Elements of Federal Securities Law

An overview of the securities industry and its regulation

- The Federal Securities Laws
- The Securities and Exchange Commission and Industry Regulation

By James Hamilton, JD, LLM

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CCH
2700 Lake Cook Rd.
Riverwoods, IL 60015
847-267-7153
mediahelp@cch.com

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James Hamilton, JD, LLM

Principal Securities Law Analyst

A Principal Securities Law Analyst for CCH, Jim Hamilton has extensive experience tracking and explaining securities legislation, regulation and case law. He has authored and co-authored respected books on the Private Securities Litigation Reform Act of 1995, the National Securities Markets Improvement Act of 1996, and the Sarbanes-Oxley Act of 2002. His analysis of the PSLRA and the Sarbanes-Oxley Act are widely known and quoted. He has also co-authored a popular guidebook on insider reporting under Section 16(a), and co-authors a yearly guide to the responsibilities of officers and directors under the federal securities laws. Hamilton serves as a leading contributor to the industry-standard publication, the CCH Federal Securities Law Reporter. He received an LL.M. from New York University School of Law.

CCH Securities Regulation Blog

Hamilton also authors a blog, "Jim Hamilton's World of Securities Regulation" at jimhamiltonblog.blogspot.com which provides insight, analysis and commentary on securities regulation. Its goal is to highlight issues of particular importance to securities lawyers and their clients, and to encourage a dialogue and exchange of opinions with particular emphasis on SEC rulemaking and industry trends. He welcomes and encourages your participation in this forum.

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Wolters Kluwer Law & Business is a leading provider of research products and software solutions in key specialty areas for legal and business professionals, as well as casebooks and study aids for law students. Its major product lines include Aspen Publishers, CCH, Kluwer Law International and Loislaw. CCH is a leading provider of securities, tax and accounting and business compliance information, software and services. CCH has been tracking, explaining and analyzing securities, tax and business law for 95 years, even before the first federal securities law was enacted.

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Introduction

This guide is a specialty securities reference designed to help you understand the fundamentals of federal securities regulation.

As the events of the last few years have made even more evident, the securities markets touch all of our lives. Through 401(k) plans and individual securities purchases, as well as the large continuing positions taken by institutional investors such as pension plans, millions of citizens have a stake in the nation's securities markets. This is compounded by the increasing securitization of assets, such as mortgages.

This guide incorporates the significant changes that have occurred in securities regulation, including details on the landmark Sarbanes-Oxley Act of 2002. The reforms effected by that Act are broad, including provisions impacting the regulation of the accounting profession, the auditing of financial statements, corporate governance, corporate disclosures and enhanced criminal penalties for securities fraud.

They also are further proof that the United States has the deepest, largest, most liquid, and most transparent securities markets in the world. This situation didn't happen by accident, but is the result of a vigorous and even-handed application of a system of securities regulation by the Securities and Exchange Commission.

The laws that govern the buying and selling of securities are above all laws about disclosing information, so they have a special interest for investors and others. If you know where and how to look, you can find out who's earning what, who's buying whom and which companies may be in trouble and why.

You also can discover how a very complex body of law passed during the Great Depression, and flexibly administered by the Securities and Exchange Commission, has adapted itself to the challenges of the next century while remaining steadfast to the principles enunciated over the past 70 years.

We hope you find this book to be a useful resource.

James Hamilton, JD, LLM
September 2007

An Overview of the Legal and Regulatory Landscape

The Federal Securities Laws

The securities industry is governed by a basic framework of laws, the goal of which is to ensure that big and small investors alike have access to accurate and timely information needed to make investment decisions.

In the early days of the "New Deal" under President Franklin D. Roosevelt — following the stock market crash of 1929 and during the Great Depression — Congress enacted two landmark statutes regulating securities. And, although these laws have been amended many times since their passage, they still form the basic framework for the federal regulation of securities today.

The first of these laws is the Securities Act of 1933, which regulates initial public offerings. It is a "truth in securities law" requiring that investors be provided with "material" information concerning securities offered for public sale.

Next, is the Securities Exchange Act of 1934, under which Congress extended the disclosure doctrine of investor protection to securities listed and registered for public trading on the national securities exchanges. Amendments in 1964 extended disclosure and reporting provisions to equity securities in the over-the-counter market.

The 1934 Act seeks to ensure fair and orderly securities markets by prohibiting certain types of activities and by setting forth rules regarding the operation of the markets and participants.

The Act also created the Securities and Exchange Commission to help ensure the protection of investors. Under the 1934 Act, national securities exchanges, broker-dealers and transfer agents, among others, must register with the SEC.

Three other seminal securities statutes were passed in the 1933-1940 formative period of the federal securities laws:

- The Trust Indenture Act of 1939, which applies to bonds, debentures, notes, and similar debt securities offered for public sale and issued under large trust indentures.

- The Investment Company Act (passed in 1940 and is popularly called the 1940 Act), which regulates the mutual fund industry.
- The Investment Advisers Act (also passed in 1940, but *never* called the 1940 Act), which regulates large investment advisers and advisers in states with no regulation.
- The Sarbanes-Oxley Act of 2002 (passed to provide for federal regulation of the auditing of financial statements and to enhance corporate governance and corporate disclosure).

The Securities and Exchange Commission

In securities law and the securities industry as a whole, all roads eventually lead to the Securities and Exchange Commission (SEC). The SEC, headquartered in Washington, D.C., is the central player in the securities industry with a mission to protect investors in the securities markets by requiring full and fair disclosure of all material information about companies whose securities are publicly traded. Prior to the creation of the SEC, the federal government played no oversight role in the securities markets.

The SEC is an independent, non-partisan regulatory agency composed of five members – a Chairman and four Commissioners. Commission members are appointed by the President for five-year terms, with the advice and consent of the Senate. The Chairman is designated by the President. Terms are staggered, one expires on June 5 of every year. No more than three members of the Commission may be of the same political party.

The Commission's work is remedial, not punitive. Its primary mission is to ensure investor protection through full disclosure of material information and to ensure that the securities markets are fair and honest.

A deliberative collegial body, the SEC meets regularly to debate and decide on regulatory issues. Commission meeting are generally open to the public and members of the press. However, meetings may be closed if necessary to protect the Commission's ability to conduct investigations and protect the rights of individuals and entities that may be subject to Commission inquiries.

Generally, SEC meetings are held to deliberate on and resolve issues that the staff brings before the commissioners. Issues may be interpretations of federal securities laws, amendments to existing rules under the law, new rules, actions to enforce laws or to discipline those subject to direct regulation, legislation to be proposed by the Commission, as well as matters concerning administration of the SEC itself.

Resolution of issues brought before the Commission may take the form of new rules or amendments to existing ones, enforcement actions or disciplinary actions. The most common activity of the SEC is rulemaking, which is usually the result of staff recommendations made to the Commission.

SEC Organization

The SEC is made up of a number of offices and divisions, each of which has responsibility for different internal functions or segments of the securities industry.

