

History of the Current Regulatory Framework Securities Regulation and History

Introduction

Federal, state, and industry regulators, operating under the authorities of a myriad of state and federal laws, carry out securities regulation in the United States. Modern securities regulation fundamentally aims to help protect investors from fraud and to maintain fair and orderly markets. The securities regulatory system, like the banking system, is a product of historical development rather than of a single overarching rationale. As a result, it reflects the accumulation of decades of legislative and regulatory developments that have largely expanded, rather than streamlined, the set of laws, rules, and procedures that apply to securities markets and market participants.

Blue Sky Laws—Securities Regulation by the States

Background—Fifty State Securities Regulators

Private agreements among market participants in the United States during the late eighteenth century form the origins of securities regulation. However, as early as the mid-1800s, the first legislative efforts to regulate securities began at the state level in order to help protect investors from fraud. The earliest state laws tended to be limited in scope and often applied only to the stock issued by companies of specific industries, such as railroads, mining, or utilities. In 1911, Kansas enacted the first modern securities law requiring the registration of most new securities issues offered within the state as well as the licensing of persons engaged in the securities business. Over the next few years, many other states enacted securities laws either identical to or largely based upon the Kansas statute.

Today, all fifty states, the District of Columbia, the U.S. Virgin Islands, and Puerto Rico have statutes regulating securities transactions. State regulatory agencies are generally organized as either independent state securities commissions or as divisions in larger state financial services regulatory departments. These agencies, headed either by appointed individuals or by career state government employees, generally administer and enforce these laws, known as “blue sky” laws.

Three Basic Elements of State Securities Laws: Registration of Securities, Registration of Securities Professionals, and Enforcement

State securities laws typically include two basic requirements: the registration of securities and the registration and supervision of securities firms and professionals. In addition, state securities statutes commonly include provisions that prohibit securities fraud and that give state authorities the power to enforce those provisions.

Unless a state exemption applies, an issuer must register its securities prior to sale with the appropriate state agency. Originally, most states’ securities regulation was essentially a form of “merit” regulation in which the state securities administrator wielded broad,

subjective discretion in determining the securities permitted to be registered. Today, however, most states no longer evaluate individual securities offerings on their subjective merits and have put in place a disclosure-based approach more closely modeled on the federal securities laws.

To guard against fraud, each state requires the registration or licensing of securities professionals who conduct business in the particular state, unless an exception applies, including brokerage firms, individual broker-dealers' sales associates, and other intermediaries, advisers, and agents. State securities regulators often condition securities professionals' registration on the fulfillment of certain requirements, such as demonstrating their knowledge and understanding of state laws and regulations. State securities laws also typically require securities professionals to maintain certain books and records, and to submit to regulatory examination.

State laws also generally include civil and criminal liabilities and most have provisions permitting private causes of action for victims of alleged securities fraud. State securities regulators may investigate investor complaints and pursue potential cases of securities fraud. These investigations may result in sanctions such as fines and penalties on violators, including payment of restitution to harmed investors.

The Need for Coordination and Uniformity

The various state securities laws share broad goals and requirements, such as the protection of investors against fraud and the registration of securities offerings and securities professionals.

Prior to the enactment of the federal securities law and in order to address the divergence of state securities laws, the National Conference of Commissioners on Uniform State Laws ("NCCUSL") approved a Uniform Sale of Securities Act in 1929 ("1929 Act"). However, only a handful of states adopted the 1929 Act before Congress passed the Securities Act of 1933 ("Securities Act"), which not only rendered the NCCUSL's initial effort obsolete, but also created an entirely new need for state and federal coordination.

In 1956, the NCCUSL promulgated a second Uniform Securities Act ("1956 Act"), by which time a full complement of six separate federal securities laws were in force. A majority of states eventually enacted the 1956 Act, either in its entirety or with selected provisions added or omitted. In 1985, the 1956 Act was revised, but only six states adopted the amendments. Most recently, in 2002, the NCCUSL approved a fourth Uniform Securities Act ("2002 Act"), adopted by thirteen states and the U.S. Virgin Islands. The 2002 Act outlines state authority for the registration of securities, the registration and supervision of broker-dealers, investment advisers, and other securities professionals, and enforcement, investigatory, and subpoena powers consistent with federal law.

