SECTION 1: FEDERAL REGULATIONS

1a. OVERVIEW

Securities Act Of 1933 Regulates The Primary Market

Federal regulation of the securities markets started after the stock market crash of 1929. Congressional investigations into the causes of the crash revealed that the new issue market was overly speculative. New issues were marketed by brokerage firms without "full and fair disclosure" to investors and new issues could be purchased with little money down (the typical deal at the time was put 5% down and get a 95% loan from a bank or broker to finance the new issue purchase). To tame the new issue marketplace (the "primary market"), the Securities Act of 1933 was passed.

Securities Exchange Of 1934 Regulates The Secondary Market

Another major problem leading to the crash was manipulation of the market. A broad variety of manipulations were discovered to have taken place, including spreading rumors to move stock prices, insider trading, misstatements of financial results by issuers, and so forth. As a result, the Securities Exchange Act of 1934 was passed, regulating all aspects of the trading markets (the "secondary market").

Insider Trading Act Amendments Of 1988

The insider trading rules included in the 1934 Act were strengthened under the Insider Trading Act Amendments of 1988. This Act was passed due to insider trading that was discovered to have taken place by investment bankers that were trading on the information that they obtained about "deals" that were in the works at their firms. The intent of the Act was to increase insider trading penalties as a deterrent and to formally make the "source" of the information, known as the "tipper," liable for insider trading as well. Thus, brokerage firms could now be held liable for insider trading penalties if their employees traded on inside information obtained from their employing firm. This required broker-dealers to put "Chinese Walls" in place to stop the potential flow of inside information to employees that might trade on it.

Investment Company Act Of 1940

Investment Advisers Act Of 1940

As additional problems surfaced, more legislation was enacted. The Investment Company Act of 1940 and the Investment Advisers Act of 1940 were passed to regulate the activities of investment companies and to safeguard purchasers of fund shares. The Investment Company Act of 1940 required SEC registration of investment companies and required that fund assets be held by a custodian bank. The Investment Advisers Act was passed at the same time primarily to require the registration of advisers to mutual funds and to insure that their fees were not excessive.

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1b. SECURITIES ACT OF 1933

Securities Act Of 1933 Requires "Full And Fair" Disclosure

The intent of the Securities Act of 1933 is to insure that purchasers of new issues receive "full and fair disclosure" of the investment's merits and risks. The Act requires that issuers of securities (unless they are exempt) to:

File a registration statement with the SEC;

Complete a 20 day "cooling off" period during which the SEC reviews the filing for full and fair disclosure; and

Sell the issue with a prospectus and require full payment from purchasers.

Prior to this legislation being passed, sales of securities were only regulated by each State under that State's "Blue Sky" laws (laws designed to stop speculators from selling the citizens of a State a piece of the big blue sky).

Securities Act Of 1933 Only Applies To Interstate Offers Of Securities

Federal law only applies to transactions that occur "interstate" - if a transaction occurs wholly within 1 State, then only that State's law applies. Thus, the Securities Act of 1933 and the Securities Exchange Act of 1934 include wording that the provisions of the Act apply to any securities offering or transaction "using the means or instrumentalities of interstate commerce."

Important to understanding the Securities Act of 1933 is the definition of a security under the Act; what is excluded from the definition of a security; and what securities are exempt from the Act's provisions.

Insurance And Bank Products Excluded From Definition Of A Security

The basic definition of a "security" is any investment in a common enterprise for profit, with management performed by a third party. Specifically **EXCLUDED** from the definition of a security are:

Life Insurance Policies;

Fixed Annuity Contracts;

Bank Certificates of Deposit.

Basically, this means that bank and insurance products do not come under the Act's provisions. The "idea" is that the investment risk of these products is carried by the bank or the insurance company, not by the purchaser, so these are not "securities." With these products, the customer is guaranteed a fixed return, regardless of how well (or how poorly) the bank or insurance company does when it invests or lends out those funds.