While the SEC is headquartered in the nation's capital, its reach extends throughout the country. The regional offices are designated by sections of the country – the Northeast, Southeast, Midwest, Central and Pacific. District offices are located in Atlanta, Boston, Fort Worth, Philadelphia, San Francisco and Salt Lake City.

There are four key divisions of the SEC. Each division is headed by a director who is supported by associate and assistant directors.

- Division of Corporation Finance

  The Division of Corporation Finance oversees public companies and their transactions in administering the SEC's full disclosure system. It has the overall responsibility for ensuring that disclosure requirements are satisfied by public companies registered with the SEC. The Division proposes regulations implementing the Securities Act, the Exchange Act and the Trust Indenture Act, as well as provides interpretations of these statutes.

  Division staff reviews registration statements for new securities, proxy materials, annual reports and tender offer documents.

  Associate directors have responsibility over accounting, regulatory policy, international issues, disclosure operations and small business. There are also offices of assistant directors within the Division whose responsibilities are divided by industry group such as health care, communications and manufacturing. These offices review filings and provide assistance to industries within their group.

  The Office of Mergers and Acquisitions and the Office of EDGAR and Information Analysis Policy also reside in this Division.

- Division of Investment Management

  The Division of Investment Management – with responsibility for the Investment Company Act and the Investment Advisers Act – oversees the investment management industry. Since 1985, it also has had responsibility for the administration of the Public Utility Holding Company Act.

  Division staff ensures compliance with regulations regarding the registration, financial responsibility, sales practices and advertising of mutual funds and of large investment advisers. New products offered by these entities are reviewed by staff. They also process investment company registration statements, proxy statements and periodic reports under the Securities Act.

- Division of Market Regulation
  The Division of Market Regulation is responsible for the operations of the securities markets and oversees the self-regulatory organizations (SROs), which include the stock exchanges and broker-dealers. It also oversees the Securities Investor Protection Corporation (SIPC), which insures customers' securities and cash that are held in brokerage firm accounts in the event of a firm failure.

- Division of Enforcement
  The Division of Enforcement is the SEC's cop on the beat. The Division brings enforcement actions against market participants who violate the securities laws. The Commission can bring enforcement actions under the federal courts or before an administrative law judge. The Division also oversees the SEC's regional offices, which bring enforcement actions for violations that occur within their jurisdictions.

  Charged with enforcing the federal securities laws, the Division is responsible for investigating possible violations and recommending appropriate remedies for SEC consideration. Possible violations may come to light through the unit's own inquiries, through referrals from other SEC divisions, from outside sources such as the self-regulatory organizations and by other means. Under a formal order of investigation from the Commission, the Division of Enforcement may require individuals to testify under subpoena, as well as produce related documents.

  At the conclusion of investigations, the Commission may authorize the staff to proceed with injunctions preventing further violative conduct, with administrative proceedings in the case of entities directly regulated by the SEC, such as broker-dealers, or with other remedies as appropriate. The Division can also negotiate settlements on behalf of the Commission.

Other key offices within the Commission include:

- Office of Chief Accountant
  The Chief Accountant consults with representatives of the accounting profession and the standard-setting bodies designated by the profession regarding the promulgation of new or revised accounting and auditing standards. The Office, which advises the Commission on accounting and auditing issues, also drafts rules and regulations prescribing requirements for financial statements.

- Office of General Counsel
  As the Commission's chief legal officer, the General Counsel serves as the focal point for handling all appellate and other litigation

brought by the Commission or brought against the Commission or its staff.

Self-Regulatory Organizations

The SEC supervises registered securities exchanges, the National Association of Securities Dealers (NASD), the over-the-counter markets and registered clearing agencies. Each of these self-regulatory organizations, or SROs, adopts its own rules and can discipline its own members.

The self-regulatory system was endorsed by Congress for the U.S. securities industry in the belief that industry oversight, backed by government power, would provide the most effective and efficient means of regulation. But the SEC can establish rules that govern the exchanges, and significant changes in the way that any exchange operates may require SEC approval. Former SEC Chairman and Supreme Court Justice William O. Douglas described the SEC's oversight role as akin to keeping a "shotgun, so to speak, behind the door, loaded, well-oiled, cleaned, ready for use, but with the hope that it would never have to be used."

The New York Stock Exchange (NYSE) is the oldest of the exchanges. The NYSE is governed by a board of directors and has a voting membership represented by "seats." Most of the members execute trades for the public but others, known as floor traders, deal for their own accounts. The NYSE has strict requirements for companies that wish to list their securities on the exchange.

The National Association of Securities Dealers is the largest securities industry self-regulatory organization in the U.S. It is the parent of the NASDAQ electronic market.

In 2007, the SEC approved a joint regulatory arm for the NYSE and the NASD. The Financial Industry Regulatory Authority (FINRA) is the largest non-government regulator for all securities firms doing business in the United States.

There are a number of regional exchanges subject to SEC oversight including the Boston Stock Exchange, the National Stock Exchange, the Chicago Stock Exchange, the Chicago Board Options Exchange and the Philadelphia Stock Exchange. These exchanges include securities that are listed on the NYSE and American Stock Exchange in addition to regional securities.

The SEC also oversees the Municipal Securities Rulemaking Board (MSRB), which establishes rules in connection with the offering of municipal securities. The MSRB has adopted a number of rules in recent years to improve the disclosure of information in municipal securities offerings.

The MSRB relies on certain nationally recognized municipal securities information repositories, known as "NRMSIRs," for housing the information. These repositories are run by private vendors that maintain copies of disclosure documents for review by interested parties. The MSRB also encourages the states to develop information depositories for local securities issues. Issuers of municipal securities deliver information to each NRMSIR and any appropriate state depository.

State Securities Regulation

Securities offerings were regulated and broker-dealers were licensed at the state level before the SEC and the federal laws were created. Today, the states have their own regulatory agencies that regulate securities offerings within their borders.

State securities laws (known as "blue sky laws") are intended to protect investors against securities fraud.

The states are able to focus on individual investor protection issues, leaving more broad-based market concerns to the SEC. State securities agencies also assist small business capital formation by providing a streamlined registration process for small corporate offerings. The states provide an important supplement to the federal securities laws in fighting against fraud, given the SEC's limited resources.

One of the best examples of federal/state cooperation occurred with the passage of the National Securities Markets Improvement Act of 1996. The states were given jurisdiction over investment advisers with less than $25 million in assets under management while the SEC retained authority over the largest investment advisers.

This division of authority enables the SEC to examine the largest investment advisers with much greater frequency than it was able to do under the previous regulatory scheme. The 1996 Act also prevents the states from imposing requirements beyond the federal regulatory scheme for securities listed on a national exchange. The states, however, retain their antifraud authority.

The North American Securities Administrators Association (NASAA) is a voluntary organization that represents the state securities agencies. Through committees on broker-dealer and investment adviser registration, enforcement, corporate finance and technology, NASAA develops model codes and guidelines. The states may then choose whether to adopt the uniform national models.

