-Based Swaps

As discussed under Principle 3, the Dodd-Frank Act was enacted to, among other reasons, promote the financial stability of the U.S. by improving accountability and transparency in the financial system, including in connection with swaps and SBSs. Title VII of the Dodd-Frank Act provides for a comprehensive new regulatory framework for swaps and SBSs. Under this framework, the CFTC regulates "swaps" while the SEC regulates SBS and the SEC and CFTC jointly

<sup>1182</sup> See, e.g., Exchange Act Release No. 60997 (November 13, 2009)(Proposed Regulation of Nonpublic Trading Interest), and Exchange Act Release No. 61358 (January 14, 2010)(Concept Release on Equity Market Structure).

<sup>1183</sup> See <http://www.sec.gov/marketstructure/index.html>

<sup>1184</sup> See Alternative Trading Systems: Description of ATS Trading in National Market System Stocks, October 13, available at <http://www.sec.gov/marketstructure/research/alternative-trading-systems-march-2014.pdf>.

<sup>1185</sup> See Equity Market Structure Literature Review, Part I: Market Fragmentation, October 7, 2013, available at <http://www.sec.gov/marketstructure/research/fragmentation-lit-review-100713.pdf>.

<sup>1186</sup> See Exchange Act Release No. 71341 (January 17, 2014), 79 Fed. Reg. 4213 (January 24, 2014). Aggregate data concerning trades in NMS stocks in Tier 1 of the NMS Plan to Address Extraordinary Market Volatility would be published on a two-week delayed basis, and aggregate information on all other NMS stocks and all OTC Equity Securities subject to FINRA trade reporting requirements on a four-week delayed basis. FINRA intends to publish aggregate data concerning trades in fixed income securities once it has the opportunity to evaluate the data.

regulate “mixed swaps.” The new framework encompasses among other areas, requirements related to clearing, trade execution, regulatory reporting, and public dissemination.<sup>1187</sup>

SBS is defined as any agreement, contract, or transaction that (i) is a swap, as defined under specified provisions of the CEA; and (ii) is based on an index that is: a narrow-based security index, including any interest therein or on the value thereof; a single security or loan, including any interest therein or on the value thereof; or the occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer.<sup>1188</sup>

Traditionally, the SBS market was characterized by privately negotiated transactions entered into by two counterparties, in which each assumes the credit risk of the other counterparty. Title VII of the Dodd-Frank Act amended the Exchange Act to require that transactions in SBSs be cleared through a clearing agency if they are of a type that the SEC determines must be cleared, unless an exemption applies.<sup>1189</sup>

### **Security-Based Swap Execution Facilities**

The Dodd-Frank Act included the statutory requirement for certain SBSs to be traded on

<sup>1187</sup> The Commission has proposed a series of rules regarding these matters. See Cross-Border Proposing Release, 78 Fed. Reg. at 30972 nn. 11-18. Most recently, the Commission proposed rules governing recordkeeping, reporting, and notification requirements for dealers and major participants. See Exchange Act Release No. 71958 (Apr. 17, 2014). The Dodd-Frank Act further provides that the SEC and CFTC jointly should further define certain terms, including “security-based swap dealer” and “major security-based swap participant.” See Dodd-Frank Act Section 712(d). Pursuant to that requirement, the SEC and CFTC jointly adopted rules to further define those terms. See Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” Exchange Act Release, Exchange Act Release No. 66868 (Apr. 27, 2012), 77 Fed. Reg. 30596 (May 23, 2012) (“Intermediary Definitions Adopting Release”); see also Cross-Border Proposing Release, 78 Fed. Reg. at 30972 n.9 (discussing joint rulemaking to further define various Title VII terms). See Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, Release No. 33-9338 (Jul. 18, 2012), 77 Fed. Reg. 48208 (Aug. 13, 2012).

<sup>1188</sup> See 15 U.S.C. 78c(a)(68)(A). Certain exceptions apply to this definition. See *id.*

<sup>1189</sup> See 15 U.S.C. 78c-3(a) (added by Dodd-Frank Act Sec. 763(a)). Section 3C(g) of the Exchange Act provides that an SBS otherwise subject to mandatory clearing is not required to be cleared if one party to the SBS is not a financial entity, is using SBSs to hedge or mitigate commercial risk, and notifies the SEC, in a manner set forth by the SEC, how it generally meets its financial obligations related to entering into non-cleared SBSs. See 15 U.S.C. 78c-3(g)(1). See also Exchange Act Release No. 34-63556 (Dec. 15, 2010), 75 Fed. Reg. 79992 (Dec. 21, 2010) (proposed rule governing this end-user exemption).

The Exchange Act specifies the process that the SEC must use to determine which specific SBSs are subject to the mandatory clearing requirement, including identification of factors that the SEC must consider when making such a determination. See Section 3C(b) of the Exchange Act, 15 U.S.C. 78c-3(b). In June 2012, the SEC adopted rules to establish a process for submissions for review of SBSs for mandatory clearing and the procedure by which the SEC may stay the requirement that an SBS is subject to mandatory clearing while the clearing of the SBS is reviewed. See Exchange Act Release No. 34-67286 (June 28, 2012), 77 Fed. Reg. 41062 (July 14, 2012).



regulated markets. Prior to the adoption of the Dodd-Frank Act, SBSs were excluded from the definition of “security” under the Exchange Act and traded exclusively on the OTC market. The Dodd-Frank Act amended the Exchange Act to implement a “mandatory trade execution requirement” for SBSs that would require any SBS that is subject to mandatory clearing<sup>1190</sup> to be traded on a registered trading platform, *i.e.*, either a national securities exchange or an SB SEF registered with the SEC.<sup>1191</sup>

Section 3D of the Exchange Act sets forth the requirement for SB SEFs to be registered with the SEC and to comply with 14 Core Principles, including any other rule that the SEC may adopt that apply to SEFs.<sup>1192</sup> The SEC has proposed rules on the registration process for SB SEFs and for complying with the 14 Core Principles.<sup>1193</sup> SBS markets and market participants will be required to comply with, respectively, the SB SEF registration requirement and the mandatory trade execution requirement on specified dates following publication of final rules regarding registration of SB SEFs.<sup>1194</sup> In the interim, SBSs are permitted to continue to trade OTC.

2. Are there criteria for the authorization of exchange and trading system operators that:
- (a) Require analysis and authorization of the market by a competent authority?

### Exchanges and Associations

Yes. The SEC must analyze and authorize the registration application of any prospective exchange or association for compliance with the requirements of Sections 6 and 15A of the Exchange Act, as applicable. See the response to Question 33.1 above, for more details about this process.

In addition to satisfying the requirements of Sections 6 and 15A of the Exchange Act, a prospective exchange or association, respectively, must demonstrate its ability to operate as part of the NMS as contemplated in Section 11A of the Exchange Act. In particular, an applicant must satisfy the NMS requirements set forth in Regulation NMS. Regulation NMS contains rules that

<sup>1190</sup> See Section 3C(a) of the Exchange Act, 15 U.S.C. 78c-3(a).

<sup>1191</sup> Section 3C(h) of the Exchange Act, 15 U.S.C. 78c-3(H). The exceptions to the mandatory trade execution requirement are: (i) if no Trading Platform makes such SBS “available to trade” or (ii) the “end-user exception” applies to the SBS transaction (see Section 3C(g) of the Exchange Act, 15 U.S.C. 78c-3a). Thus, SBSs that: (i) are required to be cleared and (ii) have been made “available to trade” will be required to be traded on a Trading Platform unless such transactions are subject to the end-user exception.

<sup>1192</sup> 15 U.S.C. 78c-4.

<sup>1193</sup> See Exchange Act Release No. 63825 (Feb. 2, 2011) 76 Fed. Reg. 10948 (Feb. 28, 2011) (“SB SEF Proposing Release”).

<sup>1194</sup> See Order Pursuant to Sections 15F(b)(6) and 36 of the Securities Exchange Act of 1934 Granting Temporary Exemptions and Other Temporary Relief, Together with Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps, Exchange Act Release No. 64678 (June 15, 2011), 76 Fed. Reg. 36287 (June 22, 2011) (File No. S7-24-11) (“SB SEF Exemption”).



govern a wide range of activity with respect to quoting, trading, and price transparency. Important areas include: (i) trade-throughs; (ii) market access; (iii) sub-pennies; and (iv) market data. The Order Protection Rule<sup>1195</sup> requires trading centers to establish policies and procedures reasonably designed to prevent the execution of trades at prices inferior to automated quotations that are the best quote of another trading center, subject to applicable exceptions. The Access Rule<sup>1196</sup> requires fair and non-discriminatory access to quotations, establishes a limit on access fees to harmonize the pricing of quotations across different trading centers, and requires rules addressing locked and crossed markets. The Sub-Penny Rule<sup>1197</sup> prohibits market participants from accepting, ranking, or displaying orders for securities priced \$1.00 or more in increments smaller than a penny. The market data provisions, among other things, modify the way the markets allocate data revenues to reward aggressive quoting and reduce distortions caused by the existing formulae. In addition, Regulation NMS has rules that govern transaction reporting, and require the publication of order execution quality statistics.

The Exchange Act contains several other specific provisions that must be satisfied by a prospective exchange or association. First, an exchange must demonstrate that its members are not permitted to trade for their own accounts, for the accounts of associated person, or for accounts with respect to which an associated person exercises investment discretion, unless such trading is consistent with the exemptions set forth in Section 11(a) of the Exchange Act and the rules thereunder. There are statutory exceptions to these prohibitions, including trading by a dealer acting as a market maker.<sup>1198</sup> The SEC also excepted, by rule, certain classes of transactions from these prohibitions.<sup>1199</sup> Section 11(b) of the Exchange Act provides for the regulation of specialists and odd-lot dealers. If an exchange plans on having members act as specialists or odd-lot dealers, the rules of the exchange must reflect the appropriate rules for their registration and activities.<sup>1200</sup>

<sup>1195</sup> 17 C.F.R. 242.611.

<sup>1196</sup> 17 C.F.R. 242.610.

<sup>1197</sup> 17 C.F.R. 242.612.

<sup>1198</sup> See Section 11(a)(1) of the Exchange Act, 15 U.S.C. 78k(a)(1).

<sup>1199</sup> Generally, if a member (except a specialist) wants to execute a transaction of a physical exchange floor for its own account, the member would have to yield priority to all non-members who seek execution at the same price. Section 11(a)(1)(G) of the Exchange Act, 15 U.S.C. 78k(a)(1)(G), and Rule 11a1-1(T) thereunder, 17 C.F.R. 240.11a1-1(T). This section is intended to prevent members of an exchange from having an advantage over non-members by virtue of their time and place opportunities on an exchange. This section does not generally apply to electronic, off-floor orders. See Rule 11a2-2(T) under the Exchange Act, 17 C.F.R. 240.11a2-2(T). As the markets have moved to more electronic models, the time/place advantages of members that Section 11(a) of the Exchange Act was intended to address have lessened.

<sup>1200</sup> See Rule 11b-1 under the Exchange Act, 17 C.F.R. 240.11b-1.

### Alternative Trading Systems

If an entity chooses to register as an exchange, it must meet the requirements for exchange registration, as described in the response to Question 33.1 above and also above in the response to this Question 33.2.

If an entity chooses to operate as an ATS, it must register as a broker-dealer and be a member of an SRO (*e.g.*, FINRA), as well as: (i) file a notice (an Initial Operations Report) on Form ATS and comply with additional reporting and record-keeping requirements set forth under Regulation ATS (including maintaining an audit trail of transactions);<sup>1201</sup> (ii) under certain circumstances, comply with order display, execution access, and fair access requirements for traded securities;<sup>1202</sup> (iii) under certain circumstances, follow procedures to ensure the capacity, integrity and security of the ATS system;<sup>1203</sup> (iv) submit to the examination, inspection, and investigation by the SEC or its SRO;<sup>1204</sup> and (v) refrain from using the terms “exchange,” “stock market” or similar terms in its name.<sup>1205</sup> Some of these requirements vary depending on the ATS’s activities and trading volume.

Form ATS Initial Operation Reports are filed with the SEC but are not “approved” by the SEC. Staff reviews Form ATS for compliance with the Form ATS instructions. A Form ATS that complies with the applicable requirements will be considered complete and thus deemed to be filed with the SEC as of the day it was received by the SEC. If a submission does not meet the applicable requirements of Form ATS, the submission is considered incomplete and deemed not filed and must be resubmitted to the SEC.

Similar to any other broker-dealer, an ATS must have sufficient clearing capabilities in place by either becoming a member of a registered clearing agency or by being affiliated with a member of a registered clearing agency through which the ATS can clear and settle trades. Moreover, all ATSs must comply with the anti-fraud, anti-manipulation and other applicable provisions of the federal securities laws and applicable SRO rules.

<sup>1201</sup> See Regulation ATS Rule 301(b)(2), 17 C.F.R. 242.301(b)(2).

<sup>1202</sup> See Regulation ATS Rule 301(b)(3) and (b)(5), 17 C.F.R. 242.301(b)(3) and (b)(5).

<sup>1203</sup> See Regulation ATS Rule 301(b)(6), 17 C.F.R. 242.301(b)(6).

<sup>1204</sup> See Regulation ATS Rule 301(b)(7), 17 C.F.R. 242.301(b)(7).

<sup>1205</sup> See Regulation ATS Rule 301(b)(11), 17 C.F.R. 242.301(b)(11).

### Security-Based Swap Execution Facilities

Under Section 3D of the Exchange Act, SB SEFs are required to register with the SEC and comply with 14 Core Principles, which principles require that they with any rules that may be adopted by the SEC that apply to SEFs, such as rules pertaining to the registration process.<sup>1206</sup>

- (b) Seek evidence of operational or other competence of the operator of an exchange or trading system as a secondary market?

Yes. In addition to the requirements listed above, the SEC considers the following additional factors in evaluating the operational or other competence of an exchange or trading system.

### Funding

While the Exchange Act does not set forth the levels of funding for maintaining the self-regulatory function, the SEC has considered the funding of the self-regulatory functions of an exchange in the context of exchange demutualization and in applications for registration as exchanges. In these filings, the SEC has approved rules designed to ensure that fees, fines, or dues collected by an exchange are not used for commercial purposes.<sup>1207</sup> Further, the SEC has recognized that the level of funding may differ among the SROs. Appropriate levels of funding may be dependent on the SRO's business model, trading systems, regulatory responsibilities, and types of members.<sup>1208</sup>

SB SEFs are required to have adequate financial, operational and managerial resources to discharge each of their responsibilities, as determined by the Commission.<sup>1209</sup> Specifically, SB SEFs must have enough financial resources (i) to meet its financial obligations of its members and participants notwithstanding a default by the member of participant creating the largest financial exposure for that organization in extreme but plausible market conditions and (ii) exceeding the total amount it would need to cover operating costs of the SB SEF for one year.<sup>1210</sup>

<sup>1206</sup> See Section 3D(d) of the Exchange Act, 15 U.S.C. 78c-4(d) and SB SEF Proposing Release.

<sup>1207</sup> See, e.g., Exchange Act Release Nos. 53382 (February 27, 2006) (order approving the NYSE business combination with Archipelago Holdings, Inc.); 55216 (January 31, 2007) (order approving NYSE Regulation Inc. policies regarding exercise of power to fine NYSE members and use money collected as fines).

<sup>1208</sup> See Exchange Act Release No. 50700 (November 18, 2004), 69 Fed. Reg. 71256 (December 8, 2004) ("SRO Concept Release").

<sup>1209</sup> See Section 3D(d)(12) of the Exchange Act, 15 U.S.C. 78c-4(d)(12).

<sup>1210</sup> *Id.*

### Systems Capacity<sup>1211</sup>

As described in the response to Question 9.4(a)(ii), the SEC has implemented a TCP (formerly known as the ARP), through which Staff conducts reviews of the information technology systems operated by the SROs to evaluate whether the systems have sufficient capacity and resiliency to accommodate conditions of increased volume and disruptions to normal operations.

If an ATS has 20% or more of the trading volume in any single security within a certain time period, the ATS must follow certain procedures to ensure adequate systems capacity, integrity and contingency planning.<sup>1212</sup>

Section 3D(d)(13) of the Exchange Act also requires SB SEFs to establish and maintain a program of risk analysis and oversight to identify and minimize sources of operational risk.<sup>1213</sup> SB SEFs are required to have controls, procedures, and automated systems that are reliable, secure and have scalable capacity. They would also be required to have emergency procedures, backup facilities, and a disaster recovery plan.

### Statutory Disqualifications

As noted above in the response to Question 9.3(f), the SEC has stated that persons responsible for operating an SRO should generally not have a disciplinary history. In connection with evaluating whether an applicant exchange or association is able to enforce compliance with the Exchange Act, the rules and regulations thereunder and an exchange's or association's own rules, the SEC reviews the persons that are listed as the exchange operators for compliance with this standard.

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| (c) | Require the operator of an exchange or trading system that assumes principal, settlement, guarantee or performance risk to comply with prudential and other requirements designed to reduce the risk of non-completion of transactions ( <i>e.g.</i> , mandatory margin assessment and collection, capital or financial resources, member contributions, guaranty fund, credit or position limits)? |
|-----|---|

In the U.S., exchanges and trading systems generally do not assume principal, settlement, guarantee or performance risk. Instead, the clearance and settlement of securities transactions generally occurs through several registered CCPs and a registered central securities depository

<sup>1211</sup> The SEC has proposed a rule that, if approved, would require certain entities, including SROs and ATSs to comply with requirements with respect to their automated systems that support the performance of their regulated activities. See Securities Act Release No. 69007 (March 8, 2013).

<sup>1212</sup> See Regulation ATS Rule 301(b)(6), 17 C.F.R. 242.301(b)(6).

<sup>1213</sup> 15 U.S.C. 78c-4(d)(13).

(CSD), which operate separately from exchanges or trading systems and are registered with the SEC as clearing agencies under the Exchange Act.<sup>1214</sup>

A “clearing agency” is defined in Section 3(a)(23)(A) of the Exchange Act as any entity that acts as an intermediary in making payments or deliveries or both in connection with securities transactions, or that provides facilities for the comparison of data regarding the terms of settlement of securities transactions, to reduce the number of settlements of securities transactions, or for the allocation of securities settlement responsibilities. The term “clearing agency” also means any person, such as a securities depository, who (i) acts as a custodian of securities in connection with a book-entry settlement system where the settlement of securities transactions (including securities that are loaned or pledged) can occur without the physical delivery of securities certificates, or (ii) otherwise permits or facilitates the settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates.

Clearing agencies are SROs, meaning that a clearing agency’s relations with its members are generally governed by rules it promulgates. Section 3(a)(27) of the Exchange Act defines the “rules” of a clearing agency to include its constitution, articles of incorporation, bylaws, rules and the stated policies, practices, and interpretations of the clearing agency that the SEC may determine to be necessary or appropriate.

Clearing agencies may offer a wide spectrum of clearing services. The SEC has identified the following types of entities and activities as falling within the definition of clearing agency: (i) clearing corporations; (ii) securities depositories; and (iii) matching services.<sup>1215</sup> The SEC also has stated that it preliminarily believes that the following service providers that facilitate SBS contracts may fall within the definition of clearing agency and may need to register with the SEC: (i) collateral management activities, (ii) matching services, and (iii) tear up/compression services (“post-trade services”).<sup>1216</sup>

<sup>1214</sup> A CCP is defined in Rule 17Ad-22(a)(1) as a clearing agency that interposes itself between the counterparties to securities transactions, acting functionally as the buyer to every seller and the seller to every buyer, and CSD services are defined in Rule 17Ad-22(a)(12) as the services of a securities depository as defined in Section 3(a)(23) of the Exchange Act, which includes any person who acts as a custodian of securities in connection with a system for the central handling of securities whereby all securities of a particular class or series of any issuer deposited within the system are treated as fungible and may be transferred, loaned, or pledged by bookkeeping entry without physical delivery of securities certificates, or otherwise permits or facilitates the settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates.

<sup>1215</sup> *Order Approving the Clearing Agency Registration of Four Depositories and Four Clearing Corporations*, Exchange Act Release No. 20221 (Sept. 23, 1983), 48 Fed. Reg. 45167 (Oct. 3, 1983), and *Confirmation and Affirmation of Securities Trades; Matching*, Exchange Act Release No. 39829 (Apr. 6, 1998), 63 Fed. Reg. 17943 (Apr. 13, 1998).

<sup>1216</sup> Exchange Act Release No. 34-68080 (Oct. 22, 2012), 77 Fed. Reg. 66219 (Nov. 2, 2012) (“Clearing Agency Standards Adopting Release”); *Confirmation and Affirmation of Securities Trades; Matching*, Exchange Act Release No. 39829 (Apr. 6, 1998), 63 Fed. Reg. 17943 (Apr. 13, 1998). See also *Order Pursuant to Section 36 of the Securities Exchange Act of 1934 Granting Temporary Exemptions from Clearing Agency Registration Requirements under*

(continued)

There are currently nine clearing agencies registered with the SEC, seven of which are actively serving the securities markets. The seven active registered clearing agencies are ICE Clear Credit LLC (ICE), ICE Clear Europe (ICEEU), Chicago Mercantile Exchange, Inc. (CME), the Options Clearing Corporation, NSCC, the Depository Trust Company (DTC) and the Fixed Income Clearing Corporation (FICC).<sup>1217</sup> These clearing agencies clear and settle the trades executed on the U.S. securities exchanges and in the U.S. OTC market for SBSs.

### Clearing Agency Registration

In the U.S., entities must register with the SEC prior to performing the functions of a clearing agency.<sup>1218</sup> Section 17A(b)(3) of the Exchange Act provides that a clearing agency shall not be registered unless the SEC determines that the clearing agency meets certain specified standards.<sup>1219</sup> Once registered, clearing agencies must comply with the requirements of the Exchange Act and the relevant regulations thereunder.<sup>1220</sup>

To register, the clearing agency must complete Form CA-1. Form CA-1 requires that the clearing agency submit certain documentation related to its operational, organizational, and other rules, procedures, or practices concerning its exposure to and ways to mitigate financial loss.

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*Section 17A(b) of the Exchange Act for Entities Providing Certain Clearing Services for Security-Based Swaps*, Exchange Act Release No. 64796 (July 1, 2011), 76 Fed. Reg. 39963 (July 7, 2011).

<sup>1217</sup> The two dormant clearing agencies are the Boston Stock Exchange Clearing Corporation and the Stock Clearing Corporation of Philadelphia.

<sup>1218</sup> See 15 U.S.C. 78q-1(b)(1) (with respect to securities) and (h) (with respect to SBSs) (added by Dodd-Frank Act Sec. 763(b)). The Dodd-Frank Act VII also added Section 17A(l) to the Exchange Act, which provides that any depository institution or derivatives clearing organization registered with the CFTC that is required to be registered as a clearing agency is deemed to be registered under this section solely for the purpose of clearing SBSs and, accordingly, must comply with all requirements of the Exchange Act. See 15 U.S.C. 78q-1(i).

As a result of this provision, the CME, ICE, and ICEEU became clearing agencies deemed registered with the SEC on July 16, 2011, solely for the purpose of clearing SBSs. Previously, in December 2008, the SEC permitted these entities, along with two others, to clear and settle CDSs on a temporary, conditional basis, in order to facilitate the central clearing of CDSs. See Exchange Act Release Nos. 60372 (July 23, 2009), 74 Fed. Reg. 37748 (July 29, 2009), 61973 (Apr. 23, 2010), 75 Fed. Reg. 22656 (Apr. 29, 2010) and 63389 (Nov. 29, 2010), 75 Fed. Reg. 75520 (Dec. 3, 2010) (CDS clearing by ICE Clear Europe Limited); 60373 (July 23, 2009), 74 Fed. Reg. 37740 (July 29, 2009), 61975 (Apr. 23, 2010), 75 Fed. Reg. 22641 (Apr. 29, 2010) and 63390 (Nov. 29, 2010), 75 Fed. Reg. 75518 (Dec. 3, 2010) (CDS clearing by Eurex Clearing AG); 59578 (Mar. 13, 2009), 74 Fed. Reg. 11781 (Mar. 19, 2009), 61164 (Dec. 14, 2009), 74 Fed. Reg. 67258 (Dec. 18, 2009), 61803 (Mar. 30, 2010), 75 Fed. Reg. 17181 (Apr. 5, 2010) and 63388 (Nov. 29, 2010), 75 Fed. Reg. 75522 (Dec. 3, 2010) (CDS clearing by CME); 59527 (Mar. 6, 2009), 74 Fed. Reg. 10791 (Mar. 12, 2009), 61119 (Dec. 4, 2009), 74 Fed. Reg. 65554 (Dec. 10, 2009), 61662 (Mar. 5, 2010), 75 Fed. Reg. 11589 (Mar. 11, 2010) and 63387 (Nov. 29, 2010), 75 Fed. Reg. 75502 (Dec. 3, 2010) (CDS clearing by ICE Trust US LLC); 59164 (Dec. 24, 2008), 74 Fed. Reg. 139 (Jan. 2, 2009) (temporary CDS clearing by LIFFE A&M and LCH.Clearnet Ltd.). LIFFE A&M and LCH.Clearnet Ltd. allowed their orders to lapse without seeking renewal.

<sup>1219</sup> See 15 U.S.C. 78q-1(b)(3)(A).

<sup>1220</sup> See 15 U.S.C. 78q-1(b)(3)(A); Exchange Act Release No. 34-16900 (June 17, 1980), 45 Fed. Reg. 41920 (June 23, 1980).

Specifically, the application must provide detailed information about the following:

- Business organization, i.e. identification of the entity's organizational structure, who controls the entity, its corporate officers and managers, their business experience, and copies of its bylaws and rules and its contracts with national securities exchanges and associations.
- Financial information, including a balance sheet and income statement for the most recent fiscal year certified by an independent accountant.
- Operational capacity, including its ability to prevent unauthorized access to its systems, the measures and procedures the clearing agency has taken to safeguard securities and funds, and a description of its computer systems and backup systems.
- Access to services, including a list of the clearing agency's participants and a description of the criteria for admitting participants or limiting membership.

The SEC is required to publish in the *Federal Register* a notice of filing of an application for registration as a clearing agency and afford interested persons the opportunity to submit written data, views, and arguments concerning the application.<sup>1221</sup> The SEC must either grant the registration or institute proceedings to determine whether the application should be denied.<sup>1222</sup>

In order to determine whether to grant registration, the Staff conducts a review of the clearing agency's organization, capacity, and rules to determine whether the clearing agency complies with a clearing agency's obligations under the Exchange Act. This review includes, as appropriate, an examination of proposed rules and supplementary information on membership standards; representation of clearing agency members in the management and operations of the clearing agency; and a review of information related to margin, financial resources, risk management, default management, liquidity, safeguarding of funds, and operational capacity.

A clearing agency can be registered with the SEC only if the SEC makes a determination that the clearing agency meets the requirements set forth in Section 17A(b)(3) of the Exchange Act. Section 17A(b)(3) requires, among other things, that the SEC make determinations with regard to whether:

- Such clearing agency is so organized and has the capacity to be able to facilitate the prompt and accurate clearance and settlement of securities transactions and derivative

<sup>1221</sup> See 15 U.S.C. 78s(a)(1).

<sup>1222</sup> *Id.*

agreements, contracts, and transactions for which it is responsible, to safeguard securities and funds in its custody or control or for which it is responsible, to comply with the provisions of this title and the rules and regulations thereunder, to enforce compliance by its participants with the rules of the clearing agency, and to carry out the purposes of this section.

- The rules of the clearing agency are designed to promote the prompt and accurate clearance and settlement of securities transactions and, to the extent applicable, derivative agreements, contracts, and transactions, to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible; to foster cooperation and coordination with persons engaged in the clearance and settlement of securities transactions; to remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions; and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination in the admission of participants.<sup>1223</sup>

Staff published guidelines for the registration of clearing agencies which illuminate the criteria set forth in Section 17A of the Act, and laid them out in a release. The release discusses:

(i) participation standards; (ii) fair representation; (iii) the clearing agency's capacity to enforce its rules and to discipline its participants in accordance with fair procedures, (iv) the safeguarding of funds; and (v) obligations to participants and clearing funds.<sup>1224</sup>

### **Clearing Agency Standards**

In addition to meeting the requirements of Section 17A(b)(3) of the Exchange Act, a registered clearing agency must comply with certain standards that the SEC promulgated by rule in October 2012.<sup>1225</sup> Generally, the adopted rule sets forth items that must be addressed in a clearing agency's rules and procedures. Clearing agencies adopt rules and procedures to mitigate their exposure to risks in the clearance and settlement system. These risks may relate to credit, liquidity, investment, custody, or general business and operations. The SEC's clearing agency standards cover a wide variety of subject areas, some of which apply only to clearing agencies that serve as CCPs.

*Risk Management Requirements for CCPs:* Rule 17Ad-22(b)(1)-(4) requires a registered clearing agency that provides CCP services to establish, implement, maintain, and enforce written policies and procedures reasonably designed to: (i) measure its credit exposures to its participants at least once a day and limit its exposures to potential losses from defaults by its participants under

<sup>1223</sup> See 15 U.S.C. 78q-1(b)(3).

<sup>1224</sup> Exchange Act Release No. 34-16900 (June 17, 1980), 45 Fed. Reg. 41920 (June 23, 1980).

<sup>1225</sup> See 17 C.F.R. § 240.17Ad-22; Clearing Agency Standards Adopting Release.



normal market conditions; (ii) use margin requirements to limit its credit exposures to participants under normal market conditions and use risk-based models and parameters to set margin requirements and review such margin requirements and the related models and parameters at least monthly; (iii) maintain sufficient financial resources to withstand, at a minimum, a default by the participant family to which it has the largest exposure in extreme but plausible market conditions, provided that a clearing agency acting as a CCP for SBSs must maintain additional financial resources sufficient to withstand, at a minimum a default by the two participant families to which it has the largest exposures in extreme but plausible market conditions; and (iv) provide for an annual model validation consisting of evaluating the performance of the clearing agency's margin models and the related parameters and assumptions by a qualified person who is not influenced by the persons responsible for the development or operation of the models.<sup>1226</sup>

*Minimum Standards:* Rule 17Ad-22(d) also requires registered clearing agencies to establish, implement, maintain, and enforce written policies and procedures reasonably designed to: (i) provide for a well-founded, transparent, and enforceable legal framework for each aspect of its activities in all relevant jurisdictions; (ii) require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the clearing agency, have procedures to monitor that participation requirements are met on an ongoing basis, and have participation requirements that are objective and publicly disclosed and permit fair and open access; (iii) hold assets in a manner that minimizes risk of loss or delay in its access to them and invest assets in instruments with minimal credit, market, and liquidity risks; (iv) identify sources of operational risk and minimize them through the development of appropriate systems, controls, and procedures; implement systems that are reliable, resilient, and secure, and have adequate scalable capacity; (v) employ money settlement arrangements that eliminate or strictly limit the clearing agency's settlement bank risks; (vi) be cost-effective in meeting the requirements of participants while maintaining safe and secure operations; (vii) evaluate the potential sources of risks that can arise when the clearing agency establishes links either cross-border or domestically to clear or settle trades and ensure that the risks are managed prudently on an ongoing basis; (viii) have clear and transparent governance requirements; (ix) provide market participants with sufficient information to identify and evaluate the risks associated with using the clearing agency's services; (x) immobilize or dematerialize securities certificates and transfer by book entry if possible; (xi) make key aspects of the clearing agency's default procedures publicly available and establish default procedures that ensure that the clearing agency can take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a participant default; (xii) ensure that final settlement occurs no later than the end of the settlement day and require that intra-day or real-time finality be provided where necessary to reduce risks; (xiii) eliminate principal risk by linking securities transfers to funds transfers to achieve delivery versus payment; (xiv) institute risk controls, including collateral requirements and limits to cover the clearing agency's credit

<sup>1226</sup>

Exchange Act Rule 17Ad-22(b)(1) – (4), 17 C.F.R. 240.17Ad-22(b)(1) – (4).

exposure to each participant family fully, that ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle; and (xv) inform its participants of the clearing agency's obligations with respect to physical deliveries and identify and manage the risks from those operations.<sup>1227</sup>

### Clearing Agency Rules

Registered clearing agencies, as SROs, are required to file with the SEC copies of any proposed rule or any proposed change in, addition to, or deletion from the clearing agency's rules.<sup>1228</sup> The SEC reviews all proposed rule changes and publishes them for comment.<sup>1229</sup> The SEC must approve many proposed rule changes prior to their going into effect, but certain limited types of proposed changes may be immediately effective upon filing with the SEC.<sup>1230</sup>

In addition, Section 806(e) of Dodd-Frank requires clearing agencies designated as systemically important to file 60 days advance notice of changes to its rules, procedures, or operations that could materially affect the nature or level of risk presented by it (Advance Notice).<sup>1231</sup> The SEC takes action on Advance Notices following consultation with the Federal Reserve, and will either approve, disapprove, or institute proceedings with respect to the proposed change. At this time, the FSOC has designated six registered clearing agencies as systemically important -- The DTC, the FICC, the NSCC, and the Options Clearing Corporation, for which the SEC is the supervisory agency under the Dodd-Frank Act, and ICE and the CME, for which the CFTC is the supervisory agency but which are also registered as clearing agencies with the SEC.

