

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION¹

IMF
Financial Sector Assessment Program

**SELF ASSESSMENT OF IOSCO OBJECTIVES AND
PRINCIPLES OF SECURITIES REGULATION**

August 2009

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

INTRODUCTION

The IMF is conducting an assessment of the United States under its Financial Sector Assessment Program (FASP). One key component of the FSAP is an evaluation of the policies, practices, laws and regulations administered by the U.S. Securities and Exchange Commission against the IOSCO Core Principles of Securities Regulation (Principles).

The 30 IOSCO Principles² represent an agreed set of high-level principles against which a jurisdiction's securities regulatory framework can be benchmarked and assessed. IOSCO has developed a Methodology to provide an assessment process to evaluate a jurisdiction's compliance with each principle.

In preparation for the IMF's assessment, the SEC undertook a self-assessment of its compliance with the IOSCO Principles. This paper sets out the SEC staff's responses to key questions contained in the IOSCO Methodology, and it is being provided by the SEC to the IMF to facilitate its review of the SEC's compliance with the Principles. The responses in this self-assessment reflect the laws and rules administered by the SEC as of July 2009.

Notwithstanding the broad powers afforded U.S. regulatory agencies and compliance with international standards and principles, recent market events suggest that there is a very real need to modernize U.S. securities market oversight to address consumer and investor protection requirements, expand those requirements to previously unregulated areas, and establish structural mechanisms to ensure that gaps are addressed as soon as new products are developed. The areas of regulatory concern include the following:

- **Over-the-counter derivatives** such as swap agreements, which are largely unregulated in the United States;
- **Hedge funds**, which now comprise a significant component of the U.S. financial market, mostly fall outside direct market oversight;
- **Municipal securities**, the market for which is only partially regulated by a self-regulatory organization, and which are exempted by legislation from SEC disclosure standards; and,
- **Broker-dealers and investment advisers**, which in the United States are regulated under two different statutory and regulatory frameworks with different

² The IOSCO Principles were approved and issued by IOSCO in September 1998 and updated in October 2003 and February 2008. The Methodology to assess compliance with the Principles was approved and issued by IOSCO in October 2003 and updated in February 2008.

While there are 30 Principles, SEC staff has prepared a self assessment against Principles 1-29 only per IMF staff instructions. Principle 30 addresses clearance and settlement issues, which will be separately assessed in the context of the FSAP by the Securities Settlement Systems Working Group.

duties and responsibilities owed investors, even though, from a retail investor's perspective, the services they provide today are virtually identical.

(For a more comprehensive discussion, *see* response to Question 3.1). Moreover, in light of the lessons learned from the failure of major investment banks subject to the agency's consolidated supervised entities regime during the recent financial crisis, and the agency's failure to detect the Bernard Madoff ponzi scheme, the agency has made – and continues to make – significant changes to its regulatory processes.

We recognize these regulatory gaps suggest that new legislation may be necessary in the United States in order to strengthen the U.S. regulatory system. They also suggest areas that IOSCO may wish to consider in the future when updating the IOSCO Core Principles. The SEC is committed to working, together with other U.S. financial authorities and regulators around the world, to make meaningful progress on these critical issues. The SEC also supports and is committed to the ongoing work of IOSCO to update the IOSCO Core Principles, as necessary, to better reflect today's financial markets and regulatory landscape.

To assist in reviewing this self assessment, the U.S. federal securities laws and regulations can be found on the SEC's web site at: <http://www.sec.gov/about/whatwedo.shtml#laws>.

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Note: The following list of abbreviations includes only commonly used abbreviations, with infrequently used abbreviations to be defined in the text where appropriate.

LIST OF FREQUENTLY USED ABBREVIATIONS

U.S. Federal Securities Laws

Advisers Act	Investment Advisers Act of 1940
Exchange Act	Securities Exchange Act of 1934
Investment Company Act	Investment Company Act of 1940
Sarbanes-Oxley Act	The Sarbanes-Oxley Act of 2002
Securities Act	Securities Act of 1933
Trust Indenture Act	Trust Indenture Act of 1939

SEC Divisions and Offices

CF	Division of Corporation Finance
Enforcement / ENF	Division of Enforcement
IM	Division of Investment Management
OCA	Office of the Chief Accountant
OCIE	Office of Compliance Inspections and Examinations
OEA	Office of Economic Analysis
OGC	Office of the General Counsel
OIA	Office of International Affairs
ORA	Office of Risk Assessment
SEC	United States Securities and Exchange Commission
Staff	Staff of the United States Securities and Exchange Commission
TM	Division of Trading and Markets