Sarbanes-Oxley Act

The Sarbanes-Oxley Act was enacted in response to financial frauds at a number of major corporations and the ensuing realization that many of the gatekeepers responsible for preventing financial fraud had failed to do their jobs. The Act is the most important securities legislation since the New Deal. The broad objectives of the Act are to restore investor confidence in corporate financial statements and the securities markets and enhance investor protection by improving corporate governance and transparency.

The reforms effected by the Act are wide-ranging, including provisions impacting the governance of the accounting profession, corporate disclosures, auditor independence, attorney up-the-ladder reporting and greatly enhanced penalties for securities fraud. In these areas, Sarbanes-Oxley represents what formerly would have been an unimaginable incursion of the federal government into corporate governance.

There are a number of underlying themes running through Sarbanes-Oxley. One is that all parties in the financial reporting system should act in the public interest. For example, auditors are prohibited from performing many non-audit services to help ensure that they act with the public's interest in mind.

Sarbanes-Oxley also makes clear that a company's senior officers and directors are responsible for the culture they create and must be faithful to the same rules they set out for other employees. For example, one goal of the SEC's rule requiring that the CEO ultimately be responsible for the quality of the company's disclosure controls and financial reporting is to ensure that the "tone at the top" has real meaning.

Gramm-Leach-Bliley Act

One of the most important milestones in the history of financial regulation occurred in 1999 with the passage of the Gramm-Leach-Bliley Act. The Act removes Depression-era barriers that had separated banks and securities firms. It allows for the creation of new financial services holding companies that can offer a full range of financial products under a strong regulatory regime based on the principle of functional regulation.

The legislation eliminates legal barriers to affiliations among banks and securities firms, insurance companies and other financial services companies. The Act provides financial organizations with flexibility in structuring these new financial affiliations through a holding company or a financial subsidiary, with appropriate safeguards.

Gramm-Leach-Bliley also establishes, for the first time, a minimum federal standard of financial privacy. Financial institutions are required to have written privacy policies that must be disclosed to customers. The disclosure of a financial institution's privacy policy must take place at the time a customer relationship is established and not less than annually during the continuation of the relationship.

The key to the success of the Gramm-Leach-Bliley Act is functional regulation. This means that the brokerage, mutual fund and investment advisory arms of the financial holding company will be regulated by the SEC, while the overall financial holding company will be under Federal Reserve Board oversight. The SEC and the Fed will have to coordinate and cooperate more than they ever have in order to make Gramm-Leach-Bliley work in the way Congress intended.

Accounting and Auditing

Accountants have been a part of the regulatory picture since the very beginning of the federal securities laws. The role of the independent public accountant has been viewed as crucial to the functioning of the federal securities laws. SEC regulations stipulate that financial statements filed with the Commission must be audited by an independent certified public accountant in accordance with generally accepted auditing standards. The independent audit of corporate financial statements is a unique franchise of the accounting profession.

The SEC is authorized to establish financial accounting and reporting standards for publicly held companies. For over 70 years the SEC has looked to the private sector for leadership in establishing and improving standards. Accounting and reporting standards are established by the private sector through the Financial Accounting Standards Board (FASB). The FASB is an independent organization funded by the private sector. The FASB's authority with regard to public companies comes from the SEC. The SEC retains oversight authority over the FASB. The Sarbanes-Oxley Act recently reaffirmed FASB's status as the accounting standard-setter and gave the board a stable source of funding.

In examining the company's books and records, the independent auditor determines if the financial reports have been prepared in accordance with generally accepted accounting principles. The auditor then issues an opinion as to whether the financial statements, taken as a whole, fairly present the financial position and operations of the company for the period indicated. In a 1984 opinion, the U.S. Supreme Court said that, by certifying the public reports that collectively depict a company's financial status, the independent auditor assumes a public responsibility that transcends any employment relationship with the client.

This special function means that the independent auditor owes ultimate allegiance to the company's shareholders, as well as to the public investors at large. The public watchdog function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

The implosions of Enron and WorldCom, and other financial reporting scandals, revealed deep failings in the U.S. accounting profession's ability to regulate itself. In response, the Sarbanes-Oxley Act created the Public Company Accounting Oversight Board (PCAOB), with the power to discipline, do quality reviews, and set rules for auditing and independence. The Board will meet the demand for a strong investigatory and disciplinary body over the accounting profession to encourage quality work and ethics. The Board, overseen by the SEC, is designed to reestablish the credibility of corporate numbers, which the Commission views as absolutely critical for securities investment and for an efficient transactional system.

In addition, Section 404 of Sarbanes-Oxley requires annual reports filed with the SEC to be accompanied by a statement by company management that management is responsible for creating and maintaining adequate internal controls over financial reporting. Management must also present its assessment of those controls. Moreover, the company's auditors must attest to management's assessment of the internal controls under a standard adopted by the PCAOB.

In 2007, the SEC and PCAOB completed a coordinated reform of internal control reporting under Section 404 in an effort to make compliance cost effective consistent with investor protection. The result was a principles-based, risk-based regime based on new SEC management guidance and a new PCAOB auditing standard.

The Private Securities Litigation Reform Act of 1995 provides procedures for auditor disclosure of corporate fraud. If a major fraud is perpetrated at a company and management refuses to correct the abuse, the company's accountant is required to report the fraud to the SEC. The Act provides that the SEC may impose a civil penalty against an independent accountant that has willfully violated the statute's reporting provisions.

With the increasing globalization of accounting standards and the European Commission's mandate that financial statements in the EU be prepared using international financial reporting standards (IFRS), the SEC has proposed eliminating the requirement that the financial statements of foreign private issuers using IFRS be reconciled to U.S. GAAP. At the same time, FASB and the IASB have agreed to a framework that will ultimately converge IFRS with GAAP.

Integrated Disclosure

Some years ago, the SEC embarked on an initiative to integrate disclosure under the various federal securities laws. Integrated disclosure has been an evolutionary process that began as far back as 1966 when Chairman Cohen noted the anomaly of the structure of the disclosure rules under the Securities Act and the Exchange Act and suggested the integration of the requirements under the two statutes. His article was followed by a study by SEC Commissioner Francis Wheat, which culminated in the seminal Wheat Report and the SEC's Advisory Committee on Corporate Disclosure. These studies eventually culminated in the adoption of the integrated disclosure system and the shelf registration of continuous and delayed offerings under which companies register an indefinite amount of securities and "take them off the shelf" to offer them as needed.

Integrated disclosure envisions the Incorporation of information from one filing in connection with another filing. Some Securities Act registration statements allow the incorporation of Exchange Act reports by reference. If certain conditions are satisfied, annual or quarterly reports to shareholders may be combined with the required information of annual and quarterly reports to the SEC.

Two of the cornerstones of the integrated disclosure system are the bodies of rules adopted by the SEC in Regulation S-X and Regulation S-K, providing uniform requirements for financial and non-financial disclosures in documents covered by the Securities Act and the Exchange Act. The SEC's accounting rules are contained in Regulation S-X, a codification of instructions as to the form and content of financial statements. Since uniform financial disclosure is required for most documents, the basic financial statements in all reports relating to a single company are generally the same.

Substantially all of the SEC's requirements for the disclosure of non-financial information in registration statements and other disclosure documents are contained in Regulation S-K. The forms and schedules adopted by the SEC specify which disclosure items of Regulation S-K are required in a given document. One of the most important requirements of Regulation S-K is a Management's Discussion and Analysis section.

Fundamentals of Securities

What Is a "Security"

The question of what a "security" is has bedeviled the federal courts for over 70 years. On the surface, the answer seems like it should be simple. A "security" is a stock or bond or note, or some indicia of ownership in a company. And indeed, the federal securities statutes do define a "security" in terms of those types of instruments.

But, there is more. The federal courts have crafted definitions of "security" that go beyond traditional instruments such as stocks. For example, it might surprise some people to know that interests in the development of an orange grove have been found to be federal securities by the U.S. Supreme Court. It was in this case, SEC *v.* W.J. Howey Co., that the Court announced the famous test for what would be considered an investment contract, and hence a security.

The test is that a security exists if there is an investment of money in a common enterprise with profits to come from the efforts of others. Under this test, federal courts have found that the investment of money in a common enterprise for the breeding of cattle was a security. It's also been found that syndication interests in thoroughbred stallions was a security.

Derivatives

Derivatives are securities that derive their value from an underlying commodity or security. In their simplest form, they may be options, but new derivatives products have become increasingly complex. They may be tied to interest rates, foreign currency rates or commodity prices, among other things. Derivatives can be effective tools for managing exposure to market risk, but they also can expose a company or investor to significant losses.

The SEC has adopted disclosure requirements for derivatives, including market risk information. It also requires the disclosure of accounting policies used to account for derivatives.

Disclosure Obligations

Disclosure is at the very heart of the federal securities laws. Companies are required to disclose certain information to the SEC and investors. Different documents contain different information and different companies have different disclosure obligations.

You should understand one thing from the start: the Securities Act and the Exchange Act are disclosure statutes. They rest on the assumption that investors must be allowed to take risks and arrange their own affairs if the markets are to flourish. They rest on the further assumption that the capital markets are competitive, and once fundamental facts have been disclosed, either competition will protect investors or investors will protect themselves. The premise the securities laws operate under is that shareholders should be allowed to make choices and take risks so long as they have access to the information or advice necessary to act intelligently.

Fair Disclosure and Regulation FD

The SEC adopted Regulation FD (Fair Disclosure) in 2000 to address the problem of selective disclosure of material information by issuers of securities. Regulation FD requires that whenever a company or a person acting on its behalf discloses material nonpublic information to securities market professionals, or to shareholders whom one has reason to believe will trade on the basis of the information, the company must make public disclosure of that same information simultaneously for intentional disclosures, or promptly for non-intentional disclosures.

Regulation FD relies on existing definitions of “material” established in the case law, which teaches that information will be considered material if there is a substantial likelihood that a reasonable shareholder would consider it important in making an investment decision. To be material there must be a substantial likelihood that a fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available.

As a result of this, companies and their senior officers are wrestling with important decisions on whether information is material under the somewhat slippery definition provided by the federal securities laws. For this reason, the securities industry urged the development of a more concise definition of materiality for Regulation FD.

A former SEC Director of Enforcement has publicly stated that Regulation FD was not designed as a “trap for the unwary” and that enforcement cases will not be based on second-guessing reasonable judgments made in good faith, including judgments about materiality. These remarks, and similar ones by other SEC officials, have indicated that enforcement of the regulation will be focused on clear violations.

Regulation FD has increased the *quantity* of information provided by issuers, but its impact on the *quality* of information is less certain.

The rule may have led to a decline in the quality of information provided since some companies have used the rule as a shield to limit information flow, while others, concerned that senior officials making on-the-spot determinations of materiality may be second-guessed, have retreated to scripted conference calls.

Public Offerings

When a company offers its securities to the public for the first time, it is known as an initial public offering or IPO. The SEC staff reviews every IPO to ensure compliance with the disclosure requirements. The staff may seek additional information, which the company may provide in amendments to its initial registration. Once the staff declares a registration effective, the company may begin to sell its securities. The completion of the IPO triggers the obligation to comply with the other Exchange Act reporting requirements. An IPO is typically filed on a Form S-1, SB-1 or SB-2, depending on the size and operating history of the company.

Registration of Securities

The registration of offers and sales of securities under the Securities Act is intended to provide accurate disclosure of material facts concerning the company and the securities it proposes to sell. This is intended to enable investors to make a reasonable appraisal of the merits of the securities and exercise an informed judgment in determining whether to purchase the securities.

It is important for all to remember that the SEC does not approve or disapprove of the securities on their merits. The issuing company's prospects for success have no bearing on the question of whether or not the securities may be registered. Registration does not preclude the sale of stock in risky or poorly managed companies. Or as stated by Justice Douglas, who also served as SEC Chairman, "the truth about the securities having been told, the matter is left to the investor."

Generally, registration forms call for the disclosure of information regarding the company's properties and businesses and information about management, as well as a description of the significant provisions of the security to be offered for sale and its relationship to the company's other capital securities. Financial statements certified by independent public accountants are also required to be disclosed.

Registration statements are subject to examination for compliance with disclosure requirements. If a statement appears to be incomplete or inaccurate, the company is usually informed and given a chance to file correcting or clarifying amendments. However, the SEC has the authority to refuse or suspend the effectiveness of any registration statement if it finds that material representations are misleading or incomplete.

The Commission may conclude that material deficiencies in some registration statements appear to stem from a deliberate attempt to conceal or mislead, or that the deficiencies do not lend themselves to informal correction. If that's the case, the Commission may decide to conduct a hearing to develop the facts. This determines if a stop order should be issued to refuse or suspend effectiveness of the statement. The SEC may issue stop orders after the sale of securities has been commenced or completed. A stop order is not a permanent bar to the statement's effectiveness or to the sale of securities. If amendments are filed correcting the statement in accordance with the stop order, the order must be lifted and the statement declared effective.

Mutual funds register an indefinite number of shares on Form N-1A. The mutual fund prospectus must disclose information about the fund's objectives, its management and fees, and its programs and policies.

Internet Offerings

Disclosure of information can come over the Internet, through online services, or through analogous computer networks. The growth in the use of electronic media to communicate with investors raises issues involving concepts as new as the Internet and as old as fraud.

Until recently, online use of corporate information was generally limited to large corporations and institutional investors. But the dramatic growth in personal computer ownership has enabled many small investors to access online corporate information just as readily as institutions. In turn, this has created an exciting and new way for issuers and others to communicate with investors.

The federal securities laws do not prescribe the medium to be used for providing information by or on behalf of issuers. Thus, the SEC believes that the delivery of information through an electronic medium generally would satisfy delivery or transmissions requirements of the federal securities laws. The federal securities laws seek to promote fair and orderly markets by requiring the disclosure of information enabling investors to make informed decisions.

The extent to which required disclosure is made, as opposed to the medium used to provide it, should be most important to the analysis of whether sufficient disclosure has occurred under the securities laws. Thus, an electronic medium would not provide an adequate means for the delivery of required disclosure, and thus not serve the statutory purposes, if the information does not allow effective communication to investors or is practically unavailable.

In this context, the Internet provides for a broad reach, with a limited marginal cost for reaching additional people. There are a number of advantages to the use of electronic media generally and the Internet in particular. One is the lowering of communication costs, while another is that it allows for a leveling of the disclosure playing field. Information about the company can be provided easily to large numbers of people. It also allows businesses to raise capital easier and through more diverse mechanisms.

It must be remembered that the liability provisions of the federal securities laws apply equally to electronic and paper-based media. For example, Rule 10b-5 would apply to any information delivered electronically as it does to information delivered in paper. Former SEC Commissioner Steven Wallman has emphasized that electronic media can provide a great benefit, but that the industry must be on guard to the real possibility of fraud.

Registration Forms

Form S-1 is the basic registration form, which may be used by all companies to register their securities offerings. Part I of the registration statement is known as the prospectus. It describes the company's business, financial condition and management information. Part II contains information that does not have to be delivered to investors, but is publicly available to those who are interested. Companies must disclose the intended use of the proceeds of the offering and must include financial statements that have been audited by an independent certified public accountant.

Form S-2 can be used by large companies with a significant operating history and may incorporate information by reference to their Exchange Act reporting documents.

Form S-3 is available to the largest companies with established reporting histories. It is a short form allowing these companies to incorporate information by reference to their Exchange Act documents.

Forms F-1, F-2 and F-3 are the foreign issuer forms that are roughly equivalent to Forms S-1, S-2 and S-3.

Form S-4 is used for mergers, exchange offers and certain business combinations. The S-4 often combines the proxy information seeking shareholder approval of a proposed transaction while simultaneously registering shares to be used in the transaction. Form S-6 is used by unit investment trusts. Form S-8 is used for employee benefit plans shares. Form S-11 is used by real estate investment trusts.

Form SB-1 is a small business registration form that can be used by companies with less than $25 million in revenues in the last fiscal year and whose outstanding publicly-held shares are worth no more than $25 million. The simplified form lets small business issuers offer up to $10 million of securities in any 12-month period. SB-1 follows a question-and-answer format but requires audited financial statements.

Form SB-2 also is used by small business issuers, but may be used to register an unlimited dollar amount of securities. The form requires less extensive disclosure than the Form S-1 and requires audited financial statements for the last two fiscal year, rather than three as required by Form S-1.

Form N-1A is used by open-end management investment companies or, as we know them, mutual funds.

Exchange Act Reporting

Public companies must file annual and quarterly reports, proxy materials relating to annual meetings of shareholders, registration statements for any securities offered to the public and interim reports to notify the public of any material events such as a merger, acquisition or significant decline in financial fortunes.

Public companies must file an annual report on Form 10-K. Small businesses use Form 10-KSB. There are specific items on which a company must report annually, including audited financial results such as earnings per share. Among the most important components in the Form 10-K is an item known as the Management's Discussion and Analysis of Financial Condition and Results of Operation (MD&A).

In this section, company management must review not only events that had a major impact on the past year's earnings, but also any known trends or events that may affect future earnings and operations. The MD&A is intended to give investors a view of the company through the eyes of management by providing both a short-term and long-term analysis of the company's business, with particular emphasis on its prospects for the future. The language of the MD&A requirement is intentionally general, reflecting the SEC's view that a flexible approach best elicits meaningful disclosure and avoids boilerplate discussion.

The Sarbanes-Oxley Act added a discussion of a company's off-balance sheet arrangements to the MD&A so that investors could gain a comprehensive understanding of the implications of corporate obligations that are not readily apparent from a reading of the financial statements alone.

The MD&A is a very important source of information about the company and its business.

In an important step designed to restore investor confidence in financial statements, Sarbanes-Oxley requires a company's chief executive officer and chief financial officers to personally certify the contents of annual and quarterly reports.

The Form 10-K provides a description of the company's business, including subsidiaries and foreign operations, information about officers, directors and insiders, and its securities structure. The cover page states what types and how many registered securities a company has outstanding. For example, a company may have common shares, preferred shares and debt securities that are registered and held by the public.

Public companies must also file quarterly reports on Form 10-Q.

This is a much shorter report than the Form 10-K and includes unaudited financial statements along with any significant new developments. For important events that cannot await annual or quarterly disclosure, the SEC provides for the filing of a Form 8-K.

Most public companies are required to hold an annual meeting of shareholders in which members of the board of directors are elected and the companies' auditors are approved. A proxy statement is mailed to shareholders in advance to provide notice of the meeting location and date and the issues on which a vote will be sought. A proxy card is included in the proxy materials so that a shareholder may register a vote and return it by mail, rather than attend the meeting in person.

Occasionally, shareholders will submit proposals to the company for consideration at the annual meetings. If these proposals meet certain criteria, they may have to be included in the company's proxy statements.

The proxy statement includes information about the compensation given to the board of directors, including any stock option plans, bonuses and perquisites.

Certain extraordinary transactions, such as a merger or business combination, typically require a special meeting to obtain shareholder approval. The proxy statement for a special meeting provides details of the transaction and management's view of why shareholders should vote in support of the proposal.

On occasion, a dissident shareholder group will launch what is known as a proxy fight, which may be in opposition to a management group or to a proposed transaction. A proxy fight may also be brought by a company that wishes to gain control of a registrant against the wishes of management. In a proxy fight the hostile group attempts to obtain the shareholders' vote for its slate of directors in order to obtain approval for its transaction. Even if the hostile group does not prevail in the shareholder vote, support may be significant enough to force management to consider the group's proposal.

Executive Compensation

In time for the 2007 proxy season, the SEC completely revamped its rules relating to the disclosure of executive compensation. The new regime requires, for the first time, the disclosure of all elements of executive compensation and that a total individual compensation number be provided for the top five senior officers and all directors. Also for the first time, a company must provide a Compensation Disclosure and Analysis (CD&A), which is a narrative overview explaining the policies and decisions related to executive compensation. According to Chairman Christopher Cox, the CD&A provides a company with both an obligation and an opportunity to explain its compensation policies.

American Depository Receipts

Foreign companies that wish to offer their securities in the United States often do so in the form of American Depository Receipts, known as ADRs. The ADRs are certificates that represent a foreign company's shares and entitle the holders to any dividends and capital gains. ADR holders may participate in the foreign companies' tender and exchange offers. The ADRs are held in U.S. depositories so there is no need to open a foreign brokerage account to invest.

EDGAR

In the 1980s, the amount of paper required to comply with the SEC's disclosure requirements threatened to overwhelm the agency. Then Chairman John Shad proposed an electronic filing system to eliminate the paper crush and provide an easier method for the staff to review filings. The Electronic Data Gathering, Analysis and Retrieval system, known as EDGAR, began with a pilot program in which participation was voluntary. EDGAR was especially attractive to industry participants such as investment companies that have significant ongoing filing requirements.

The pilot program proved successful, and Congress authorized the SEC to proceed with full implementation of EDGAR. The SEC phased companies into the system over a number of years, beginning with the largest. The phase-in of all entities required to file with the SEC was completed in May 1996. Just as the phase-in was completed, the SEC recognized that the EDGAR technology was outmoded. Under a new contract awarded in 1998, the EDGAR vendor will bring new technological advancements to the system to improve its appearance and accessibility.

All public companies and mutual funds are required to file reports on EDGAR. Reporters and the public can access these filings through the SEC's web site at www.sec.gov or through private vendors that provide access to the documents with certain enhancements, such as key word searches. Using EDGAR via the SEC is free, while the private vendors charge for their services.

How Securities Law Is Made

The organic federal securities laws are the statutes passed by Congress between 1933 and 1940. Congress has amended these statutes a number of times over the years, most notably in the Securities Reform Act of 1975, the Private Securities Litigation Reform Act of 1995, the National Securities Markets Improvement Act of 1996 and the Sarbanes-Oxley Act of 2002. The original source of federal securities law is Congress. All SEC rulemaking must be based on statutory authority.

Congress

The SEC reports to a number of congressional committees, not only for its annual appropriation of operating funds, but also in connection with pressing securities issues. The Senate Banking Committee and its Securities Subcommittee oversee the securities industry. In the House of Representatives, the Financial Services Committee has primary oversight of the securities industry. The House Energy and Commerce Committee has jurisdiction over the setting of accounting standards by the Financial Accounting Standards Board (FASB), oversight with regard to electronic communications networks, and matters relating to the regulation and SEC oversight of public utility holding companies and their subsidiaries. Finally, the Commerce Committee also has jurisdiction over matters dealing with the privacy of customers of financial institutions, including brokerage firms, mutual funds and investment advisers.

SEC officials are often called to testify before these Committees on proposed or pending legislation or are asked to conduct studies to assist Congress in drafting legislation.

SEC Actions

The SEC engages in rulemaking to flesh out the federal securities statutes passed by Congress.

When the SEC proposes rules under any of the Acts it oversees, it usually holds an open meeting under the government in the sunshine laws. The meeting may be attended by the press and interested parties. Typically, the staff describes a rule proposal to the commissioners who may question the staff or seek changes to the proposal. The commissioners then vote on whether to issue the proposal for public comment. The proposal is available on paper through the SEC's public reference room and also is posted on the SEC's web site. In addition, the proposal is printed in the Federal Register, usually within a week of its approval.

Public comment periods can range from 30 days to 120 days, and sometimes get extended, depending on the complexity of the issue. Interested parties submit comment letters with respect to the proposal either on paper or electronically. All of the comment letters are publicly available. The letters are of interest because the views of significant industry groups may persuade the SEC to adopt an approach other than that which has been proposed. Significant support of the proposal can lead to the adoption of the matter as initially proposed. Occasionally, the opposition is so negative that the staff will drop an initiative altogether, or at least place it on the back burner. On rare occasions, rule proposals are changed and reproposed.

The SEC generally holds another open meeting when the staff is ready to present the proposal in its final version for adoption. This version of the proposal has taken into account the comments from the industry and any changes recommended by the staff and commissioners during the comment period. If the commissioners adopt the proposal, it typically becomes effective once it is published in the Federal Register. Occasionally the SEC adopts a delayed effective date to allow the industry time to prepare for a significant new approach to a way of doing business.

Another source of securities law is SEC interpretive releases, which address the Commission's views on a particular matter and how the securities laws and SEC regulations relate to the matter. An SEC concept release represents a somewhat different approach. When the SEC issues a concept release for public comment it is attempting to obtain views in advance of proposing a rulemaking initiative. The concept release provides the staff with the opportunity to thoroughly research an issue by hearing from outside experts before drafting a proposal.

The SEC has an informal process for responding to industry questions about the securities laws through staff no-action letters. These are not legally binding positions, but reflect staff views on how the securities laws and the SEC's regulations apply to a specific matter.

Each division responds to letters relating to its particular area of expertise. For example, the Division of Investment Management responds to inquiries affecting investment companies and investment advisers, the Division of Market Regulation responds to market issues, and the Division of Corporation Finance responds to issues affecting reporting companies.

SRO Rules

All of the exchanges and the NASD, and now FINRA, propose and adopt rules for their members and operations. Rule proposals are first circulated to members for comment and then submitted to the SEC in the form the exchange plans to adopt. Occasionally, a proposal will undergo a number of amendments before being adopted in final form.

Securities Transactions and Investor Protections

Tender Offers and Takeovers

Until 1968, tender offers were essentially unregulated. But, in that year, the Exchange Act was amended to extend the reporting and disclosure provisions to situations in which control of a company is sought through a tender offer or other planned stock acquisition of a target company. The Williams Act requires disclosure of pertinent information by anyone seeking to acquire over five percent of a company's securities by direct purchase or by tender offer.

The primary objective of federal regulation in this area has been the protection of investors in companies being subjected to a takeover attempt. Thus, the concept of neutrality has guided federal regulation in that the Williams Act walks a delicate line so as not to tip the balance in favor of either the bidder or the target company. Congress wanted to remove the secrecy that had heretofore cloaked transactions involving a shift in corporate control.

The term "tender offer" is not precisely defined in the Exchange Act. Federal courts have focused on a number of characteristics as being indicative of a tender offer, including active solicitation of public shareholders, an offer at a premium price, firm rather than negotiable terms and the offer being open for only a limited period of time.

In the years since the enactment of the Williams Act, acquisition practices have undergone fundamental changes, highlighted by complex bidding strategies and equally inventive defensive responses. A popular defensive tactic has been the adoption of a "poison pill" by the target company. This defense is designed to make a takeover prohibitively expensive through the issuance of a special class of stock, the "poison pill," that the bidder will have to swallow if successful.

A "lock-up" arrangement gives one bidder an advantage in acquiring the target company over other real or potential bidders. There are also times when a target company facing a hostile bid will search for a "white knight" to make a friendly offer and thwart the hostile takeover attempt.

Insider Trading

Insider trading can result in fraudulent conduct within the scope of the federal securities laws. The term "insider" generally refers to officers, directors and controlling shareholders. Insider trading prohibitions are designed to curb misuse of material non-public information not available to the general public. Examples of such misuse are buying and selling securities to make profits or avoid losses based on inside information, or by telling others of the information so that they may buy or sell securities before such information is generally available to all shareholders.

The general rule that has been in existence for many years is that a company insider in possession of material non-public information must either disclose the information to the investing public or abstain from trading on it.

The duty to disclose inside information before trading arises from the existence of a relationship giving access to information intended to be available only for a corporate purpose and not for the personal benefit of anyone and the unfairness of allowing a corporate insider to take advantage of that information with knowledge of unavailability to the public.

Misappropriation Theory of Insider Trading

The classic theory of insider trading involves a company insider, or one who receives inside information in violation of the insider's fiduciary duty to the company, who then trades in the company's stock. A more difficult question arises when the inside information comes into the hands of a third party, who then trades on it.