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Variable Products Sold By Insurance Companies Are Defined As A Security

However, variable products sold by insurance companies are a completely different animal. Variable life insurance and variable annuity premiums are invested in a separate account that buys shares of a designated mutual fund, with the performance of the underlying mutual fund determining the amount of insurance or annuity benefit to be paid. With these products, the customer bears the investment risk, so these are non-exempt securities that must be registered with the SEC under the 1933 Act and sold with a prospectus.

Exempt Securities

The most important of the issues that are **EXEMPT** from SEC registration under the Securities Act of 1933 are government issues (the basic idea is that we trust our government, so there is no need for investor protection in the form of an SEC review and sale with a prospectus). The government issues that are **EXEMPT** include:

U.S. Government securities (Treasury Bills, Treasury Notes and Treasury Bonds);

U.S. Government Agency securities (for example Fannie and Ginnie Mae Mortgage Backed Pass-Through Certificates) and:

Municipal securities (for example General Obligation and Revenue Bonds).

Non-Exempt Securities

The most important securities that are **NON-EXEMPT** (which means they must be registered with the SEC and sold with a prospectus) include:

Corporate common stock; preferred stock and bonds;

Investment company securities (mutual funds, exchange traded funds and unit trusts);

Variable life insurance and variable annuities; and

Limited partnership issues.

For interstate offerings of non-exempt issues, the Act of 1933 requires that:

Registration Statement Form S-1 For Initial Public Offerings

A registration statement - Form S-1 - must be filed with the SEC for initial public offerings before any sales related activities can take place. It is the issuer's responsibility to file the registration statement, which is primarily a copy of the proposed prospectus.

Information In Registration Statement

Included in the registration statement is the general character of the business; the uses of the proceeds of the offering; historical audited financial statements; biographical data on officers and directors as well as their

percentage holdings; legal issues; the proposed price of the issue; underwriting spread; a copy of the proposed prospectus; and any other relevant information.

20-Day Cooling Off Period

"Full and Fair Disclosure"

Once the registration statement is filed, the issue enters into the "20-day cooling off" period. During this time, the SEC reviews the filing for "full and fair disclosure." If the SEC feels that the disclosure is adequate, there is no problem. If the SEC feels that there is not sufficient disclosure, the issuer gets a "deficiency letter" from the SEC asking for more disclosure. Until disclosure is adequate, registration is not "effective."

Prohibitions During Cooling Off Period

Quiet Period

During the "20-day cooling off" period, the issue cannot be sold; it cannot be advertised; recommendations of the issue are prohibited; soliciting orders to buy are prohibited. The "20-day cooling off" period is often called the "quiet" period because anyone that is involved in the offering must be "quiet" about it and cannot "hype" the offering.

Preliminary Prospectus

However, the underwriters are allowed to distribute a "preliminary prospectus" to interested parties. This is called a "red herring." The "red herring" is not considered to be "offering" the securities to investors, so it is allowed. SEC Rule 134, known as the "tombstone" rule, permits an extremely limited "announcement" of the issue to be published during the cooling off period without it being considered an advertisement. The announcement is called a "tombstone" because it looks like one and is limited to:

Issuer's Name and Type of Business;
Type of Security;
Offering Size;
Estimated Public Offering Price (if available); and
Names of the Underwriters.

Any more information would make the announcement be considered an advertisement - which is prohibited unless accompanied by the final prospectus. The announcement must include the legend:

> *"This announcement is neither an offer to sell nor a solicitation of an offer for any of these securities. This offer is made only by Prospectus."*

Allowed Activities During Cooling Off Period

During the 20 day cooling-off period, lists of interested customers may be drawn, but no orders can be taken and no sales can be made. This is termed "taking indications of interest."