Other Acronyms

AICPA	American Institute of Certified Public Accountants
AML	Anti-Money Laundering
APA	Administrative Procedures Act
ASB	Auditing Standards Board
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
CBOE	Chicago Board Options Exchange
CCO	Chief Compliance Officer
CDS	Credit Default Swaps
CEA	Commodity Exchange Act
CFMA	Commodity Futures Modernization Act of 2000
CFTC	Commodity Futures Trading Commission
CGFS	Committee on the Global Financial System
CHX	Chicago Stock Exchange

CIS	Collective Investment Schemes
CPSS	Committee on Payment and Settlement Systems
CRA	Credit Rating Agency
CRA Act	Credit Rating Agency Reform Act of 2006
CRD	Central Registration Depository
DOJ	Department of Justice
DTCC	The Depository Trust & Clearing Corporation
DTC	The Depository Trust Company
EDGAR	Electronic Data Gathering, Analysis, and Retrieval system
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
Federal Reserve	Board of Governors of the Federal Reserve System
FinCEN	Financial Crimes Enforcement Network
FINRA	Financial Industry Regulatory Authority
FOIA	Freedom of Information Act
FSB	Financial Stability Board
FSF	Financial Stability Forum
FSP	FASB Staff Position
GAAP	Generally Accepted Accounting Principles
GAO	Government Accountability Office
Glass-Steagall Act	Banking Act of 1933
GLBA	Gramm-Leach-Bliley Act
IAASB	International Auditing and Assurance Standards Board
IAIS	International Association of Insurance Supervisors
IAPD	Investment Adviser Public Disclosure
IARD	Investment Adviser Registration Depository
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
IOSCO MMOU	IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information dated May 2002
IPO	Initial Public Offering
ISA	International Standards on Auditing
ISG	Intermarket Surveillance Group
LCFI	Large and Complex Financial Institution
LLC	Limited Liability Company
MSRB	Municipal Securities Rulemaking Board
MOU	Memorandum of Understanding
NASD	National Association of Securities Dealers
NASDAQ	National Association of Securities Dealers Automated Quotations
NMS	National Market System
NRSRO	Nationally Recognized Statistical Rating Organization
NSCC	National Securities Clearing Corporation
NYSE	New York Stock Exchange
OCC	Office of the Comptroller of the Currency

OFAC	Office of Foreign Assets Control under Treasury
OMB	Office of Management and Budget
ORSA	Options Regulatory Surveillance Authority
OTCBB	Over the Counter Bulletin Board
OTS	Office of Thrift Supervision
Patriot Act	Uniting and Strengthening American by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001
PCAOB	Public Company Accounting Oversight Board
PWG	President's Working Group
RADAR	Risk Assessment Database for Analysis and Reporting
RFPA	Right to Financial Privacy Act
SAS	Statements of Auditing Standards
SIPA	Securities Investor Protection Act of 1970
SIPC	Securities Investor Protection Corporation
SRO	Self regulatory Organization
Sunshine Act	Government in Sunshine Act
TARP	Troubled Assets Relief Program
Treasury	Department of Treasury
TRO	Temporary Restraining Order
U.S. GAAP	United States Generally Accepted Accounting Principles
XBRL	eXtensible Business Reporting Language

THE REGULATOR

Principles 1-5

The Regulator – Principle 1

The responsibilities of the regulator should be clear and objectively stated.

Assessment

Fully Implemented.

1.1

Are the regulator's responsibilities, powers and authority:

- a) Clearly defined and transparently set out, preferably by law, and in the case of powers and jurisdiction, enforceable?*

The SEC is an independent federal agency established pursuant to the Exchange Act. The responsibilities, powers and authority of the SEC are clearly defined and transparently set forth in the following federal securities statutes (discussed in greater detail below), and in the rules and regulations that the SEC has adopted under these statutes:

- Securities Act of 1933
- Securities Exchange Act of 1934
- Trust Indenture Act of 1939
- Investment Company Act of 1940
- Investment Advisers Act of 1940
- Sarbanes-Oxley Act of 2002

Applicable Laws

Securities Act of 1933: The Securities Act has various goals:

- Require that investors have access to financial and other significant information concerning securities being offered for public sale (registration);
- Outline the exemptions under which such registration is not required; and
- Prohibit deceit, misrepresentations, and other fraud in the sale of securities.