The misappropriation theory has been developed to deal with this contingency. Under this theory, which has been approved by the U.S. Supreme Court, the person who trades on the information need not be an insider or receive the information from an insider in order to be held liable under Rule 10b-5. It is enough that the person trading received the information due to a breach of a fiduciary duty owed to any lawful possessor of inside information or, in some instances, through a breach of trust or confidence.

The misappropriation theory has been applied to find violations of the antifraud rule by employees of an investment banker and a law firm office manager for trading in the securities of the employer's corporate client on the basis of misappropriated information.

Insider Reporting

The Exchange Act contains a comprehensive scheme designed to provide the public with information on the securities trades of corporate insiders and deter them from profiting on short-term trading in the securities of their companies while in possession of inside information.

These are the insider reporting and short-swing profit recovery provisions of Section 16. It should be noted that this is quite different from insider trading, which can be a species of fraud. The insider reporting regulations are largely driven by the SEC, and the short-swing recovery provisions are not dependent on a showing of fraud.

Section 16(b) calls for the recovery of any profit realized by corporate insiders as a result of short-swing trading – the purchase and sale (or sale and purchase) of an equity security in a period of less than six months. It is a statute that imposes liability without fault within its narrowly drawn limits, and such liability does not depend on the actual use or possession of inside information by the insider.

The stock transaction reporting provisions of Section 16(a) establish disclosure requirements for corporate officers, directors and principal shareholders. These reporting requirements allow investors to see when and in what quantity company senior officers and directors buy and sell the company's stock.

Forms

Before passage of Sarbanes-Oxley, corporate insiders did not have to file a Form 4 with the SEC reporting a transaction in company stock until the tenth day of the month following the month in which the transaction occurred, giving them potentially up to 40 days to file. They also had the option of filing in paper or electronically through EDGAR.

Sarbanes-Oxley changed all that. The Act mandates that the Form 4 must be filed electronically within two business days of the transaction. In addition, the Act directs that companies must post the form on its web sites within one business day of the SEC filing, if the company maintains a web site.

Delinquent Reports

In 1991, the SEC mandated that proxy statements and annual reports disclose information regarding delinquent Section 16 filings. A company was required to name its insiders who reported transactions late or failed to file and to disclose the number of delinquent filings and transactions for each such insider. In light of the shift from relatively leisurely paper filing to two-day electronic filing, the SEC granted temporary relief from the delinquency requirement for Form 4s filed not later than one business day following the regular due date, and filed during the first 12 months following the effective date of mandated electronic filing.

Investment Companies, Investment Advisers and Broker-Dealers

The Investment Company Act is the primary federal statute regulating investment companies. It is a complex statute that recognizes the unique nature of these entities. An investment company invests in the securities of other companies and issues securities of its own. Shares in an investment company thus represent proportionate interests in the company's investment portfolio. The most common form of investment company is the mutual fund, which is technically an open-end management investment company.

A mutual fund is required by law to redeem its shares on demand. It follows that mutual funds must continuously issue and sell new shares in order to avoid liquidation by redemption. Management companies whose securities lack this redeemability feature are called closed-end investment companies. Since mutual funds are obligated to redeem their shares at a net asset value upon receipt of a tender from a shareholder, they must restrict their investments to assets that can be readily liquidated to meet redemption demands.

A mutual fund has been described as a pool of assets consisting primarily of portfolio securities and belonging to the individual investors holding shares in the fund. With some exceptions, mutual funds are not operated by their own employees. Most are formed and managed by external organizations called investment advisers that are separately owned and operated. The adviser selects the fund's investments and operates the fund's business, providing investment advice, management services, office space, staff and the like.

Investment Advisers

The Investment Advisers Act of 1940 is the primary vehicle for the federal regulation of investment advisers. The Advisers Act is applied on an "entity" basis, that is, when an investment adviser registers under the Act its activities everywhere are subject to the Act.

The Act defines an "investment adviser" as a person who, for compensation, engages in the business of advising others either directly or through publications or writings as to the value of securities or as to the advisability of investing in or purchasing or selling securities. The definition is broad and also includes persons who, as part of a regular business, issues analyses or reports concerning securities.

But the Advisers Act specifically excludes lawyers, accountants and brokers whose investment advice is solely incidental to their professions. However, it's important to note that brokers who receive special compensation for their advice must register as investment advisers. The Act also excludes publishers of newspapers, magazines or financial publications of general and regular circulation from registration as advisers.

Investment advisers pay a one-time fee to the SEC upon registration. The securities laws require that advisers disclose to clients information about their backgrounds, business practices and potential conflicts of interest. Advisers must also keep certain prescribed books and records and make them available to SEC examiners.

In addition, advisers owe their clients a fiduciary obligation to act in the client's best interest and to refrain from engaging in self-dealing and conflicts of interest or to otherwise take advantage of the client. Breaches of this duty may be actionable under the Advisers Act. The primary means by which the SEC enforces the requirements of the Advisers Act is through periodic and "cause" inspection of investment advisers.

Most states also regulate investment advisers, and this dual regulation often has led to duplication and inefficiency. In 1996, Congress eliminated regulatory overlap and improved allocation of resources by giving the states the primary responsibility for the supervision of investment advisers managing less than $25 million in client assets, while giving the SEC the primary responsibility for the supervision of advisers who manage $25 million or more in client assets or who advise mutual funds.

The SEC continues to regulate all investment advisers in those states that do not have their own regulatory scheme.

Broker-Dealers

The SEC imposes stringent capital requirements on brokers and dealers in order to deal with the risks inherent in securities activities. A broker is any person in the business of effecting transactions in securities for the account of others. A dealer is any person in the business of buying and selling securities for such person's own account through a broker or otherwise.

The SEC's net capital rule requires securities firms to have total capital exceeding the full value of illiquid assets, such as property and equipment, and a prescribed percentage of other assets, such as security positions.

Both the SEC and various self-regulatory organizations such as the NASD and the stock exchanges examine various aspects of broker-dealer firms. They have programs for examining a firm's financial integrity and for evaluating a firm's trading integrity. They also have sales practice programs for evaluating a firm's compliance with SEC rules pertaining to fair and non-manipulative sales practices. The Commission has repeatedly stressed the obligation of broker-dealers to assure that retail sales activities comply with the antifraud provisions of the securities laws.

The concept of suitability is a very important one in this area. Suitability means that brokers must recommend investments that are suitable to the individual financial status and investment goals of their clients. For example, a brokerage firm that recommended to elderly retired investors seeking conservative investments that they transfer money from investments with relatively little risk to naked options or to speculative, illiquid limited partnerships would violate securities antifraud provisions.

Churning is another practice that can result in SEC sanctions. Churning occurs when a broker exercising control over the volume and frequency of trading abuses the customer's confidence for personal gain by initiating transactions excessive in the view of the character of the account. The hallmarks of churning are disproportionate turnover, frequent in and out trading and large brokerage commissions.