Effective Date

After the "20 day cooling off" period ends, and the issuer has complied with additional information requests from the SEC (if any), registration is effective. The issue can

Prospectus Delivered At Or Prior To Confirmation

now be sold; orders to buy can be solicited, as long as the offer is made through the final prospectus that is now available. Any purchaser of the issue must get the final prospectus at or prior to the confirmation of sale.

SEC "No Approval" Clause

Under Rule 425, the SEC requires a "no approval" clause on the 1st page of the prospectus. While the SEC reviews the registration filing for full and fair disclosure, it never approves of an issue. The prospectus cover must include the disclaimer that:

"The SEC does not approve or disapprove of the securities being offered herein, nor has the Commission passed on the accuracy or adequacy of this prospectus. Any representation to the contrary is a criminal offense."

Electronic Prospectus Delivery Is Permitted

Access Equals Delivery

Also note that SEC rules now permit electronic delivery of prospectuses. Thus, the purchaser can be sent an e-mail confirmation that has a link that the customer can use to download and print the prospectus. This is known as "access equals delivery." The SEC has interpreted that this rule can only be used if the member firm or issuer knows that the customer has Internet access. If the member firm or issuer has no reason to know that the customer has Internet access, then a paper prospectus must be delivered, at or prior to, confirmation.

Electronic Delivery For Mutual Fund Prospectuses But NOT For Mutual Fund Profile Prospectuses

Regarding prospectus deliveries on investment company offerings, the SEC mandates that the customer receive a "Profile Prospectus" as a paper copy. This is an easy-to-read prospectus summary. It must include the offer of the full detailed fund prospectus, which can be delivered electronically under the "Access Equals Delivery" rule.

Stop Order Suspending Effectiveness Of Registration

If the SEC finds that there is an untrue statement of material fact in the registration statement at any time during the "20-day cooling off" period or after the effective date, it can issue a "stop" order suspending effectiveness. The stop order can only be issued after 15 days' notice is given to the issuer and underwriters and an opportunity for a hearing is given.

"Omission Or Misstatement Of Material Fact Is Fraud"

Under the Act of 1933, an omission or misstatement of material fact in a registration statement or prospectus is fraud. It is fraud for all those individuals involved in the offering: the issuer, the underwriters, the accountants, and the lawyers.

It is in the best interests of these people to make sure that there are no omissions or misstatements of material fact in the registration statement or prospectus; otherwise they can be criminally liable. This legal requirement forces these persons to perform "due diligence" on the issue.

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Due Diligence

When performing "due diligence," each party is making sure that disclosure is adequate and truthful. Before the registration is effective, a number of "due diligence" meetings may be held to which the public is invited. At these meetings, the offering materials are reviewed for "full disclosure." By demonstrating that due diligence has been performed, liability under the Act is minimized.

Civil Liability All Persons Named In Registration Statement And All "Control" Persons

All persons who sign the registration statement; directors of the company; accountants preparing the financial statements; engineers or persons giving appraisals; attorneys preparing the SEC filings; and other responsible persons are liable for civil damages if there is an omission or misstatement of material fact in the registration statement or prospectus. Any persons who are in a "control" relationship with all of the named individuals are also liable under the Act.

Suits Brought Within 2 Years Of Discovery But No Later Than 5 Years After Offering

The amount of damages is the difference between the price paid for the issue plus interest (but reduced by any income received on the security) and its current market value. All suits must be instituted within 2 years of discovery of the omission or untruth and no later than 5 years after the security was offered to the public.

Criminal Liability

Civil penalties apply when the omission or misstatement is unintentional. If there is **willful** omission or misstatement, criminal penalties apply under the Act. Criminal penalties consist of a $10,000 fine and up to 5 years in prison for each offense.

1b. SECURITIES EXCHANGE ACT OF 1934

The Securities Exchange Act of 1934 was passed virtually at the same time as the '33 Act ('33 Act passed at the end of 1933; 1934 Act passed in the beginning of 1934). Whereas the '33 Act covered new issue disclosure and sale requirements, the '34 Act covered abuses in the trading markets. To really understand the reasons for this Act, one should consider how the markets operated before the Crash of 1929.