### Ongoing Monitoring of Clearing Agencies

Staff participates in a variety of ongoing monitoring of registered clearing agencies. Staff reviews a variety of materials, which may include internal audit findings and resolutions, Board of Directors materials, and risk management frameworks, including new products/initiatives reviews

<sup>1227</sup> Exchange Act Rule 17Ad-22(d)(1) – (15), 17 C.F.R. 240.17Ad-22(5)(1) – (15). The SEC recently proposed additional standards for certain registered clearing agencies that meet the definition of a “covered clearing agency,” which includes clearing agencies designated systemically important clearing security based swaps. See *Standards for Covered Clearing Agencies*, Exchange Act Release No. 71699 (Mar. 12, 2014), 79 Fed. Reg. 16865 (Mar. 26, 2014).

<sup>1228</sup> See 15 U.S.C. 78s(b)(1).

<sup>1229</sup> See 15 U.S.C. 78s(b)(2) (providing the statutory time frame by which the SEC must either approve, disapprove, or institute proceedings with respect to a proposed rule change filing).

<sup>1230</sup> See 15 U.S.C. 78s(b)(3)(A) (setting forth the types of proposed rule changes that are permitted to take effect immediately upon filing and without the notice and approval procedures required by Section 19(b)(2) of the Exchange Act). The SEC may temporarily suspend such rule changes within 60 days of filing and institute proceedings to determine whether to approve or disapprove the changes. See 15 U.S.C. 78s(b)(3)(C).

<sup>1231</sup> The SEC published a final rule defining and describing when a designated clearing agency is required to file an Advance Notice on June 28, 2012. See Exchange Act Release No. 34-67286 (June 28, 2012), 77 Fed. Reg. 41602 (July 13, 2012).

and approvals, margin methodologies, back-testing and stress-testing procedures, risk monitoring practices, model governance practices, and the sizing and allocation of total financial resources. Staff also oversees registered clearing agencies through regular contact, including onsite visits, by Staff with clearing agency senior management and other personnel, as well as through ongoing interactions with clearing agencies regarding current and expected proposed rule changes under Section 19(b) of the Exchange Act, as well as Advance Notices.

Registered clearing agencies are also subject to examination by Staff.<sup>1232</sup> The areas of review may include corporate governance, internal controls, membership, financial surveillance of members, clearing fund issues, margin models, risk management frameworks, capitalization and liquidity, information security, systems capacity, systems development, computer operations, and other critical processes. During an examination, Staff assesses the clearing agency's compliance with applicable statutory and regulatory requirements and the clearing agency's oversight of its members' compliance with its rules. Staff documents its review, analysis, and findings over the course of an examination. The clearing agency receives the examination findings through an exit interview and a letter summarizing the findings. Staff expects the clearing agency to respond in writing and address all issues and findings identified in the course of the examination, and Staff may work closely with the clearing agency to ensure that it addresses the findings in a timely manner.

- (d) Permit the regulator to impose ongoing conditions (as appropriate) on the operator of an authorized exchange or regulated trading system, such as the obligation to establish rules, policies and procedures to prevent fraudulent behaviour, treat all members or participants fairly, and have the capacity to carry out the market's and the competent authority's obligations?

Yes. Continued compliance with the initial registration requirements, as noted above, is a condition for continued registration. Registered exchanges and associations are both required to maintain rules, policies, and procedures consistent with their statutory obligations, and to have the capacity to carry out their obligations, and to prevent fraudulent and manipulative acts and practices. Registered ATs also are required to maintain rules, policies, and procedures designed to provide fair access and to have the capacity to carry out their obligations. See response to Question 33.2(a) above for further discussion.

SB SEFs are required to have and enforce rules consistent with their core principles, including to deter abuses and to provide market participants with impartial access to the market. SB SEFs also are required to have trading procedures and to monitor trading through surveillance, compliance, and disciplinary practices and procedures, including real-time trade monitoring, in order to prevent manipulation, price distortion, and disruptions of the delivery or cash settlement process.

<sup>1232</sup>

See *generally* Exchange Act Section 17, 15 U.S.C. 78q.

The federal securities laws also prohibit fraudulent or deceptive conduct. Specifically, the anti-fraud and anti-manipulation provisions are found in Sections 9(a) and 10(b) of the Exchange Act, and Rule 10b-5 thereunder. Additional prohibitions are found in Sections 17(a) of the Securities Act and Sections 15(c) and 14(e) of the Exchange Act. Section 17(a) bars fraudulent conduct in the “offer or sale” of securities. Section 15(c) prohibits fraudulent and manipulative conduct by broker-dealers. With regard to tender offers, Section 14(e) prohibits untrue statements of material fact or the misleading omission of material facts, or any fraudulent, deceptive, or manipulative acts or practices.

### *Supervision*

3. Does regulation require an assessment of:

- (a) The reliability of all arrangements made by the operator for the monitoring, surveillance and supervision of an exchange or trading system and its members or participants to ensure fairness, efficiency, transparency and investor protection, as well as compliance with securities legislation? The market’s dispute resolution and appeal procedures or arrangements as appropriate, its technical systems standards and procedures related to operational failure, information on its record keeping system, reports of suspected breaches of law, arrangements for holding client funds and securities, if applicable, and information on how trades are cleared and settled?

Yes. The Exchange Act requires all registered securities exchanges and associations to be able to enforce compliance by their members and persons associated with their members with the provisions of the Exchange Act, the rules and regulations thereunder, and their own rules.<sup>1233</sup> To this end, the SEC evaluates each applicant’s ability to survey their members and their trading and to address any potential violations of the market’s rules or the federal securities laws. All markets must tailor their surveillance functions to their market’s characteristics. The SEC has broad authority to review the applications submitted by applicants seeking to register as a national securities exchange or registered securities association. To register as an exchange or association requires that extensive information be submitted to the SEC on a wide range of topics, including all arrangements for monitoring, surveillance and supervision of the trading system and its participants. The SEC must determine whether the applicant has provided enough information and made sufficient arrangements with reliable and capable third parties (if applicable), to implement systems that will meet the applicable statutory standards set forth in Section 6 of the Exchange Act for national securities exchanges, and Section 15A for registered securities associations.<sup>1234</sup> The Exchange Act requires that an exchange or association applicant have in place arrangements to address all of the types of conduct and activity. The SEC evaluates

<sup>1233</sup> See Sections 6(b)(1) and 15A(b)(2) of the Exchange Act, 15 U.S.C. 78f(b)(1) and 78o-3(b)(2).

<sup>1234</sup> A broker in the United States that conducts business with the public must also become a member of a registered securities association, which currently means FINRA, the sole registered securities association. FINRA adopts rules that govern the broker’s interaction with customers, including sales practice and suitability rules.

the sufficiency of the applicant's arrangements by assessing its mechanisms for compliance with the applicable federal securities law and regulation, and in the case of activity or conduct relating to public customers, also by reference to the applicable FINRA rule.

ATs are registered as broker-dealers and are subject to the FINRA rules that cover the types of conduct and activity performed.

OCIE carries out the SEC's examination responsibilities through the NEP. OCIE staff may select an entity for examination for any number of reasons, including, but not limited to, the entity's risk profile, a review of a particular compliance risk areas, or a TCR. See the response to Question 9.4 above and Principle 12 for further discussion of OCIE's examination and inspection role. The SEC can also review SRO disciplinary action against a member, and denials of membership in, or access to, an SRO.<sup>1235</sup>

The Exchange Act requires SB SEFs to establish and enforce compliance with any rules established by the SB SEF, including the terms and conditions of the SBSs traded or processed on the facility and any limitation on access. It also requires SB SEFs to establish and enforce trading, trade processing, and participation rules that will deter abuses and have the capacity to detect, investigate, and enforce those rules, including means to capture information that may be used in establishing whether rule violations have occurred.<sup>1236</sup> It further requires SB SEFs to monitor trading in SBSs to prevent manipulation, price distortion, and disruptions of the delivery or cash settlement process through surveillance, compliance, and disciplinary practices and procedures, including methods for conducting real-time monitoring of trading and comprehensive and accurate trade reconstructions.<sup>1237</sup>

### **Dispute Resolution and Appeal Procedures**

SROs have an obligation to have rules that are designed to, among other things, prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, and, in general, protect investors and the public interest.<sup>1238</sup> In furtherance of this obligation, SROs' arbitration rules are generally designed to effectively facilitate the resolution of disputes involving members, associated persons of members, and customers.<sup>1239</sup> Today, the vast majority of brokerage-related arbitration claims are handled through the forum of one SRO, FINRA.

<sup>1235</sup> See Section 19(d)(2) of the Exchange Act, 15 U.S.C. 78s(d)(2).

<sup>1236</sup> See Section 3D(d)(2) of the Exchange Act, 15 U.S.C. 78c-4(d)(2). These requirements are pending effectiveness as described in the SB SEF Exemption, see *supra* note 1194 and accompanying text.

<sup>1237</sup> See Section 3D(d)(4) of the Exchange Act, 15 U.S.C. 78c-4(d)(4). These requirements are pending effectiveness as described in the SB SEF Exemption, see *supra* note 1194 and accompanying text.

<sup>1238</sup> Exchange Act Sections 6(b)(5) and 15A(b)(6), 15 U.S.C. 78f(b)(5) and 78o-3(b)(6).

<sup>1239</sup> See FINRA Rule 12000 Series for the Code of Arbitration Procedure for Customer Disputes and FINRA Rule 13000 Series for the Code of Arbitration Procedure for Industry Disputes. FINRA also conducts arbitrations on

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As part of the account opening process, members typically require their customers to agree to resolve any future disputes through arbitration. SRO rules typically grant investors the right to require SRO members and associated persons of members to arbitrate any eligible dispute upon a customer's request, regardless whether there is dispute arbitration agreement.<sup>1240</sup> In addition, SROs' rules generally require their members to comply with certain requirements when using such agreements (*e.g.*, requiring specific content, and requiring firms to alert customers to the existence of such agreements).<sup>1241</sup>

The SEC exercises its authority over the SRO arbitration process through its approval or disapproval of FINRA's arbitration rules. The SEC reviews SRO rules pursuant to Section 19(b) of the Exchange Act, including arbitration rules, before they can become effective.<sup>1242</sup> Section 19(b)(2)(C)(i) of the Exchange Act requires the SEC to approve a rule change if it finds that the change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder. Section 19(b)(2)(C)(ii) requires the SEC to disapprove a proposed rule change if it does not make the finding discussed above.<sup>1243</sup> In addition, the SEC has the authority to conduct inspections of FINRA's dispute resolution forum.

### **Technical System Standards and Procedures Related to Operational Failure**

To evaluate whether the exchanges and other trading systems have addressed their systems capacity needs, the SEC put ARP in place. As discussed in Principle 9, the ARP group, which was historically administered by the TM, transitioned to OCIE in February 2014 and was renamed the TCP. TCP staff conducts inspections of the trading and related information technology systems operated by the exchanges, clearing agencies, and certain high-volume ATSS (collectively ARP entities) to evaluate whether the systems have sufficient capacity and resiliency to accommodate conditions of increased volume and disruptions to normal operations. TCP staff also monitors planned significant system changes and responds to reports of system failures, disruptions, and other systems issues of ARP entities. The TCP is staffed with information technology experts who regularly confer and meet with members of the information technology staff of the various ARP entities. One goal of the TCP group's inspections is to evaluate whether an examined entity's controls over its information technology resources are consistent with industry guidelines. In

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behalf of other SROs. See, *e.g.*, Exchange Act Release No. 56208 (Aug. 6, 2007), 72 C.F.R. 45077 (Aug. 10, 2007) (order approving changes to NYSE arbitration rules to conform to the arbitration rules for the National Securities Dealers Association, Inc. (NASD) (now known as FINRA), to reflect the NASD's regulation of mutual NYSE and NASD members).

<sup>1240</sup> See, *e.g.*, FINRA Rule 12200.

<sup>1241</sup> See, *e.g.*, FINRA Rule 2268.

<sup>1242</sup> See Sections 6(b)(5) and 15A(b)(6) of the Exchange Act, 15 U.S.C. 78f(b)(5) and 15 U.S.C. 78o-3(b)(6).

<sup>1243</sup> See Principle 9, Question 2(d) for a discussion of the types of proposed SRO rule changes that may become effective upon filing.

addition to reviewing the systems capability of an ARP entity, the TCP staff will also consider whether the entity has sufficient capital to maintain its automated systems, and the appropriate staff with technical expertise.

### **Information on Records Keeping System**

Please see the response to Question 34.1(c), for a description of the record keeping requirements of exchanges and broker-dealers.

In addition, all SROs and ATs have adopted rules and procedures governing audit trails and implementing audit trails to aid in the surveillance of their market. In general, an audit trail requires information about the parties to the trade, the security, the type of order, the time of the trade, the number of shares to which the order applies, and the price of the trade. Individual markets can, and often do, require additional information, such as special handling requests, the type of account for which an order was submitted, etc.

The Exchange Act requires SB SEFs to maintain audit trails and records of all activities relating to the business of its facility and any other recordkeeping and reporting requirements the SEC may adopt.<sup>1244</sup>

### **Reports of Suspected Breaches of Law**

As part of its duty as a front-line regulator, each SRO is itself responsible for investigating and disciplining any breaches of the SRO's rules, the Exchange Act and/or rules thereunder.<sup>1245</sup> The SEC also may, in its discretion, investigate and prosecute any violations of the Exchange Act and the rules thereunder.<sup>1246</sup>

### **Arrangements for Holding Customer Funds and Securities**

Under the Exchange Act, the SEC must set financial responsibility rules for broker-dealers. The broker-dealer financial responsibility rules are discussed more fully above in response to Principle 31. The SEC promulgated a number of rules including the Customer Protection Rule,<sup>1247</sup> the Hypothecation Rules,<sup>1248</sup> and the Quarterly Count Rule.<sup>1249</sup> The SEC's Customer Protection

<sup>1244</sup> See Section 3D(d)(9) of the Exchange Act, 15 U.S.C. 78c-4(d)(9). These requirements are pending effectiveness as described in the SB SEF Exemption, see *supra* note 1194 and accompanying text.

<sup>1245</sup> See Exchange Act Section 6(b)(1) and (6), and Section 15A(b)(2) and (7), 15 U.S.C. 78f(b)(1) and (6), and 78o-3(b)(2) and (7).

<sup>1246</sup> See Section 21 of the Exchange Act, 15 U.S.C. 78u.

<sup>1247</sup> 17 C.F.R. 240.15c3-3.

<sup>1248</sup> 17 C.F.R. 240.8c-1 and 15c2-1.

<sup>1249</sup> 17 C.F.R. 240.17a-13.



Rule requires that every broker-dealer obtain and maintain possession or control of customer fully paid and excess margin securities.<sup>1250</sup> This means the broker-dealer cannot lend or hypothecate these securities and must hold them itself or, as is more common, in a satisfactory control location.<sup>1251</sup> Broker-dealers are also required to maintain a special reserve account for the exclusive benefit of customers that contains at least the net dollar amount of cash the broker-dealer owes customers. The Hypothecation Rules restrict the ability of the broker-dealer to pledge customer securities. The Quarterly Count Rule requires a broker-dealer that maintains custody of securities (proprietary, customer, or both), on a quarterly basis, to physically examine and count the securities it holds, account for the securities that are subject to its control or direction but are not in its physical possession (*e.g.*, securities held at a control location), verify the locations of securities under certain circumstances, and compare the results of the count and verification with its records.<sup>1252</sup>

### **Information on How Trades are Cleared and Settled**

In the U.S., the clearance and settlement of securities transactions generally occurs through a series of registered clearing agencies and a registered centralized securities depository, not exchanges or markets. A registered clearing agency is an SRO, and its relations with its members are generally governed by the rules it promulgates. Clearing agencies must register with the SEC prior to performing the functions of a clearing agency, and, once registered, clearing agencies must comply with the requirements of the Exchange Act and the relevant regulations thereunder. Additionally, clearing agencies, as SROs, must file with the SEC any proposed rule change for approval, and they are subject to ongoing monitoring and examination by the SEC. The registration process and the applicable statutory and regulatory requirements for registered clearing agencies are discussed in more detail above.

Registered clearing agencies compare member transactions (or report to members the results of exchange comparison operations), clear those trades, and prepare instructions for automated settlement of those trades, and often act as intermediaries in making those settlements. A CSD holds securities certificates in bulk form for its participants and maintains ownership records of the securities on its own books. Physical securities are maintained in vaults, and ownership records are maintained on the books of the depository. Clearing agencies generally instruct depositories to make securities deliveries that result from settlement of securities transactions. Depositories also receive instructions from participants to move securities from one participant's account to another participant's account, either for free or in exchange for a payment of money.

Clearance may be accomplished on a trade-by-trade basis or through netting of several trades,

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<sup>1250</sup> 17 C.F.R. 240.15c3-3.

<sup>1251</sup> Id.

<sup>1252</sup> See, *e.g.*, NYSE Rule 402 and NASD Rule 2330.



either bilaterally between the two counterparties or multilaterally among all members of a clearing agency to yield balance orders reflecting a single day's trades or all open positions to date. Clearing agencies notify participants of their securities delivery and payment obligations each day. In addition, the clearing agency performing CCP services guarantees the completion of all transactions and interposes itself as the counterparty to both sides of any transaction.

NSCC clears and settles virtually all broker-to-broker trades involving equities, corporate and municipal debt, American depositary receipts, exchange-traded funds, and UIT. NSCC uses its Continuous Net Settlement System to net and allocate transactions. Within Continuous Net Settlement, each security is netted to one position per participant, with NSCC as its CCP.

DTC provides settlement services for virtually all equity, corporate, and municipal debt trades in the U.S. The payment and transfer of securities ownership occurs at DTC. Settlement of a trade is completed when DTC transfers the ownership of the shares from the selling firm to the buying firm in its book-entry recordkeeping system.

The Government Securities Division of the FICC serves as a CCP for Government securities, and the Mortgage-Backed Securities Division of FICC is a CCP for the mortgage-backed securities market.

The Options Clearing Corporation is the CCP for exchange-listed options, security futures, and OTC options transactions. ICE serves as a CCP for SBSs transactions (specifically, CDSs) in the U.S.<sup>1253</sup>

- (b) The mechanisms that must be in place to identify and address disorderly trading conditions and to deal with any contravening conduct that is detected, including details of procedures for trading halts, other trading limitations and assistance available to the regulator in circumstances of potential trading disruption on the system?

There are a variety of emergency intervention tools available to the exchanges, associations, and the SEC, including trading halts, trading suspensions, and the SEC's emergency authority. It is important to note that the SEC generally supports keeping markets open, and that if a catastrophic event arises, the SEC would normally seek a consensus from the exchanges and associations on the necessity of closing markets -- as was the case on September 11, 2001 and in response to Superstorm Sandy in 2012. Additionally, note that the markets, not the SEC, typically make most trading halt and market closure decisions.

The markets can impose trading halts and suspensions for a variety of reasons. For example, a

<sup>1253</sup> Both CME and ICEEU have been deemed registered as clearing agencies solely for the purpose of clearing SBSs, but are not yet providing any such services in the U.S. market for SBSs.

market can halt trading (or delay the opening) in securities on the trading floor because of an order imbalance (that is, an imbalance of buy and sell interest), or for regulatory reasons, such as pending corporate news. A market can also halt trading (or delay the opening) in equity options due to a trading halt (or delayed opening) in the underlying stock. A market can halt trading (or delay the opening) in index options if officials believe that there have been trading halts (or delayed openings) in many underlying stocks or if trading in necessary hedging vehicles, such as index futures, has been halted or restricted (e.g., by futures price limits). Finally, a market also has the authority to suspend trading in all securities on that market, adopt abbreviated trading hours or close the exchange if such actions would be in the public interest.

The listing standards of the markets address when a listed company is required to notify the market of certain material events that would reasonably be expected to affect the value of their securities.<sup>1254</sup> Upon notification by a listed issuer, a market may institute a regulatory trading halt to allow the news of the material event to be disseminated to investors.<sup>1255</sup> Trading halts can also be imposed by means of circuit breakers. Generally speaking, under the circuit breaker halts all trading in stock, options, and futures markets halt for a certain periods of time if the S&P 500 Index declines by certain set amounts during certain set times.<sup>1256</sup>

The SEC may also suspend trading and issue emergency orders under certain circumstances. Pursuant to Section 12(k)(1)(A) of the Exchange Act, the SEC, if the public interest and the protection of investors so require, can issue an order summarily to suspend all trading in a specific security for up to 10 business days. Pursuant to Section 12(k)(1)(B) of the Exchange Act, the SEC, if the public interest and the protection of investors so require, can issue an order summarily to suspend all trading in securities for up to 90 calendar days. The SEC must first notify the President of its decision and the President must not disapprove. Pursuant to Section 12(k)(2) of the Exchange Act, the SEC, in an emergency, may by order summarily take such action (for no more than 10 business days) to alter, supplement, suspend, or impose requirements or restrictions with respect to any matter or action subject to SEC or exchange/association regulation that the SEC determines is necessary in the public interest and for the protection of investors: (i) to maintain or restore fair and orderly securities markets; or (ii) to ensure prompt, accurate, and safe clearance and settlement of transactions in securities. A market emergency is defined as “sudden and excessive fluctuations of securities prices generally, or a substantial threat thereof, that threaten fair and orderly markets, or a substantial disruption of the safe or efficient operation of the national system for clearance and settlement of securities, or a substantial threat thereof.”<sup>1257</sup>

<sup>1254</sup> See, e.g., NYSE Listed Company Manual Section 202 (specifically 202.05) and 204; and NASDAQ IM-5250-1.

<sup>1255</sup> See, e.g., NYSE Listed Company Manual Section 202.07 and NASDAQ Rule 4120(a).

<sup>1256</sup> See, e.g., NYSE Rule 80B. See also e.g., CBOE Rule 6.3B, ISE Rule 703 (following NYSE’s lead in initiating trading halts in the event of unusual market conditions).

<sup>1257</sup> Section 12(k)(6) of the Exchange Act, 15 U.S.C. 78l(k)(6).

Finally, a mechanism exists for listed equities (except rights and warrants), which is intended to prevent erroneous trades and moderate volatility in the market for these securities. This mechanism requires all trading centers in NMS stocks (*i.e.*, exchanges, ATSS, and broker-dealers executing internally) – directly or through SRO rule – to establish policies and procedures reasonably designed to prevent trades from occurring outside the applicable LULD price band, to honor any trading pause, and to otherwise comply with the procedures set forth in the National Market System Plan to Address Extraordinary Market Volatility.<sup>1258</sup> The LULD mechanism prevents trades in individual securities from occurring outside of a specified price band and is coupled with a trading pause mechanism to accommodate more fundamental price moves. In essence, an individual stock enters a “limit state” if the stock moves a certain percentage – generally 5%, 10%, or 20%, depending on the stock and the time of day – over a five-minute period. If the market does not naturally exit the limit state within 15 seconds, there is a five-minute trading pause at the conclusion of which trading resumes under normal reopening procedures.

- (c) Does the relevant market authority (*i.e.*, the regulator or relevant SRO), the outsourcing market, and its auditors, have access to the books and records of service providers relating to an exchange’s outsourced activities and the ability to obtain promptly, upon request, other information concerning activities that are relevant to regulatory oversight?

Yes, as discussed in the response to Question 34.1(c), all records of a national securities exchange and registered securities association are subject, at any time or from time to time, to such reasonable, periodic, special or other examination by representatives of the SEC.<sup>1259</sup>

In the context of RSAs, where one SRO contracts with another SRO to provide regulatory services on its behalf, the parties generally enter into a contractual arrangement that provides, among other things, for the sharing of all relevant information on a prompt basis as is necessary to perform the regulatory services. As noted above, the federal securities laws and rules thereunder require SROs to make and keep for prescribed periods, and to furnish them to the SEC upon request, records relating to the performance of the SROs’ regulatory activity. In addition, the governing documents of the SROs, including their holding companies, typically provide a clause in which the entity agrees to provide the Staff with access to its books and records relevant to the SEC’s regulatory oversight.

The Exchange Act requires SB SEFs to establish and enforce rules that will allow it to obtain any necessary information to perform its functions under the Exchange Act, to provide information to

<sup>1258</sup> See, *e.g.*, Exchange Act Release No. 71851 (April 3, 2014).

<sup>1259</sup> Section 17(b) of the Exchange Act, 15 U.S.C. 78q(b).

the SEC upon request, and to have the capacity to carry out such international information-sharing agreements as the SEC may require.<sup>1260</sup>

*Securities and Market Participants?*

4. With respect to securities and market participants:

- (a) Is the regulator informed of the types of securities to be traded and does it approve the rules governing the admission of the securities to trading or listing?

Yes. An SRO's listing criteria are set out in the SRO's rules that are submitted to the SEC pursuant to the Section 19(b) rule filing process. Pursuant to Section 19(b) of the Exchange Act and Rule 19b-4, every SRO files with the SEC any proposed rule, or any proposed change to a rule, of the SRO.<sup>1261</sup> Generally, the SEC publishes these rules for comment by interested persons, and approves the proposed rule change only if the SEC finds that the rule change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder. In addition, pursuant to Section 19(b)(3)(A), certain rules and rule changes are effective upon filing. See the response to Question 9.2(d) for a detailed description of the rule filing process.

SRO listing rules may impose qualitative and quantitative conditions for initial listing and continued listing, including matters pertaining to corporate governance of the issuer, shareholder rights and conformity of the issuer's financial statements to accepted accounting and auditing standards. As part of the listing requirements, the exchanges also require issuers to make timely disclosure of information that would be material to investors or likely to have a significant effect on the price of an issuer's securities. Section 10A(m) and Rule 10A-3 thereunder also directs each national securities exchange and registered securities association to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements set forth in the statute and rule.<sup>1262</sup> In addition, Section 10C-1 of the Exchange

<sup>1260</sup> See Section 3D(d)(5) of the Exchange Act, 15 U.S.C. 78c-4(d)(5). These requirements are pending effectiveness as described in the SB SEF Exemption, see *supra* note 1194 and accompanying text. See also Section 3D(d)(9) of the Exchange Act, 15 U.S.C. 78c-4(d)(9).

<sup>1261</sup> Clearing agencies registered with the SEC are SROs that file proposed rule changes under Section 19(b) and Rule 19b-4. However, because clearing agencies provide post-trade processing services, they do not have rules related to securities trading or listing.

<sup>1262</sup> In general, under Exchange Act Section 10A(m), 15 U.S.C. 78j-1, and Rule 10A-3 thereunder, 17 C.F.R. 240.10A-3, national securities exchanges and registered securities associations are prohibited from listing any security of an issuer that is not in compliance with the following standards: (i) each member of the audit committee of the issuer must be independent according to specified criteria; (ii) the audit committee of each issuer must be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review, or attest services for the issuer, and each such registered public accounting firm must report directly to the audit committee; (iii) each audit committee must establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, including procedures for the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters; (iv) each audit committee must have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties; and (v) each issuer must provide appropriate funding for the audit committee, as determined by the audit committee.

Act,<sup>1263</sup> and Rule 10C-1 thereunder,<sup>1264</sup> directs national securities exchanges and national securities associations to prohibit the listing of any equity security of an issuer that does not comply with independent compensation committee and compensation adviser requirements, as set forth in the statute and rule. To comply with Section 10C-1 and Rule 10C-1, SROs that list equity securities must have listing standards that require each member of a listed issuer's compensation committee to be an independent member of the board of directors, after considering certain relevant factors including any sources of compensation and affiliations with the issuer. The compensation committee must also consider independence when selecting a compensation consultant or advisor after taking into consideration certain specified factors.<sup>1265</sup>

As noted above, the listing rules of an exchange are set out in the SRO's rules and are submitted to the SEC pursuant to the Section 19(b) rule filing process. These rules would include the listing of derivatives products. Exchange Act Rule 19-4(e), however, provides that the listing and trading of certain derivative products (defined as an "option, warrant, hybrid securities product or any other security whose value is based, in whole or in part, upon the performance of, or interest in, an underlying instrument"), are not deemed to be a proposed rule change, and an SRO need not file with the SEC prior to listing and trading such a qualified product if the SEC has approved the SRO's trading rules, procedures and listing standards for the product class that would include the new derivative securities product. Pursuant to Rule 19b-4(e), the SRO must also have a surveillance program for the product class, and fulfill certain record keeping and reporting requirements.

(b) Where applicable, does the regulator or the market take product design and trading conditions into account in order to admit a product for trading?

All securities traded on any SRO must meet certain listing standards, which are rules submitted to the SEC under Section 19(b) of the Exchange Act and Rule 19b-4, as described above. The trading rules are designed to prevent market abuse and manipulation and ensure a fair, orderly, efficient, transparent and liquid market. Section 6(b)(5) and Section 15A(b)(6) of the Exchange Act, in turn, specifically require that the SEC find that the rules of the exchange and the association, respectively, are "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect the investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers...."

<sup>1263</sup> 15 U.S.C. 78j-3.

<sup>1264</sup> 17 C.F.R. 240.10C-1.

<sup>1265</sup> Rule 10C-1 also requires disclosure about the use of compensation advisers and related conflicts of interest.

The listing of new products is normally subject to the 19(b) rule filing process. The SEC has adopted Exchange Act Rule 19b-4(e) to allow new derivative securities products to be listed without a proposed rule change, provided that the new derivative securities product meets the definition in the rule,<sup>1266</sup> and provided that the SEC has approved the SRO's trading rules, procedures, and listing standards for the product class that would include the new derivatives securities product.

(c) Does the regulatory framework provide for fair access to the exchange or trading system through oversight of the related rules for participation?

Yes. The regulatory framework provides for fair access. Pursuant to Sections 6(b)(2) and 15A(b)(3) of the Exchange Act, a national securities exchange or registered securities association must have rules that permit any registered broker-dealer or natural person associated with a broker-dealer to become a member of the exchange or association. An exchange or association's ability to deny membership to its market is limited pursuant to Sections 6(c) and 15A(g) of the Exchange Act. An exchange or association, generally, must deny membership to any non-registered broker-dealer and may deny membership to any broker-dealer that is subject to a statutory disqualification.<sup>1267</sup> A denial on the grounds of a statutory disqualification must be reported to the SEC. Further, an exchange or association may deny membership to a broker-dealer that does not meet financial responsibility or operational capability standards, does not have the minimum level of training, experience or competence prescribed by the exchange's rules. In addition, an exchange or association may deny membership to a broker-dealer that has engaged in or is likely to engage in acts or practices that are inconsistent with just and equitable principles of trade.

Each national securities exchange or registered securities association has rules that prescribe the means by which a registered broker-dealer may apply to become a member. In addition to not permitting an exchange or association to exclude any registered broker-dealer,<sup>1268</sup> the exchange's or association's rules may not be designed to permit unfair discrimination between broker-dealers<sup>1269</sup> and may not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.<sup>1270</sup> Further, Sections 6(b)(4) and

<sup>1266</sup> Rule 19b-4(e) defines a "new derivative securities product" as "any type of option, warrant, hybrid securities product or any other security, other than a single equity option or a SFP, whose value is based, in whole or in part, upon the performance of, or interest in, an underlying instrument." 17 C.F.R. 240.19b-4(e).