Compliance is a very important aspect of broker-dealer oversight. The SEC has emphasized that the responsibility of broker-dealers to supervise their employees is a critical component of the federal securities regulatory scheme. The Exchange Act authorizes the Commission to impose sanctions for deficient supervision on the firm and on individuals associated with the firm.

Taking Legal Action Under the Securities Laws

SEC Enforcement

The SEC's Division of Enforcement investigates possible violations of the federal securities laws and recommends appropriate remedies to the Commission. Sometimes violations are discovered by the division in connection with its own inquiries. Some matters are referred by other divisions or by the SROs. Others are brought to the Enforcement Division's attention by investors.

The SEC has a legal duty to investigate complaints and other indications of possible violations in securities transactions. Most investigations arise under the Securities Act and the Exchange Act, which contain similar antifraud provisions. Most of the SEC's investigations are conducted privately and are essentially fact-finding inquiries. Facts are developed to the fullest extent possible through informal inquiry, interviewing witnesses, examining brokerage records and other documents, reviewing trading data and similar means. The Commission is empowered to issue subpoenas, requiring sworn testimony and the production of books and records. The Commission may apply to a federal court for an order compelling obedience to a subpoena.

The SEC also uncovers violations of the securities laws during field office inspections or during reviews by the Office of Compliance Inspections and Examinations of the books and records of regulated entities. The SEC and the SROs monitor market fluctuations in certain stocks that may signal illegal insider trading.

The facts developed by the staff are considered by the Commission to determine if there is valid evidence of a violation and, if so, whether or what sanctions should be imposed. When the facts show a possible fraud or other violation, the law provides several courses of action that the SEC may pursue. For example, the Commission could seek a civil injunction from a federal court to prohibit the acts or practices alleged to have violated the securities laws.

The SEC may decide to pursue an administrative remedy under which the agency can take specific action after hearings. The SEC may issue orders to suspend or expel members from exchanges or over-the-counter dealers associations, or deny, suspend, or revoke broker-dealer registrations, censure for misconduct or bar individuals either temporarily or permanently from employment with a registered firm.

The federal court injunction is an order that prohibits future violations of the law. This is one of the SEC's chief enforcement tools. If the injunction is violated, the result may be fines or imprisonment. In seeking an injunction, the SEC also may request a temporary restraining order and a preliminary injunction as emergency relief. Another emergency action is a freeze order to protect investor funds and assets.

In an effort to prevent corporate executives from enriching themselves while a company is subject to an SEC investigation but before the Commission has gathered enough evidence to file formal charges, Sarbanes-Oxley allows the SEC to seek a federal court order imposing a 45-day freeze on extraordinary payments to company executives.

Before 1990, the SEC was limited in its ability to craft civil remedies appropriate to the particular violation in question. For cases other than those involving insider trading, which had its own directive on fines, the Commission did not have an effective alternative between the simple "slap on the wrist" represented by an injunction or the "nuclear bomb" represented by barring someone from the securities industry. However, with the 1990 passage of the Securities Enforcement Remedies Act, the SEC can both seek court orders imposing civil monetary penalties and impose money fines in its own administrative proceedings.

One note of interest is that the SEC has only civil authority. If fraud or other violations are suspected, the SEC may refer the matter to the Department of Justice for criminal prosecution. The DOJ, through local U.S. attorneys, may present the evidence to a federal grand jury and seek an indictment. This type of investigative cooperation is common, and also extends to other federal, state and local law enforcement officials.

The SEC's Office of the General Counsel represents the Commission in judicial proceedings and in disciplinary proceedings under the Rules of Practice. It represents the Commission in cases in the appellate courts, files briefs and presents oral arguments on behalf of the Commission. The General Counsel also supervises all contested civil litigation and SEC responsibilities under the Bankruptcy Code.

Wells Submissions

wThe States

In securities enforcement, the states are the local police force. By their locality alone, the states are best equipped to address issues affecting individual investors. The states are often referred to as the "back stop" or the "safety net" to the federal enforcement efforts.

Individual Investors

Private individuals can bring securities fraud actions when they feel they have been injured. The actions are usually brought under the authority of the SEC's Rule 10b-5, a general anti-fraud prohibition. Rule 10b-5 applies to practically any securities transaction, even the sale of securities that do not have to be registered.

While Rule 10b-5 is a very broad antifraud remedy for private investors, its reach is not limitless. Federal court decisions have established parameters within which the anti-fraud rule must operate. For example, the Supreme Court has ruled that an intent to defraud – not simply negligence – has to be shown. The Court has also held that a person must be either a purchaser or seller of a security in order to use Rule 10b-5. In addition, the Court has distinguished corporate mismanagement from fraud and placed a statute of limitations on suits.

In 1994, the Supreme Court held that investors do not have a private right of action under Rule 10b-5 against those who aid and abet securities fraud. This ruling is evidence of the Court's growing dislike for judicially implied private rights of action. However, the Supreme Court has accepted the basic Rule 10b-5 private remedy for many years and is highly unlikely to eliminate it. In a 1983 case, Justice Marshall proclaimed that the existence of this implied remedy is "simply beyond peradventure."

Under the issue of scheme liability, the Supreme Court may have occasion to reexamine the 1994 case during its 2007-2008 term. The concept of scheme liability is that non-speaking actors, such as investment banks and auditors that knowingly participate in the issuer's fraud can be liable in private securities fraud actions as primary violators of Rule 10b-5. Some former SEC chairs, such as Harvey Pitt, consider scheme liability a ploy to recast secondary liability as primary liability in order to circumvent the Court's 1994 ruling, while others, such as Arthur Levitt, urge the Court to hold that non-speaking actors who engage in deceptive acts as part of a scheme to defraud investors may be liable under the anti-fraud rule.

Another limit on securities fraud actions is the "bespeaks caution" doctrine. Under this approach, projections and forecasts by company management are protected so long as they are accompanied by meaningful cautionary language that warns investors of any risks. But note that vague or blanket disclaimers or boilerplate will not be sufficient. Rather, the cautionary statements must be substantive and tailored to the specific projections. It is also important to remember that the doctrine applies to soft information, such as projections, and has no application to hard facts. For example, a statement regarding a plan to restore profitability could not be protected by the bespeaks caution shield since whether the company had such a plan in place was a question of fact.

In 1995, Congress enacted a safe harbor for corporate projections in an effort to encourage companies to give shareholders more forward-looking information. This was part of the Private Securities Litigation Reform Act (PSLRA), and the action grew out of a congressional concern that the proliferation of private securities litigation had begun to inhibit free and open communication among company executives, financial analysts and investors. After passage of the Act, the lower federal courts divided over the proper pleading of intent to defraud under the Act.

Ending this debate, in 2007 the Supreme Court held that the PSLRA's requirement that investors in a securities fraud action state facts that the defendants acted with a strong inference of scienter means that the claim will survive only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged. The Court deemed this a "workable construction" of the strong inference standard that achieves the PSLRA's goal of curbing frivolous litigation while preserving an investor's ability to pursue a meritorious claim.

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