Manipulation of the market was a commonplace activity - and perfectly legal. Excessive credit was granted. Brokers misappropriated customer securities held in "street name" to obtain loans from banks - and then used the funds to finance the firms' trading activities. Companies reported their financial results however they saw fit - there were no standardized reporting requirements. Corporate officers made huge profits from trading their company's stock in advance of releasing "inside" information

After the great meltdown, these activities were "exposed" under Congressional investigation and the Act of '34 was passed to restore public confidence in the markets.

The provisions of the 1934 Act included in the exam are:

S SEC Created - The Securities and Exchange Commission was created to regulate the markets.

I Insiders - Are defined under the Act and prohibited from profiting from inside information.

M Manipulation - Becomes fraud under the Act. The most famous anti-manipulation rule under the Act is Rule 10b-5 - the "catch-all" fraud rule. It basically says that whatever illegal activity you dream up, even if it is not explicitly prohibited under the Act, is fraud under Rule 10b-5.

M Margin - Control over credit on securities was given to the Federal Reserve.

E Exchanges - Must now register with the SEC and regulate themselves under SEC guidance, as must their members (broker-dealers). FINRA is the "SRO" - Self Regulatory Organization - for member firms that sell investment company securities.

R Reports - Corporate issuers must file annual and quarterly financial reports which are public information.

("**SIMMER**" is a memory device for the provisions of the Securities Exchange Act of 1934 included in the Series #26 Exam.)

Act Does Not Apply To Exempt Securities

To understand the Act of '34, first "step back" and consider that its provisions do not apply to exempt issuers. As an example, the U.S. Government does not file annual and quarterly reports with the SEC. As another example, Federal Reserve margin rules such as Reg. T do not apply to municipals.

Fraud Provisions Apply To Both Exempt And Non-Exempt Securities

However, one provision of the Act of '34 applies to **both** exempt and non-exempt securities. Manipulation, whether it involves an exempt security or a non-exempt security, is fraudulent under the Act. Thus, if municipal bonds are sold to a customer in a fraudulent manner, those responsible can be prosecuted for violating the '34 Act.

Insider Definition

The emphasis of the 1934 Act on the exam is the insider trading rules. The Act defines a "statutory insider" as a director, officer, or 10% shareholder of an equity security

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of the issuer. These persons must report their holdings and transactions in that issuer's equity securities to the SEC.

Upon Becoming An Insider, Form 3 Filed In 10 Business Days

An initial filing by any person defined as an "insider" must be made on Form 3 within 10 business days of attaining that status.

Insiders Must Report Their Trades Within 2 Business Days On Form 4

Changes in ownership by any person defined as an insider must be made on Form 4 no later than 2 business days after the day of the event.

We all know that insiders are prohibited from trading based on material non-public information. The SEC has used Rule 10b-5 (the "catch-all" fraud rule) to bring action against persons who do not fit the statutory definition - and has succeeded. In a famous court case, an engineer for a company that discovered a rich mineral field, and who bought the shares before the information was made public, was considered to be an "insider."

Court's Definition Of An Insider

Through court cases, the current definition of an "insider" is any person who has received material non-public information that can be expected to influence the price of a company's stock. If that person trades on the information prior to its becoming public, he is an insider who is in violation of the Act.

Liability For Both "Tipper" and "Tippee"

Please note that giving someone "inside information" is not a violation. A violation occurs if the recipient ("the tippee") uses the information to trade for profit or to avoid a loss. If this occurs, then the "tipper" is **also** liable under the Act.

The Act states that trading of equivalent securities or options of that issuer is a violation as well.

Inside Information Not Public Until News Media Release

Once the information is made public, that person can trade. Information is considered to be public once it has been released by the news media.

Under the Insider Trading and Fraud Enforcement Act of 1988 ("the Act"), insider rules were strengthened by Congress.

Broker-Dealers Must Have Procedures To Prevent Misuse Of Material Non-Public Information

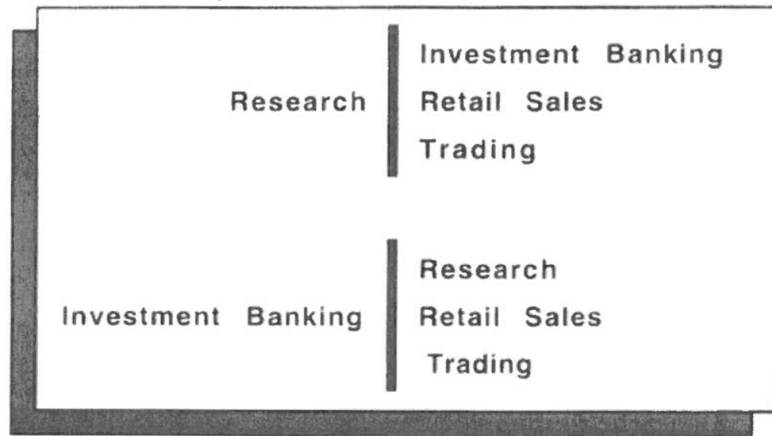
This Act requires broker-dealers to establish, maintain, and enforce written policies and procedures designed to prevent the misuse of material, non-public information by any associated person.

In particular, this legislation was aimed at investment bankers engaged in takeovers. Large broker-dealers have divisions for investment banking; mergers and acquisitions; trading; and retail. Inside information is routinely received through investment banking and

merger activities. It is not a violation to receive inside information. Remember, it is a violation to use the information to trade for profit or to avoid a loss.

Chinese Walls

To insure that such inside information is not communicated to the firm's trading or retail operations, all firms set up "Chinese Walls" that fully segregate the information flow. For example: A company's true identity may only be known to one or two top people; all communications about that company use a pseudonym.



Violation For Insider - Defined As Person Who Misuses Material Inside Information

If a person violates the insider trading rules by purchasing or selling a security while in the possession of material non-public information or by giving that information in connection with a transaction in those securities, he is liable for civil penalties. The penalty can be up to 3 times the profit realized or loss avoided (treble damages). Criminal penalties for individuals include a fine of up to $5,000,000 and up to 20 years in jail for each violation.

Liability To Company Shareholders

The Act also provides that any person convicted of insider trading can be sued by the shareholders of the company that suffered losses due to that person's insider trading. Any suit must be brought within 2 years of discovery, but no later than 5 years after the violation occurred.

Violation For Controlling Person If He Knew About Misuse

In addition, if that person is "controlled," e.g., that person is an employee of a broker-dealer that was supposed to have procedures designed to prevent misuse, the controlling person is liable under the Act. The liability for such firms is greater (since they have deeper pockets!) and is set at a $25,000,000 fine. However, the SEC will not impose damages on the controlling person **unless** it can be proven that the person knew or recklessly disregarded the fact that a violation occurred and that such failure substantially contributed to the occurrence of the Act.

Informer Bounty

Furthermore, the Act allows informants to be paid anywhere from 10% to 30% of the amounts recovered under civil penalties.

1d. INVESTMENT ADVISERS ACT OF 1940

The Investment Advisers Act of 1940 was established to require the registration of investment advisers with the Securities and Exchange Commission and to regulate the actions of investment advisers at the Federal level. The main intention of the Act was to require the registration of investment advisers to mutual funds, which were now becoming regulated under the Investment Company Act of 1940 (the Investment Company Act of 1940 is covered later in this chapter).

Also note that regulation of investment advisers is basically split between the Federal and State governments.

> The bigger investment advisers and advisers to investment companies are registered at the Federal level; and are not required to register in each State in which they do business.
>
> The smaller investment advisers are regulated at the State level and must register in each State in which they do business; but they are not required to register with the SEC.