Another important driving force for state regulatory uniformity, the North American Securities Administrators Association Inc. ("NASAA"), representing all state securities

regulators in the United States, works to coordinate the regulatory and enforcement actions of its members. NASAA, founded in 1919, has issued numerous “statements of policy” and “model rules” on various securities matters, and has developed a series of “uniform forms,” intended to standardize state securities regulation. NASAA also attempts to coordinate state legislative and regulatory initiatives with Congress and the SEC.

Federal Intervention

When passing the first federal securities law, the Securities Act, Congress deliberately included a provision that saved state securities laws from preemption. State laws continued to diverge and the complexity of securities regulation, from a national perspective, increased. Ultimately, despite efforts by the states to promote uniformity in implementation and interpretation of state laws, Congress had to address the states’ perceived failure to standardize the interstate regulation of securities and securities professionals.

In 1996, Congress passed the National Securities Markets Improvement Act (“NSMIA”) in an effort to reduce complexity and duplicative regulation among state and federal securities regulators, as well as to promote efficiency and capital formation in the national securities markets. To achieve this, NSMIA, among other things, amended the federal securities laws to preempt many state securities laws.

NSMIA created a category of federal “covered securities” exempted from state registration requirements, and which included securities listed (or approved for listing) on national securities exchanges, mutual fund shares, commercial paper, and government or municipal securities, among others. Similarly, NSMIA substantially curtailed states’ rulemaking and supervisory authority over broker-dealers. Though states could still require broker-dealer registration, the SEC and the National Association of Securities Dealers (“NASD”), a SRO, would carry out most broker-dealer regulation. NSMIA also divided the regulation of investment advisers between state and federal regulators, limiting state regulation to those advisers with less than \$25 million under management. NSMIA did, however, preserve states’ jurisdiction to investigate fraud and unlawful conduct by a broker-dealer with respect to securities transactions.

The NSMIA preemptions effectively limited state securities law registration requirements to a narrow class of small securities offerings, such as those offered only on an intrastate basis, and reduced state authority over securities professionals. Nevertheless, NSMIA did call for continued coordination and cooperation among state and federal securities regulators. The changes in NSMIA prompted the NCCUSL to draft the 2002 Act.

Federal Securities Laws and the Securities and Exchange Commission

Overview of the Federal Securities Laws

Of the three levels of securities regulation in the United States (i.e., federal, state, or

industry self-regulation), federal regulation emerged last. Federal securities regulation today encompasses numerous, sweeping statutes and countless regulations, all administered by the SEC and enforced by the SEC with the states. The Securities Act and the Securities Exchange Act of 1934 (“Exchange Act”), together with the Investment Company Act of 1940 (“Investment Company Act”) and the Investment Advisers Act of 1940 (“Advisers Act”), form the core of federal securities regulation.

Securities Act of 1933

This first federal securities law, like its precursors in state law, prohibits securities fraud and requires either the registration or an exemption from registration of securities offered for public sale. However, in contrast to “merit” regulation, the Securities Act generally permits the registration of securities upon the satisfaction of required disclosures of important financial and other information. In general, companies issuing securities for sale to the public must file registration statements and prospectuses with the SEC that include a detailed description of the securities being offered, information about the issuer’s business and management, and audited financial statements. These disclosures, made available to the public, allow investors to decide whether or not to purchase a particular security.

Securities Exchange Act of 1934

Whereas the Securities Act focuses on the issuance and initial registration of securities, the Exchange Act focuses on transactions in securities and the regulation of the securities industry. The Exchange Act created the SEC and established its sweeping authority over the nation’s securities markets. The Exchange Act went far beyond state securities laws by giving the SEC the authority not only to register, regulate, and supervise securities professionals, including broker-dealers and transfer agents, but also the power to regulate and oversee national securities exchanges and securities associations, clearing agencies, and industry SROs. This power included the authority to approve (and, implicitly, to reject) rules of the exchanges and SROs. In addition, the Exchange Act established a system of securities registration and ongoing public disclosure through required annual, quarterly, and other reports. Numerous amendments over the years have added additional authorities and responsibilities, including the regulation of tender offers, the prohibition of insider trading, and a mandate to establish a “national market system.” In addition, the SEC has authority under the Exchange Act to establish accounting standards for the preparation of reports and audited financial statements required by the Securities Act and the Exchange Act, although the SEC generally defers to the generally accepted accounting principles (“U.S. GAAP”) set by the independent Financial Accounting Standards Board.

Investment Company Act of 1940

Congress passed the Investment Company Act in response to the growing popularity of investment companies and their management expertise and diversification possibilities among investors and a finding by the SEC that such companies could affect the “national

public interest.” There are generally three types of investment companies: open-end funds (e.g., most mutual funds), closed-end funds, and unit investment trusts.¹¹ The Investment Company Act governs many aspects of investment companies (e.g., organization, governance, capital structure, disclosure practices, and valuation methodologies) and requires SEC registration, although numerous exemptions are available. Upon selling their first shares, and subsequently on a regular basis, registered investment companies must make periodic public disclosures regarding their financial condition, investment policies, fees, and other company information. Registered investment companies are prohibited from engaging in fraudulent, deceptive, or manipulative practices and certain investment activities, such as using borrowed funds to buy securities (i.e., purchasing on margin) or selling borrowed securities in the belief that they can be bought back at a later time at a lower price (i.e., short-selling).

Investment Advisers Act of 1940

Though far narrower in scope, the Advisers Act imposes registration and other requirements on investment advisers, firms or individuals, providing investment advice to investors for compensation. In essence, the Advisers Act seeks to protect investors and compel fair practices by advisers by broadly prohibiting fraud and deception, preventing the misuse of nonpublic information, and regulating investment advisory contracts, including the terms of compensation, among other requirements. The Advisers Act also gives the SEC authority to require advisers to maintain certain books and records. Like other federal securities laws, the Advisers Act provides several exemptions from its registration requirements, but it also gives the SEC broad discretion to exempt any person or transaction from any or all provisions of the Advisers Act as long as the exemption is consistent with the protection of investors and purposes of the Advisers Act.

Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act aimed to restore investor confidence in the securities markets following the accounting scandals at Enron, WorldCom and other companies. The Sarbanes-Oxley Act created a new regulator for the auditing profession, the Public Company Accounting Oversight Board (“PCAOB”), and enhanced corporate responsibility and financial disclosures, provided more stringent standards for auditor independence, and significantly increased criminal penalties for various types of fraud and “white-collar” crimes. The Sarbanes-Oxley Act led to numerous additional requirements for public companies, including executive certifications of financial statements, accelerated reporting requirements, and management reports and auditor attestation on internal controls over financial reporting, among many others.

Other Federal Securities Laws

The Trust Indenture Act of 1939 (“Trust Indenture Act”) governs trust indentures, the special agreements or contracts between certain issuers of publicly offered debt securities and bondholders. Though narrow in purpose, the Trust Indenture Act supplements federal securities laws to help protect the rights of investors in debt securities.

The Securities and Exchange Commission

The Exchange Act created the SEC, an independent, administrative agency of the federal government. In particular, the SEC has broad authority to enforce the federal securities laws and to promulgate rules for the national securities markets. Federal securities laws give the SEC a three-fold mandate: to protect investors, to maintain the integrity and stability of markets, and to promote efficiency in capital formation.

Not until the stock market crash of 1929 and the subsequent events of the Great Depression did sentiment begin to solidify around the need for a federal regulator to protect investors and oversee the securities markets. The SEC is led by five Commissioners, one of whom serves as Chairman, who serve staggered five-year terms and are appointed by the President after the advice and consent of the Senate. Under the Chairman's leadership, the Commissioners guide overall SEC policy by interpreting federal securities laws, proposing new rules as market developments or congressional mandates warrant, amending existing rules, and overseeing and approving SEC enforcement actions.

Regulated Entities – Markets & Clearing, Broker-Dealers, SROs, and Others

Whereas the Securities Act focuses on the issuance of securities and their initial registration, the Exchange Act is primarily concerned with the secondary market and trading of securities through broker-dealers and other market professionals. This system has evolved significantly over the years in response to numerous changes in market structure and practices.

Markets and Clearing

The Exchange Act regulates the secondary markets where most public equity trading occurs. The Exchange Act regulates the two basic types of secondary equity markets: exchange markets as “national securities exchanges” and dealer markets as “national securities associations.” The traditional stock exchanges (e.g., NYSE Euronext) are examples of auction-style national securities exchanges. There are no registered national securities associations in operation today. However, the NASDAQ, which is today a national securities exchange, was originally established as a dealer-centered national securities association.

The Exchange Act and the SEC's rules require the registration of securities exchanges, mandate some of the types of rules that securities exchanges are required to adopt, and require that their operating procedures and governance structures meet minimum public interest standards. The basic approach to regulation of trading on the exchanges, including the regulation of market participants such as specialists and broker-dealers, is through self-regulation with oversight by the SEC. Exchanges must file rule proposals with the SEC, for example, which then publishes the proposals for public review and comment. The SEC may then approve, modify, or disallow the proposed rules. The exchanges are also subject to other laws and SEC rules regarding, for example, their use

and extension of margin, the prevention of manipulation, and restrictions on short selling.

The Exchange Act also provides for the regulation of securities clearing agencies, which provide clearing, netting and settlement, and central counterparty services for transactions in the securities markets. Securities clearing agencies generally are SROs subject to SEC oversight.

Brokers-Dealers and Other Intermediaries

The principal category of intermediary in the securities markets is the broker-dealer. Essentially, a broker is a firm or individual who acts as an intermediary between buyers and sellers of securities, usually charging a commission for these services. A dealer is a firm or person who is in the business of buying and selling securities for its own account, either directly or through a broker. Many firms operate as both brokers and dealers.

The Exchange Act prohibits any person from acting as a broker or dealer unless they are registered with the SEC or an exemption applies. The Exchange Act provides, for example, broad exceptions from the definitions of broker and dealer for certain securities-related activities traditionally conducted by banks. Moreover, even if it is required, the SEC may deny registration if it finds that registration requirements are not satisfied. The SEC also has authority to set standards for operational ability and professional conduct, and can establish requirements for testing and training as prerequisites for entering the industry.

Beyond registration, the Exchange Act and the SEC's rules and regulations impose a broad set of requirements on broker-dealers, including specialists and market-makers. In general, broker-dealers are subject to regulations concerning fraud and manipulation, protection from excessive risk and insolvency, and duties to customers. Broker-dealers are also subject to antifraud provisions of the Exchange Act as well as SEC regulations that define acceptable practices. The Exchange Act also authorizes the SEC to establish rules regulating the financial soundness of broker-dealers. Thus, broker-dealers are subject to various record-keeping requirements and the SEC's net capital rules. Broker-dealers' duties to their customers include rules covering best execution and investor suitability rules, among others. Broker-dealers may also be barred from the industry for certain misconduct or for certain violations of SEC, exchange, or SRO rules.

A special category of broker-dealers are those that specialize in the trading and dealing in government securities, as defined in the Exchange Act. Prior to the enactment of the Government Securities Act of 1986 ("GSA"), government securities brokers and dealers were exempt from registration and regulation under the securities laws. The GSA imposed new requirements on government securities brokers and dealers, including a requirement to register with the SEC and a system of regulation that includes recordkeeping, net capital requirements, and large position reporting rules. Rulemaking authority under the GSA resides with Treasury and enforcement resides with the SEC.

The Exchange Act also generally requires broker-dealers, including government

securities broker-dealers, to be members of a registered national securities exchange or national securities association. Today, nearly all broker-dealers in the United States are members of the Financial Industry Regulatory Authority (“FINRA”), a SRO formed in 2007 by the merger of the NASD and the regulatory and enforcement units of the New York Stock Exchange. Thus, in addition to the Exchange Act and SEC rules and regulations, broker-dealers are subject to the rules and oversight of the exchange or the securities association (or both) of which they are members.

Self-Regulatory Organizations

The federal system of securities regulation relies to a great extent upon self-regulation by various segments of the securities markets. Indeed, self-regulation in the securities industry preceded both state and federal regulation, and today all of the exchanges in operation (e.g., the stock exchanges, options exchanges, and exchanges that trade security futures products¹²) effectively perform self-regulatory functions. With the enactment of the securities laws and the creation of the SEC, federal regulation was laid on top of, that is, in addition to, the system of regulation already in place in the markets.

Over the years, amendments to the securities laws authorized the creation of additional SROs for the industry. The Maloney Act of 1938, for example, authorized the SEC to register national securities associations to act as self-regulatory bodies for brokers and dealers.

In general, SROs have broad authority to impose governance standards, set rules, and undertake enforcement and disciplinary proceedings with respect to their members. However, the activities of the SROs are subject to SEC oversight. For example, the SEC must approve SRO rulemakings, prior to their being enacted, and the SEC may in some instances require that the SROs establish specific rules. In addition, most market participants must be members of the SRO for their segment of the securities market.

Other Entities

Public Companies

Public companies are a primary source of securities, issuing both debt and equity securities into the public securities markets. Public companies that list their securities on public markets are subject to a wide variety of securities law obligations, as well as the exchanges’ financial requirements and listing standards.

Consolidated Supervised Entities

In 2004, the SEC implemented a voluntary program to regulate certain major U.S. securities firms on a consolidated or group-wide basis. The groups in the program, referred to as consolidated supervised entities (“CSEs”), are firms predominantly engaged in the securities business and have one or more large broker-dealer units. The aim of the CSE program is to enable the SEC to monitor and respond to problems in the

group-wide structure while offering a less-restrictive regulatory environment for the individual firms. If the CSE group contains an affiliate that is regulated by another functional regulator, such as a banking regulator, the SEC defers to that regulator's oversight authority over the affiliate. Under the program, the CSEs are required to maintain a system of internal controls, adequate capital, and sufficient liquidity to ensure that they can meet any obligatory cash commitments, even in a stressed environment. For its part, the SEC must approve the CSEs' internal controls systems, examine and monitor the implementation of internal controls, and generally monitor the CSEs for financial and operational weaknesses. Further, the SEC has broad authority to require the CSEs to increase their holdings of regulatory capital or expand their liquidity pools if weaknesses develop or as market conditions may dictate.

Credit Rating Agencies

Credit rating agencies are independent entities that issue credit ratings on securities and other instruments offered by public companies, banks, governments, and other issuers. As a result, credit rating agencies serve as an integral part of the securities markets. Previously, under the SEC's regulations, credit rating agencies could apply to receive a designation as a nationally recognized statistical rating organization ("NRSRO"), but they were not subject to SEC regulation. The Credit Rating Agency Reform Act of 2006, however, gave the SEC the authority to register and oversee rating agencies as NRSROs. Registered NRSROs are subject to, among other duties and authorities, ongoing disclosure and recordkeeping requirements and SEC examination.

Auditors

The Sarbanes-Oxley Act created the PCAOB to register and inspect public company auditors. The PCAOB, subject to SEC oversight, also sets auditing standards for public companies and has enforcement authority for compliance with its rules and other provisions of the Sarbanes-Oxley Act.