A primary means of accomplishing these goals is the registration of securities through which companies disclose important financial information to investors. The registration forms required under the Securities Act provide essential facts while minimizing the burden and expense of complying with the law. In general, registration forms call for:

(i) a description of the company's properties and business; (ii) a description of the security to be offered for sale; (iii) a description of the plan of distribution for the offering; (iv) information

about the management of the company; and (v) financial statements certified by independent accountants.

Securities Exchange Act of 1934: The Exchange Act empowers the SEC with broad authority over all aspects of the securities industry. This includes the power to register, regulate, and oversee brokers, dealers, transfer agents, CRAs, clearing agencies, and the nation's SROs (including securities exchanges). The Exchange Act also identifies and prohibits certain types of conduct in the markets and provides the SEC with disciplinary powers over regulated entities and persons associated with them.

The Exchange Act empowers the SEC to require periodic reporting of information by companies with publicly traded securities and, among other things, generally governs the following areas:

- Corporate Reporting
- Proxy Solicitations
- Tender Offers
- Insider Trading and Market Manipulation
- Registration of Exchanges, Associations, and Others

Trust Indenture Act of 1939: The Trust Indenture Act applies to debt securities such as bonds, debentures, and notes that are offered for public sale. Even though such securities may be registered under the Securities Act, they may not be offered for sale to the public unless a formal agreement between the issuer of bonds and an independent trustee, for the benefit of bondholder, known as the trust indenture, conforms to the standards of the Trust Indenture Act.

Investment Company Act of 1940: The Investment Company Act regulates the organization of companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public. The regulation is designed to minimize conflicts of interest that arise in these complex operations. The Investment Company Act requires these companies to disclose their financial condition and investment policies to investors when stock is initially sold and, subsequently, on a regular basis. The focus of the Investment Company Act is on disclosure to the investing public of information about the fund and its investment objectives, as well as on investment company structure and operations.

Investment Advisers Act of 1940: The Advisers Act regulates investment advisers. With certain exceptions, the Advisers Act requires that firms or sole practitioners compensated for advising others about securities investments register with the SEC and conform to regulations designed to protect investors. Generally, only advisers who have at least \$25 million of assets under management or advise a registered investment company must register with the SEC.

Sarbanes-Oxley Act of 2002: The Sarbanes-Oxley Act mandated a number of reforms to enhance corporate responsibility, enhance financial disclosures and combat corporate and accounting fraud. The Sarbanes-Oxley Act also created the PCAOB to oversee the activities of auditors of public issuers.

Other Relevant Laws: Additionally, other federal laws, such as the APA and the Sunshine Act, confer responsibilities on the SEC and govern the disposition of SEC business. These statutes also apply to other federal agencies.

Structure of the SEC

The SEC is an independent federal agency headed by a bipartisan five-member commission, comprised of the Chairman and four Commissioners, who are appointed by the President and confirmed by the Senate for staggered five-year terms. By law, no more than three of the Commissioners may belong to the same political party.

The agency's functional responsibilities are organized into four Divisions and 19 Offices, each of which is headquartered in Washington, DC. The SEC's approximately 3,500 Staff is located in Washington, DC and in eleven regional offices located in New York, Boston, Philadelphia, Atlanta, Chicago, Miami, Fort Worth, Denver, Salt Lake City, Los Angeles, and San Francisco.

The SEC convenes regularly at meetings that are open to the public and the news media unless the discussion pertains to confidential subjects.

Funding for the SEC is discussed in response to Questions 2.2 and 2.3 below.

Responsibilities, Powers, Authorities, and Enforceability

The mission of the SEC is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. It is the responsibility of the SEC to:

- Interpret and enforce the federal securities laws;
- Issue new rules and amend existing rules;
- Oversee the inspection of brokers, dealers, investment advisers, CRAs, and SROs;
- Oversee private regulatory organizations in the securities, accounting, and auditing fields; and
- Coordinate U.S. securities regulation with federal, state, and foreign authorities.

Divisions

Much of the SEC's day to day functions are carried out by the Staff of the relevant offices and divisions. Other than the five Commissioners, no Staff of the SEC is appointed by the President or is subject to Senate confirmation. Below is a brief description of the responsibilities carried out by the SEC's operational divisions:

The Division of Corporation Finance: CF assists the SEC in executing its responsibility to oversee corporate disclosure of material information to the investing public. Corporations are required to comply with regulations pertaining to disclosure that must be made when stock is initially sold and then on a continuing and periodic basis. CF Staff reviews the disclosure documents filed by companies. The Staff also provides companies with assistance interpreting

the SEC's rules and recommends to the SEC new rules for adoption. CF reviews documents that publicly-held companies are required to file with the SEC, including:

- