Major Financial Laws: Securities Regulations

Center Forward Basics

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The Financial Services industry's maze of regulations and laws often leaves many confused. While the securities industry, relative to the banking industry, has fewer laws, these laws have been around for a significant period of modern American history, changing little until the 21st century. An additional difference from banking regulations is that securities regulations focus primarily on disclosures and transparency, whereas banking regulations are primarily prudential and supervisory. In recent years, especially with the rise of Financial Holding Companies, many federal and state laws have regulated firms offering banking, payments, and securities services as financial firms adapted to provide full-service financial products to clients. While U.S. capital markets continue to innovate and thrive, the regulatory landscape will need to adapt to the changing nature of the U.S. economy and the needs of investors.

Securities Act of 1933

The Securities Act, sometimes referred to as the "Truth in Securities Law," was the first major federal securities law enacted and was passed after the 1929 stock market crash, which led to the Great Depression. The law focused on two overlapping objectives: ensuring that investors obtain all relevant and material information and restricting intentional misrepresentations in securities. For the purposes of securities laws, a "security" has been broadly defined as debt instruments (notes, bonds, debentures, etc.), equity instruments (stocks, preferred stock, etc.), or any investment that derives its value from a debt or security instrument (call option, put option, etc.).

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In order to meet our challenges we need to put aside the partisan bickering that has gridlocked Washington and come together to find common sense solutions.

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The Securities Act aims to ensure that persons offering securities provide investors and potential investors with the necessary information to make informed decisions about their investment. The act requires the registration of securities, unless an exemption applies, and for issuers to disclose all material information, but does not guarantee the accuracy of the information disclosed. While most securities must be registered before sale, there are exemptions from the registration. One of the most notable exemptions is for a non-public offering, otherwise known as a private placement. For example, rule 144A streamlines the sale and purchase of private securities to and among "qualified institutional buyers" (QIBs). QIBs are defined generally as owning and investing at least $100 million in securities. These institutional investors are considered more sophisticated and capable of evaluating the merits of a particular investment. Other eligibility standards for investing in private placements include an "accredited investor" standard. Qualifying as an accredited investor generally requires a net income of at least $200,000 per year ($300,000 if jointly with a spouse) or a net worth of at least $1 million. The requirements for who is an accredited investor have often been debated, with calls to lower the threshold and, though rarer, arguments to raise the qualifications. Other proposed reforms to the accredited investor standard include determining financial sophistication by passing a designated examination. Striking a balance between access to private placements and protecting less sophisticated market participants from higher risks will remain an ongoing challenge for regulators.

Securities registration can be a long, multifaceted process. Aspects of a registration process differ depending on the security being offered. The most well-known registration process occurs when a private company decides to go public and conducts an initial public offering (IPO). Once registered and filed with the SEC, all required documentation becomes public and is available

on the SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system.

Securities Exchange Act of 1934

The Exchange Act, the second major securities law enacted in response to the 1929 market crash that triggered the Great Depression, also requires the dissemination of information to benefit investors and the markets more broadly. The act is commonly referred to as the Exchange Act. Compared to the Securities Act, which regulates primary offerings and sales, the Exchange Act regulates secondary offerings and sales in addition to the conduct of market professionals.

First, the Exchange Act created the Securities and Exchange Commission (SEC) as the primary agency responsible for regulating and overseeing securities transactions. The SEC was given authority over brokerage firms, transfer agents, and clearing agencies, as well as the nation's securities self-regulatory organizations (SROs). SROs; like the New York Stock Exchange, the NASDAQ, and the Financial Industry Regulatory Authority (FINRA); are unique in many ways and are required to create their own rules, which are subject to the oversight by the SEC. The act requires multiple market participants, such as those listed above, to register with the SEC, file registration documents, and update them. The Exchange Act also requires broker-dealers and others to satisfy capital and recordkeeping requirements and protect customer-owned assets.

This legislation also regulates market activity by either outlawing unfair practices, such as insider trading, or requiring the disclosure of material information to investors and the markets. The SEC currently requires public companies to file quarterly financial reports. One of the quarterly reports must be an audited annual financial report, which is subject to more in-depth reporting requirements and thus longer than the other quarterly reports. The quarterly and annual reports are available on the EDGAR database and referred to as a 10-Q (quarterly report) or a 10-K (annual report). Additionally, the act also governs the materials that need to be provided for proxy votes, votes by shareholders at annual shareholder meetings, and for tender offers, an offer by an individual or entity to shareholders with the intent to acquire the company by purchasing the requisite amount of shares to gain control of said company.

Investment Company Act of 1940

The third of the major securities laws enacted in response to the 1929 stock market crash, this law, also referred to as the 1940 Act, gives the SEC the power to regulate investment companies. Investment companies are those whose shares are publicly traded and primarily invest in and trade securities, such as mutual funds. However, certain types of pooled assets are exempted from the 1940 Act, such as private funds. The exemptions from investment company regulation depend in part on whether the private fund being offered follows the private placement rules of the Securities Act and by requiring that investors meet minimum financial requirements.

The 1940 Act requires disclosures by investment companies subject to the law. The disclosures include information on the company's financials, structure, and investment policy. The disclosures are meant to increase the public trust in investment companies and reduce conflicts of interest. Additionally, the act also places limits on how levered (the amount of debt a company takes on) an investment company can be. The 1940 Act also requires registered funds to be overseen by a board of directors and limits certain types of investments, such as limiting the ownership of other investment funds or limiting the percentage of illiquid (hard to sell due to a lack of availability or trading volume) assets in the fund. However, these limitations aside, the legislation does not allow the SEC to oversee or judge the investments made by investment funds directly. Essentially, the law seeks to outlaw egregious investment fund activities (most of which contributed to compounding the negative economic effects of the stock market crash) and to provide investors with the information needed to make informed investment decisions. The law *does not* attempt to regulate the investment decisions made by funds subject to the Investment Company Act, nor does it give regulators the ability to analyze, rate, or discuss the merits of such decisions.

Investment Advisers Act of 1940

The Investment Adviser Act, or the Advisers Act, is the final act passed in relation to the stock market crash of 1929. As the name suggests, this law regulates investment advisers. Investment advisers is anyone who provides direct or indirect investment advice in return for compensation, which includes the investment managers that manage mutual funds and private funds. The act requires investment advisers to register with the SEC unless they are exempt. Additionally, it compels registered investment advisers to comply with various restrictions and requirements, such as maintaining books and records, reporting information to the SEC, complying with restrictions on marketing, and disclosing information to clients and potential clients. Investment advisers provide fiduciary advice to investors and typically charge a flat fee for financial management.

Additionally, all investment advisers are bound to a fiduciary duty to clients. A fiduciary is anyone who must act in the best interests of their clients and put their client's welfare, in this case their financial health, ahead of their own. Failure to act as a fiduciary can result in hefty fines and potential imprisonment.

Securities Investor Protection Act of 1970

The Securities Investor Protection Act of 1970, or SIPA, created the Securities Investor Protection Corporation (SIPC). SIPC is a non-profit organization backed by the U.S. government that protects the value of investors' assets in the case of a broker-dealer's failure. As a result, most registered broker-dealers are members of the SIPC. The SIPC protects up to $500,000, but cash in a brokerage account is protected only up to $250,000. When a brokerage firm fails, the SIPC attempts to transfer its clients' brokerage accounts to another broker-dealer. If that is not possible, then the SIPC will compensate the investor for the market value of the assets remaining at the failed brokerage firm, subject to the above limits. The SIPC is sometimes compared to the FDIC, since the FDIC insures bank accounts similarly to the SIPC. However, the FDIC is a government agency, while the SIPC still operates as an independent corporation backed by the U.S. government. However, the SIPC coverage does not apply to customer losses resulting from fraud by the brokerage firm.

Employee Retirement Income Security Act of 1974

The Employee Retirement Income Security Act, otherwise known as ERISA, regulates private retirement and health plans, like 401(k)s, pension plans, and HSAs, to protect those enrolled in them. The act creates minimum standards that private retirement plan administrators need to follow, such as information that needs to be provided about the plans and clear guidelines for participation, vesting, benefit accrual, etc. Additionally, ERISA imposes fiduciary responsibilities on employers and providers of investment advice to retirement investors and gives employees and plan participants the right to sue their employer if it breaches those duties in administering a retirement plan. Lastly, the act established the Pension Benefit Guaranty Corporation (PBGC), which guarantees certain benefits in the case that a defined benefit plan (i.e., pension plans) can no longer meet its financial obligations.

Sarbanes-Oxley Act of 2002

This legislation, often referred to as Sarbanes-Oxley, SOX, or Sarbox, was enacted in response to the Enron and WorldCom scandals preceding the law's enactment. This act changed accounting and public reporting procedures for corporations. Sarbox created the Public Company Accounting Oversight Board (PCAOB). The PCAOB oversees the audits of public companies, generally achieving this objective by overseeing auditors of public companies and by setting auditing standards. Additionally, Chief Executive Officers (CEOs) and Chief Financial Officers (CFOs) are to be held directly responsible for the accuracy of a company's financial statements, and company executives can be held accountable for consciously submitting erroneous financial statements. Sarbox also required companies to establish internal controls over their financial reporting and, as part of their year-end statements, to assess the quality of those controls. Lastly, Sarbox restricts the services that firms can provide to the business clients they audit and mandates a rotation of auditors. The audit rotation applies to each company getting audited, not the company conducting the audit. For example if the U.S. Accounting Corp. audits Company X, Sarbox mandates that the auditors of Company X must change after a prescribed period of time, but the new auditors can still be employees of U.S.

Accounting Corp. While these regulations have strengthened the U.S. auditing industry and, so far, have prevented further accounting scandals, the regulations have imposed burdens on companies that force them to divert resources to fulfill the audit requirements..

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

This law, referred to as Dodd-Frank, is the most significant legislative change to the financial system since the Great Depression. The act aims to promote the financial stability of the U.S. and outlaw unfair, deceptive, or abusive business acts or practices (UDAAP). The legislation implemented new securities regulations in addition to banking and payments regulations (which were discussed in the previous Basic of this series).

One of the most significant changes introduced by this law is the Volcker Rule. The Volcker Rule, named after a former Federal Reserve Chairman who was a leading proponent of the rule, prohibits financial institutions from using their own accounts to trade securities for their own profit rather than trading on behalf of clients for commissions or fees. However, the Volcker Rule contains several exemptions from the broad prohibition against proprietary trading. Dodd-Frank also introduced new derivatives regulations to strengthen that financial subsector. For example, the act requires swaps to trade through registered dealers and cleared through a clearinghouse, often viewed as a financially stable intermediary. Lastly, Dodd-Frank also requires any bank or lender engaged in securitization of home, auto, credit card, and other loan types to retain a portion of the securitized asset on their books.

As mentioned in the banking regulations Basic, the implementation and certain components of Dodd-Frank have been subject to large political debates since its inception, mainly due to the overarching nature of the bill's reform. In addition to many of the criticisms and praise mentioned in the last basic, one major criticism of this legislation is the Volcker Rule. There has been extensive debate over the causes of the 2008 Financial Crisis, with many opponents of the Volcker Rule arguing that proprietary trading was not a contributor to the crisis, while proponents argue the opposite. In addition, some say that the Volcker Rule and many of the other securities regulations impose regulatory costs that don't add materially to financial stability.

Links to Other Resources

- Cornell Law School – Pension Benefit Guaranty Corporation (PBGC)
- Cornell Law School – Sarbanes-Oxley Act
- Cornell Law School – Securities Law History
- Georgetown Law Library – Securities Law (U.S. and International) Research Guide
- Investor.gov – The Laws That Govern the Securities Industry
- The University of Chicago Law School – A New Market-Based Approach to Securities Law
- U.S. Courts – Securities Investor Protection Act (SIPA)
- U.S. Department of Labor – Employee Retirement Income Security Act (ERISA)
- U.S. Department of Labor – ERISA