<sup>1267</sup> Section 3(a)(39) of the Exchange Act lists the types of misconduct which cause a person to become subject to a statutory disqualification, which includes, but is not limited to, such events as SEC bars or suspensions, injunctions, and felony convictions. 15 U.S.C. 78c(a)(39).

<sup>1268</sup> Other than pursuant to Sections 6(c) and 15A(g) of the Exchange Act, 15 U.S.C. 78f(c) and 78o-3(g), as discussed above.

<sup>1269</sup> Sections 6(b)(5) and 15A(b)(6) of the Exchange Act, 15 U.S.C. 78f(b)(5) and 78o-3(b)(6).

<sup>1270</sup> Sections 6(b)(8) and 15A(b)(9) of the Exchange Act, 15 U.S.C. 78f(b)(8) and 78o-3(b)(9).

15A(b)(5) of the Exchange Act requires that the rules of an exchange or association provide for an equitable allocation of reasonable dues, fees, and other charges among its members and other persons using its facilities. The SEC has plenary authority to review exchange or association rules that govern the admission of members pursuant to Section 19 of the Exchange Act. Section 6(d)(3), Section 15A(h)(3), and Section 19(d) of the Exchange Act provide that the SEC may review denials of membership in, or access to, an SRO.

If an exchange denies membership or participation to an applicant, it must provide the SEC notice of such action.<sup>1271</sup> A denial of membership or participation by an exchange is reviewable by the SEC.<sup>1272</sup> The SEC will dismiss an appeal if the SEC finds that the SRO's action is based on fact and that the rules were applied in a manner that is consistent with the Exchange Act.<sup>1273</sup> If the SEC cannot make such a finding, it will set aside the SRO's action and require it to admit the applicant to membership or participation.<sup>1274</sup> Accordingly, the ability to trade on a national securities exchange is readily attainable by those qualified registered broker-dealers who seek membership.

In recent years, many markets have demutualized and moved away from a "membership" structure to a trading permit structure, making opportunities to access such exchanges greater because, unlike membership-based exchanges historically, there is typically no limit on the number of trading permits that a fully electronic exchange issues. Some exchanges that still have trading floors, though demutualized, have retained their limits on access.<sup>1275</sup> The SEC, however, may increase or remove limitations on the number of memberships for an exchange if it finds that such limitations impose burdens on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.<sup>1276</sup>

In addition, Rule 610(a) of Regulation NMS prohibits an SRO from imposing unfairly discriminatory terms that prevent or inhibit any person from obtaining efficient access through a member of the SRO to the quotations in an NMS stock displayed in the SRO trading facility. This anti-discrimination provision provides non-members indirect access to quotes by members. This provision prohibits, for example, different fees or order priority rules based on the identity of a member's customer. Paragraph (c) of Rule 610 also limits the amount of fees that may be charged by a trading facility to access its best bids and offers. Generally, the rules provide that a

<sup>1271</sup> Section 19(d)(1) of the Exchange Act, 15 U.S.C. 78s(d)(1). See Rule 19d-1, 17 C.F.R. 240.19d-1, for the required contents of the notice that an SRO must make to the SEC.

<sup>1272</sup> Section 19(d)(2) of the Exchange Act, 15 U.S.C. 78s(d)(2).

<sup>1273</sup> Section 19(f) of the Exchange Act, 15 U.S.C. 78s(f).

<sup>1274</sup> *Id.*

<sup>1275</sup> NYSE is an example of this. Additionally, exchanges are not allowed to decrease market access below membership levels in effect at the time of exchange registration or May 1, 1975. See Section 6(c)(4) of the Exchange Act, 15 U.S.C. 78f(c)(4).

<sup>1276</sup> *Id.*



trading center may not impose a fee for the execution of an order against a “protect quotation,” as defined, of the trading center that exceed or accumulate to more than \$0.003 per share or for a stock priced less than \$1.00 that exceed or accumulate to more than 0.3% of the quotation price.

ATSs are also subject to certain fair access standards. ATSs that account for 5% or more of the average daily trading volume within a certain time period in any equity security, municipal security, investment grade or non-investment grade corporate debt must comply with the fair access requirements of Rule 301(b)(5)(ii) of the Exchange Act. Specifically, Rule 301(b)(5)(ii) states that these ATSs must establish written standards for granting access to trading on their systems and maintain these standards in their records. An ATS is prohibited from unreasonably prohibiting or limiting any persons with respect to access to services of the ATS with respect to any such securities, when trading exceeds the 5% volume threshold, and must not apply these standards in an unfairly or discriminatorily manner.

SB SEFs are required to establish and enforce trading, trade processing, and participation rules that will deter abuses and have the capacity to detect, investigate, and enforce those rules, including means to provide market participants with impartial access to the market.<sup>1277</sup>

#### *Fairness of Order Execution Procedures*

##### 5. With respect to order execution procedures:

- (a) Are order routing procedures clearly disclosed to regulators and to market participants, applied fairly and not inconsistent with relevant securities regulation (e.g., requirements with respect to precedence of client orders and prohibition of front-running or trading ahead of customers)?

Yes. An SRO’s order routing procedures are clearly disclosed to the regulator and to market participants in the context of the registration of the SRO. As noted above, Section 6 of the Exchange Act requires that all applicants seeking to register as a national securities exchange file a registration form, a “Form 1”, with the SEC, which would include its proposed rules (including its order routing procedures). The Form 1 requires the applicant to provide comprehensive information about the system and the system operator. Applicants seeking to register as a national securities association file Form X-15AA-1 when registering. Form X-15AA-1 also requires that any rules, which would include any order routing procedures, be filed with the SEC.

The SEC evaluates whether a system’s order routing procedures are fairly applied and not inconsistent with relevant securities requirements by evaluating the application consistent with the Exchange Act’s mandates to only approve an application for registration if the SEC finds that the applicant is so organized and has the capacity to carry out the purposes of the Exchange Act.

<sup>1277</sup> See Section 3D(d)(2) of the Exchange Act, 15 U.S.C. 78c-4(d)(2). These requirements are pending effectiveness as described in the SB SEF Exemption, see supra note 1194 and accompanying text.



Thus, an SRO's order routing procedures can only be approved if they are consistent with relevant securities laws and regulations, including those with respect to precedence and front-running or trading ahead of customer orders. Furthermore, one of the stated purposes of the Exchange Act is to prohibit the "unfair discrimination between customers, issuers, brokers, or dealers."<sup>1278</sup> Thus, an applicant seeking to register as a national securities exchange or registered securities association would only obtain approval to register if its rules were not unfairly discriminatory.

In addition, order routing rules/procedures and actual order routing practices are disclosed publicly via two rules adopted by the SEC in December 2000 that improve public disclosure of order routing practices. Under Exchange Act Rule 606 of Regulation NMS, broker-dealers that route customer orders in equity and option securities are required to make publicly available quarterly reports that, among other things, identify the venues to which customer orders are routed for execution. In addition, broker-dealers are required to disclose to customers, on request, the venues to which their individual orders were routed. By making visible the execution quality of the securities markets, the rules are intended to spur more vigorous competition among market participants to provide the best possible prices for investor orders.

Furthermore, an SRO's rules must be designed to prevent fraudulent and manipulative acts and practices and promote just and equitable principles of trade.<sup>1279</sup> Specifically, the SROs have rules that govern how a broker-dealer may trade for its own account when representing customer orders. Pursuant to these SRO rules, broker-dealers are generally prohibited from trading for their own account when they hold an order for the same security that may be executed at the same price.<sup>1280</sup> Failure to execute the customer's order first can result in a violation of SRO rules.

In addition, as noted above in the response to Question 9.2(c) above, a broker-dealer has a legal duty to seek to obtain best execution of customer orders. The SEC has adopted its own rule, Exchange Act Rule 611 under Regulation NMS, to support a broker-dealers' duty of best execution. Rule 611 helps to ensure that investors' orders are not executed at prices inferior to the best protected quotations, as defined,<sup>1281</sup> across the markets.

Sections 6(b)(5) and 15A(b)(6) of the Exchange Act require that the rules of an SRO be designed to, among other things, prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade. In addition, the rules of an SRO must be designed as to not permit unfair discrimination between customers, issuers, brokers, or dealers. Moreover, an SRO's rules must provide for the equitable allocation of reasonable dues, fees and other charges

<sup>1278</sup> Sections 6(b)(5) and 15A(b)(6) of the Exchange Act, 15 U.S.C. 78f(b)(5) and 78o-3(b)(6).

<sup>1279</sup> *Id.*

<sup>1280</sup> See, e.g., NYSE Rule 92 and NASD IM-2110-2 and NASD Rule 2111.

<sup>1281</sup> See Rule 600(a)(58), 17 C.F.R. 242.600(a)(58).

among its members and issuers and other persons using its facilities.

The SEC reviews all prospective SRO rules to evaluate whether they satisfy these standards. Further, the SEC reviews the prospective rules of the markets to evaluate whether the members of the markets have unfair trading advantages over non-members, or investors generally. For example, the SEC reviews the operations of the SROs' trading systems to ensure that investor orders are able to compete freely with orders of market professionals and are executed on an equitable basis, such as price/time priority.<sup>1282</sup> Indeed, the SEC reviews any changes to the SRO rules to evaluate whether and how investor protections are effected. In addition, the SEC will analyze any proposed rule that gives a member a trading advantage against the obligations the member has to the market. For example, exchange specialists and market makers are permitted to trade for their own account ahead of public orders in certain instances due to their obligations to maintain a fair and orderly market.<sup>1283</sup>

In addition, the SEC has adopted its own rule geared at helping to ensure that public orders are represented in the markets. Specifically, Exchange Act Rule 604 of Regulation NMS provides that exchange specialists and OTC market makers must display public customer limit orders for NMS stocks that improve the bid or offer of the specialist or market maker.<sup>1284</sup> In addition, specialists and market makers must include the size of public customer limit orders for NMS stocks that are priced equal to the specialist's or market maker's bid or offer. This rule helps to ensure that public customer orders are able to compete in the market for quality executions.

The SROs also have rules addressing fraudulent or deceptive conduct. For example, NYSE Rule 476(a) prohibits fraudulent acts. FINRA Rule 2020 prohibits any transaction or inducement to purchase or sell a security by means of any manipulative, deceptive, or otherwise fraudulent device or contrivance.

Any prospective SRO must demonstrate its ability to operate as part of the NMS as contemplated in Section 11A of the Exchange Act. In particular, an applicant that wishes to list and trade NMS stocks must comply with the Order Protection Rule<sup>1285</sup>, which requires trading centers to establish policies and procedures reasonably designed to prevent the execution of trades at

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<sup>1282</sup> The SEC has stated that it believes that it is beneficial for orders in the same securities directed to an exchange to interact with each other as it promotes efficient trading and protects investors by assuring that orders executed pursuant to a single set of priority rules that are consistently and fairly applied. See, e.g., Exchange Act Release No. 53128 (January 13, 2006), 71 Fed. Reg. 3550 (January 23, 2006) (Order approving the application of the NASDAQ Stock Market LLC as a national securities exchange).

<sup>1283</sup> See, e.g., Exchange Act Release No. 53539 (March 22, 2006), 71 Fed. Reg. 16353 (March 31, 2006) (Order approving NYSE Hybrid). See also Section 11(b) of the Exchange Act, 15 U.S.C. 78k(b), and Rule 11b-1 thereunder, 17 C.F.R. 240.11b-1.

<sup>1284</sup> 17 C.F.R. 242.604.

<sup>1285</sup> 17 C.F.R. 242.611.

prices inferior to automated quotations that are the best quote of another exchange or FINRA, subject to applicable exceptions. The Access Rule<sup>1286</sup> requires fair and non-discriminatory access to quotations in NMS stocks, establishes a limit on access fees to harmonize the pricing of quotations in NMS stocks across different trading centers, and requires rules addressing locked and crossed markets in NMS stocks.

The Exchange Act contains several additional provisions relating to order execution that must be satisfied by a prospective exchange. First, an exchange must demonstrate that its members are not permitted to trade for their own accounts, for the accounts of associated person, or for accounts with respect to which an associated person exercises investment discretion, unless such trading is consistent with the exemptions set forth in Section 11(a) of the Exchange Act and the rules thereunder. There are statutory exceptions to these prohibitions, including trading by a dealer acting as a market maker.<sup>1287</sup> The SEC also excepted by rule, certain classes of transactions from these prohibitions.<sup>1288</sup>

Section 11(b) of the Exchange Act provides for the regulation of specialists and odd-lot dealers. If an exchange plans on having members act as specialists or odd-lot dealers, the rules of the SRO must reflect the appropriate rules for their registration and activities.<sup>1289</sup>

(b) Are execution rules disclosed to the regulator and to market participants, and consistently applied to all participants?

All SRO rules and rule changes are required to be filed with the SEC and, once approved or effective, must be posted on the SRO's website. Further, an SRO must post any proposed new rules or rule amendments filed with the SEC on its website.

With regard to the consistent application of execution rules, as noted above, the SEC reviews the operations of the SROs' trading systems to evaluate whether investor orders are able to compete freely with orders of market professionals and are executed on an equitable basis, such as price/time priority.<sup>1290</sup> In addition, the SEC has adopted its own rule geared at ensuring that the

<sup>1286</sup> 17 C.F.R. 242.610.

<sup>1287</sup> See Section 11(a)(1), 15 U.S.C. 78k(a)(1).

<sup>1288</sup> Generally, if a member (except a specialist) wants to execute a transaction of a physical exchange floor for its own account, the member would have to yield priority to all non-members who seek execution at the same price. Section 11(a)(1)(G) of the Exchange Act, 15 U.S.C. 78k(a)(1)(G), and Rule 11a1-1(T) thereunder, 17 C.F.R. 240.11a1-1(T). This section is intended to prevent members of an exchange from having an advantage over non-members by virtue of their time and place opportunities on an exchange. This section does not generally apply to electronic, off-floor orders. See Rule 11a2-2(T) under the Exchange Act, 17 C.F.R. 240.11a2-2(T). As the markets have moved to more electronic models, the time/place advantages of members that Section 11(a) of the Exchange Act was intended to address have lessened.

<sup>1289</sup> See Rule 11b-1 under the Exchange Act, 17 C.F.R. 240.11b-1.

<sup>1290</sup> The SEC has stated that it believes that it is beneficial for orders in the same securities directed to an exchange to interact with each other as it promotes efficient trading and protects investors by assuring that orders

(continued)

public orders are represented in the markets. Specifically, Exchange Act Rule 604 of Regulation NMS provides that exchange specialists and OTC market makers must display public customer limit orders in NMS stocks that improve the bid or offer of the specialist or market maker.<sup>1291</sup> In addition, specialists and market makers must include the size of public customer limit orders in NMS stocks that are priced equal to the specialist's or market maker's bid or offer. This rule helps to ensure that public customer orders are able to compete in the market for quality executions.

(c) Where applicable, does the regulator review the trade matching or execution algorithm of automated trading systems for fairness?

OCIE conducts examinations of SROs and broker-dealers for compliance with the securities laws and rules and SRO rules, including rules regarding best execution. The SEC reviews order matching and execution systems to evaluate compliance with the applicable statutory standards as stated in Section 6 of the Exchange Act for national securities exchanges and Section 15A for registered securities associations, among other provisions. OCIE and FINRA examine broker-dealers that operate as ATSs, and may review, as applicable, a firm's algorithmic trading system or proprietary trading systems to ensure they fairly allocate and execute orders, do not discriminate among certain types of orders, and do not use nonpublic information about order flow obtained through the firm's other business activities to benefit the firm's own account. The ATS reviews may also focus on the firm's order handling practices and processes for selecting trading venues for order execution.

(d) Do all system users have equal opportunity to connect and maintain the connection to the electronic trading system and are differences in order execution response times disclosed by the system operator?

As noted in the response to Question 33.4(c) above, the regulatory framework provides for fair access, which would include the opportunity of members to connect to an exchange's electronic trading system.

Co-location services offered by an exchange provide users close physical proximity to an exchange's servers, and thus faster electronic access to an exchange's trading system.

The terms of any trading service offered by an exchange or its affiliates that impacts access to the exchange and its facilities, such as co-location services, including the fees being charged for such services, are required to be filed as proposed rule changes under Section 19(b) of the Act. Section 6(b)(4) of the Act requires that the rules of the exchange provide for the equitable

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executed pursuant to a single set of priority rules that are consistently and fairly applied. See, e.g., Exchange Act Release No. 53128 (January 13, 2006), 71 Fed. Reg. 3550 (January 23, 2006) (Order approving the application of the NASDAQ Stock Market LLC as a national securities exchange).

<sup>1291</sup>

17 C.F.R. 242.604.

allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities. Section 6(b)(5) of the Act requires, among other things, that the rules of the exchange are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers. Finally, Section 6(b)(8) of the Act requires that the rules of the exchange do not impose any burden on competition not necessary or appropriate in furtherance of the Act. The filing of these proposed rule changes enables the SEC to review their scope and coverage in an effort to ensure that the proposed rule is equitable, not unfairly discriminatory, and not a burden on competition.

- (e) Are there in place effective systems and controls reasonably designed to enable the management of risk with regard to fair and orderly trading including, in particular, automated pre-trade controls that enable intermediaries to implement appropriate risk limits?

Yes. In November 2010, the SEC adopted Rule 15c3-5 – Risk Management Controls for Brokers or Dealers with Market Access.<sup>1292</sup> Rule 15c3-5 is applicable to broker-dealers with access to trading securities, by virtue of being an exchange member, an ATS subscriber, or an ATS operator with non-broker-dealer subscribers. Such broker-dealers with market access are required to establish, document, and maintain a system of risk management controls and supervisory procedures that, among other things, are reasonably designed to: (i) systematically limit the financial exposure of the broker or dealer that could arise as a result of market access, and (ii) ensure compliance with all regulatory requirements that are applicable in connection with market access. Specifically, the risk management controls and supervisory procedures are required to be reasonably designed to:

- prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds, or that appear to be erroneous;
- prevent the entry of orders unless there has been compliance with all regulatory requirements that must be satisfied on a pre-order entry basis; and
- prevent the entry of orders that the broker-dealer or customer is restricted from trading, restrict market access technology and systems to authorized persons, and assure appropriate surveillance personnel receive immediate post-trade execution reports.

<sup>1292</sup>

Exchange Act Release No. 63241 (November 3, 2010), 75 Fed. Reg. 69791 (November 15, 2010).

<i>Operational Information</i>	
6.	With respect to trading information:
(a)	Do similarly situated market participants have equitable access to market rules and operating procedures?
<p>Yes. The federal securities laws, including all statutes, rules and regulations, are readily available from many public sources. For example, the SEC's public website has a link to all current federal securities laws and contains notices of all pending changes to the federal securities laws.</p> <p>Rule 19b-4(m) requires that each SRO post and maintain a current and complete version of its rules on its website. The websites must be updated to reflect any additions or changes to the rules of the SRO that have been filed with the SEC or otherwise become effective within two business days after the SRO receives notification of the approval or issuance of a notice pursuant to Section 19(b)(3)(A) of the Exchange Act.</p> <p>All proposed additions or changes to an SRO's rules are publicly available. The SEC publishes for public comment all proposed rule changes filed with the SEC by an SRO pursuant to Exchange Act Section 19(b). In addition, SROs must post proposed rule changes and any amendments thereto on its website within two business days of filing such proposed rule change or amendment with the SEC.<sup>1293</sup></p>	
(b)	Are adequate records ( <i>i.e.</i> , audit trails) available to reconstruct trading activity within a reasonable time?
<p>The exchanges and associations must also keep a transaction record of all trades for audit purposes. All exchanges, associations, and ATs have adopted procedures governing audit trails and implementing audit trails to aid in the surveillance of their markets. In general, an audit trail requires information about the parties to the trade, the security, the type of order, the time of the trade, the number of shares to which the order applies, and the price of the trade. Individual markets can, and often do, require additional information, such as special handling requests, and the type of account for which an order was submitted. SB SEFs are also required to maintain complete audit trails.<sup>1294</sup></p> <p>SROs are required to keep certain other records.<sup>1295</sup> Specifically, Section 17(a) of the Exchange Act provides that every SRO must make and keep for prescribed periods of time such records, furnish such copies thereof, and make and disseminate such reports as the SEC, by rule,</p>	

<sup>1293</sup> Rule 19b-4(l), 17 C.F.R. 240.19b-4(1).

<sup>1294</sup> See Section 3D(d)(9)(A)(i) of the Exchange Act, 15 U.S.C. 78c-4(d)(9)(A)(i). This requirement is pending effectiveness as described in the SB SEF Exemption, see *supra* note 1194 and accompanying text.

<sup>1295</sup> Section 17(a) of the Exchange Act, 15 U.S.C. 78q(a), and Rule 17a-1.

prescribes as necessary or appropriate in the public interest, for the protection of investors or otherwise in furtherance of the purposes of the Exchange Act. The SEC exercised this rulemaking authority by adopting Rule 17a-1, which provides that an SRO must keep and preserve at least one copy of all documents, including all correspondence, memoranda, papers, books, notices, accounts and such other records as shall be made or received by it in the course of its business as such and in the conduct of its self-regulatory activity. Section 17(b) of the Exchange Act authorizes representatives of the SEC to conduct “reasonable, periodic, special or other exams” of “[a]ll records” of an SRO. These examinations may be conducted at any time or from time to time as the SEC “deems necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the [Exchange Act.]”

In addition, Exchange Act Rule 605 of Regulation NMS requires market centers that trade “national market system stocks,” to make available to the public monthly electronic reports that include uniform statistical measures of execution quality.

Likewise, an ATS is subject to record keeping and reporting requirements, including the maintenance of an audit trail for all orders and transactions entered into the system, under the rules of Regulation ATS.<sup>1296</sup> These rules facilitate effective oversight and supervision by the SEC. In addition, trades executed on an ATS are subject to post-trade reporting rules promulgated by FINRA.

In 2012, the SEC adopted rules to require the exchanges and FINRA to submit an NMS plan to the SEC to create, implement, and maintain a CAT that would collect and report customer and order event information for all orders across all markets -- including dark pools -- to a central repository, thus creating a single database of comprehensive and readily accessible audit trail data that will be available for regulatory purposes, including surveillance. The deadline for the exchanges and FINRA to submit an NMS plan to the SEC is September 30, 2014. The exchanges and FINRA will be required to provide to the central repository the required data within one year after effectiveness of the NMS plan. Members of the exchanges and FINRA will be required to provide to the central repository the required data within two years after effectiveness of the NMS plan and the NMS plan may provide small broker-dealers up to three years after effectiveness of the NMS plan to the central repository the required data.

The SEC has also adopted the Large Trader Rule to address its near-term need for access to more information about the largest market participants and their trading activities. Specifically, in July 2011, the SEC adopted new Rule 13h-1 and new Form 13H under Section 13(h) of the Exchange Act to establish large trader reporting requirements.<sup>1297</sup> In addition to requiring large traders to register with the SEC, the Large Trader Rule also requires certain broker-dealers to keep records

<sup>1296</sup> Regulation ATS Rules 302 and 303, 17 C.F.R. 242.302 and 303.

<sup>1297</sup> See 17 C.F.R. 240.13h-1 and 17 C.F.R. 249.327.



of transactions effected for large traders and produce that information to the SEC upon request. The Large Trader Rule is intended to assist the SEC in both identifying, and obtaining trading information on, market participants that conduct a substantial amount of trading activity, as measured by volume or market value, in the U.S. securities markets, and provides useful data to support the SEC's investigative and enforcement activities.

- (c) Is the system capable of disclosing the types of information that it is designed to make available, and, conversely, of providing safeguards to preserve the confidentiality of other information, the disclosure of which is not intended?

Exchanges, associations, and ATSs are required to disclose certain types of information in accordance with the requirements of the Exchange Act and rules, including with Regulation NMS and the NMS plans. For example, they are required to disseminate quotations and transaction information for NMS securities consistent with Exchange Act Rules 602 and 603 of Regulation NMS.<sup>1298</sup> In addition, on a monthly basis, exchanges and associations are required to publish order execution quality information consistent with Exchange Act Rule 605 of Regulation NMS.<sup>1299</sup>

As discussed further above in the response to Question 9.5(a), exchanges, associations, and ATSs have a duty to safeguard any material, nonpublic information they receive under their duty of trust or confidence.

- (d) Does the market provide member intermediaries with access to relevant pre-and post-trade information (on a real time basis) to enable these intermediaries to implement appropriate monitoring and risk management controls?

Yes. As discussed in more detail in the discussion of Principle 35, SEC, exchange, and association rules require real-time reporting of quotes and transactions occurring on exchanges or in the OTC market, which are made widely available to the public on fair, reasonable and non-discriminatory terms. There is no exception for the real-time reporting of block trades.

In November 2010, the SEC adopted Exchange Act Rule 15c3-5 – Risk Management Controls for Brokers or Dealers with Market Access.<sup>1300</sup> Rule 15c3-5 is applicable to broker-dealers with access to trading securities, by virtue of being an exchange member, an ATS subscriber, or an ATS operator with non-broker-dealer subscribers. Such broker-dealers with market access are required to establish, document, and maintain a system of risk management controls and supervisory procedures that, among other things, are reasonably designed to: (i) systematically limit the financial exposure of the broker or dealer that could arise as a result of market access,

<sup>1298</sup> See 17 C.F.R. 242.602 and 603.

<sup>1299</sup> See 17 C.F.R. 242.605.

<sup>1300</sup> Exchange Act Release No. 63241 (November 3, 2010), 75 Fed. Reg. 69791 (November 15, 2010).



and (ii) ensure compliance with all regulatory requirements that are applicable in connection with market access. Specifically, the risk management controls and supervisory procedures are required to be reasonably designed to:

- prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds, or that appear to be erroneous;
- prevent the entry of orders unless there has been compliance with all regulatory requirements that must be satisfied on a pre-order entry basis; and
- prevent the entry of orders that the broker-dealer or customer is restricted from trading, restrict market access technology and systems to authorized persons, and assure appropriate surveillance personnel receive immediate post-trade execution reports.

The dissemination of post-trade information (and pre-trade information) for equities and options is governed by NMS plans that operate in accordance with Exchange Act rules.<sup>1301</sup> The NMS plans require participants, who are the SROs, to collect and promptly report both pre-trade and post-trade information to NMS plan processors. The processors are then responsible for receiving the pre-trade and post-trade information from the participants, consolidating the information, and disseminating it to the public, including all market participants; thus, information is made available to all comparable parties on the same basis (fees charged to non-professionals are typically much lower than fees paid by professionals). Pursuant to the applicable NMS plans, the SROs must report the stock symbol, volume, and price at which transactions were executed to the plan processor generally within 10 seconds after the time of execution. However, the 10-second requirement generally only applies to OTC transactions because exchanges report transactions on a real-time or near real-time basis. Last sale and trade data is reported on the “consolidated tape,” a high-speed, electronic system that constantly reports the latest price and volume data on sales of exchange-listed stocks. If a transaction is not reported within 10 seconds, the SRO must designate the last sale price as “late” on the report to the NMS plan processor. The SROs must also keep a transaction record of all trades for audit purposes.

### **SBSs**

SB SEFs are required to make public timely information on price, trading volume, and other trading data on SBSs to the extent prescribed by the SEC. SB SEFs are also required to have the

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<sup>1301</sup> See Regulation NMS Release. The Consolidated Tape Association (CTA) Plan and Consolidated Quotation (CQ) Plan govern the reporting requirements for equity securities; the Options Price Reporting Authority (OPRA) “Plan for Reporting of Consolidated Options Last Sale Reports and Quotation Information” governs the reporting requirements for options.

capacity to electronically capture and transmit and disseminate trade information with respect to transactions executed on or through the facility.<sup>1302</sup>

The SEC has proposed rules governing the reporting and dissemination of SBS information.<sup>1303</sup>

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<sup>1302</sup> See Section 3D(d)(8) of the Exchange Act, 15 U.S.C. 78c-4(d)(8). These requirements are pending effectiveness as described in the SB SEF Exemption, see *supra* note 1194 and accompanying text.

<sup>1303</sup> See Regulation SBSR – Reporting and Dissemination of Security-Based Swap Information, Exchange Act Release No. 34-63346 (Nov. 19, 2010), 75 Fed. Reg. 75208 (Dec. 2, 2010).

**Principle 34** There should be ongoing regulatory supervision of exchanges and trading systems, which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.

### Key Questions

1. Does the regulatory system:

- (a) Include a program whereby the regulator or an SRO, subject to oversight by the regulator, (i) monitors day-to-day trading activity on the exchange or trading system (through a market surveillance program), (ii) monitors conduct of market intermediaries (through examinations of business operations) and (iii) collects and analyses the information gathered through these activities?

Yes. The U.S. regulatory system includes oversight of trading activity. Subject to SEC oversight, the SROs<sup>1304</sup> have the primary responsibility for the daily surveillance of trading activities and regulatory compliance.<sup>1305</sup> The SROs are responsible for establishing, reviewing, and enforcing standards of conduct for their members, and for fair and orderly operation of trading or other facilities they provide. The SEC has the authority to inspect both the SROs and market participants to determine whether the various anti-fraud, anti-manipulation, and reporting regulations are being complied with. The SEC can also obtain surveillance and/or trading data from the SROs.

Section 19(g)(1) of the Exchange Act provides that every SRO shall comply with the provisions of the Exchange Act, the rules and regulations thereunder and its own rules, and absent reasonable justification or excuse enforce compliance with such provisions by its members and persons associated with its members. Accordingly, an SRO must have procedures to surveil its market and its members for securities laws violations, including violations of the SRO's own rules.<sup>1306</sup> When considering an application for registration as an SRO, the SEC will consider whether an applicant has adequate surveillance measures, as well as sufficient resources, including staff expertise and capital, to monitor its markets. Surveillance mechanisms are not standardized among the markets and the SEC recognizes that surveillance procedures may vary depending on the nature and structure of the market and the securities traded on a particular exchange. As part of its surveillance responsibilities, an SRO must have the capability to maintain an order audit trail for all transactions in its system.

<sup>1304</sup> Clearing agencies are SROs under Section 19(b) of the Exchange Act; however, this response does not include clearing agencies because they provide post-trade processing and do not monitor day-to-day trading activity.

<sup>1305</sup> See Principles 12.1 and 12.2 for a more detailed discussion of SRO market regulation functions.

<sup>1306</sup> See Exchange Act Sections 6(b)(1) and 15A(b)(2), 15 U.S.C. 78f(b)(1) and 78o-3(b)(2).

To further assist regulators' efforts to reconstruct trading activity, on July 11, 2012, the SEC adopted Rule 613 which requires the SROs to jointly submit an NMS plan to create, implement, and maintain a CAT that would collect and report customer and order event information for all orders across all markets -- including dark pools -- to a central repository, thus creating a single database of comprehensive and readily accessible audit trail data that will be available for regulatory purposes, including surveillance.<sup>1307</sup> The SROs are required to submit the NMS plan to SEC by September 30, 2014.

The SEC has also adopted the Large Trader Rule to address its near-term need for access to more information about the largest market participants and their trading activities. Specifically, in July 2011, the SEC adopted new Rule 13h-1 and new Form 13H under Section 13(h) of the Exchange Act to establish large trader reporting requirements.<sup>1308</sup> In addition to requiring large traders to register with the SEC, the Large Trader Rule requires certain broker-dealers to keep records of transactions effected for large traders and produce that information to the SEC upon request. The Large Trader Rule is intended to assist the SEC in both identifying, and obtaining trading information on, market participants that conduct a substantial amount of trading activity, as measured by volume or market value, in the U.S. securities markets, and provides useful data to support the SEC's investigative and enforcement activities.

In addition to national securities exchanges, the SEC and SROs regulate ATSS. The SEC will regulate SB SEFs.<sup>1309</sup> ATSS must comply with Regulation ATS.<sup>1310</sup> Under Regulation ATS, an ATS is exempt from registration as a national securities exchange, but must register as a broker-dealer, and in that capacity is subject to SEC and SRO oversight. Regulation ATS also includes certain other rules and obligations that provide the SEC with information necessary to monitor trading activity.

Under Section 3D of the Exchange Act, SB SEFs are required to register with the SEC and comply with 14 Core Principles, which principles require complying with any rules that may be adopted by the SEC that apply to SEFs, such as rules pertaining to the registration process.<sup>1311</sup> The Exchange Act requires SB SEFs to maintain audit trails and records of all activities relating to the

<sup>1307</sup> See 17 C.F.R. 242.613.

<sup>1308</sup> See 17 C.F.R. 240.13h-1 and 17 C.F.R. 249.327.

<sup>1309</sup> See discussion under Question 33.1 for a discussion of SEFs.

<sup>1310</sup> See Regulation ATS, 17 C.F.R. 240.300.

<sup>1311</sup> As discussed in Principle 33, the SEC has proposed rules on the registration process for SB SEFs and for complying with the 14 Core Principles. As a result, the SEC has exempted SBS markets and market participants from complying with all SB SEF related requirements in the Exchange Act, including the SB SEF registration requirements and the 14 Core Principles, until at least 60 days from the date on which the SEC rules for SB SEFs become effective.

business of its facility and any other recordkeeping and reporting requirements the SEC may adopt.<sup>1312</sup>

- (b) Includes regulatory oversight mechanisms to verify compliance by the exchange or trading system with its statutory or administrative responsibilities, particularly as they relate to the integrity of the markets, market surveillance, the monitoring of risks, and the ability to respond to such risks?

Yes. The U.S. regulatory system includes oversight mechanisms to verify compliance by exchanges and trading systems with their statutory and administrative responsibilities. Sections 6(b)(1) and 15A(b)(2) of the Exchange Act provide that an exchange or association must have the capacity to be able to carry out the purposes of the Exchange Act and the rules and regulations thereunder and to comply, and to enforce compliance by its members and persons associated with members, with the Exchange Act, rules, and the rules of the SRO. Further, national securities exchanges and registered securities associations are expected to maintain sufficient systems capacity to handle foreseeable trading volume.<sup>1313</sup> In this regard, the SEC requires that applicants for registration as a national securities exchange or registered securities association have adequate computer system capacity, integrity, and security to support the operation of the exchange. To evaluate whether the exchanges and associations have adequately addressed their systems capacity needs, the SEC has put in place the TCP (formally known as the ARP program) as discussed in more detail above under Principle 9.<sup>1314</sup> In addition to reviewing the systems capability of an exchange, the SEC will consider whether an exchange or association has both sufficient capital to maintain its automated systems, and staff with sufficient technical expertise.

The securities markets are also required to have rules that preserve the integrity of the market and that protect against risks to market integrity. Sections 6(b)(5) and 15A(b)(6) of the Exchange Act require that an exchange's or association's rules are designed to, among other things, prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect investors and the public interest. Sections 6(b)(4) and 15A(b)(5) of the Exchange Act provide that an exchange's or association's rules contain provisions that allow for an equitable allocation of reasonable dues, fees and other charges among its members, issuers, and other persons using the facilities of the exchange. While the Exchange Act does not set forth

<sup>1312</sup> See Section 3D(d)(9) of the Exchange Act, 15 U.S.C. 78c-4(d)(9). These requirements are pending effectiveness as described in the SB SEF Exemption. See Order Pursuant to Sections 15F(b)(6) and 36 of the Securities Exchange Act of 1934 Granting Temporary Exemptions and Other Temporary Relief, Together with Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps, Exchange Act Release No. 64678 (June 15, 2011), 76 Fed. Reg. 36287 (June 22, 2011) (File No. S7-24-11) (SB SEF Exemption).

<sup>1313</sup> See Regulation ATS Release.

<sup>1314</sup> The Commission is currently considering additional measures to ensure systems capacity and integrity. The Commission proposed for comment Regulation Security, Compliance and Integrity on March 7, 2013.

the levels of funding for maintaining the self-regulatory function, the SEC has considered the funding of the self-regulatory functions of an SRO in the context of exchange demutualizations. In these filings, the SEC has sought to ensure that fees, fines, or dues collected by an SRO are not used for commercial purposes, and that mechanisms have been established that are designed to ensure a proper level of funding of the SRO regulatory function.<sup>1315</sup> Further, the SEC has recognized that the level of funding may differ among the SROs. Specifically, appropriate levels of funding may be dependent on the SRO's business model, trading systems, regulatory responsibilities, and types of members.<sup>1316</sup>

Securities markets are required to maintain certain operational capability standards such that market participants can be confident in each market's ability to handle securities transactions directed to it. Securities markets in the U.S. are required to maintain a level of operational capability such that they are not at risk of failure.

SB SEFs are required to have adequate financial, operational and managerial resources to discharge each of their responsibilities, as determined by the SEC.<sup>1317</sup> Specifically, SB SEFs must have enough financial resources (i) to meet its financial obligations of its members and participants notwithstanding a default by the member or participant creating the largest financial exposure for that organization in extreme but plausible market conditions and (ii) exceeding the total amount it would need to cover operating costs of the SB SEF for one year.<sup>1318</sup>

Section 3D(d)(13) of the Exchange Act also requires SB SEFs to establish and maintain a program of risk analysis and oversight to identify and minimize sources of operational risk.<sup>1319</sup> This would require SB SEFs to have controls, procedures, and automated systems that are reliable, secure and have scalable capacity. They would also be required to have emergency procedures, backup facilities, and a disaster recovery plan.

SB SEFs are required to designate an individual to serve as their CCO. Under Section 3D(d)(14)(C) of the Exchange Act, the CCO is required annually to prepare and file a report with the SEC that contains a description of the SB SEF's compliance with the Exchange Act and the SB SEF's policies and procedures, including the code of ethics and conflict of interest policies. Along with this report, the CCO is required to submit a financial report and a certification that, under penalty of law, the report is accurate and complete.

<sup>1315</sup> See, e.g., Exchange Act Release Nos. 53382 (February 27, 2006) (order approving the NYSE business combination with Archipelago Holdings, Inc.); 55216 (January 31, 2007) (order approving NYSE Regulation Inc. policies regarding exercise of power to fine NYSE members and use money collected as fines).

<sup>1316</sup> See Exchange Act Release No. 50700 (November 18, 2004) (SRO Concept Release).

<sup>1317</sup> See Section 3D(d)(12) of the Exchange Act, 15 U.S.C. 78c-4(d)(12).

<sup>1318</sup> *Id.*

<sup>1319</sup> 15 U.S.C. 78c-4(d)(13).

**Additional IMF Question: *Information on the oversight of exchanges and trading platforms, including both off-site reporting and on-site inspections. For the latter, please include information on the frequency and scope of inspections.***

Staff has the authority to inspect exchanges and ATSs pursuant to its authority to conduct SRO inspections and broker-dealer examinations. Subject to the SEC's oversight, SROs have the frontline responsibility for overseeing daily trading activities and regulatory compliance on the exchanges. Additional information about the SEC's supervision of exchanges and regulated trading systems can be found in response to Question 10.3.

Additionally, the SEC coordinates with the SROs through the MS group in the OMI to detect any anomalous market activity, including suspect trading by particular persons and/or entities. In addition, OCIE reviews the surveillance activity conducted by the SROs, including SRO surveillance of trading that occurs on the exchanges. Staff may also request and obtain copies of SRO surveillance reports as necessary to assess an exchange's market activity on a specified date or in a particular security. The various automated surveillance programs used by the SROs are discussed in more detail in response to Question 12.2.

OCIE further reviews trading systems through examinations of broker-dealers that operate as an ATS or as an ECN. OCIE's examinations of broker-dealers, including those operating as an ATS or ECN, are discussed in more detail in Question 12.1. FINRA also has SRO obligations to oversee its members, including those members that operate ATSs. Additionally, as discussed in the response to Question 7.2(a)(ii), OCIE's TCP group conducts reviews of the information technology systems operated by the exchanges, clearing agencies, and certain high-volume ATSs to ensure that the systems have sufficient capacity and resiliency to accommodate conditions of increased volume and disruptions to normal operations.

(c) Provide the regulator with adequate access to all pre-trade and post-trade information available to market participants?

Yes. The regulatory system provides the SEC with access to pre- and post-trade information.

All of the records of every national securities exchange, members of an exchange, broker-dealers who transact a business in securities through the medium of any such member, registered securities associations, registered broker-dealers, registered municipal securities dealers, municipal advisors, registered SIPs, registered transfer agents, NRSROs, registered clearing agencies, and the MSRB are subject, at any time, or from time to time, to reasonable periodic, special, or other examinations by representatives of the SEC.<sup>1320</sup> Section 17(a) of the Exchange Act requires that all of these entities must make and keep for prescribed periods of time such records, furnish such copies of those records, and make and disseminate such reports as the SEC,

<sup>1320</sup> Section 17(b) of the Exchange Act, 15 U.S.C. 78q(b).

by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors or otherwise in furtherance of the purposes of the Exchange Act.<sup>1321</sup>

Rule 17a-1 implements this authority and provides that every national securities exchange, national securities association, and registered clearing agency and the MSRB must keep and preserve at least one copy of all documents, including all correspondence, memoranda, papers, books, notices, accounts and such other records as shall be made or received by it in the course of its business as such and in the conduct of its self-regulatory activity. Section 17(b) of the Exchange Act authorizes the SEC to conduct “reasonable, periodic, special or other exams” of “[a]ll records” maintained by the SRO. These examinations may be conducted at any time or from time to time as the SEC “deems necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the [Exchange Act]”.

There are also several NMS plans that the SEC has approved to coordinate the reporting of quotes and transaction information in accordance with the requirements of the Exchange Act and the applicable rules.<sup>1322</sup> The Consolidated Tape Association Plan/Consolidated Quotation Plan and NASDAQ UTP Plan coordinate the dissemination of real-time trade and quote information in equity securities. The Options Price Reporting Authority Plan provides, through market data vendors, last sale information and current options quotations from participant option exchanges. In addition, as discussed above, the SEC adopted Rule 613 which requires the SROs to jointly submit an NMS plan to create, implement, and maintain a CAT that would collect and report customer and order event information for all orders across all markets -- including dark pools -- to a central repository, thus creating a single database of comprehensive and readily accessible audit trail data that will be available for regulatory purposes, including surveillance.<sup>1323</sup>

### **SB SEFs**

SB SEFs are required to make public timely information on price, trading volume, and other trading data on SBS to the extent prescribed by the SEC.<sup>1324</sup> SB SEFs are also required to have the capacity to electronically capture and transmit and disseminate trade information with respect to transactions executed on or through the facility.<sup>1325</sup> In addition, Title VII of the Dodd-Frank Act

<sup>1321</sup> Section 17(a) of the Exchange Act, 15 U.S.C. 78q(a).

<sup>1322</sup> See Principle 35 for a complete discussion about pre- and post-trade transparency requirements.

<sup>1323</sup> See 17 C.F.R. 242.613.

<sup>1324</sup> See Section 3D(d)(8) of the Exchange Act, 15 U.S.C. 78c-4(d)(8).

<sup>1325</sup> See Section 3D(d)(8) of the Exchange Act, 15 U.S.C. 78c-4(d)(8). These requirements are pending effectiveness of as described in the SB SEF Exemption, see *supra* note 1194 and accompanying text.



amended the Exchange Act to require that transactions in SBS, whether cleared or uncleared, be reported to a registered swap data repository (SDR) or the SEC.<sup>1326</sup> The SEC has proposed rules governing SDRs and the reporting and dissemination of SBS information.<sup>1327</sup>

An SDR, which is subject to inspection and examination by the SEC, is statutorily required to maintain the SBS data reported to it and provide the SEC with direct electronic access to the trade data.<sup>1328</sup> The SEC has proposed rules to implement the statutory requirements governing SDRs.<sup>1329</sup>

2. Does the regulatory framework require that amendments to the rules or requirements of the exchange or trading system must be provided to, or approved by, the regulator?

Yes. As discussed in the response to Question 9.2(d), all SROs must file all proposed changes to their rules with the SEC.

An ATS must provide a description of its operations to the SEC on Form ATS and keep such materials current.<sup>1330</sup> ATSs are required to file an amendment on Form ATS at least 20 days prior to implementing a material change to the operation of the ATS, within 30 days after the end of a quarter when information contained in an initial operation report filed on Form ATS becomes inaccurate, and promptly upon discovering that an initial operation report filed on Form ATS or an amendment on Form ATS was inaccurate when filed.<sup>1331</sup> In addition, an ATS is required to provide the SEC with transaction volume reports on Form ATS-R on a quarterly basis.<sup>1332</sup>

<sup>1326</sup> See Sections 13(m)(1)(G) and 13A(A)(1) of the Exchange Act, 15 U.S.C. 78m(m)(1)(G) and 15 U.S.C. 78m-1(A)(1). For a detailed description of this requirement, see Security-Based Swap Data Repository Registration, Duties, and Core Principles, Exchange Act Release No. 34-63347 (Nov. 19, 2010), 75 Fed. Reg. 77306 (Dec. 10, 2010).

<sup>1327</sup> See Regulation SBSR – Reporting and Dissemination of Security-Based Swap Information, Exchange Act Release No. 34-63346 (Nov. 19, 2010), 75 Fed. Reg. 75208 (Dec. 2, 2010).

<sup>1328</sup> See Pub. L. No. 111-203, § 763(i) (adding Sections 13(n)(2), 13(n)(5)(C), and 13(n)(5)(D) of the Exchange Act).

<sup>1329</sup> See, e.g., Security-Based Swap Data Repository Registration, Duties, and Core Principles, Exchange Act Release No. 63347 (Nov. 19, 2010), 75 Fed. Reg. 77306 (Dec. 10, 2010), *corrected at* 75 Fed. Reg. 79320 (Dec. 20, 2010) and 76 Fed. Reg. 2287 (Jan. 13, 2011) (“SDR Proposing Release”).

<sup>1330</sup> Regulation ATS Rule 301(b)(2), 17 C.F.R. 242.301(b)(2).

<sup>1331</sup> Regulation ATS Rule 301(b)(2)(ii)-(iv), 17 C.F.R. 242.301(b)(2)(ii)-(iv).

<sup>1332</sup> Regulation ATS Rule 301(b)(9), 17 C.F.R. 242.301(b)(9).

3. When the regulator determines that the exchange or trading system is unable to comply with the conditions of its approval, or with securities law or regulation, is there a mechanism that permits the regulator to:

(a) Re-examine the exchange or trading system and impose a range of actions, such as restrictions or conditions on the market operator?

Yes. As described in the response to Question 9.4, the SEC examines the exchange's rules and its system for compliance with the Exchange Act and rules as well as its own rules. To the extent that the exchange is not in compliance with any of those laws or rules, the SEC the authority to, among other things, restrict or suspend an SRO's activities, as further described in the response to paragraph (b) of this Question 34.3.

In general, Regulation ATS gives ATSs the choice to register as national securities exchanges, or to register as broker-dealers and comply with Regulation ATS.

The notice, reporting, and recordkeeping requirements under Regulation ATS contribute to the SEC's ability to effectively oversee ATSs regulated as broker-dealers. Regulation ATS provides that ATSs are required to permit inspections and examinations of their records by the SEC or the SRO of which they are a member, and to cooperate with the SEC's or an SRO's inspection, examination, or investigation of the ATS or any of its subscribers.

Section 3D(d)(1) of the Exchange Act states that for an SB SEF to be registered and maintain registration it shall comply with the core principles in Section 3D of the Exchange Act and any requirement that the SEC may impose by rule or regulation.<sup>1333</sup>

(b) Withdraw the exchange or trading system's authorization?

Yes. The SEC has the authority under Section 19(a)(3) of the Exchange Act to cancel, suspend, or revoke an SRO's registration. Section 19(a)(3) states that "[a] self-regulatory organization may, upon such terms and condition as the SEC, by rule, deems necessary or appropriate in the public interest or for the protection of investors, withdraw from registration by filing a written notice of withdrawal with the SEC. If the SEC finds that any SRO is no longer in existence or has ceased to do business in the capacity specified in its application for registration, the SEC, by order, shall cancel its registration."

Section 19(h) of the Exchange Act generally provides the SEC with the authority to impose penalties on SROs and their members for certain violations of the federal securities laws and/or exchange rules. Specifically, the SEC has the authority (i) to suspend or revoke the registration of

<sup>1333</sup>

15 U.S.C. 3D(d)(1).

an SRO; (ii) to censure or impose limitations on its activities; and (iii) remove from office or censure officers or directors of an SRO for violations of the Exchange Act or the SRO's rules.<sup>1334</sup> The SEC also has the authority to suspend or expel any member or person associated with a member from an SRO for violations of the federal securities laws or rules.<sup>1335</sup> Under Sections 21(d) and (e) of the Exchange Act, the SEC has the authority to enforce an SRO's rules and to compel an SRO to enforce its rules with regard to its members by filing an action in federal court; relief available includes, among other things, monetary penalties, injunctive action, and any form of equitable relief.

As noted above in the response to 34.3(b), an ATS that chooses to be registered as a broker-dealer must comply with the SEC's Regulation ATS. The SEC may bring charges against an ATS if it finds that it is in violation of Regulation ATS (in addition to other charges for violating obligations of broker-dealers under the Exchange Act).<sup>1336</sup>

Under Section 3D(d)(1) of the Exchange Act, it states that to be registered, and maintain registration, as an SB SEF, the SB SEF shall comply with the core principles in Section 3D of the Exchange Act and any requirement that the SEC may impose by rule or regulation.<sup>1337</sup>

<sup>1334</sup> Section 19(h)(1) of the Exchange Act, 15 U.S.C. 78s(h)(1).

<sup>1335</sup> Section 19(h)(2) and (3) of the Exchange Act, 15 U.S.C. 78s(h)(2) and (3).

<sup>1336</sup> See, e.g., *In the Matter of LavaFlow, Inc.*, Exchange Act Rel. No. 72673 (July 25, 2014).

<sup>1337</sup> 15 U.S.C. 3D(d)(1).

**Principle 35      Regulation should promote transparency of trading.**
**Key Questions**

1. Does the regulatory framework include:

- (a) requirements or arrangements for providing pre-trade (e.g., posting of orders) information to market participants?

Yes. The U.S. regulatory framework includes requirements for providing pre-trade information to market participants. The securities laws and rules and national securities exchange and association rules require real-time reporting of quotes and transactions occurring on exchanges or in the OTC market. The information is made widely available to the public on fair, reasonable and non-discriminatory terms.

In Section 11A(a)(1)(C) of the Exchange Act, Congress found that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure "the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities." To this end, in Section 11A(a)(2) of the Exchange Act, Congress directed the SEC to use its authority under the Exchange Act to facilitate the establishment of an NMS for securities in accordance with this finding, among others. The SEC adopted Regulation NMS, consistent with this directive in the Exchange Act, to strengthen and modernize the NMS.

Rule 602 under Regulation NMS requires exchanges and associations to establish procedures and mechanisms for collecting bids, offers, quotation sizes, and aggregate quotation sizes from responsible brokers or dealers and for making such bids, offers, and sizes available to vendors.<sup>1338</sup> Under this rule, responsible brokers or dealers are required to promptly submit to the exchange or association, their best bids, best offers, and quotation sizes for any NMS security. Each exchange and association is then required to collect, process, and make available to vendors the best bid, best offer, and aggregate quotation sizes for each subject security. With respect to the frequency and timing of pre-trade information, pursuant to Exchange Act Rule 602 of Regulation NMS and required NMS plans for quote and trade reporting, the exchanges and associations must submit the best bids and offers of their members and quotation sizes to the NMS plan processor promptly. For both competitive and regulatory reasons, SROs submit best bids and offers, normally within milliseconds. Real-time reporting of quotes made in the OTC market is also required if the quotation is communicated by a registered market-maker, by any OTC market-maker whose executed volume in the security is greater than 1% of the aggregate trading volume in such security, or by an ATS that trades 5% or more of the volume in NMS

<sup>1338</sup> Rule 600(b)(8) under Regulation NMS limits the definition of "bid" and "offer" to a price communicated to a broker-dealer or customer at which a member is willing to buy or sell one or more round lots of an NMS security.

securities.

The dissemination of pre-trade information for equities and options is governed by the CQ Plan, NASDAQ UTP Plan or OPRA Plan, as appropriate, which require participants, who are the SROs, to collect and promptly report pre-trade information to the NMS plan processors. The NMS plan processors are responsible for receiving the pre-trade information from the participants, consolidating the information, and disseminating it to the public, including all market participants; thus, information is made available to all comparable parties on the same basis. (In this regard, fees charged to non-professionals are typically much lower than fees paid by professionals.)

(b) requirements or arrangements for providing post-trade information (e.g., last sale price and volume of transaction) to market participants on a timely basis?

Yes. The U.S. regulatory framework includes requirements for providing post-trade information to market participants on a timely basis. Rule 601(a) under Regulation NMS requires exchanges and associations to file transaction reporting plans for approval with the SEC. Rule 601(b) prohibits broker-dealers from executing any transaction in any NMS stock unless there is an effective transaction reporting plan with respect to reporting transactions in such security. Rule 601 also requires broker-dealers that are members of an exchange or association to promptly transmit to the SRO all information required by the NMS plans.

The SEC and SRO rules require real-time reporting of transactions occurring on exchanges or in the OTC market.<sup>1339</sup> There is no exception for the real-time reporting of block trades.

The dissemination of post-trade information for equities and options is governed by the CTA Plan, NASDAQ UTP Plan or OPRA Plan, as appropriate, that operate in accordance with Exchange Act rules. The NMS plans require participants, who are the SROs, to collect and promptly report post-trade information to NMS plan processors. The processors are then responsible for receiving the post-trade information from the participants, consolidating the information, and disseminating it to the public, including all market participants; thus, information is made available to all comparable parties on the same basis. (In this regard, fees charged to non-professionals are typically much lower than fees paid by professionals.)

Pursuant to the applicable NMS plans for equities, the SROs must report the stock symbol, volume, and price at which transactions were executed to the NMS plan processor after the time of execution. Last sale and trade data is reported on the "consolidated tape," a high-speed,

<sup>1339</sup> On May 14, 2014, the CTA filed with the SEC an amendment to the CTA Plan, which, if approved by the SEC, would reduce to 10 seconds the amount of time within which trades are to be reported to the CTA Plan processor. See also FINRA Rule 6622, which requires transactions to be reported as soon as practicable but no later than 10 seconds.

electronic system that constantly reports the latest price and volume data on sales of exchange-listed stocks. If a transaction is not reported within the required time periods, the SRO must designate the last sale price as “late” on the report to the NMS plan processor. The SROs must also keep a transaction record of all trades for audit purposes.

### **Post-Trade Transparency for SBSs**

The Dodd-Frank Act amended the Exchange Act by, among other things, providing for: (i) the reporting of SBSs to a registered SDR or the SEC; and (ii) the public dissemination of SBS transaction data.<sup>1340</sup> Section 13(n)(4)(A) of the Exchange Act, as amended by the Dodd-Frank Act, requires the SEC to prescribe standards that specify the data elements for each SBS that must be collected and maintained by each registered SDR. Section 13(m) of the Exchange Act, as amended by Section 763(i) of the Dodd-Frank Act, provides for the public availability of SBS transaction data, which must be in “real time.”

(c) requirements or arrangements that information on completed transactions be provided on an equitable basis to all market participants?

Yes. Section 11A(c)(1)(C) of the Exchange Act requires that similarly situated market participants have equitable access to trading information by requiring the SEC to assure that all SIPs (*e.g.*, information vendors) have equitable access to market information from an exclusive processor of that information (*e.g.*, an exchange or association) on terms that are “fair and reasonable.” In addition, Section 11A(c)(1)(D) of the Exchange Act directs the SEC to assure that all persons may obtain market information on terms that are “not unreasonably discriminatory.” If a registered SIP limits the access of any person to its services, Section 11A(b)(5) provides for SEC review of the limitation.

2. Where derogation from the objective of real-time transparency is permitted:

(a) Are the conditions clearly defined?

Yes. An exchange or trading system operator typically can only derogate from the rules governing real-time transparency if the SEC grants them an exemption, pursuant to SEC Rule 601(f) (for post-trade transparency) or SEC Rule 602(d) (for pre-trade transparency). In each case, the SEC may grant such exemption unconditionally or on specified terms and conditions, if the SEC determines that such exemption is consistent with the public interest, the protection of investors and the removal of impediments to and perfection of the mechanism of an NMS. As

<sup>1340</sup>

The SEC has proposed rules related to post-trade transparency of SBS transactions, Regulation SBSR – Reporting and Dissemination of Security-Based Swap Information. The Commission initially proposed Regulation SBSR in November 2010. See Exchange Act Release No. 63346 (November 19, 2010), 75 Fed. Reg. 75207 (December 2, 2010). In May 2013, the Commission re-proposed the entirety of Regulation SBSR as part of the Cross-Border Proposing Release and re-opened the comment period for all of its other outstanding Title VII rulemakings. See Exchange Act Release No. 69490 (May 1, 2013), 78 Fed. Reg. 30967 (May 23, 2013).

discussed above, the NMS plans require SROs to collect and promptly report both pre-trade and post-trade information. Generally, the only transactions that are excluded from the NMS plans are those that are not comparable to regular open-market transactions, such as exercised options, purchases pursuant to a tender offer, and primary-market issuance (e.g., an IPO).

- (b) Does the market authority (being either, or both, the exchange operator and the regulator) have access to the complete information to be able to assess the need for derogation and if necessary, to prescribe alternatives?

Yes. As discussed above, the dissemination of both pre-trade and post-trade information for equities and options is governed by NMS plans that operate in accordance with Exchange Act rules. Pursuant to Rule 608 under the Exchange Act, the text of the NMS plan or amendment thereto must be filed with the SEC together with a statement of the purpose of such plan or amendment and to the extent applicable any supporting documents required the rule. The SEC reviews the NMS plan or the amendment and publishes it for notice and comment from interested persons. No NMS plan or amendment is effective unless approved by the SEC, with some limited exceptions for routine filings. Although the SEC has the authority to grant exemptions from the pre-trade and post-trade transparency requirements in Rules 602(d) and 601(f), the SEC may request access to information it needs to assess the need for an exemption to derogate from the real-time transparency requirements in considering whether to issue an exemption. The SEC also has the discretion not to issue such an exemption.

- (c) Does the regulator have access to adequate information to monitor the development of dark trading and dark orders?

As discussed in Principle 9, the rules of an exchange, including rules related to order types, such as dark orders, are subject to Section 19 of the Exchange Act.<sup>1341</sup>

The SEC has acted to address the changing marketplace by enhancing its oversight and monitoring capabilities. Access to information has been a priority with regard to advancements in technology. To aid in the surveillance of their markets, all exchanges, associations and ATSSs have adopted procedures governing audit trails. For example, FINRA has developed OATS, which it uses to broadly oversee the OTC market, including trading that occurs without pre-trade transparency. OATS is an integrated audit trail of order, quote and trade information for all NMS stocks and OTC equity securities. FINRA uses OATS to recreate events in the lifecycle of orders and to monitor the trading practices of its members. The SEC also has access to OATS data.

In addition, the SEC adopted rules to require the exchanges and FINRA to submit an NMS plan to

<sup>1341</sup> Pursuant to Section 19(b)(1) of the Exchange Act, an SRO must file any proposed change in, addition to, or deletion from the rules of the SRO ("proposed rule change") electronically on a Form 19b-4, submitted to the SEC through the Electronic Form 19b-4 Filing System, which is a secure website operated by the SEC.

the SEC to create a CAT that would collect and report customer and order event information for all orders across all markets -- including dark pools -- to a central repository, thus creating a single database of comprehensive and readily accessible audit trail data that will be available for regulatory purposes, including surveillance.<sup>1342</sup>

To keep pace with the market structure changes, the SEC implemented a new website devoted to market structure data and analysis drawn from a range of sources.<sup>1343</sup> The SEC assesses this data in considering critical issues raised by the current market structure concerns. The website contains white papers by Staff and data series generated using MIDAS. Staff white papers include an analysis of off-exchange trading on ATSs and a review of the economic literature addressing market fragmentation and dark venue trading and high frequency trading. The data series generated with MIDAS include individual daily metrics on thousands of stocks and ETPs. The data series shed light on issues such as the speed of order cancellations and executions, cancellation rates, hidden order executions, and odd-lot executions.

The SEC continues to study and consider regulatory initiatives concerning ATSs.<sup>1344</sup> Staff published a white paper that describes ATS trading activity on the market structure website<sup>1345</sup> and published a review of current economic literature on fragmentation in the equity markets.<sup>1346</sup> This literature review addressed several topics, including dark, or undisplayed, liquidity. The purpose of these efforts is to generate a sound empirical basis for conclusions on whether problems exist that require regulatory action and, if so, what potential solutions to the problems should look like.

Additional data concerning ATS trading activity recently became available as a result of FINRA rule 4552 that the SEC approved.<sup>1347</sup> The rule requires registered ATSs to report to FINRA aggregate weekly trading volume and number of trades executed within the ATS on a security-by-security basis.<sup>1348</sup> The new regime also requires each individual ATS to use a unique market

<sup>1342</sup> See expanded discussion of the adoption of new audit trail rules in Principle 33.6.

<sup>1343</sup> See <http://www.sec.gov/marketstructure/index.html>

<sup>1344</sup> See, e.g., Exchange Act Release No. 60997 (November 13, 2009) (Proposed Regulation of Nonpublic Trading Interest), and Exchange Act Release No. 61358 (January 14, 2010) (Concept Release on Equity Market Structure).

<sup>1345</sup> See Alternative Trading Systems: Description of ATS Trading in National Market System Stocks, October 13, available at <http://www.sec.gov/marketstructure/research/alternative-trading-systems-march-2014.pdf>.

<sup>1346</sup> See Equity Market Structure Literature Review, Part I: Market Fragmentation, October 7, 2013, available at <http://www.sec.gov/marketstructure/research/fragmentation-lit-review-100713.pdf>.

<sup>1347</sup> See Exchange Act Release No. 71341 (January 17, 2014), 79 Fed. Reg. 4213 (January 24, 2014).

<sup>1348</sup> See *id.* Aggregate data concerning trades in NMS stocks in Tier 1 of the NMS Plan to Address Extraordinary Market Volatility would be published on a two-week delayed basis, and aggregate information on all other NMS stocks and all OTC Equity Securities subject to FINRA trade reporting requirements on a four-week delayed basis.



participant identifier (MPID), which can be used only for activity on the ATS, for reporting trades and orders to FINRA.<sup>1349</sup> FINRA makes the reported volume and trade count information for equity securities publicly available on its website.

(d) Do transparent orders have priority over dark orders?

The rules of the exchanges typically provide that displayed orders receive priority over undisplaced orders at the same price.<sup>1350</sup> As discussed in Principle 9, the rules of an exchange, including rules related to the priority of orders, are subject to Section 19 of the Exchange Act.<sup>1351</sup>

(e) Do dark pools and transparent markets that offer dark orders provide market participants with sufficient information so that they are able to understand the manner in which their orders are handled and executed?

As discussed in Principle 9, the rules of an exchange, including rules related to order handling and execution are subject to Section 19 of the Exchange Act.<sup>1352</sup> In addition, pursuant to Rule 19b-4(m)(1), each SRO must post and maintain a current and complete version of its rules on its website.

Among the pre-trade and post-trade information made available for all transactions discussed in more detail previously, market participants also receive dark pool transaction information. Dark pools must report their execution information to FINRA for inclusion in the consolidated tape. Their transaction information is identified as OTC transactions.

In addition, under Rule 605 of Regulation NMS, market centers must make available public monthly electronic reports that include uniform statistical measures of execution quality.

The SEC is able to understand the manner in which orders are handled and executed on exchanges via the Exchange Act's comprehensive regulatory framework for SRO oversight.

<sup>1349</sup> An ATS that trades both debt securities reported to TRACE and equity securities reported to a FINRA equity reporting facility is permitted to use two MPIDs, rather than a single unique MPID, if each MPID is used exclusively for either debt or equity securities.

<sup>1350</sup> See, e.g., BATS Rule 11.2 (Priority of Orders); and NYSE Rule 72 (Priority of Bids and Offers and Allocation of Executions).

<sup>1351</sup> Pursuant to Section 19(b)(1) of the Exchange Act, an SRO must file any proposed change in, addition to, or deletion from the rules of the SRO ("proposed rule change") electronically on a Form 19b-4, submitted to the SEC through the Electronic Form 19b-4 Filing System, which is a secure website operated by the SEC.

<sup>1352</sup> Pursuant to Section 19(b)(1) of the Exchange Act, an SRO must file any proposed change in, addition to, or deletion from the rules of the SRO ("proposed rule change") electronically on a Form 19b-4, submitted to the SEC through the Electronic Form 19b-4 Filing System, which is a secure website operated by the SEC.

Among other things, SROs are required under the Exchange Act to be registered with, and have their rules reviewed and, with some limited exceptions, approved by the SEC.<sup>1353</sup> The SEC conducts ongoing oversight of SROs through its examination authority to evaluate compliance with rules governing trading and order handling as well as all the federal securities laws and SRO rules as discussed in more detail in Principles 10 and 12

Additional data concerning trading activity has become available as a result of FINRA rule 4552 as discussed in response to Question 2(c).

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<sup>1353</sup> See Response to Questions 9.2(a) and 9.2(d) for a description of the registration and rule filing process for SROs. See *also* discussion in response to Question 33.5(b).

<b>Principle 36      Regulation should be designed to detect and deter manipulation and other unfair trading practices</b>	
<b>Key Questions</b>	
1.	Does the regulatory system prohibit the following with respect to securities admitted to trading on authorized exchanges and regulated trading systems:
(a)	Market or price manipulation?
<p>Yes, the federal securities laws prohibit market manipulation, including engaging in wash sales or other attempts to create a false or misleading appearance of active trading in any security, as well as affecting a series of transactions to raise or depress the price of a security for the purpose of inducing transactions in the security by others.</p> <p>Sections 9 and 10(b) of the Exchange Act outlaw manipulative practices by any person. Section 15(c) prohibits fraudulent and manipulative conduct by broker-dealers. Section 10(b) gives the SEC the authority to adopt rules barring manipulative and deceptive conduct. Additional federal laws and rules govern specific manipulation activities.<sup>1354</sup> The SROs and the MSRB have additional rules that bar market or price manipulation by their member firms.<sup>1355</sup> In addition, investors who believe that they were injured by violations of the securities laws can bring a civil action in court for damages.<sup>1356</sup></p> <p>Market manipulations violate Section 10(b) and Rule 10b-5 or Section 9(a) of the Exchange Act because they involve executed orders with prices that are reported to the tape, which give the false impression to the market and investors of legitimate investor interest. A person violates Section 9(a)(1) if he or she engages in matched orders or wash trades for the purpose of creating a false or misleading appearance of active trading in the security. A person violates Section 9(a)(2) if he or she effects a series of transactions that create actual or apparent active trading in a security, or raise or depress the price of the security, for the purpose of inducing the purchase or sale of the security.<sup>1357</sup> A person violates Section 9(a)(3) if he or she disseminates information stating that the price of a security will likely rise or fall because of market operations of a group of persons conducted for the purpose of raising or depressing the price of the</p>	

<sup>1354</sup> See, e.g., Sections 9(b) and (e), 13(e), 14(e), 10(a) and (b), and 15(c) of the Exchange Act; Rules 10b-1, 10b-3, 10b-5, 10b-9, 10b-10, 14e-3, 14e-4, 14e-5, 10b-16, 10b-17, 10b-18, 15c1-2, 15c1-3, 15c1-5, 15c1-6, 15c1-7, 15c1-8, 15c1-9, 15c2-1, 15c2-4, 15c2-5, 15c2-7, 15c2-8, and 15c2-11; Regulation M; and Section 17(a) of the Securities Act.

<sup>1355</sup> Generally, broker-dealers are members of SROs and both the firms and their associated persons (generally, their employees) must comply with SRO rules.

<sup>1356</sup> See, e.g., Sections 11, 12, and 17 of the Securities Act; Section 10(b) of the Exchange Act and Rule 10b-5 (under which there is an implied private right of action). See also Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA) (providing an express private right of action with respect to insider trading).

<sup>1357</sup> See *SEC v. Kwak*, 2008 U.S. Dist. Lexis 10201 (D.C. Conn. 2008); *Michael Batterman*, Exchange Act Rel. No. 12278 (March 29, 1976) (settled order); *Harold T. White*, 3 SEC 466 (June 21, 1938) (SEC opinion).

security and the person intends by the dissemination of information to induce others to buy or sell the security.<sup>1358</sup> A person violates Section 9(a)(4) if he or she is purchasing or selling a security and makes statements that at the time are false or misleading, for the purpose of inducing the purchase or sale of the security by others.

### **Matched Orders and Wash Sales**

Engaging in matched orders and wash sales violates Sections 9(a)(1) and 10(b) if the person engaging in the trading intends to defraud the market or (in the case of Section 10(b)) recklessly disregards the impact of the trading on the market.

### **Anti-Manipulation Rules: Regulation M and Rule 10b-21**

The SEC has long recognized that securities offerings present special opportunities and incentives for market manipulation. Because price integrity is essential during an offering, the SEC adopted Regulation M to protect the integrity of the securities trading market as an independent pricing mechanism.<sup>1359</sup> Regulation M governs the market activities of underwriters, broker-dealers, and other securities distribution participants, as well as issuers, selling security holders, and their affiliated purchasers, in connection with a securities offering. Rather than addressing manipulation after the fact, Regulation M regulates conduct by persons that are planning to participate in a distribution of securities. In particular, Regulation M seeks to prevent manipulation by barring persons with an interest in an offering from engaging in specified market activities during a securities distribution.<sup>1360</sup> When bringing enforcement actions for violations of Regulation M, the SEC does not need to prove that the persons intended to manipulate the market. The SEC just has to show that the person (for example, the issuer or the underwriter) engaged in certain market activities involving the distributed security during certain defined time periods.

In addition, the SEC adopted Rule 10b-21, a “naked” short selling anti-fraud rule. Rule 10b-21 specifically provides that it is a manipulative device or contrivance for persons to deceive broker-dealers, participants of a registered clearing agency, and purchasers about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate source or ownership of shares and who fail to deliver such securities by

<sup>1358</sup> See *In the Matter of the Proceeding under Sec. 9(a)(3) regarding Abbott, Proctor & Paine*, Exchange Act Rel. No. 1214 (May 22, 1937); *W.E. Hutton*, Exchange Act Rel. No. 932 (Nov. 13, 1936).

<sup>1359</sup> See 17 C.F.R. 242.100-105. Regulation M consists of six rules (Rules 100-105). Rule 100 provides definitions. Rule 101 governs the activities of persons participating in a distribution of securities, other than the issuer and selling security holders. Rule 102 governs the activities of an issuer and selling security holders. Rule 103 governs NASDAQ “passive” market making during an offering. Rule 104 governs underwriters’ stabilization transactions, syndicate short covering activity, and penalty bids in connection with an offering. Rule 105 governs short selling in advance of the pricing of an offering. See Exchange Act Rel. No. 38067 (Dec. 20, 1996).

<sup>1360</sup> See Exchange Act Rel. No. 38067 (Dec. 20, 1996).

settlement date.

### Other Manipulative Practices

Some examples of other types of manipulative practices that violate the anti-fraud provisions of the federal securities laws include the following:

- “Marking the close” is the practice of attempting to influence the closing price of a stock by executing purchase or sale orders at or near the close of the market.”<sup>1361</sup> This conduct violates Section 10(b) of the Exchange Act and Rule 10b-5 and, depending on the particular facts of the case, may violate Section 9(a) of the Exchange Act and Section 17(a) of the Securities Act.
- Spoofing involves traders who submit small orders in order to “bait” market makers to adjust their quotes to reflect the order on one side of the market and as soon as the quote is adjusted, immediately submit a second order for a larger share amount to “hit” the market maker’s quote while also canceling the initial, bait order. The market maker is left with the obligation to fill the second order to its detriment.<sup>1362</sup> This conduct violates Section 10(b) of the Exchange Act and Rule 10b-5 and, depending on the particular facts of the case, may violate Section 9(a) of the Exchange Act and Section 17(a) of the Securities Act.

#### (b) Misleading information?

Yes, anyone who makes material misrepresentations in connection with the purchase or sale or offer or sale of a security violates the anti-fraud provisions of the federal securities laws. In addition, persons violate the law if (i) they omit material facts that are necessary so that their other statements are not misleading; or (ii) they omit material facts where they have an affirmative duty to disclose. The Supreme Court has stated that a failure to disclose material information is fraudulent if there is a duty to make such disclosure arising out of “a fiduciary or similar relation of trust and confidence.”<sup>1363</sup> Broker-dealers, for example, violate the anti-fraud provisions if they fail to disclose material information to their customers where they owe a fiduciary duty or are in a similar relationship of trust and confidence or owe a duty to act in a fair and equitable manner. In addition, if a person or entity makes a statement that was misleading

<sup>1361</sup> *Donald L. Koch*, Exchange Act Rel. No. 72179 (May 16, 2014) (SEC opinion).

<sup>1362</sup> See *Frazee*, Exchange Act Rel. No. 47522 (March 18, 2003) (settled order); *Blackwell*, Exchange Act Rel. No. 45018 (Nov. 5, 2001 (settled order)); *Shenker*, Exchange Act Rel. No. (45017 (Nov. 5, 2001) (settled order); *Monski*, Exchange Act Rel. No. 44250 (May 3, 2001) (settled order); *Fishman*, Exchange Act Rel. No. 40115 (June 24, 1998) (settled order).

<sup>1363</sup> See *Basic v. Levinson*, 485 U.S. 224, 239 n.17 (1988); *Chiarella v. U.S.*, 445 U.S. 222, 228 (1980).

at the time it was made, this gives rise to an obligation to make any additional statements necessary to make the original statement not misleading.<sup>1364</sup>

Many types of fraudulent schemes violate the federal securities laws. A few examples are as follows:

- A frequently used market manipulation scheme is the “pump and dump,” in which persons use favorable, false publicity to dupe unsuspecting investors into buying the security, which “pumps” up the price of the security.<sup>1365</sup> Manipulators sell into the rising market, and following the scam, the price bottoms out and investors, lured into the hyped market, lose their investment.<sup>1366</sup> This conduct violates Section 10(b) of the Exchange Act and Rule 10b-5 and, depending on the particular facts of the case, may violate Section 15(c) of the Exchange Act and Section 17(a) of the Securities Act.
- A registered representative at a broker-dealer who recommends a security must affirmatively disclose all material adverse facts, including any economic self-interest, so that customers may evaluate any overlapping motivations.<sup>1367</sup> Persons that make secret payments of cash, kickbacks, gifts, or gratuities in connection with securities transactions violate the anti-fraud provisions.<sup>1368</sup> This conduct violates Section 10(b) of the Exchange Act and Rule 10b-5 and, depending on the particular facts of the case, may violate

<sup>1364</sup> See *U.S. v. Skelly*, 442 F.3d 94, 97 (2d Cir. 2006) (a “middleman may be liable for fraud if he . . . tells [the purchaser] misleading half truths”); *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 944 (7<sup>th</sup> Cir. 1989) (“incomplete disclosures or ‘half-truths’ implicate a duty to disclose whatever additional information is necessary to rectify the misleading statements”); *Siemers v. Wells Fargo & Co.*, 2006 WL 2355411, \*5 (N.D. Cal. 2006) (to be liable under the omissions provision of Rule 10b-5, there must be “an affirmative statement that was materially misleading because of a failure to make additional disclosure”); *Wallace Computers Svcs, Inc. v. David Noyes & Co.*, 1994 WL 23110, \*4, Fed. Sec. L. Rep. P 98,130 (N.D. Ill. 1994).

<sup>1365</sup> See *SEC v. Softpoint, Inc.*, 958 F. Supp. 846, 862-63 (S.D.N.Y. 1997), *aff’d*, 159 F.3d 1348 (2d Cir. 1998) (table) (false press releases and reports designed to increase stock price violated the anti-fraud provisions); *SEC v. Aqua Vie Beverage Corp.*, 2007 WL 2025231 (D. Idaho 2007) (fax tout sheets projecting \$7 million in revenues lacked reasonable basis and violated the anti-fraud provisions).

<sup>1366</sup> See *SEC v. Richard Karp*, Lit. Rel. No. 21054 (May 21, 2009).

<sup>1367</sup> See, e.g., *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1172 (2d Cir. 1970); *SEC v. Hasho*, 784 F. Supp. 1059, 1110 (S.D.N.Y. 1992) (salespersons falsely stated that they would receive no commissions on certain of their customers’ transactions and failed to disclose the amount of commissions they were earning on other customer transactions).

<sup>1368</sup> See, e.g., *United States v. Brown*, 79 F.2d 321, 325 (2d Cir. 1935) (stating that the defendant engaged in deceitful conduct by paying a bribe to a broker to advise a customer to misrepresent a fact (i.e., that the broker’s advice was not corrupted)); *United States v. Blitz*, 533 F.2d 1329, 1338 (2d Cir.), *cert. denied*, 429 U.S. 819 (1976); *United States v. Haddy*, 134 F.3d 542, 544-46 (3d Cir. 1998) (affirming conviction of defendants who paid kickbacks to brokers as part of overall scheme); *United States v. Feyrer*, 333 F.3d 110, 112-13 (2d Cir. 2003) (affirming conviction of corporate officer who engaged in a scheme to bribe brokers to solicit stock of corporation); *SEC v. Alliance Leasing Corp.*, 2000 U.S. Dist. LEXIS 5227, at \*32 (S.D. Cal. Mar. 17, 2000) (payment of 30% commissions on securities sales was material fact as a matter of law); *SEC v. Softpoint, Inc.*, 958 F. Supp. 846, 863 (S.D.N.Y. 1997) (payments to brokerage firms under kickback agreement was material information).

Section 15(c) of the Exchange Act and Section 17(a) of the Securities Act.

- Transfer agents can also play a role in manipulative schemes that violate the federal securities laws, including by conspiring with the issuer to manipulate securities in violation of the federal securities laws and rules.<sup>1369</sup> Attorneys also can play a role in manipulative schemes by drafting false legal opinion letters to, for example, fraudulently induce the transfer agent to remove restrictive legends on shares (which essentially allows shareholders to illegally sell the shares in the market).<sup>1370</sup> This conduct violates Section 10(b) of the Exchange Act and Rule 10b-5 and, depending on the particular facts of the case, may violate Section 17(a) of the Securities Act.
- One type of fraudulent scheme that violates the federal securities laws and occurs in the municipal financing area is a “pay to play” in which decision-makers for a municipality (often political officials) accept payments from financial firms for the investment business of the municipality.<sup>1371</sup> This conduct violates Section 10(b) of the Exchange Act and Rule 10b-5 and MSRB Rules G-17 and G-20 and, depending on the particular facts of the case, may violate Section 17(a) of the Securities Act.
- Broker-dealers may not recommend certain classes of mutual fund shares in order to obtain higher commissions without fully disclosing the relevant fee structures. Mutual funds often have several classes of shares. Class A shares generally have an upfront fee, or front-end load, which is reduced with the size of the investment. Class B shares have no front-end load, but instead include a back-end load when the mutual fund is sold. Mutual funds often require a large minimum initial investment (“breakpoints”) before investors can qualify to purchase Class A shares. In the case of these larger investments, where the Class A front-end load is reduced, Class A shares are often better investments than Class B shares. However, in many instances, broker-dealers obtain higher commissions for selling Class B shares than for Class A shares, creating a conflict of interest. If a broker-dealer recommends such mutual funds, it must disclose the various class expenses and fees and how they will impact the expected return on an investment.<sup>1372</sup> This conduct violates Section 10(b) of the Exchange Act and Rule 10b-5

<sup>1369</sup> See *SEC v. CIBC Mellon Trust Co.*, Lit. Rel. No. 19081 (February 16, 2005).

<sup>1370</sup> See *SEC v. Albert J. Rasch, Jr., et al.*, Lit. Rel. No. 21024 (May 5, 2009).

<sup>1371</sup> See *SEC v. Henry Morris, et al.*, Lit. Rel. No. 21018 (April 30, 2009) (charging Aldus Equity Partners, L.P. and one of its founding principals, Saul Meyer, in connection with a multi-million dollar kickback scheme involving New York’s largest pension fund); *SEC v. Larry P. Langford, et al.*, Lit. Rel. No. 20545 (April 30, 2008) (charging the President of the County Commission of Jefferson County, Alabama with accepting cash and benefits from the chairman of a local broker-dealer in return for selecting the broker-dealer to participate in every municipal bond offering and SBS agreement transaction during 2003 and 2004).

<sup>1372</sup> See, e.g., *Flanagan, Kindschi, and Spectrum Administration, Inc.*, Exchange Act Rel. No. 49979 (July 7, 2004) (SEC opinion) (the SEC may charge broker with fraud for failing to disclose fully the difference between Class A and Class B shares of mutual funds); *Sandra K. Simpson*, Exchange Act Rel. No. 45923, 2002 SEC LEXIS 1278 (May 14,

(continued)

and, depending on the particular facts of the case, may violate Section 15(c) of the Exchange Act and Section 17(a) of the Securities Act.

(c) Insider trading?

Yes, the federal securities laws and regulations prohibit insider trading, as discussed below. Insider trading is a specific form of fraud that undermines confidence in the securities markets and violates Exchange Act Section 10(b) and Rule 10b-5.

The SEC brings enforcement actions under two theories of insider trading, classical and misappropriation. Under the classical (or traditional) theory, a person violates the anti-fraud provisions when he or she buys or sells securities on the basis of material, nonpublic information and is an insider of the corporation whose securities are traded. Under the classical theory, traditional insiders, such as officers, directors, and employees, in possession of material, nonpublic information have a fiduciary duty to the issuer and its shareholders to publicly disclose such information or to abstain from trading.<sup>1373</sup> If the insider trades while in possession of the material, nonpublic information, the insider's failure to disclose the information prior to trading operates as a fraud.<sup>1374</sup>

Under the misappropriation theory, a person violates the anti-fraud provisions when he or she misappropriates (or essentially, "steals") nonpublic information, "in breach of a duty owed to the source of the information" and trades on the basis of this information.<sup>1375</sup> Because the misappropriator gains access to the confidential information because of the fiduciary relationship (or relationship of trust and confidence), there is an obligation not to appropriate the information for personal use.<sup>1376</sup> The misappropriation theory imposes liability on outsiders who would not ordinarily be deemed fiduciaries of the corporate entities in whose stock they trade.<sup>1377</sup> Under both the classical and misappropriation theories, it is also unlawful for a "tippee" to trade on material, nonpublic information that the tippee knew or should have known was communicated by a "tipper" in breach of a duty owed by the tipper.<sup>1378</sup>

2002) (SEC opinion) ("[Respondent] arranged the purchases to avoid breakpoints, and thereby improperly maximized the brokerage commissions.").

<sup>1373</sup> *Chiarella v. United States*, 445 U.S. 222, 230 (1980) ("[C]orporate insiders . . . have an obligation to place the shareholder's welfare before their own.").

<sup>1374</sup> *Id.* at 228.

<sup>1375</sup> *United States v. O'Hagan*, 521 U.S. 642, 652 (1997) ("[T]he misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.").

<sup>1376</sup> See *United States v. Chestman*, 947 F.2d 551, 569 (2d Cir. 1991) (*en banc*).

<sup>1377</sup> See *U.S. v. Cherif*, 933 F.2d 403, 411 (7<sup>th</sup> Cir. 1991) (after his termination, an employee is obligated to continue to protect any confidential information entrusted to him by his employer during employment).

<sup>1378</sup> See *Dirks v. SEC*, 463 U.S. 646, 660 (1983). When a person who knows the nonpublic information shares (or "tips") the information with another person, the person who shares the information is called a "tipper" and the person who receives the information is called a "tippee."



The SEC has adopted specific rules that address insider trading in the securities industry (Exchange Act Rules 10b5-1 and 10b5-2),<sup>1379</sup> as well as the tender offer rule, Exchange Act Rule 14e-3, discussed below. To address the potential adverse market effects of selective disclosure by issuers, which bears a close resemblance to “tipping” and insider trading, the SEC adopted Regulation FD, which addresses the selective disclosure of information by reporting issuers. This regulation is designed to promote full and fair disclosure among all classes of investors in reporting issuers. It requires a reporting issuer to make simultaneous or prompt public disclosure, depending on whether the disclosure was intentional, when it discloses material nonpublic information to certain individuals or entities (generally, securities market professionals, such as stock analysts or holders of the issuer’s securities who may trade on the basis of the information).

In addition, Section 16(b) of the Exchange Act imposes liability for short-swing profits in the issuer’s stock upon officers, directors, and beneficial owners of more than 10% of any class of equity security, who may be in a position to obtain material, nonpublic information. These corporate insiders must disgorge to the issuer any profit realized as a result of a purchase and sale of equity securities occurring within a six-month period.

Section 14(e) of the Exchange Act and corresponding Rule 14e-3 prohibit insider trading in the context of tender offers. A tender offer is a broad solicitation by an issuer or a third party to purchase within a limited period of time a substantial percentage of an issuer’s debt or equity securities. Section 14(e) and Rule 14e-3 apply to every tender offer, regardless of whether the class of securities that is the subject of the offer is registered under Section 12. Section 14(e) and Rule 14e-3 prohibit tipping and trading while in possession of material, nonpublic information if any person has taken substantial steps toward commencement of a tender offer, and the person knows or had reason to know that the information was nonpublic and came from a prohibited source specified in the rule such as the offeror.

(d) Front running?

Yes, front running is also illegal under the anti-fraud provisions of the federal securities laws. One example of this practice is a broker-dealer that trades a security based on information from its research and analyst department before the analyst or his or her firm provides the information to customers. FINRA rules also prohibit this conduct.<sup>1380</sup>

<sup>1379</sup> Rule 10b5-1 addresses the issue of when insider trading liability arises in connection with a trader’s “use” or “knowing possession” of material nonpublic information. Rule 10b5-2 addresses the issue of when a breach of a family or other non-business relationship may give rise to liability under the misappropriation theory of insider trading. Rule 10b5-2 sets forth three non-exclusive bases for determining that a person receiving information owes a duty of trust or confidence.

<sup>1380</sup> See FINRA Rule 5280 (prohibiting trading ahead of research reports).

“Trading ahead” also violates the anti-fraud provisions of the federal securities laws. Trading ahead is a type of illegal conduct in which a broker-dealer executes a customer order (which the customer expected the broker-dealer to execute acting as the customer’s agent) through a proprietary trade for the firm’s proprietary account – and thereby improperly ‘steps in front’ of, or ‘trades ahead’ of, the customer’s order – simply to allow the firm to take advantage of market conditions.<sup>1381</sup> SROs prohibit this conduct through their own rules.<sup>1382</sup> FINRA Rule 5320 prohibits trading ahead of customer limit and market orders.

(e) Other fraudulent or deceptive conduct and market abuses?

Yes, the federal securities laws prohibit market participants from engaging in fraud. Section 17(a) of the Securities Act prohibits fraud, material misstatements, and omissions of fact “in the offer or sale of any security.” Section 10(b) of the Exchange Act prohibits any person, in connection with a purchase or sale of any security, from using or employing any manipulative or deceptive device or contrivance in contravention of the SEC’s rules. Rule 10b-5 implements Section 10(b) of the Exchange Act and makes it unlawful for any person, directly or indirectly, to use any device, scheme or artifice to defraud, to make any untrue statements of material fact or to omit to state a material fact necessary in order to make the statements made not misleading, and to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.<sup>1383</sup> Section 9 of the Exchange Act prohibits manipulative practices by any person. Section 15(c) of the Exchange Act prohibits fraudulent and manipulative conduct by broker-dealers. Section 14(e) of the Exchange Act prohibits fraudulent, deceptive, and manipulative acts in connection with a tender offer.

The SROs also have rules prohibiting fraudulent or deceptive conduct. For example, FINRA Rule 2010 prohibits conduct inconsistent with just and equitable principles of trade, including front running.<sup>1384</sup> FINRA Rule 2020 prohibits any transaction or inducement to purchase or sell a security by means of any manipulative, deceptive, or otherwise fraudulent device or contrivance. Similarly, MSRB Rule G-17 requires each broker, dealer, and municipal securities dealer to deal fairly with all persons and not to engage in any deceptive, dishonest, or unfair practice.

<sup>1381</sup> See *Opper v. Hancock Securities Corp.*, 250 F. sup. 668 (SDNY), *aff’d*, 367 F.2d 157 (2d Cir. 1966) (broker engaged in fraud in violation of its duties under the federal securities laws when it sold for its own account ahead of a customer’s sell order).

<sup>1382</sup> In *E.F. Hutton & Co.*, Exchange Act Rel. No. 25887 (July 6, 1988), the SEC found that a broker-dealer violated duties to its customer under SRO rules by failing to disclose that it traded ahead of customer orders.

<sup>1383</sup> The Advisers Act and the Investment Company Act also include anti-fraud provisions. See, e.g., Section 206 of the Advisers Act and Section 34(b) of the Investment Company Act.

<sup>1384</sup> See FINRA Rule 5270 (Frontrunning of Block Transactions).

The SEC investigates and enforces a wide variety of misconduct under the anti-fraud provisions of the federal securities laws.<sup>1385</sup> Some examples of these fraudulent practices and market abuses include:

- Interpositioning involves a two-step process that allows the broker-dealer firm to generate a profit from the spread between a customer order to buy and a customer order to sell. The SEC has repeatedly held that interpositioning violates the anti-fraud provisions of the federal securities laws when it results in customers not receiving the best available market price.<sup>1386</sup> This conduct violates Section 10(b) of the Exchange Act and Rule 10b-5 and, depending on the particular facts of the case, may violate Section 15(c) of the Exchange Act and Section 17(a) of the Securities Act.
- Unauthorized trading occurs when a broker purchases or sells stock on behalf of an investor who has not authorized the transaction.<sup>1387</sup> This conduct violates Section 10(b) of the Exchange Act and Rule 10b-5 and, depending on the particular facts of the case, may violate Section 15(c) of the Exchange Act and Section 17(a) of the Securities Act. In addition to violating the anti-fraud provisions of the federal securities laws, FINRA has a number of rules that address unauthorized trading.<sup>1388</sup>
- Churning is excessive trading in an account that is not in the customer's financial interests, where the broker intends to act in his or her own self-interest (*i.e.*, with *scienter*). The SEC often proves that the broker is self-interested by showing a benefit to the broker in the form of substantial commissions that the broker received on the trading.<sup>1389</sup> In addition, a broker must have control over the customer account. This can either be explicit control, in the case of a discretionary account, or *de facto* control, in the case of a nondiscretionary account, where the customer lacks the ability to independently evaluate the broker's recommendations.<sup>1390</sup> This conduct violates Section 10(b) of the Exchange Act and Rule 10b-5 and, depending on the particular facts of the case, may violate Section 15(c) of the Exchange Act and Section 17(a) of the Securities Act.

<sup>1385</sup> See, e.g., *In re AOL Time Warner Sec. & "ERISA" Litig.*, Fed. Sec. L. Rep. (CCH) ¶ 92,812 (S.D.N.Y. 2004) ("10b-5(a) and (c) claims need not contain the magic words 'wash sales, matched orders, or rigged prices' to be valid").

<sup>1386</sup> See, e.g., *In the Matter of Synovus Securities, Inc.*, Exchange Act Rel. No. 34313 (July 5, 1994).

<sup>1387</sup> See, e.g., *Edgar B. Alacan*, Exchange Act Rel. No. 49970 (July 6, 2004); *William C. Piontek*, Exchange Act Rel. No. 48903 (Dec. 11, 2003).

<sup>1388</sup> See NASD Rule 2510 and FINRA Rule 2010.

<sup>1389</sup> See, e.g., *Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 767 F.2d 1498 (11th Cir. 1985).

<sup>1390</sup> See, e.g., *Al Rizek*, Exchange Act Rel. No. 41725 (Aug. 11, 1999).

- Scalping is the practice “whereby the owner of a security recommends that security for investment and then immediately sells it at a profit upon the rise in the market price which follows the recommendation.”<sup>1391</sup> Failure to disclose such activity is a violation of Section 10(b) of the Exchange Act and Rule 10b-5 and, depending on the particular facts of the case, may violate Section 17(a) of the Securities Act.<sup>1392</sup>
- Revenue sharing occurs when a broker-dealer is paid by a mutual fund in exchange for promoting the funds to the broker-dealer’s customers. Revenue sharing is a material fact that, if not disclosed to customers, constitutes deceptive and misleading conduct that violates the federal securities laws.<sup>1393</sup> This conduct violates Section 10(b) of the Exchange Act and Rule 10b-5 and, depending on the particular facts of the case, may violate Section 15(c) of the Exchange Act and Section 17(a) of the Securities Act.
- A broker-dealer has a legal duty to seek to obtain best execution of customer orders.<sup>1394</sup> Violation of this duty can constitute fraud under the federal securities laws because when a broker-dealer agrees to execute a customer’s order, it implicitly represents that it will maximize the customer’s economic gain in the transaction.<sup>1395</sup> If the broker-dealer intends not to act in a manner that maximizes the customer’s benefit when the order is accepted and does not disclose this to the customer, the broker-dealer’s implied representation is false.<sup>1396</sup> This conduct violates Section 10(b) of the Exchange Act and Rule 10b-5 and, depending on the particular facts of the case, may violate Section 15(c) of the Exchange Act and Section 17(a) of the Securities Act.
- If a broker-dealer sells a security to a customer with a mark-up on the price paid by the broker-dealer, the broker-dealer violates the anti-fraud provisions of the federal securities laws if it knowingly or recklessly sells the security at a price not reasonably

<sup>1391</sup> *SEC v. Huttoe*, 1998 WL 34078092, \*7 (D.D.C. 1998).

<sup>1392</sup> See *Zweig v. Hearst Corp.*, 594 F.2d 1261 (9<sup>th</sup> Cir. 1979) (financial columnist failed to disclose his scalping activities).

<sup>1393</sup> See *In re AIG Advisor Group*, 2007 WL 1213395, \*7-9 (E.D.N.Y. 2007) (where broker-dealers received kickbacks in form of revenue sharing and directed brokerage from mutual funds in exchange for recommending the funds to customers, broker-dealers had to disclose such payments because they created a material conflict of interest).

<sup>1394</sup> See, e.g., *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 269-70, 274 (3d Cir.), cert. denied, 525 U.S. 811 (1998); FINRA Rule 5310(a) and FINRA Regulatory Notice 12-13 (May 31, 2012).

<sup>1395</sup> See *Newton*, 135 F.3d at 273 (“[T]he basis for the duty of best execution is the mutual understanding that the client is engaging in the trade – and retaining the services of the broker as his agent – solely for the purpose of maximizing his own economic benefit, and that the broker receives her compensation because she assists the client in reaching that goal.”); *Marc N. Geman*, Exchange Act Rel. No. 43963 (Feb. 14, 2001) (citing *Newton*, but concluding that respondent fulfilled his duty of best execution). See also *Payment for Order Flow*, Exchange Act Rel. No. 34902 (Oct. 27, 1994), 59 Fed. Reg. 55006, 55009 (Nov. 2, 1994).

<sup>1396</sup> See *Newton*, 135 F.3d at 273-274.

related to the prevailing market price (“excessive markups”) without disclosing the fact to the customer.<sup>1397</sup> This conduct violates Section 10(b) of the Exchange Act and Rule 10b-5 and, depending on the particular facts of the case, may violate Section 15(c) of the Exchange Act and Section 17(a) of the Securities Act.

- Failure to make suitable recommendations to customers can violate Exchange Act Sections 10(b) and 15(c) and Rule 10b-5, as well as Securities Act Section 17(a).<sup>1398</sup> A broker-dealer must have an adequate and reasonable basis for recommending an investment to a customer.<sup>1399</sup> In addition, a broker-dealer must reasonably believe that its securities recommendations are suitable for its customer in light of the customer’s financial needs, objectives, and circumstances.<sup>1400</sup> SROs also have rules addressing this misconduct. For example, FINRA Rule 2111 and MSRB Rule G-19 require broker-dealers to make suitable recommendations to “non-institutional” customers and require broker-dealers to make reasonable effort to obtain certain information about customers.
- Account intrusions may result in fraudulent activities that violate the federal securities laws. For example, after gaining access to account holders’ user names and passwords, the hacker places orders to buy securities in his or her account and places matching orders to sell the same securities in the intruded accounts at market or below market prices. Once the trade is executed, the hacker places orders to sell the securities in his or her account at inflated prices, and places matching orders to buy the same securities at the inflated price in the intruded accounts. By intruding into online brokerage accounts of unsuspecting investors and placing unauthorized trades in the accounts, the hacker defrauds the unwitting investors who were the victims of the intrusions and the online broker-dealers who service the intruded accounts.<sup>1401</sup> This conduct violates Section 10(b) of the Exchange Act and Rule 10b-5 and, depending on the particular facts of the case, may violate Section 17(a) of the Securities Act.

<sup>1397</sup> See, e.g., *Grandon v. Merrill Lynch & Co.*, 147 F.3d 184, 189-90 (2d Cir. 1998).

<sup>1398</sup> See *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 600 (2d Cir. 1978); *Mauriber v. Shearson/ American Express, Inc.*, 567 F. Supp. 1231 (S.D.N.Y. 1983); *Olde Discount Corp.*, Exchange Act Rel. No. 40423 (Sept. 10, 1998) (settled order).

<sup>1399</sup> *Hanley v. SEC*, 415 F. 2d 589, 596 (2d Cir. 1969).

<sup>1400</sup> *F.J. Kaufman and Co.*, Exchange Act Rel. No. 27535, 50 SEC 164 (Dec. 13, 1989) (SEC opinion) (“The suitability rule thus requires a broker-dealer to make a customer-specific determination of suitability and to tailor his recommendations to the customer’s financial profile and investment objectives.”); *Richard N. Cea*, Exchange Act Rel. No. 8662, 44 SEC 8 (Aug. 6, 1969) (SEC opinion).

<sup>1401</sup> See generally *SEC v. Van T. Dinh*, Civil Action No. 03-CV-11964-RWZ (D. Mass. filed Oct. 9, 2003) (defendant permanently enjoined from violating the anti-fraud provisions of the federal securities laws in connection with unauthorized intrusion and trading in an online brokerage account).

2. Does the regulatory approach to detect and deter such conduct include an effective and appropriate combination of mechanisms drawn from the following:

- (a) Direct surveillance, inspection, reporting, such as, for example, (i) securities listing or product design requirements (where applicable), (ii) position limits, (iii) audit trail requirements, (iv) quotation display rules, (v) order handling rules, (vi) settlement price rules or (vii) market halts complemented by enforcement of the law and trading rules?

Yes, the SEC's regulatory approach to detect and deter such conduct includes an effective and appropriate combination of mechanisms such as those described in Principle 36 Question 2(a), as discussed below.

Congress established the regulatory structure for the U.S. marketplace, which contemplates the SEC's regulation and oversight of the SROs and their conduct of their self-regulatory responsibilities, as well as an active and routine collaboration between the SEC and SROs (such as FINRA and the registered exchanges) in effecting, among other regulatory functions, surveillance. Within that structure, each SRO is responsible for regulating and monitoring its own membership and marketplace, with the SEC providing oversight of the SROs. Primary market surveillance occurs at the level of the SROs with routine and daily communication with the SEC. The SEC also conducts surveillance of the markets and actively exchanges information on a daily basis with the SROs. In addition, the SEC uses technology to review all merger and acquisition activity and major market moving events in coordination with the SROs where the stocks in question are located so that the SRO can conduct the proper review of the market activity. For example, if the SEC finds unusual activity in the equity or options market, it alerts each market to the activity to heighten surveillance of that activity.

Subject to SEC oversight, the SROs have responsibility for the enforcement of their rules; those responsibilities include enforcement of trading and conduct rules.<sup>1402</sup> In order to carry out all of their responsibilities, as discussed above, SROs engage in daily surveillance of trading activities and regulatory compliance. The SROs also have rules that require broker-dealers to report transaction-related information for dissemination to the public. For example, NASD Rule 6622 requires broker-dealers to report the stock symbol, number of shares, price, type of transaction, and time of execution for certain OTC equity securities for public dissemination.

The SEC also has and uses its authority to inspect both the SROs and market participants (such as broker-dealers) to evaluate whether they and their customers are complying with the anti-fraud, anti-manipulation, reporting, and other statutory and rule requirements. The SEC can also obtain surveillance and trading data from the SROs. Exchange Act Section 11A established the NMS. Among other things, it requires that market centers adopt plans to report, consolidate, and

<sup>1402</sup> The Exchange Act requires all SROs to police their members and their trading to address any potential violations of the market's rules or the federal securities laws.

disseminate market data.

The SEC may suspend trading in a particular security or a group of securities pursuant to Section 12(k) of the Exchange Act.<sup>1403</sup> Further, national securities exchanges can suspend or remove a security from trading.<sup>1404</sup> In addition, under Exchange Act Sections 12(d) and 12(j), the SEC can deregister and de-list securities for the protection of investors. Under Rule 13d-1 of the Exchange Act, any person acquiring more than 5% ownership of the class of any equity security must file a statement reporting such ownership to the SEC within 10 days of acquisition.

The SEC has the tools to implement an effective enforcement program, including authority to bring an administrative proceeding or an action in federal court to seek sanctions against persons or entities that violate the law, to refer a matter to an SRO to pursue enforcement action, and/or to refer a matter to the criminal authorities or other law enforcement or regulatory authorities to pursue action.

- For additional information regarding surveillance and inspection, see responses to Principles 10 and 12.
- For additional information regarding trading halts and suspensions, see response to Principle 33.
- For additional information regarding trade reporting, see response to Principle 35.
- For information regarding securities listing and issuer reporting requirements, see responses to Principles 16 and 33.
- For information regarding position reporting and risk monitoring of positions, see response to Principle 37.
- For information regarding large trader reporting and audit trail requirements, see response to Question 36.3(a) below and responses to Principles 33 and 34.
- For information regarding order handling and best execution, see responses to Principles 9 and 33.

<sup>1403</sup> See, e.g., *Texscan Corp.*, Exchange Act Rel. No. 29112 (Apr. 22, 1992) (SEC suspended trading because recent market activity could have been the result of manipulative conduct or other illegal activity). See also *Sloan v. SEC*, 547 F.2d 152 (2d Cir. 1976), *aff'd*, 436 U.S. 103 (Mar. 15, 1978) (court held that there was sufficient evidence of probable manipulation and false statements as to company's soundness and value to justify SEC's conclusion that it was in the public interest to summarily suspend trading pursuant to Section 12(k)).

<sup>1404</sup> See Exchange Act Rules 12d2-1 and 12d2-2; NASDAQ Rule 4120.



## (b) Effective, proportionate and dissuasive sanctions for violations?

Yes, the SEC's regulatory approach to detect and deter such conduct includes effective, proportionate, and dissuasive sanctions for violations. The SEC is responsible for non-criminal enforcement of the federal securities laws and it prosecutes cases in federal courts and in SEC administrative proceedings. As in other civil cases, the SEC must prove that violations occurred by a preponderance of the evidence.

The SEC may seek either temporary or permanent injunctive relief in a federal district court "whenever it shall appear to the SEC that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation."<sup>1405</sup> In civil suits, the SEC may obtain injunctions, which are orders that prohibit future violations; a person who violates an injunction may be subject to fines or imprisonment for contempt. The SEC also may obtain emergency relief in federal court in the form of a TRO. Also in federal court, the SEC may obtain a court order "freezing" assets to preserve the ability to obtain monetary relief at the successful conclusion of the case and return money to defrauded investors.

In a civil action, in addition to injunctive relief, the SEC may obtain other relief to address the harm caused by the violation.<sup>1406</sup> Such relief may include an accounting or disgorgement<sup>1407</sup> of ill-gotten gains where a defendant has profited from a violation of law. The SEC may also obtain civil money penalties and court orders barring a defendant from serving as an officer or director of a public company or from participating in an offering of penny stock.

The SEC may also institute administrative actions against a person or an entity regulated by the SEC or any person that it believes has violated or is about to violate the law. These types of enforcement actions are litigated before an SEC ALJ and are subject to appeal directly to the SEC. One type of administrative action is the "administrative proceeding." In an administrative proceeding, the SEC may obtain a censure; a limitation on activities such as suspension or revocation of registration (in the case of a regulated entity); a suspension of up to twelve months or bar from the industry (in the case of an associated person); disgorgement and civil money penalties. Another type of administrative action is the "cease-and-desist proceeding." In a cease-and-desist proceeding, the SEC may order a respondent, who can be any person, including public companies and officers and directors, to cease and desist from the violative conduct

<sup>1405</sup> Securities Act Section 20(b). Similar provisions are found in the Exchange Act, the Trust Indenture Act, the Investment Company Act, and the Advisers Act.

<sup>1406</sup> Exchange Act Section 21(d)(5) provides that "[i]n any action or proceeding brought or instituted by the SEC under any provision of the securities laws, the SEC may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors."

<sup>1407</sup> Disgorgement of ill-gotten gains is a well-established remedy created by case law. The amount of disgorgement ordered "need only be a reasonable approximation of the profits causally connected to the violation." *SEC v. Patel*, 61 F.3d 137, 179 (2d Cir. 1995). The measure of disgorgement need not be tied to the losses suffered by defrauded investors.



alleged, and order disgorgement and civil penalties. The Dodd-Frank Act adopted in 2010, expanded the SEC's enforcement authority to permit the SEC to seek civil penalties in cease-and-desist proceedings.

Section 925 of the DFA authorizes the SEC to impose collateral bars, which prohibit securities professionals found to have violated the securities laws from associating with any regulated entity. In addition to the previously existing authority to impose bars and suspensions, the SEC now has the authority to "suspend for a period not exceeding 12 months, or bar any such person from being associated with a broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization." By expressly empowering the SEC to impose broader prophylactic relief, the new collateral bar authority enables the SEC to provide more effective protection to investors and more efficient use of SEC resources.

In both civil injunctive actions and administrative proceedings, the SEC has the power to enter into enforceable settlements. In recent years, the SEC changed its longstanding settlement policy and now requires admissions of misconduct in a discrete category of cases where heightened accountability and acceptance of responsibility by a defendant are appropriate and in the public interest. The first settlements under the new policy came in actions against Philip A. Falcone and his firm Harbinger Capital Partners<sup>1408</sup> and JPMorgan Chase & Co.<sup>1409</sup>

The SEC's ability to settle allows the SEC to obtain substantial and effective remedies from the party that violated the securities laws, to publish the facts of the case and to tie the defendant to those facts to demonstrate violations of the law. In addition, in settlements, in both civil actions and administrative proceedings, the SEC may also obtain undertakings from entities, for example, to hire an independent compliance consultant to review the entity's policies and procedures and to recommend improvements, which the entity agrees to address.

For additional information regarding the SEC's enforcement powers and sanctions available, see responses to Principles 11 and 12. For additional information regarding the SEC's use of inspection, investigation, and surveillance; see response to Principle 12. For information regarding criminal sanctions, see response to Principle 9.

### **Enforcement by SROs**

Exchange Act Sections 6(b), 15A, and 19(g) require SROs to comply with certain standards, including enforcement of compliance with the federal securities laws, rules, and SRO rules by SRO members. The SROs also must have rules to prevent fraud and to bring disciplinary actions

<sup>1408</sup> Press Release 2013-159.

<sup>1409</sup> Press Release 2013-187.

against members and persons associated with members. SROs can bring disciplinary actions to fine, suspend, and expel from the industry member firms (*i.e.*, broker-dealers) and persons associated with firms. Broker-dealers generally must become members of at least one SRO, such as a national securities exchange or a registered securities association (*i.e.*, FINRA). Natural persons who are “associated with” a registered broker-dealer must register with the appropriate SRO (generally FINRA). SRO disciplinary actions against a firm or associated person may have the practical effect of barring the firm or individual from the brokerage industry.

The SROs examine their own members, and under Section 17(b) of the Exchange Act, the SEC examines the SROs themselves to determine whether they are complying with their legal obligations. The SEC can enforce the rules of an SRO against a broker-dealer or persons associated with the broker-dealer if it finds that the SRO is unable or unwilling to take action against a firm or person who violated an SRO rule or if it is in the public interest or to protect investors.<sup>1410</sup> The SEC can also bring an enforcement action against the SRO itself.

3. Are there arrangements in place for:

- (a) The continuous collection and analysis of information concerning trading activities?
- (b) Providing the results of such analysis to market and regulatory officials in a position to take remedial action if necessary?
- (c) Monitoring the conduct of market intermediaries participating in the market(s)?
- (d) Triggering further inquiry as to suspicious transactions or patterns of trading?

Yes. Regarding Question 36.3(a), the collection and analysis of information concerning trading activities, generally, the SROs collect and analyze information relating to trading activities. All stock trades are reported to either the Securities Industry Automation Corporation or NASDAQ. Both of these entities are SIPs that disseminate consolidated quotation and transaction data to the public. The Securities Industry Automation Corporation processes transaction reporting for listed securities, other than NASDAQ listed securities. NASDAQ receives the information related to trades in NASDAQ securities as well as trades in OTC securities. In addition, as described below, FINRA and NYSE have implemented order audit trail systems to capture order details throughout the lifecycle of a trade. The SROs monitor trade reports electronically and their programs are designed to identify unusual trading activity, which is then reviewed by the SROs to determine if market participants have violated any laws or rules. SROs monitor intra-day as well as after the close of the trading day.

In 1996, the SEC ordered FINRA (then NASD) to design and implement an audit trail system that

<sup>1410</sup> Exchange Act Section 21(f).

would capture a time-sequenced record of orders and transactions from receipt of an order through execution or cancellation of that order.<sup>1411</sup> In response, FINRA developed OATS. Brokerage firms entering orders into the marketplace are responsible for reporting order details to OATS. OATS captures new orders, cancels, cancel/replaces, and executions for all OTC equity securities.

The SEC also ordered the NYSE to design and implement an audit trail that would capture a time-sequenced record of orders, quotations, and transactions from the receipt of an order by any NYSE member firm, documenting the life of the order through the execution or cancellation of that order.<sup>1412</sup> In response, the NYSE established its Front End Systemic Capture (FESC) and Order Tracking System or OTS. FESC captures order information at the point of sale, and OTS captures order information at the point of receipt. Brokerage firms entering orders in listed securities into the marketplace are responsible for reporting order details to FESC and OTS. FESC and OTS capture new orders, cancels, cancel/replaces, and executions for all listed orders.

In 2012, the SEC adopted new Rule 613 under the Exchange Act to require the national securities exchanges and FINRA to establish a market-wide CAT to significantly enhance regulators' ability to monitor and analyze trading activity.<sup>1413</sup> The CAT must collect and accurately identify every order, cancellation, modification, and trade execution for all exchange-listed equities and equity options across all U.S. markets. The CAT will increase the data available to regulators investigating illegal activities such as insider trading and market manipulation, and it will significantly improve the ability to reconstruct broad-based market events in an accurate and timely manner.

In 2011, the SEC adopted new Rule 13h-1 under the Exchange Act establishing large trader reporting requirements to enhance the SEC's ability to identify large market participants, collect information on their trading, and analyze their trading activity.<sup>1414</sup> The new rule requires large traders, including high frequency traders, to identify themselves to the SEC, which will then assign each trader a unique identification number. Large traders will provide this number to their broker-dealers, who will be required to maintain transaction records for each large trader and report that information to the SEC upon request. The new rule will enable the SEC to promptly and efficiently identify significant market participants and collect data on their trading activity so that the SEC can reconstruct market events, conduct investigations, and bring enforcement actions.<sup>1415</sup>

<sup>1411</sup> See *In the Matter of National Association of Securities Dealers, Inc.*, Exchange Act Rel. No. 37538 (Aug. 8, 1996).

<sup>1412</sup> See *In the Matter of New York Stock Exchange, Inc.*, Exchange Act Rel. No. 41574 (June 29, 1999).

<sup>1413</sup> See Press Rel. 2011-154.; see also 77 F.R. 45722.

<sup>1414</sup> See Press Rel. 2011-154.

<sup>1415</sup> In addition, SEC-registered investment advisers that exercise investment discretion over at least \$100 million in certain securities must periodically file Form 13F with the SEC. See Section 13(f) of the Exchange Act and Rule 13f-

(continued)

The SEC launched MIDAS in 2013.<sup>1416</sup> MIDAS combines advanced technologies with empirical data to promote better understanding of markets. MIDAS collects and processes data from the consolidated tapes (which generally include information about every trade of 100 shares or more in listed equities) and proprietary feeds of each equity exchange. This data includes posted orders and quotes, modifications and cancellations, and trade executions. Every day, MIDAS collects about one billion records time-stamped to the microsecond. MIDAS allows the SEC to readily perform analyses of thousands of stocks and over periods of six months or a year. In addition to data on listed stocks and exchange-traded products, MIDAS also collects and processes data on equity options and futures contracts. Among other things, the SEC can use MIDAS to help monitor and understand mini-flash crashes, identify possibly troublesome or illegal behavior, reconstruct market events, and develop a better understanding of long-term trends.

Regarding Question 36.3(b), providing the results of such analysis to market and regulatory officials in a position to take remedial action if necessary, the SROs regularly analyze and review information relating to trading activities for violations of the federal securities laws and rules and SRO rules. The SROs take remedial action for violations of SRO rules or refer violations of federal securities laws and rules to the SEC so that the SEC can take remedial action.

For additional information regarding the collection and analysis of information concerning trading activities and providing the results of such analysis to market and regulatory officials in a position to take remedial action if necessary, see responses to Principles 10 and 12.

Regarding Question 36.3(c), monitoring the conduct of market intermediaries participating in the market(s), all broker-dealers must be registered with the SEC and also be a member of an SRO. SROs are subject to the SEC's oversight and adopt rules to regulate broker-dealers' conduct in the market and with customers. The SEC reviews SRO rules under Exchange Act Section 19(b). The federal securities laws, rules, and SRO rules contain general and specific anti-fraud provisions and other provisions designed to maintain high industry standards.

The SROs examine broker-dealers for compliance with the federal securities laws, rules, and SRO rules. The SEC monitors the largest broker-dealers by meeting periodically with representatives of such firms' risk and control functions. In addition, the SEC examines broker-dealers on a risk-assessed basis. Broker-dealers may be selected for examination for any number of reasons including, but not limited to, the entity's risk profile; Tips, complaints, and referrals; or a review of a particular compliance risk area. For additional information on SEC and SRO examinations, see

1(a). This requirement is intended "to create a central depository of historical and current data about the investment activities of institutional investment managers" to assist investors and regulators. See S. Rep. No. 94-75, 94<sup>th</sup> Cong., 2d Sess. 82-85 (1975).

<sup>1416</sup> See [www.sec.gov/marketstructure/midas.html](http://www.sec.gov/marketstructure/midas.html). See also Press Rel. 2013-217.

response to Principle 12.1. Broker-dealers that are violating the federal securities laws and/or SRO rules may be disciplined. Disciplinary actions may include imposing civil monetary penalties, restricting the activities of broker-dealers, and expulsion from the industry. The SEC also has an office within Enforcement that monitors the markets for suspicious activity.

Regarding Question 36.3(d), triggering further inquiry as to suspicious transactions or patterns of trading, as part of their surveillance programs, the SROs review exception reports for suspicious transactions or patterns of trading. SROs review exceptions flagged by the surveillance reports for violations of SRO rules or securities laws and rules. For additional information on SROs' surveillance programs, see response to Principle 12. SROs refer potential violations of federal securities laws and regulations to the SEC for further investigation and remedial action. As discussed above and in the response to Principle 9, in addition SROs have responsibility for the enforcement of their rules and the Exchange Act and the rules thereunder with respect to their members and persons associated with their members.

In addition, the U.S.' AML regime requires broker-dealers to confidentially report suspicious transactions and activities that customers and other firms have undertaken or have attempted to undertake. In response to these reports, the SEC or the appropriate SRO may investigate further.

At the SEC, OCIE is responsible for administering the SEC's nationwide examination and inspection program. OCIE examiners conduct examinations of the nation's registered entities, including SROs, broker-dealers, transfer agents, investment companies, investment advisers, and NRSROs. The purpose of examinations is to prevent fraud and other violations of the securities laws, foster compliance with those laws, and help ensure that the SEC is continually made aware of developments and areas of potential risk in the securities industry. If, during an examination, OCIE identifies violations of the federal securities laws, it may make a referral to Enforcement for further investigation and potential enforcement action.

Within the SEC, TM has an Office of Interpretation and Guidance (TM's OIG). TM's OIG provides legal information to the industry, the markets, market participants, and others through a telephone hotline and email, on an expedited basis. Among other things, TM's OIG coordinates with Enforcement on information that may warrant further inquiry and investigation. Over the past year, TM's OIG received approximately 12,500 communications.

With respect to Questions 36, 3(a)-(d), see responses to Principles 10, 12, and 34. In particular, for additional information regarding the SEC's inspection, investigation, and surveillance powers, see response to Principle 10. For additional information regarding the SEC's use of inspection, investigation, surveillance, and enforcement powers and implementation of an effective compliance program, see response to Principle 12. For additional information regarding the SEC's regulatory supervision of exchanges and trading systems, see response to Principle 34.

4. If there is potential for domestic cross-market trading, are there: (a) inspection, (b) assistance, and (c) information-sharing requirements or arrangements in place to monitor and/or address domestic cross-market trading abuses?

Yes. In the U.S., there are mechanisms for information sharing and surveillance among the markets. The ISG is an industry organization created in 1983 to coordinate intermarket surveillance among the SROs by cooperatively sharing regulatory information pursuant to a written agreement between the parties. The goal of the ISG's information sharing is to coordinate regulatory efforts to address potential intermarket trading abuses and manipulations.

For information regarding the SEC's authority to share public and nonpublic information with domestic and foreign counterparts, see response to Principle 13.

5. If there are foreign linkages, substantial foreign participation, or cross listings, are there cooperation arrangements with relevant foreign regulators and/or markets that address manipulation or other abusive trading practices?

Yes. The SEC has entered into numerous MOUs, both bilateral and multilateral, with various domestic and foreign regulators concerning consultation, cooperation, and information sharing. Many of these MOUs, including the IOSCO MMOU, are aimed at cooperation in securities enforcement matters, while others facilitate regulatory cooperation in the supervision of financial services firms and the oversight of markets.

For additional information regarding the SEC's authority to share information with domestic and foreign counterparts, the SEC's information-sharing mechanisms, and the assistance that the SEC can provide to foreign regulators, see responses to Principles 13, 14, and 15.

6. Regarding authorities responsible for the supervision of commodity futures markets (e.g., either the market, a governmental regulator or an SRO) ("futures market regulators") only: Does the authority have access to information that permits it to identify concentrations of positions and the overall composition of the market, including the power to access a trader's related financial and underlying market positions?

The SEC is not responsible for the supervision of commodity futures markets.

**Principle 36: Additional Question Related to 36.2 and 36.3 above, for 2014 Assessment:**

**\*\***

- **Information on administrative/civil sanctions imposed during the last three years on major misconducts, such as market manipulation and insider trading.**

Below is a representative sample of administrative and civil sanctions imposed during the last three years for major misconduct, such as market manipulation and insider trading. For additional information regarding major SEC enforcement cases in 2011-2013, please refer to

Appendix B of each annual Agency Financial Report on the SEC's website.

**Market or price manipulation**

- On September 25, 2012, the SEC instituted an administrative proceeding against Hold Brothers On-Line Investment Services, LLC (a registered broker-dealer), Demostrate, LLC, Trade Alpha Corporate, Ltd., Steven Hold, Robert Vallone, and William Tobias, charging them with violations of Section 9(a)(2) of the Exchange Act in connection with overseas traders engaging in a manipulative trading strategy (called "layering" or "spoofing") under which the traders entered multiple non-*bona fide* orders on one side of the market to move the stock's price and create a false appearance of market activity. The SEC accepted the respondents' settlement offers in which they agreed to cease and desist from future violations; Vallone, Tobias, and Hold agreed to a bar from association with a broker, dealer, investment adviser, or certain other financial entities, from serving as an employee, officer, or director of a registered investment company, or from participating in an offering of penny stocks, with a right to reapply after three years (two years for Hold). Hold also agreed to a bar from acting as a supervisor for a broker, dealer, investment adviser, or certain other financial entities for a period of three years. Hold Brothers agreed to a censure and to pay disgorgement of over \$629,000 plus interest and a civil penalty of \$1,887,500. Demostrate agreed to pay disgorgement in the amount of over \$1.258 million. Hold, Vallone, and Tobias each agreed to pay a civil penalty of \$75,000.<sup>1417</sup>
- On December 18, 2012, the SEC instituted an administrative proceeding against Biremis Corporation (a registered broker-dealer), Peter Beck, and Charles Kim (Biremis's co-founders and co-owners) charging them with failing reasonably to supervise over 4,000 associated persons who were overseas day traders and who repeatedly used Biremis' order management system to engage in a manipulative trading practice known as "layering" on U.S. securities markets. The SEC accepted the respondents' settlement offers in which Biremis agreed to cease and desist from future violations, and the SEC revoked the firm's registration; Beck and Kim agreed to a bar from association with a broker, dealer, investment adviser, or certain other financial entities, or from participating in an offering of penny stocks, and to pay a civil penalty of \$250,000.<sup>1418</sup>
- On April 4, 2014, the SEC instituted an administrative proceeding against Joseph

<sup>1417</sup> *In the Matter of Hold Brothers On-Line Investment Services, LLC, Demostrate, LLC, Trade Alpha Corporate, Ltd, Steven Hold, Robert Vallone, and William Tobias*, Exchange Act Rel. No. 67924 (Sept. 25, 2012).

<sup>1418</sup> *In the Matter of Biremis Corporation, Peter Beck, and Charles Kim*, Exchange Act Rel. No. 68456 (Dec. 18, 2012).



Dondero charging him with violations of Sections 9(a)(2) and 10(b) of the Exchange Act in connection with engaging in a manipulative trading strategy referred to as “layering” or “spoofing.” The SEC accepted the respondent’s settlement offer in which he agreed to cease and desist from future violations of those provisions; to pay a civil penalty of \$785,000; and to a bar from association with a broker, dealer, investment adviser, or certain other financial entities, and from serving as an employee, officer, or director of a registered investment company, and from participating in an offering of penny stocks.<sup>1419</sup>

- In September 2013, the SEC brought enforcement actions against 23 firms charging short selling violations as part of a coordinated effort between the SEC’s NEP and Enforcement focused on deterring and preventing firms from improperly participating in public stock offerings after selling short those same stocks (“Rule 105 initiative”).<sup>1420</sup> The SEC charged the firms with buying offered shares from an underwriter, broker, or dealer participating in a follow-on public offering after having sold short the same security during the restricted period, in violation of Rule 105 of Regulation M. The 23 firms agreed to settle the SEC’s charges, resulting in more than \$14.4 million in monetary sanctions.<sup>1421</sup> As part of the Rule 105 initiative, in September 2014, the SEC also brought enforcement actions against 19 firms and one individual trader charging violations of Rule 105 of Regulation M.<sup>1422</sup> Each firm and the trader agreed to settle the SEC’s charges and pay a combined total of more than \$9 million in disgorgement, interest, and penalties.

### **Misleading Information**

- In June 2013, the SEC continued its program to address potential manipulation of the securities of certain microcap shell companies by suspending trading in the securities of 61 empty shell companies, under its authority in Section 12(k) of the

<sup>1419</sup> *In the Matter of Visionary Trading LLC, Lightspeed Trading LLC, Andrew Actman, Joseph Dondero, Eugene Giaquinto, Lee Heiss, and Jason Medvin*, Exchange Act Rel. No. 71871 (Apr. 4, 2014).

<sup>1420</sup> “SEC Charges 23 Firms with Short Selling Violations in Crackdown on Potential Manipulation in Advance of Stock Offerings,” Press Rel. 2013-182 (Sept. 17, 2013). The NEP simultaneously issued a Risk Alert to highlight risks to firms from non-compliance with Rule 105. The risk alert highlights observations by SEC examiners focusing on Rule 105 compliance issues as well as corrective actions that some firms proactively have taken to remedy Rule 105 concerns. See NEP Risk Alert, Vol. III, Issue 4 (Sept. 17, 2013).

<sup>1421</sup> See Press Rel. 2013-182 (describing charges against 23 firms and settlements with 22 of them); *G-2 Trading LLC*, Exchange Act Rel. No. 72231 (May 22, 2014) (settlement with 23<sup>rd</sup> firm).

<sup>1422</sup> See “SEC Sanctions 19 Firms and Individual Trader for Short Selling Violations in Advance of Stock Offerings,” Press Rel. 2014-195 (Sept. 16, 2014).



Exchange Act. This was the second largest trading suspension in SEC history and a follow-up to its 2012 trading suspension of 379 dormant shell companies.<sup>1423</sup>

This action and the 2012 action were the result of an initiative by the SEC's Microcap Fraud Working Group to utilize agency resources including the enhanced intelligence technology of OMI to scrutinize microcap stocks in the markets nationwide and to help identify clearly dormant shell companies that could be subject to market manipulation. Because microcap companies are thinly traded, once they become dormant, fraudsters purchase shares in the shell company at a low price, use false and misleading statements to increase investor activity in the stock, and then dump the stock for significant profit once other investors have been tricked into buying shares. By suspending trading in the securities of these companies, the companies will likely need to provide updated financial information to demonstrate that they are still operational which will deter fraudsters from using the companies' securities to conduct manipulative pump-and-dump schemes.

- On October 24, 2011, the SEC instituted an administrative proceeding against Pipeline Trading Systems LLC, a registered broker-dealer that operated an ATS (a private stock-trading platform commonly referred to as a "dark pool"), charging violations of, among other provisions, Section 17(a)(2) of the Securities Act, for making false and misleading claims that it would not give preferential access to subscribers' order or trade information and misrepresenting that it had no proprietary trading desk trading against subscribers' orders. The SEC accepted respondents' settlement offers under which Fred J. Federspiel and Alfred R. Berkeley III, two senior executives of Pipeline, settled to charges that they caused Pipeline's violations; the three respondents agreed to cease and desist from future violations; Pipeline agreed to pay \$1 million in civil penalties and the two executives each agreed to pay \$100,000 in civil penalties.<sup>1424</sup>
- On September 11, 2013, a federal court entered a final judgment by consent against Yusuf Jawed permanently enjoining him from future violations of Section 10(b) of the Exchange Act and Rule 10b-5, Section 17(a) of the Securities Act, and Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-8. The SEC alleged that Jawed made false and misleading statements to investors about how money was invested in hedge funds he offered, sent out false account statements and false statements about performance, and misappropriated

<sup>1423</sup> See "SEC Suspends Trading of 61 Companies Ripe for Fraud in Over-the-Counter Market," Press Rel. 2013-97 (June 3, 2013). In 2012, the SEC suspended trading in 379 companies in a single day before they could be manipulated for fraudulent activity. See *SEC Microcap Fraud-Fighting Initiative Expels 379 Dormant Shell Companies to Protect Investors from Potential Scams*, Press Rel. 2012-91 (May 14, 2012).

<sup>1424</sup> *In the Matter of Pipeline Trading Systems LLC, Fred J. Federspiel, and Alfred R. Berkeley III*, Exchange Act Rel. No. 65609 (Oct. 24, 2011).

investor money. Jawed agreed to pay \$26.98 million in disgorgement of ill-gotten gains and \$6.9 million in prejudgment interest.<sup>1425</sup> On September 25, 2013, in the SEC's related administrative proceeding, Jawed agreed to the SEC's imposition of a bar from association with any broker, dealer, investment adviser, or certain other financial entities.<sup>1426</sup>

- On January 9, 2014, the SEC instituted an administrative proceeding against Michel Mendes charging him with violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act, and Sections 13(b)(2)(A) and 13(b)(2)(B) and related rules of the Exchange Act for overstating the earnings of a public corporation, Diamond Foods, Inc. The SEC accepted Mendes' settlement offer in which he agreed to cease and desist from future violations and to pay a civil penalty of \$125,000.<sup>1427</sup>
- On October 2, 2013, the SEC instituted an administrative proceeding against Manarin Investment Counsel, Ltd. (MIC), Manarin Securities Corp. (MSC), and Roland R. Manarin charging, among other provisions, violations of Section 17(a)(2) of the Securities Act, in connection with using misleading offering documents to sell interests in investment funds that they managed. The SEC accepted the respondents' settlement offers in which they agreed to be censured; Manarin and MSC agreed to pay disgorgement of \$685,006.90 plus interest; and Manarin agreed to pay a civil penalty of \$100,000.00.<sup>1428</sup>

### **Insider Trading**

- In the past three years, the SEC has brought charges related to the massive insider trading scheme spearheaded by Raj Rajaratnam and hedge fund advisory firm Galleon Management, charging a total of 34 firms and individuals in its Galleon-related enforcement actions.<sup>1429</sup>
- In 2011, a federal court approved a settlement of the SEC's insider trading charges against Annabel McClellan, the wife of a former Deloitte Tax LLP partner, for violations of Section 10(b) of the Exchange Act and Rule 10b-5.<sup>1430</sup> The SEC

<sup>1425</sup> *SEC v. Jawed, et al.*, Civil Case No. 3:12-cv-01696-PK (D. Or. Sept. 11, 2013).

<sup>1426</sup> *In the Matter of Yusuf Jawed*, Advisers Act Rel. No. 3680 (Sept. 25, 2013).

<sup>1427</sup> *In the Matter of Michael Mendes*, Exchange Act Rel. No. 71264 (Jan. 9, 2014).

<sup>1428</sup> *In the Matter of Manarin Investment Counsel, Ltd., Manarin Securities Corp., and Roland R. Manarin*, Exchange Act Rel. No. 70595 (Oct. 2, 2013).

<sup>1429</sup> See, e.g., *SEC v. Douglas F. Whitman and Whitman Capital, LLC*, Lit. Rel. No. 22653 (March 20, 2013); *SEC v. Rajarengan (a/k/a Rengan) Rajaratnam*, Lit. Rel. No. 22658 (March 22, 2013); *SEC v. Kieran Taylor*, Press Rel. 2013-189 (Sept. 20, 2013).

<sup>1430</sup> *SEC v. Arnold McClellan and Annabel McClellan*, Lit. Rel. No. 22139 (Oct. 25, 2011).

alleged that McClellan repeatedly leaked confidential merger and acquisition information to family members in the UK, who traded in advance of seven deals worked on by McClellan's husband, netting nearly \$3 million for themselves (and approximately \$20 million for friends and clients). McClellan agreed to pay a \$1 million penalty in the SEC's action, and, in a related criminal case, she pleaded guilty to obstruction of justice during the SEC's investigation. In a case of international cooperation, the UK Financial Services Authority filed charges against McClellan's family members for their role in the scheme.

- In April 2011, the SEC charged Dr. Joseph F. Skowron, a former hedge fund portfolio manager, with insider trading based on confidential information about negative details of an experimental drug that he received from Dr. Yves Benhamou, a medical researcher overseeing a clinical drug trial.<sup>1431</sup> The material nonpublic information that Skowron allegedly received allowed the hedge funds that he managed to avoid losses of approximately \$30 million. In November 2011, a federal court entered judgments against Dr. Skowron and Dr. Benhamou permanently enjoining them from violations of Section 10(b) of the Exchange Act and Rule 10b-5 and Section 17(a) of the Securities Act; and ordering that Skowron pay over \$29 million in disgorgement and a civil penalty of \$2.72 million. Both Skowron and Benhamou pled guilty in parallel criminal cases. On November 17, 2012, the SEC accepted Skowron's settlement offer in which he agreed to a bar from association with any broker, dealer, investment adviser, or certain other financial entities and a bar from participating in any offering of a penny stock.<sup>1432</sup>
- In May 2011, the SEC charged Donald L. Johnson, a former managing director of The NASDAQ Stock Market, for trading on confidential information that he misappropriated while working in a market intelligence unit at NASDAQ that communicates with executives at listed companies about impending public announcements that could affect their stocks.<sup>1433</sup> Johnson consented to a permanent injunction, disgorgement of illicit profits with prejudgment interest, and a monetary penalty to settle the SEC's case. The DOJ charged Johnson in a parallel criminal action. (See related criminal action discussed below.)
- In January 2012, the SEC charged two, multi-billion dollar hedge fund advisory firms as well as seven fund managers and analysts at Diamondback Capital Management and Level Global Investors LP for a \$78 million insider trading

<sup>1431</sup> *SEC v. Joseph F. "Chip" Skowron III, et al.*, Lit. Rel. No. 21928 (Apr. 13, 2011). The SEC previously charged Benhamou for tipping Skowron. See *SEC v. Dr. Yves M. Benhamou*, Lit. Rel. No. 21721 (Nov. 2, 2010).

<sup>1432</sup> See *In the Matter of Dr. Joseph F. Skowron III*, Exchange Act Rel. No. 65783 (Nov. 17, 2011).

<sup>1433</sup> *SEC v. Donald L. Johnson, et al.*, Lit. Rel. No. 21981 (May 26, 2011).

scheme based on material, nonpublic information about Dell's quarterly earnings and other similar inside information about Nvidia Corporation.<sup>1434</sup> Diamondback paid more than \$9 million to settle the SEC's charges.

- On April 15, 2013, the SEC instituted an administrative proceeding against Scott Reiman charging violations of Section 10(b) and Rule 10b-5 in connection with insider trading in the securities of Delta Petroleum Corporation. The SEC accepted Reiman's settlement offer in which he agreed to: cease and desist from future violations of those provisions; a bar from acting as an officer or director of any public company for a period of five years; a bar from association with any broker, dealer, investment adviser, or certain other financial entities with the right to reapply after five years; and to pay disgorgement of \$398,000 plus interest and a civil penalty of \$398,000.<sup>1435</sup>
- On January 9, 2014, the SEC instituted an administrative proceeding against Marcus S. Spillson charging violations of Sections 10(b) and 14(e) of the Exchange Act and Rules 10b-5 and 14e-3 in connection with trading on inside information in the securities of Petrohawk Energy Corp. in advance of an announcement that the company was being acquired. The SEC accepted Spillson's settlement offer in which he agreed to cease and desist from future violations and to pay disgorgement of over \$154,800 plus interest and a civil penalty of over \$154,800.<sup>1436</sup>

#### **Other Fraudulent or Deceptive Conduct**

- On December 18, 2013, the SEC instituted an administrative proceeding against G-Trade Services LLC, ConvergeX Global Markets Limited, and ConvergeX Execution Solutions LLC charging violations of Section 10(b) of the Exchange Act and Rule 10b-5 in connection with concealing their practice of unnecessarily routing customer orders to an offshore affiliate which then added undisclosed mark-ups or mark-downs to the price of the securities and failing to seek to obtain best execution on customer orders. The SEC accepted respondents' settlement offers in which they agreed to: hire an independent compliance consultant to conduct an internal review; a cease-and-desist order; and pay disgorgement of \$79.8 million, prejudgment interest of \$7.62 million, and a civil penalty of \$20,000,000.<sup>1437</sup>

<sup>1434</sup> *SEC v. Adondakis, et al.*, Lit. Rel. No. 22230 (Jan. 19, 2012).

<sup>1435</sup> *In the Matter of Scott Reiman*, Exchange Act Rel. No. 69379 (Apr. 15, 2013).

<sup>1436</sup> *In the Matter of Marcus S. Spillson*, Exchange Act Rel. No. 71270 (Jan. 9, 2014).

<sup>1437</sup> *In the Matter of G-Trade Services LLC, ConvergeX Global Markets Limited, and ConvergeX Execution Solutions LLC*, Exchange Act Rel. No. 71128 (Dec. 18, 2013).

- In January 2012, the SEC charged a trader in Latvia in connection with conducting a widespread online account intrusion scheme in which he manipulated the prices of more than 100 NYSE and NASDAQ securities and caused more than \$2 million in harm to customers of U.S. brokerage firms.<sup>1438</sup> The SEC also instituted related administrative proceedings against four electronic trading firms and eight executives charged with enabling the trader's scheme by allowing him anonymous and unfiltered access to the U.S. markets.<sup>1439</sup> In these related actions, the SEC either accepted settlements from respondents that included civil money penalties or the actions were litigated, resulting in an ALJ imposing sanctions that included civil money penalties.<sup>1440</sup>

**Principle 36: Additional Question Related to 36.2 and 36.3 above, for 2014 Assessment:**

★★

- **Information on criminal sanctions imposed for major offences, such as insider trading and market manipulation.**

Below is a representative sample of criminal sanctions imposed during the last three years for major offences, such as insider trading and market manipulation. The representative list above of administrative/civil sanctions imposed during the last three years on major misconducts also references parallel criminal proceedings brought with the SEC's actions. For additional information regarding major criminal sanctions in 2011-2013, please refer to the DOJ's website.

**Market or price manipulation**

- On February 27, 2013, a federal court sentenced Blake Williams and Derek Lopez to 32 and 24 months in prison, respectively, in connection with orchestrating a scheme to manipulate the prices of securities that traded in the OTC market. After obtaining control of large stock positions in various publicly traded companies, Williams, Lopez, and others then coordinated trades among each other to create the false appearance of greater investor interest in the stock and then resold the stock at inflated prices, accruing gains of over \$1 million. The

<sup>1438</sup> SEC v. Igors Nagaicevs, Lit. Rel. No. 22238 (Jan. 26, 2012).

<sup>1439</sup> In the Matter of Alchemy Ventures, Inc., et al., Exchange Act Rel. No. 66249 (Jan. 26, 2012).

<sup>1440</sup> Most respondents settled, agreeing to sanctions including disgorgement, civil money penalties, and cease-and-desist orders. See *In the Matter of Mercury Capital and Lisa R. Hyatt*, Exchange Act Rel. No. 66248 (Jan. 26, 2012); *In the Matter of Alchemy, et al.*, Exchange Act Rel. No. 67028 (May 18, 2012); *In the Matter of Alchemy, et al.*, Exchange Act Rel. No. 67206 (June 15, 2012). In the litigated action against one of the trading firms and its principal, an ALJ found that they violated Section 15(a) of the Exchange Act by acting as unregistered broker-dealers and imposed sanctions, including civil money penalties. See *In the Matter of Alchemy, et al.*, Initial Decision No. 473 (Nov. 28, 2012); *In the Matter of Alchemy, et al.*, Exchange Act Rel. No. 66801 (Apr. 12, 2012).

court also ordered Williams to forfeit \$125,000 and Lopez to forfeit \$72,442; and sentenced both to serve two years of supervised release.<sup>1441</sup>

- On May 16, 2013, a federal court sentenced Joshua Wayne Lankford, a former stockbroker, to 84 months in prison and ordered him to forfeit \$250,000 for his role in an extensive pump-and-dump stock manipulation scheme. Lankford and his co-conspirators obtained a majority of the free-trading shares of stock of three publicly traded companies that they intended to manipulate. Subsequently, they engaged in coordinated trading in order to create the appearance of investor demand for these stocks, after which they conducted massive promotional campaigns in which they sent millions of unsolicited fax and email “blasts.” Lankford and others obtained significant profits by selling large amounts of shares after they had artificially inflated the stock price. The court sentenced co-conspirator James Reskin to serve five years of probation for his role in the scheme. In May 2010, a jury convicted co-conspirators George David Gordon and Richard Clark; a federal court sentenced Gordon to serve 188 months in prison and sentenced Clark to serve 151 months in prison.<sup>1442</sup>

### **Misleading information**

- On June 29, 2012, Peter B. Madoff, the CCO and Senior Managing Director at Bernard L. Madoff Investment Securities LLC (BMIS), pleaded guilty in federal court to conspiracy to commit securities fraud, falsify records of an investment adviser and of a broker-dealer, and making false filings with the SEC.<sup>1443</sup> The court imposed a 10-year prison sentence and ordered him to forfeit approximately \$143 million in personal assets. In a related action, on December 30, 2013, the SEC suspended Madoff from appearing or practicing before the SEC for purporting to create policies and procedures for BMIS’ investment advisory operations and its compliance program, even though no such policies and procedures ever existed, and for creating false and misleading compliance documents, making false statements to investors about BMIS’ compliance program, and filing false reports with the SEC.<sup>1444</sup>

<sup>1441</sup> *Stock Manipulators Sentenced in Texas to Prison for \$1 Million Securities Fraud Scheme*, Press Rel., Dept. of Justice (Feb. 27, 2013).

<sup>1442</sup> *Former Dallas Securities Broker Sentenced in Oklahoma to 84 Months in Prison for Role in Stock Manipulation Scheme*, Press Rel., Dept. of Justice (May 16, 2013).

<sup>1443</sup> See *United States v. Peter Madoff*, 10 Cr. 228 (S.D.N.Y. June 29, 2012) (LTS).

<sup>1444</sup> *In the Matter of Peter B. Madoff, Esq.*, Exchange Act Rel. No. 71207 (Dec. 30, 2013).

- On May 9, 2013, David Applegate, a former senior executive of ArthroCare Corp, pleaded guilty to conspiracy to commit securities fraud.<sup>1445</sup> Applegate admitted that he and others falsely inflated ArthroCare's sales and revenue and that they caused ArthroCare to file reports with the SEC that materially misrepresented ArthroCare's sales, revenues, expenses, and earnings. After the company announced publicly that it would be restating its previously reported financial results, the company's stock price dropped, causing an immediate loss in shareholder value of more than \$400 million. In a related case, on July 23, 2013, John Raffle, another former ArthroCare senior executive, pleaded guilty for his role in the scheme.<sup>1446</sup> Applegate and Raffle consented to the entry of permanent injunctions in federal court in the SEC's related case; and the court ordered Applegate to pay over \$620,000 in disgorgement plus interest and Raffle to pay over \$1.78 million in disgorgement plus interest.<sup>1447</sup> Sentencing has been scheduled for Aug. 29, 2014.
- On May 21, 2013, a jury convicted Mitchell J. Stein of conspiracy to commit securities fraud, money laundering, and conspiracy to obstruct justice for his role in operating a five-year, multimillion-dollar fraud by generating false information about a publicly traded company, Signalife Inc. Stein engaged in a scheme to inflate the price of Signalife stock by disseminating false information about the company's product sales. Stein and his co-conspirators created fake purchase orders and related documents from fictitious customers, then caused Signalife to issue press releases and file documents with the SEC trumpeting these fictitious product sales.<sup>1448</sup> The SEC conducted a parallel investigation that resulted in a civil enforcement action against Stein and others, filed in December 2011.<sup>1449</sup> Sentencing has been scheduled for October 24, 2014.
- In November 2013, JP Morgan agreed to settle charges brought by federal and state agencies that the firm misrepresented to investors that the mortgage loans in certain residential mortgage-backed securities complied with underwriting guidelines when the firm knew that they did not and were not otherwise appropriate for securitization. JP Morgan agreed to pay \$13 billion to settle the

<sup>1445</sup> *Former Senior Executive of Arthrocare Corp. Pleads Guilty in \$400 Million Securities Fraud Scheme*, Press Rel., Dept. of Justice (May 9, 2013).

<sup>1446</sup> *Former Senior Executive of ArthroCare Corp. Pleads Guilty in \$400 Million Securities Fraud Scheme*, Press Rel., Dept. of Justice (July 23, 2013).

<sup>1447</sup> *SEC v. John Raffle, David Applegate and Kathy Raffle (Relief Defendant)*, Lit. Rel. No. 22027 (July 5, 2011).

<sup>1448</sup> *Attorney Convicted in Multimillion-Dollar Stock Fraud*, Press Rel., Dept. of Justice (May 21, 2013).

<sup>1449</sup> *SEC Charges Heart Tronics, Inc. and Six Individuals in Connection with a Series of Fraudulent Schemes Pumping Company Stock*, Lit. Rel. No. 22204 (Dec. 20, 2011).



civil claims, including \$4 billion to aid consumers harmed by the unlawful conduct.<sup>1450</sup>

- On December 6, 2013, a federal court sentenced William Dean Chapman, the founder and owner of Alexander Capital Markets (ACM), to serve 144 months in prison for orchestrating a \$270 million stock loan scheme that defrauded 122 clients. ACM's clients provided securities as collateral for loans of 85% to 90% of the securities' value. Contrary to its claims, ACM sold the securities upon receipt, gave borrowers the loan amount, and kept the remaining proceeds for itself and the parties who assisted with the scheme. Chapman continued to solicit new customers despite knowing that ACM would never be able to fulfill its financial obligations.<sup>1451</sup>
- In May 2014, Bradley Holcom, a commercial real estate developer, pleaded guilty to criminal charges that he committed fraud by selling \$50 million worth of promissory notes to investors, falsely claiming that the investors had a priority lien on property that he was developing. In addition, he continued to solicit investors for new funds by making misrepresentations about his financial condition and the manner in which he was using investor money.<sup>1452</sup> Sentencing has been scheduled for October 3, 2014.

### ***Insider Trading***

- On May 26, 2011, Donald Johnson, a former managing director of The NASDAQ Stock Market pleaded guilty to insider trading as a result of purchasing and selling stock in NASDAQ-listed companies based on material, nonpublic information he obtained in his capacity as a NASDAQ executive. Johnson worked on NASDAQ's market intelligence desk monitoring the stock of companies traded on the exchange. Companies routinely entrusted Johnson with material, nonpublic information about their stock, including advance notice of announcements concerning earnings, regulatory approvals and personnel changes, and Johnson repeatedly traded on the basis of this information, generating gains totaling more than \$640,000.<sup>1453</sup> (See related SEC action discussed above.)

<sup>1450</sup> *Federal and State Partners Secure Record \$13 Billion Global Settlement with JPMorgan for Misleading Investors About Securities Containing Toxic Mortgages*, Press Rel., Dept. of Justice (Nov. 19, 2013).

<sup>1451</sup> *Virginia Man Sentenced for Conducting \$270 Million Investment Fraud Scheme*, Press Rel., Dept. of Justice (Dec. 6, 2013).

<sup>1452</sup> *Real Estate Developer Pleads Guilty to \$50 Million Securities Fraud Scheme*, Press Rel., Dept. of Justice (May 8, 2014).

<sup>1453</sup> *Former NASDAQ Executive Pleads Guilty to Insider Trading*, Press Rel., Dept. of Justice (May 26, 2011).



- On March 5, 2012, a federal court sentenced Cheng Yi Liang, a former Food and Drug Administration (FDA) chemist, to 60 months in prison for engaging in insider trading based on material, nonpublic information he obtained in his capacity as an FDA scientist. The court previously ordered Liang to forfeit \$3.7 million representing the proceeds of the insider trading scheme. Liang reviewed FDA computer systems that contained confidential information about experimental drugs undergoing the FDA's approval process. He then purchased stocks of drug companies experiencing favorable reviews and sold short the stocks of companies when the FDA's information was negative.<sup>1454</sup>
- On April 10, 2014, a federal court accepted the guilty pleas and sentenced S.A.C. Capital Advisors, L.P. and several affiliated entities that manage hedge funds in connection with insider trading by their employees. For over a decade, numerous employees of the SAC companies obtained and traded on material, nonpublic information about more than 20 issuers, or recommended trades based on such information to SAC companies' portfolio managers. The court imposed a sentence that included a criminal fine of \$900 million, a statutory maximum five-year term of probation for each of the companies, the condition that the companies terminate their investment advisory business, effectively closing their hedge funds to outside investors, and requirements that the defendants use the compliance procedures necessary to identify and prevent insider trading and retain an independent compliance consultant to review and report on those procedures to the government.<sup>1455</sup> Together with the settlement of the civil forfeiture action, which a federal court approved on Nov. 6, 2013, the hedge funds are required to pay \$1.184 billion financial penalty on top of the \$616 million the SAC companies agreed to pay to the SEC in its related action.

<sup>1454</sup> *Former FDA Chemist Sentenced to 60 Months in Prison for Insider Trading*, Press Rel., Dept. of Justice, (Mar. 5, 2012).

<sup>1455</sup> *SAC Capital Management Companies Sentenced In Manhattan Federal Court For Insider Trading*, Press Rel., U.S. District Attorney, Southern District of New York (Apr. 10, 2014).

***Other fraudulent or deceptive conduct and market abuses***

- On December 18, 2013, two employees and a Bermuda brokerage subsidiary of ConvergeX Group LLC pleaded guilty to charges of conspiracy to commit securities fraud by making misrepresentations and omissions to customers regarding the firm's practice of routing orders to the Bermuda affiliate which then added undisclosed mark-ups and mark-downs to the price of the securities.<sup>1456</sup> ConvergeX Group and the subsidiary agreed to pay \$43.8 million in criminal penalties and restitution. (See related SEC action discussed above.)

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<sup>1456</sup> *ConvergeX Group Subsidiary and Two Employees Plead Guilty to Securities and Wire Fraud Charges*, Press Rel., Dept. of Justice (Dec. 18, 2013).

## Principle 37 Regulation should aim to ensure the proper management of large exposures, default risk and market disruption

### Key Questions

#### *Monitoring of Large Exposures*

1. Does the market authority have a mechanism in place that is intended to monitor and evaluate continuously the risk of open positions or credit exposures that are sufficiently large to expose a risk to the market or to a clearing firm that includes:

- (a) Qualitative or quantitative trigger levels appropriate to the market for the purpose of identifying large exposures (as defined by the market authority), continuous monitoring and an evaluative process?

Yes. There are mechanisms in place to monitor and evaluate large positions at both broker-dealers and clearing agencies.

#### **Broker-Dealers**

The SEC's financial responsibility rules for broker-dealers provide, among other things, that a broker-dealer must be in capital compliance at all times. The SEC's net capital rule requires that broker-dealers haircut securities positions to account for the market risk of the position to the firm,<sup>1457</sup> and these charges include capital charges specific to the broker-dealers' exceeding certain position limits. To the extent that a broker-dealer's net capital falls below 25% of its haircuts on proprietary positions, it is restricted from withdrawing large amounts of capital from the firm. Further, if the market value of a securities position exceeds 10% of the tentative net capital of the broker-dealer, the broker-dealer must apply an additional haircut to the amount in excess. To the extent that a broker-dealer's net capital falls below the amount it is required to maintain, the firm must immediately notify the SEC and its DEA. As part of helping to ensure that a broker-dealer remains in capital compliance at all times, the Staff, and staff from the firm's DEA monitor and evaluate the risk of open positions and credit exposures. SEC and DEA monitoring and oversight is accomplished via the ongoing review of monthly and quarterly FOCUS reports,<sup>1458</sup> regular meetings and discussions with the firms, and regular examinations. Please see Principle 30 for a fuller description of the SEC's net capital rule.

#### **Clearing Agencies**

The SEC has implemented monitoring mechanisms at the clearing agency level. Clearing agencies, specifically clearing agencies that perform CCP services, have a range of tools that can be used to manage the financial risks to which they are exposed, and the tools that an individual CCP uses will depend upon the nature of its obligations. Nonetheless, there is a common set of

<sup>1457</sup> 17 C.F.R. 240.15c3-1(c)(2)(vi)(M).

<sup>1458</sup> 17 C.F.R. 240.17a-5(a).

procedures that are implemented by many CCPs to manage counterparty credit and liquidity risks. Broadly, these procedures enable CCPs to manage their risks by limiting the likelihood of defaults, by limiting the potential losses and liquidity pressures if a default should occur, and by ensuring that there are adequate resources to cover losses and meet payment obligations on schedule.

To manage its counterparty credit exposures to its participants effectively, a clearing agency must be able to measure those exposures. A clearing agency can ascertain its current credit exposure to each participant by marking each participant's outstanding contracts to current market prices and (to the extent permitted by a clearing agency's rules and supported by law) netting any gains against any losses. A clearing agency faces the risk that its exposure to a participant can change as a result of a change in prices, in positions, or both.

The current practice of each CCP registered with the SEC includes these procedures:

(i) measuring credit exposures at least once a day; (ii) setting margin coverage at a 99% confidence level over some set period; (iii) using risk-based models; (iv) establishing a fund that mutualizes losses of defaults by one or more participants that exceed margin coverage; and (v) maintaining sufficient financial resources to withstand the default of at least the largest participant family, and in the case of SBS transactions, maintaining enough financial resources to be able to withstand the default of their two largest participant families.

Additionally, the SEC adopted rules concerning risk management requirements for CCPs. On October 22, 2012, the SEC adopted Rule 17Ad-22 under the Exchange Act. Rule 17Ad-22 is intended to strengthen the substantive regulation of registered clearing agencies, promote the safe and reliable operation of registered clearing agencies, and improve efficiency, transparency, and access to registered clearing agencies by establishing minimum requirements, with due consideration given to observed practices and international standards.

Specifically, Rules 17Ad-22(b)(1)–(4) concern risk management requirements for clearing agencies that perform CCP services. In particular, these rules require a clearing agency that provides CCP services to have written policies and procedures reasonably designed to: measure its credit exposures at least once a day, use margin requirements to limit its exposures to potential losses from defaults by its participants, use risk-based models and parameters to set margin requirements and to review such requirements at least monthly, maintain sufficient financial resources to withstand a default by the two participant families, if clearing SBSs, or one participant family otherwise, to which it has the largest exposure, and provide for an annual model validation process.

Rules 17Ad-22(b)(1)–(4) provide minimum standards regarding how clearing agencies manage counterparty credit and default risks. One of the primary roles of a CCP is to mitigate counterparty credit and default risk. Because of the role margin plays in a default, a CCP must have confidence that the liquidation value of available margin will be sufficient to cover amounts owed by a defaulting participant to the clearing agency, and that the margin will be available for liquidation without delay. To effectively mitigate counterparty credit risk, a CCP must have

accurate and timely measurements of its credit exposures to each of its counterparties, and must impose adequate margin requirements determined by risk-based models and parameters. CCPs may be faced with significant and rapid changes in counterparty credit exposures.

- (b) Access to information, if needed, on the size and beneficial ownership of positions held by direct customers of market intermediaries?

Yes, The SEC has access to information on the size and beneficial ownership of positions held by direct customers of market intermediaries.

Broker-dealers are required to create and maintain records regarding all securities positions<sup>1459</sup> and the accounts to which they belong.<sup>1460</sup> This information includes the size of every position held in each account, and the identity and address of the beneficial owner of each account. Broker-dealers are required to provide this information to the SEC upon request.<sup>1461</sup>

- (c) The power to take appropriate action against a market participant that does not provide relevant information needed to evaluate an exposure (e.g., require liquidation of positions, increase margin requirements and/or revoke trading privileges)?

Yes, the SEC has the power to take appropriate action against a market participant that does not provide relevant information needed to evaluate an exposure.

### Broker-Dealers

A broker-dealer must comply with applicable securities laws, rules and regulations, including making and keeping specified records and reports. These records and reports include, among other things, detailed information about the broker-dealer's proprietary positions as well as positions held on behalf of customers. To the extent that a broker-dealer fails to provide information requested by the SEC,<sup>1462</sup> the SEC may take appropriate action against the broker-dealer. As an SEC-registered entity, broker-dealers are subject to the full range of the SEC's enforcement authority. A broker-dealer must also comply with the rules of each SRO of which it is a member. To the extent that a broker-dealer fails to furnish information requested by an SRO, the SROs have rules as to what action the SRO may take. In the event a broker-dealer fails to comply with either the SEC's rules, or the rules of FINRA, the SEC and FINRA have the ability to, among other things, raise the capital requirement of a carrying or clearing broker-dealer or require the broker-dealer to curtail its business activities.

<sup>1459</sup> 17 C.F.R. 240.17a-3(a)(5).

<sup>1460</sup> 17 C.F.R. 240.17a-3(a)(3), (5), and (9).

<sup>1461</sup> 17 C.F.R. 240.17a-4(j).

<sup>1462</sup> 15 U.S.C. 78q(b)(1) and 17 C.F.R. 240.17a-4(j).

### Clearing Agencies

Section 17 of the Exchange Act requires registered clearing agencies to make and keep records, and authorizes the SEC to obtain any such documents upon request. The SEC has the authority to examine the records of a clearing agency at any time and communicates with clearing agencies on a regular basis.

Pursuant to Section 21(a) of the Exchange Act, the SEC may initiate and conduct investigations to determine if there have been violations of the federal securities laws, including those specifically applicable to clearing agencies. Following an investigation, the SEC has the authority to institute civil actions seeking injunctive and other equitable remedies and/or administrative proceedings to, among other things, suspend or revoke registration; impose limitations upon a clearing agency's activities, functions, or operations; or impose other sanctions, such as undertakings.

Additionally, the SEC has broad authority to grant, deny, or revoke the registration of a clearing agency pursuant to Exchange Act § 17A and Rule 17Ab2-1, and also has discretion to approve, modify, or deny any rule change submitted under the SRO rule filing process, pursuant to the requirements of Exchange Act § 17A and 19(b) and Form 19b-4. Together, these sections create a legal framework whereby the SEC has authority to condition the registration of a clearing agency on specified terms, revoke that registration if the clearing agency fails to abide by those terms, and monitor the rules and operations of a clearing agency on an ongoing basis. This authority is broad. Section 3(a)(27) of the Exchange Act defines the "rules" of a clearing agency to include "the constitution, articles of incorporation, bylaws, and rules, or instruments corresponding to the foregoing . . . and such of the stated policies practices, and interpretations of such [clearing agency] as the SEC, by rule, may determine to be necessary or appropriate in the public interest or for the protection of investors to be deemed to be rules of such [clearing agency]."

See also response to subparagraph (d) question below.

- (d) The general power to take appropriate action, such as to compel market participants carrying or controlling large positions to reduce their exposures or to post increased margin?

Yes, There are a number of actions that can be taken to address financial risks of market participants.

### Broker-Dealers

In addition to utilizing the tools referenced in the answer to Question 37.1(c), acting in coordination with the SEC, the broker-dealer's SRO has a range of actions it may invoke under appropriate circumstances. Those actions may include trading limits, forced liquidation,

increased margin requirements, revocation of trading privileges, suspension from trading, and imposition of higher capital charges. In addition, an SRO may take steps to shut the broker-dealer down, either through imposition of a suspension or bar, or by revocation of the broker-dealer's membership (pursuant to the SEC's registration rules, a broker-dealer must be a member of at least one SRO in order to do business).

The margin rules also help SROs control the risk of open positions. Although the Federal Reserve's Regulation T sets minimum initial margin levels,<sup>1463</sup> the SROs are responsible for setting margin maintenance requirements.<sup>1464</sup> In addition, the SROs may set initial margin levels higher than those set pursuant to Regulation T.<sup>1465</sup> Thus, an SRO could increase the margin level for a particular security, forcing an individual or entity to post additional margin or reduce a position in order to comply with the new margin level.

### Clearing Agencies

In addition to utilizing the tools referenced in the answer to Question 37.1(c), acting in coordination with the SEC, the clearing agencies' SRO has a range of actions it may invoke under appropriate circumstances. A clearing agency may place a firm that is a bank netting member, dealer netting member or inter-dealer broker netting member on a watch list based on that member's rating as determined by the clearing agency's credit risk rating matrix. Clearing agencies may place other types of members on the watch list without assigning them a rating under this matrix. A member's continued activities with a clearing agency may be limited, or it may be required to post an additional deposit to the clearing fund, if the member fails to comply with the clearing agency's operational standards and requirements. In addition, a clearing agency may prohibit a member from taking on new positions if it deems the member to be a financial concern.

2. Do arrangements, whether formal or informal, exist to enable markets and regulators to share information on large exposures of common market participants or on related products with regulators and markets:

(a) In the domestic jurisdiction?

(b) In other relevant jurisdictions?

Yes, The SEC has in place arrangements to share information on supervisory issues both internationally and domestically.

There are arrangements for the sharing of large trader and other concentration risk, both

<sup>1463</sup> 15 U.S.C. 78g(a).

<sup>1464</sup> See, e.g., FINRA Rule 4210(c) and (f)(8)(A).

<sup>1465</sup> See, e.g., FINRA Rule 4210(b)(3) and (f)(8)(A).

domestically and, to some extent, cross-border. The SEC has an MOU for information sharing arrangement with the Federal Reserve and is in regular contact with other financial regulators both in the U.S. and abroad about key developments they are observing and the risks they pose to individual firms and the broader marketplace. These include observations about issues at broker-dealers, mutual funds, and insurance companies and are used to inform views about emerging issues. In addition, the SEC has entered into bilateral agreements with various agencies that allow the SEC to share information on a timely basis with those agencies.

In addition, the SEC has entered into MOUs with other domestic regulatory agencies such as the Federal Reserve (in 2008) and the CFTC (also in 2008) regarding the clearance and settlement of financial products.

The SEC routinely cooperates and coordinates with other regulatory authorities outside of the U.S., including entering into MOUs, and shares information with such authorities regarding clearing agencies. The SEC has entered various MOUs, including information-sharing arrangements; and supervisory cooperation arrangements with foreign regulators, including the following jurisdictions: Brazil (2012), Canada (2011, 2010), Germany (2007), Australia (2008), Belgium (2006), and the United Kingdom (2006, 2011).

The SEC also participates in regular supervisory colleges with other U.S. and foreign regulators that permit the U.S. and foreign regulators to act in a coordinated manner regarding issues of mutual regulatory interest. These working groups and supervisory activities consist of:

- College of Supervisors: Acting under the auspices of the FSB recommendations, holding company supervisors have established a College of Supervisors for each large global financial institution in order to enhance cooperation among regulators internationally. The colleges typically consist of one in-person meeting annually, with *ad hoc* conference calls throughout the year.
- Crisis Management Groups (CMG): Also under the auspices of the FSB, U.S. and foreign regulators have established a CMG for each large global financial institution to facilitate institution-specific crisis management planning and cooperation between and among relevant authorities.
- Ongoing supervisory meetings at Alternative Net Capital Broker-Dealers: As part of the ongoing supervision of ANC Broker-Dealers, Division staff attends regularly scheduled monthly and quarterly meetings at the ANC Broker-Dealers. The meetings may also be attended by supervisors for affiliates of the ANC Broker-Dealers such as the Federal Reserve staff. Each existing ANC Broker-Dealer has either a national bank affiliate supervised by the OCC or a New York state chartered bank supervised by the New York State Banking Department. The OCC or the New York State Banking Department also conducts ongoing supervisory meetings with the holding companies of the ANC Broker-Dealers.



- **Quants without Borders (QwB) and ongoing model reviews:** QwB is a multilateral interagency working group co-chaired by the Federal Reserve and the SEC. QwB provides a forum for quantitative specialists to discuss various aspects of the financial models used by large firms and other quantitative risk management controls. In addition, QwB is intended to foster the opportunity to achieve more coordination of schedules and resources among the agencies regarding ongoing models reviews.
- **Supervisory Colleges for Credit Rating Agencies:** Consistent with the *IOSCO Final Report on Supervisory Colleges for Credit Rating Agencies*, OCR took the lead in a collaboration by international supervisors to establish supervisory colleges for each of the large, globally active credit rating agencies (Fitch, Moody's and S&P). The colleges serve as a resource for credit rating agency supervisors by facilitating, among other things, information exchange. The colleges typically consist of one in-person meeting annually and three conference calls throughout the year.

The SEC's participation in these interagency meetings provides a forum for regulators to discuss issues of potential concern.

Staff is in frequent contact weekly with senior officers at regulated broker-dealers and asset managers, among others, in order to help understand market developments that could adversely impact systemic institutions or markets. Outside of these groups, information, either specific to a large position or of general regulatory concern, may be shared on a case by case basis, as appropriate. If such is the case, the regulator or market participant may share certain information with another regulator (for instance, an SRO may discuss a large option position at a firm with the Staff).

See Principle 6 discussion pertaining to MOUs and SEC's annual evaluation of the metrics and data used to designate the FMUs.

#### *Default Procedures – Transparency and Effectiveness*

3. Does a market authority make its default procedures available to market participants, including specifically information concerning:

(a) The general circumstances in which action may be taken?

(b) Who may take it?

(c) The scope of actions which may be taken.

Yes, the SEC makes the information listed with regard to its default procedures available to market participants.

Generally, before a broker-dealer becomes illiquid it must cease doing a securities business (*i.e.*, when a firm's net capital falls below the required amount, it must cease doing a securities

business: this generally occurs before the firm becomes illiquid). Federal securities regulation is designed to achieve an orderly liquidation of a broker-dealer that is in financial difficulty. Customer securities and monies are segregated from proprietary positions and monies so that if a liquidation were to occur, those customer securities and funds would be available to satisfy customer claims and would not be available to satisfy claims of creditors of the broker-dealer. To the extent that a broker-dealer approaches financial difficulty, a broker-dealer must file telegraphic notice with the SEC and its DEA. These laws and regulations are publicly available.

To the extent that a broker-dealer must liquidate, unless the broker-dealer were determined to be a “covered broker-dealer” under Title II of the Dodd-Frank Act, the U.S. bankruptcy laws would apply. Thus, either the broker-dealer itself could seek the protection of the bankruptcy court, or the SEC or SIPC could seek to do so if, in general terms, a broker-dealer is in or nearing financial distress. It is important to note that with respect to a broker-dealer that holds customer funds or securities, SIPA may also apply. Finally, if the broker-dealer is a member of a clearing agency, the clearing agency rules may apply to the rights of the clearing agency to close out any open exposures to its defaulting clearing members. These laws and rules are publicly available.

SIPA is designed to restore funds and securities to customers of financially troubled brokerage firms and to insulate the securities markets from disruption following the failure of broker-dealers. With limited exceptions, all broker-dealers are members of SIPC. Generally, when a broker-dealer goes out of business, it self-liquidates by transferring customer accounts to a new firm. When a self-liquidation is not possible, and a court supervised proceeding is needed, SIPA replaces the liquidation process under Title 11 of the U.S. bankruptcy code, though these processes are similar in many respects and a SIPA proceeding is conducted in a U.S. bankruptcy court. SIPC either acts as trustee or works with an independent court-appointed trustee in a brokerage insolvency case to recover brokerage assets. The trustee in a SIPA liquidation is responsible for, among other things, distributing customer property and liquidating the failed broker-dealer. Whenever feasible, customer accounts are quickly transferred to another operating broker-dealer to facilitate customers’ orderly receipt of cash and securities and continuing access to brokerage services. If a broker-dealer is not able to meet its obligations to customers, then customers’ cash and securities held by the broker-dealer are returned to customers on a *pro rata* basis. If sufficient funds are not available at the firm to satisfy customer net equity claims, the reserve funds of SIPC are used to supplement the distribution, up to \$500,000 per customer, including a maximum of \$250,000 for cash claims.

### **Clearing Agencies**

In the context of the SRO framework, each registered clearing agency makes publicly available rules, policies or procedures that set forth the actions the clearing agency may take in the event of a participant default, with the exception of certain of their policies and procedures that are kept nonpublic to ensure their integrity, such as those associated with the oversight of clearing participants. For example, clearing agency rules typically state what constitutes a default, identify whether the board or a committee of the board may make that determination and describe what

steps the clearing agency may take to protect itself and its participants. In this regard, clearing agencies typically attempt, among other things, to close-out, to hedge or to liquidate a defaulting participant's positions.

In addition, the SEC adopted rules governing default management requirements for registered clearing agencies. Rule 17Ad-22(d)(11) requires registered clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to make key aspects of their default procedures publicly available and establish default procedures that ensure that the clearing agency can take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a participant default.

In addition, pursuant to existing SEC regulations, changes to the rules of an SRO, including clearing agencies, are required to be available on the SRO's website and are published by the Commission.

Clearing agencies take action with respect to a participant default pursuant to their published rules and procedures. As delineated in their rules and procedures, a clearing agency's participation requirements, and rules and procedures governing access address the circumstances under which a CCP can suspend or terminate participants' membership and the arrangements a CCP has in place to facilitate the suspension and orderly exit of participants that no longer meet the participation requirements.

The scope of the action is set forth in the published rules and procedures of each clearing agency. A clearing agency will generally suspend or cease to act for a participant that is in default to the clearing agency.

4. Do default procedures and/or national law permit markets and/or the clearing and settlement system(s) promptly to isolate the problem of a failing firm by addressing its open proprietary positions and positions it holds on behalf of customers or otherwise protect customer funds and assets from an intermediary's default under national law?

Yes, there are comprehensive provisions in place to protect customer funds and assets from an intermediary's failure.

### **Broker-Dealers**

The Exchange Act provides that the SEC must set financial responsibility rules for broker-dealers. In accordance with the Exchange Act, the SEC promulgated a number of rules including the Customer Protection Rule,<sup>1466</sup> the Hypothecation Rules,<sup>1467</sup> and the Quarterly Count Rule.<sup>1468</sup>

<sup>1466</sup> 17 C.F.R. 240.15c3-3.

<sup>1467</sup> 17 C.F.R. 240.8c-1 and 15c2-1.

These rules help protect customer property and assure that customers have first priority in the event of the liquidation of a broker-dealer.

The SEC's Customer Protection Rule requires that every broker-dealer obtain and maintain possession and control of customer securities, and maintain a reserve account for the exclusive benefit of customers that contains (at least) the net dollar amount of cash the broker-dealer owes to its customers. The SEC's Hypothecation Rules require that a broker-dealer segregate customer securities from its own proprietary securities, and prohibit a broker-dealer from hypothecating customers' fully paid securities. The SEC's Quarterly Count Rule requires that broker-dealers count positions owed to customers and securities on hand and reconcile those two numbers on a quarterly basis. In addition, the SROs have rules that restrict a broker-dealer's use of customer securities.<sup>1469</sup> Combined, these rules serve to reduce the risk that a firm failure will have a widespread detrimental effect on the marketplace and customers and alert the SEC and SROs to a potential failure so that any impact may be minimized.

In addition, the SEC's Books and Records Rules require that a broker-dealer create and maintain certain books and records relating to its business, including: ledger accounts as to each customer account and each account of the broker-dealer that itemize every purchase, sale, receipt and delivery of securities and commodities, and all other debits and credits; and a securities record or ledger reflecting for each security which accounts hold the security and what quantity the account holds, and where the securities positions are held (*e.g.*, in a vault, at DTC, in transfer, etc.). These records can be used to distinguish firm and customer positions, deposit collateral, and accrual proceeds, and identify the underlying nature of participants in omnibus accounts.

The net capital rule requires that all broker-dealers maintain certain minimum level of liquid net capital at all times. All broker-dealers are subject to the SEC's Net Capital Rule. If a firm's net capital falls below the level of net capital it is required to maintain pursuant to the rule, that firm must cease doing a securities business. New firms are subject to more stringent capital requirements than firms that have been in the business for more than one year. The SEC's Net Capital Rule serves multiple purposes. It serves to: (i) ensure that a firm has sufficient liquid assets to meet ongoing liabilities as they come due; (ii) allow for orderly liquidation on the failure of a firm and may go to repay liabilities to customers to the extent that the firm has not otherwise sufficiently segregated or reserved for those liabilities to customer subject to Exchange Act Rule 15c3-3 (commonly referred to as the Customer Protection Rule);<sup>1470</sup> and (iii) protect the financial system from systemic risk.

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<sup>1468</sup> 17 C.F.R. 240.17a-13.

<sup>1469</sup> See, *e.g.*, FINRA Rules 2150 and 4330.

<sup>1470</sup> 17 C.F.R. 240.15c3-3.

The early warning rule requires that a broker-dealer file telegraphic notice with the SEC and its DEA if: its net capital is reduced to an amount within a certain percentage of the amount it is required to have by the rule; it fails to make and keep current books and records; or, it is informed by its independent public accountant of the existence of a material inadequacy. To the extent a broker-dealer is experiencing financial difficulty, its SRO may restrict its activities or cause it to reduce its business.<sup>1471</sup>

Although bankruptcy code provisions do apply, they generally allow a financial institution to liquidate financial instruments and close-out open positions in order to reduce exposure to an insolvent firm. For example, a financial institution holding a repurchase agreement or stock loan with a broker-dealer that becomes illiquid may liquidate collateral to close out that position. In addition, if a broker-dealer were to self-liquidate, it may transfer customer positions to another broker-dealer.

### **Clearing Agencies**

Section 17A(b)(3)(F) requires that the rules of a registered clearing agency be designed to assure the prompt and accurate clearance and settlement of securities and the safeguarding of securities of funds which are in the custody or control of the clearing agency or for which it is responsible. Registered clearing agencies such as DTC, NSCC, and FICC have rules granting them clear authority to take over accounts, and manage positions, and utilize the defaulting participant's collateral to meet the participant's settlement obligations. The primary purpose of these rules is to minimize any losses that might result to the clearing agency and to its participants as a result of the default and to cause the least disruption to clearing participants and to the securities markets in general. Articles 8 and 9 of the Uniform Commercial Code provide legal certainty with respect to a clearing agency's lien on participants' collateral and provisions in the U.S. Bankruptcy Code, FDIA, FDICIA, and the SIPA provide legal certainty regarding a clearing agency's authority to liquidate or transfer a position and to apply margin or draw down liquidity resources in the event of the insolvency of a participant.

Generally, clearing agencies treat their participants as principals and do not distinguish between the participants' customer and proprietary positions.<sup>1472</sup> The rules of clearing agencies, however, include procedures to allow participants to keep customer positions separate from proprietary positions. For example, DTC allows participants to use delivery exemptions to prevent automated book-entry delivery of customer fully paid securities and the rules of the NSCC allow participants in certain circumstances to move open long positions to a fully paid for subaccount.

Clearing participants that clear customer positions are registered broker-dealers and, as such, are

<sup>1471</sup> See, e.g., FINRA Rule 4120.

<sup>1472</sup> An exception to this is the Options Clearing Corporation, which clears options and futures and follows a futures customer segregation regime.

subject to the SEC's customer protection rules in Rule 15c3-3 and the rules regarding the hypothecation of customer securities in Rule 8c-1. In addition, the insolvency of a broker-dealer that has customer accounts is administered by the SIPC pursuant to the framework in SIPA. In the event of a participant default, the clearing agency will work with the receiver appointed by SIPC to distribute customer cash and securities (SIPC provides some insurance coverage if there is a shortfall).

The rules and procedures of a clearing agency must be designed to assure the safeguarding of securities and funds—including customer securities and funds-- under its control or for which it is responsible. See Section 17A(b)(3)(F) of the Exchange Act of 1934.

In addition, Rule 17Ad-22(d)(3) requires registered clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to hold assets in a manner whereby risk of loss or of delay in access to them is minimized, and invest in instruments with minimal credit, market and liquidity risks. Compliance with the requirement is intended to improve the ability of the clearing agency to meet its settlement obligations by reducing the likelihood that assets securing participant obligations to the clearing agency would be unavailable or insufficient when the clearing agency needs to draw on them.<sup>1473</sup>

5. Is there a mechanism by which market authorities for related products can consult with each other in order to minimize the adverse effects of market disruptions?

Yes. There are mechanisms by which market authorities for related products can consult with each other in order to minimize the adverse effects of market disruptions.

The SEC has MOUs with several federal regulators. For example, an MOU with the CFTC on general regulatory cooperation states that the SEC and CFTC recognize that enhanced coordination and cooperation concerning issues of common regulatory interest is necessary in order to foster market innovation and fair competition and to promote efficiency in regulatory oversight.

As another example, the SEC has entered into an MOU with the CFTC and the Federal Reserve relating to CDSs which states that it reflects the agencies' intent to cooperate, coordinate and share information, including by establishing regulatory liaisons, in carrying out their respective responsibilities and exercising their respective authorities with regard to CCPs for CDSs.

The SEC also participates in firm-specific supervisory colleges and crisis management groups, as discussed more fully above. These forums permit U.S. and foreign regulators to discuss issues of mutual concern, and would provide another means for market authorities to consult with one another in order to minimize adverse effects associated with market disruptions.

<sup>1473</sup>

See Clearing Agency Standards at 66247-48.

In the case of broker-dealers experiencing financial or operational distress, there is a sharing of information on a real-time basis between SROs and exchanges so that the implications of ones actions can be understood by all and the impact assessed to the respective marketplaces.

With respect to clearing agencies, Staff participates in an FSOC FMU committee that serves as an information sharing forum on a variety of topics concerning designated FMUs. See the response to Principle 6 for further information regarding FSOC and the FMU designation process.

See also response to Principle 12.

### *Short Selling on Equity Market*

6. Does the relevant market authority provide for:

- (a) Controls which are appropriate to the equity market in question and that have as their goal to reduce or minimize the potential risks that could affect the orderly and efficient functioning and stability of equity markets including, at a minimum, a strict settlement of failed trades?
- (b) A reporting regime that provides timely short selling information to the market or, as a minimum requirement, to market authorities?
- (c) As part of an effective compliance and enforcement system (assessed under Principle 11), (i) measures that promote settlement discipline, including regular monitoring by the market authority of settlement failures and (ii) surveillance of short selling activities. Any deficiency here should also be taken into account in the assessment of principle 11.
- (d) Appropriate exceptions for certain types of transactions for efficient market functioning and development (such as, but not limited to, *bona fide* hedging, market making and arbitrage activities)?

Yes. The SEC provides appropriate controls for risks arising out of short selling that could affect the efficient functioning of equity markets, with appropriate exceptions for activities that contribute to efficient market functioning.

Regulation SHO is designed to reduce failures to deliver in equity securities, to target potentially problematic short selling<sup>1474</sup> and abusive "naked" short selling,<sup>1475</sup> and otherwise reduce the

<sup>1474</sup> Short selling involves a sale of a security that the seller does not own, or a sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. In order to deliver the security to the purchaser, the short seller will borrow the security, typically from a broker-dealer or an institutional investor. Typically, the short seller later closes out the position by purchasing equivalent securities on the open market and returning the security to the lender. In general, short selling is used to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand, or to hedge the risk of an economic long position in the same security or in a related security.

potential destabilizing effect that short selling, if used in an abusive manner, could cause on the equity markets.

Regulation SHO has four general principles. First, Regulation SHO contains detailed provisions regarding when a security can be marked “long,” “short,” or “short exempt.” Second, Regulation SHO’s “locate” requirement directs a broker or dealer, prior to effecting a short sale, to borrow or enter into an arrangement to borrow the security. Third, Regulation SHO requires that a clearing firm deliver securities by settlement date, or if the clearing firm has not done so, immediately purchase or borrow securities to close out a fail to deliver position resulting from a short sale by no later than the morning of the fourth day following trade date (also known as “T+4”). Fourth, Regulation SHO includes a “price test” which effectively restricts the price at which short sales may be effected. The price test is triggered whenever the price of the security drops 10% or more from the prior trading day’s closing price. Once triggered, the price test prevents short sales from being effected at or below the National Best Bid (also known as the NBB).

Regulation SHO provides certain exceptions to assist in promoting efficient market functioning and development. For example, Regulation SHO defines when a person or broker or dealer is “deemed to own” a security for short sale purposes, and provides certain exceptions to the deemed to own requirements for a broker or dealer that is engaged in certain arbitrage or hedging activity. Regulation SHO also provides an exception from the locate requirement to market makers engaged in *bona fide* market making activity. In addition, for market makers engaged in *bona fide* market making activity, the close out requirement is extended to the morning of the sixth day following trade date (also known as “T+6”).

As described on the SEC’s website,<sup>1476</sup> to increase the transparency surrounding short sale transactions, several SROs are providing on their websites daily aggregate short selling volume information for individual equity securities. The SROs are also providing website disclosure on a one-month delayed basis of information regarding individual short sale transactions in all exchange-listed equity securities. In addition, the SEC discloses twice-monthly disclosure on its website fails to deliver data for all equity securities. The SROs’ websites also provide the threshold securities list for those securities for which the SRO is the primary market.

The SEC has a robust examination and enforcement program to monitor for, and prosecute, violations of these rules. Also, the SROs have varying programs in place to monitor short selling activity, including, but not limited to, failures to deliver in equity securities.

<sup>1475</sup> Although abusive “naked” short selling is not defined in the federal securities laws, it refers generally to selling short without having stock available for delivery and intentionally failing to deliver stock within the standard three-day settlement cycle.

<sup>1476</sup> <http://www.sec.gov/answers/shortsalevolume.htm> (last visited May 8, 2014).



In addition to the general anti-fraud provisions of the federal securities laws, including Section 10(b) and Rule 10b-5 under the Exchange Act, the SEC has Rule 10b-21, a “naked” short selling anti-fraud rule. Rule 10b-21 highlights the liability of persons that are deceptive regarding their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate source or share ownership and who fail to deliver such securities by settlement date. A seller misrepresenting its short sale locate source or ownership of shares may intend to fail to deliver securities in time for settlement and, therefore, engage in abusive “naked” short selling.

**Principle 38      Securities settlement systems and central counterparties should be subject to regulatory and supervisory requirements that are designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.**

**\*\*\*Note: Due to the ongoing monitoring by IOSCO and CPSS of the implementation of the CPSS-IOSCO Principles for Financial Market Infrastructures, authorities are not expected to provide a self-assessment on this Principle. Nonetheless, below is a responsive overview on the topic.\*\*\***

The SEC is in full compliance with Principle 38.

The SEC's regulatory framework for clearance and settlement systems is designed to ensure that securities settlement systems and CCPs are fair, effective and efficient and that they reduce systemic risk. The SEC has broad statutory authority to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities. The SEC's authority includes requirements for registration of clearing agencies, periodic compliance inspections and examinations, and rules regarding risk management and operation standards for registered clearing agencies. In addition, the SEC has the authority to review all proposed rule changes of clearing agencies in their capacity as SROs.

The SEC's regulatory framework for clearing agencies consists of (i) Sections 17, 17A, 19 and 21 of the Exchange Act; (ii) Title VIII of the Dodd-Frank Act; and (iii) Exchange Act Rules 17a-1, 17Ad-22 and 19b-4. The term "clearing agency" is broadly defined under the Exchange Act, and covered entities are required to register with the SEC, contingent upon meeting statutory and regulatory standards. The SEC oversees a registered clearing agency through reviews of its risk management framework, conducting periodic inspections and examinations of its compliance with the Exchange Act and the rules thereunder, and assessing a clearing agency's technological infrastructure against SEC guidance. The SEC also reviews and can approve or disapprove of all the proposed rule changes of a clearing agency in its capacity as an SRO, which include, among other things, changes to a clearing agency's rulebooks, procedures and governance arrangements.

Title VIII provides for enhanced regulation of clearing agencies that have been designated as systemically important by the FSOC, which are known as "designated financial market utilities" (DFMUs). The SEC is the Supervisory Agency for four DFMUs under Title VIII, and regulates three other clearing agencies, two of which are DFMUs for which the CFTC is the Supervisory Agency. In 2012, the SEC adopted rules regarding standards for the risk management and operation of registered clearing agencies as well as an advance notice filing process for DFMUs. In 2014, the SEC proposed rules that would subject certain covered clearing agencies, including DFMUs for which the SEC is the Supervisory Agency, to enhanced requirements concerning risk management, operations, governance, and disclosure.

The following resources can be consulted for more information:

Securities Exchange Act of 1934

<http://www.sec.gov/about/laws/sea34.pdf>

Title VIII of the Dodd-Frank Act

<http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>

Rules adopted under 17 C.F.R. 240 (17a-1, 17Ad-22 and 19b-4)

[http://www.ecfr.gov/cgi-bin/text-](http://www.ecfr.gov/cgi-bin/text-idx?SID=2f4c198e63bec9e6edc4541934ee71cb&tpl=/ecfrbrowse/Title17/17cfr240_main_02.tpl)

[idx?SID=2f4c198e63bec9e6edc4541934ee71cb&tpl=/ecfrbrowse/Title17/17cfr240\\_main\\_02.tpl](http://www.ecfr.gov/cgi-bin/text-idx?SID=2f4c198e63bec9e6edc4541934ee71cb&tpl=/ecfrbrowse/Title17/17cfr240_main_02.tpl)

2012 Advanced Notice Filing Rule

<http://www.sec.gov/rules/final/2012/34-67286.pdf>

2012 Clearing Agency Standards Rule

<http://www.sec.gov/rules/final/2012/34-68080.pdf>

2014 Proposed Rules on Standards for Covered Clearing Agencies

<http://www.sec.gov/rules/proposed/2014/34-71699.pdf>

FSOC Designation Process

<http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx>

## FREQUENTLY USED ABBREVIATIONS

### Applicable Federal Statutes

Abbreviation	Complete Name
Advisers Act.....	Investment Advisers Act of 1940
APA.....	Administrative Procedure Act
BSA .....	Bank Secrecy Act of 1970
CEA .....	Commodity Exchange Act
CFMA .....	Commodity Futures Modernization Act of 2000
CRA Act.....	Credit Rating Agency Reform Act of 2006
Dodd-Frank Act .....	Dodd-Frank Wall Street Reform and Consumer Protection Act
Exchange Act .....	Securities Exchange Act of 1934
FCPA.....	Foreign Corrupt Practices Act of 1977
FOIA.....	Freedom of Information Act
FTCA.....	Federal Tort Claims Act
Glass-Steagall Act .....	Banking Act of 1933
GLBA .....	Gramm-Leach-Bliley Act
Investment Company Act .....	Investment Company Act of 1940
JOBS Act .....	Jumpstart Our Business Startups Act
NSMIA .....	National Securities Markets Improvement Act of 1996
PATRIOT Act.....	Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001
PRA .....	Paperwork Reduction Act of 1995
RFA .....	Regulatory Flexibility Act
RFPA.....	Right to Financial Privacy Act of 1978
Sarbanes-Oxley Act.....	Sarbanes-Oxley Act of 2002
SBREFA .....	Small Business Regulatory Enforcement Fairness Act of 1996
Securities Act .....	Securities Act of 1933
SIPA .....	Securities Investor Protection Act of 1970
Sunshine Act.....	Government in the Sunshine Act
Trust Indenture Act .....	Trust Indenture Act of 1939

## SEC Divisions, Offices, and Units

Abbreviation	Complete Name
AMU .....	Asset Management Unit
CF .....	Division of Corporation Finance
CFIU .....	Complex Financial Instruments Unit
CRQA .....	Center for Risk and Quantitative Analytics
DERA .....	Division of Economic and Risk Analysis
Enforcement.....	Division of Enforcement
FCPAU.....	Foreign Corrupt Practices Act Unit
IM .....	Division of Investment Management
LFM.....	Office of Large Firm Monitoring
MAU .....	Market Abuse Unit
MSPPU.....	Municipal Securities and Public Pensions Unit
OCIE.....	Office of Compliance, Inspections and Examinations
OCR .....	Office of Credit Ratings
OEC.....	Office of Ethics Counsel
OGC.....	Office of the General Counsel
OIA.....	Office of International Affairs
OIEA .....	Office of Investor Education and Advocacy
OIG.....	Office of Inspector General
OMI.....	Office of Market Intelligence
OMS .....	Office of Market Surveillance
OWS .....	Office of the Whistleblower
QAU.....	Quantitative Analytics Unit
RAE .....	Risk Analysis Examination
REO.....	Risk and Examinations Office
SEC.....	Securities and Exchange Commission
Staff .....	Staff of the Securities and Exchange Commission
TM.....	Division of Trading and Markets

## Other Acronyms

Abbreviation	Complete Name
ABS .....	Asset-Backed Securities
AFR .....	SEC Annual Financial Report
AICPA.....	American Institute of Certified Public Accountants
ALJ.....	Administrative Law Judge
AML.....	Anti-Money Laundering
ANC.....	Alternative Net Capital
ANC Broker-Dealer.....	Alternative Net Capital Broker-Dealer
ARP .....	Automation Review Policy
ASB .....	Auditing Standards Board
ASC.....	Accounting Standards Codification
ASR.....	Accounting Series Release
ATS.....	Alternative Trading System
BCP .....	Business Continuity Plan
CAT .....	Consolidated Audit Trail
CBOE .....	Chicago Board Options Exchange
CCO .....	Chief Compliance Officer
CCP .....	Central Counterparty
CD&A.....	Compensation Disclosure and Analysis
CDO .....	Collateralized Debt Obligation
CDS.....	Credit Default Swap
CFTC.....	Commodity Futures Trading Commission
CHX.....	Chicago Stock Exchange
CIP .....	Customer Identification Program
CIS.....	Collective Investment Scheme
CME .....	Chicago Mercantile Exchange
CP&P.....	Compliance Policies and Procedures
CRA.....	Credit Rating Agency
CRD.....	Central Registration Depository
CSD.....	Central Securities Depository
DEA.....	Designated Examining Authority
DFMU.....	Designated Financial Market Utility
DGCL.....	Delaware General Corporation Law
DOJ .....	Department of Justice
DTC.....	The Depository Trust Company
ECN.....	Electronic Communications Network
EDGAR.....	Electronic Data Gathering, Analysis, and Retrieval system
ERA .....	Exempt Reporting Adviser
FASB .....	Financial Accounting Standards Board
FBI .....	Federal Bureau of Investigation
FCM .....	Futures Commission Merchant

## Other Acronyms

Abbreviation	Complete Name
FDIC.....	Federal Deposit Insurance Corporation
Federal Reserve.....	Board of Governors of the Federal Reserve
FESC.....	Front End Systemic Capture
FHFA.....	Federal Housing Finance Agency
FHFOB.....	Federal Housing Finance Oversight Board
FICC.....	Fixed Income Clearing Corporation
FinCEN.....	Financial Crimes Enforcement Network
FinOp.....	Financial Operations (unit of TFCE)
FINRA.....	Financial Industry Regulatory Authority
FinSOB.....	Financial Stability Oversight Board
FMU.....	Financial Market Utility
FSB.....	Financial Stability Board
FSOC.....	Financial Stability Oversight Council
GAAP.....	Generally Accepted Accounting Principles
GAO.....	Government Accountability Office
House Financial Services Committee.....	House of Representatives Committee on Financial Services
HUD.....	Department of Housing and Urban Development
IAC.....	Investor Advisory Committee
IASB.....	International Accounting Standards Board
ICE.....	ICE Clear Credit LLC
ICEEU.....	ICE Clear Europe
IFRS.....	International Financial Reporting Standards
IOSCO.....	International Organization of Securities Commissions
IOSCO MMOU.....	IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information
IPO.....	Initial Public Offering
IRS.....	Internal Revenue Service
ISG.....	Intermarket Surveillance Group
LLC.....	Limited Liability Company
LULD.....	Limit-Up Limit-Down
MD&A.....	Management's Discussion and Analysis
MIDAS.....	Market Information Data and Analytics System
MOU.....	Memorandum of Understanding
MPID.....	Market Participant Identifier
MSRB.....	Municipal Securities Rulemaking Board
MSBSP.....	Major Security-Based Swap Participants
NASD.....	National Association of Securities Dealers
NASDAQ.....	National Association of Securities Dealers Automated Quotations
NAV.....	Net Asset Value

## Other Acronyms

Abbreviation	Complete Name
NCUA.....	National Credit Union Administration
NEP.....	National Examination Program
NMS.....	National Market System
NRSRO.....	Nationally Recognized Statistical Rating Organization
NSCC.....	National Securities Clearing Corporation
NYSE.....	New York Stock Exchange
OATS.....	Order Audit Trail System
OCC.....	Office of the Comptroller of the Currency
OFR.....	Office of Financial Research
OGE.....	Office of Government Ethics
OMB.....	Office of Management and Budget
OTC.....	Over-the-Counter
PCAOB.....	Public Company Accounting Oversight Board
PTCS.....	Personal Trading Compliance System
RAUM.....	Regulatory Assets Under Management
ROOR.....	Risk Oversight and Operational Regulation
RSA.....	Regulatory Service Agreement
RSD.....	Regulatory Services Division
SAI.....	Statement of Additional Information
SAR.....	Suspicious Activity Report
SBS.....	Security-Based Swaps
SBSD.....	Security-Based Swap Dealer
SB SEF.....	Security-Based Swap Execution Facility
SCI.....	Systems Compliance and Integrity
SDR.....	Swap Data Repository
Senate Banking Committee.....	Senate Committee on Banking, Housing and Urban Affairs
SFP.....	Securities Futures Product
SIPC.....	Securities Investor Protection Corporation
SIP.....	Securities Information Processor
SRO.....	Self-Regulatory Organization
TCP.....	Technology Control Program
TCR.....	Tip, Complaint, or Referral
TFCE.....	Trading and Financial Compliance Examinations
Treasury.....	Department of the Treasury
TRO.....	Temporary Restraining Order
UIT.....	Unit Investment Trust
UNTOC.....	U.N. Convention Against Transnational Organized Crime
VAR.....	Value at Risk
XBRL.....	eXtensible Business Reporting Language