The "idea" here is that the big cops - the SEC - regulates the big advisers, while the local police "on the beat" - the States - regulate the smaller advisers.

Investment Adviser Definition

The Investment Advisers Act of 1940 is very broadly written and defines an "investment adviser" as:

> "a person who receives compensation for advising others about securities, or about the advisability of investing in securities."

Note that, under this definition, if a person gives advice about securities, but does not charge a fee (is not compensated), then this person is not defined as an investment adviser. Similarly, if a person gives advice about investing in commodities for a fee, this person is not defined as an investment adviser (since he or she is not giving advice about a security).

Persons Not Required To Be SEC-Registered

Persons **NOT** required to register with the SEC as advisers are:

- banks or bank holding companies;
- lawyers, accountants, engineers or teachers whose performance of such services is solely incidental to the practice of their profession;
- broker-dealers and their registered representatives whose advisory services are solely incidental to the securities business and who receive no special compensation for making recommendations;
- publishers of bona-fide newspapers, magazines, or financial publications of a general and regular circulation;
- any person who advises solely about U.S. Government guaranteed obligations; or
- any adviser to an insurance company.

Notice that advisers to investment companies are not on this list and must register with the SEC as investment advisers. This was the main intent of the Act. Advisers to insurance companies are not required to register because the insurance company hiring the adviser is deemed to be a sophisticated investor.

Broker-dealers are excluded from the definition as long as they charge commissions for trades and don't separately charge for investment advice. If a broker-dealer sets up a financial advisory financial planning division and charges separately for this service, that division would be defined as an investment adviser that must register. If a broker-dealer offers "wrap" accounts (which wrap all services into an annual flat fee or a fee based on a percentage of assets under management), again, they become defined as investment advisers that must register.

Federal Registration With The SEC Is Only Required For Certain Advisers

Finally, in 1996, the National Securities Markets Improvement Act of 1996 was passed to limit the duplicate registration of investment advisers that occurred previously at both the Federal and State level.

The Act basically requires that only investment advisers:

$100,000,000 Of Assets

with assets of $100,000,000 or more under management; or

Advisers To Investment Companies

advisers to investment companies;

must register with the SEC.

Federal Covered Advisers

These are both defined as "federal covered advisers" under Uniform State law; and no registration is required with the State.

State-Registered Advisers

Those investment advisers with less than $100,000,000 of assets under management are not required to register with the SEC - they are only registered at the State level.

The concept here is that the Federal regulators are only concerned with the "big guys;" while the "local police" - the States - are concerned with the little guys.

The Investment Advisers Act of 1940 requires that all investment advisory contracts be in writing. Such contracts:

Adviser Cannot Be Paid Based On Capital Gains

cannot provide for compensation to the investment adviser based upon capital gains in the account;

cannot provide for a "reduction" in the advisory fee if the account does not reach a specified performance level (such a contingency fee reduction, is, in essence, a fee tied to capital gains, approached from a negative point of view, instead of a positive point of view).

The only acceptable advisory contracts are those that provide for a fixed annual dollar fee or a fee based on a percentage of assets under management.

Performance Fees

Also, please note than an exception to the prohibition on basing the advisory fee on capital gains is allowed for "substantial" clients - that is, clients with a net worth of at least $2,000,000 or who have at least $1,000,000 under management with the investment adviser. In this case, the adviser may use a formula, stated in the written advisory contract, that provides for a:

Fulcrum Fee: - the basic fee to be charged by the investment adviser; and a

Performance Fee: - an additional fee based upon a comparative performance to a specified index.

This is often called the "hedge-fund" rule, because it permits hedge funds that are only open to wealthy investors to charge performance fees. A common hedge fund fee is called "2 and 20" - the adviser gets 2% of assets under management plus 20% of capital gains as the fee.

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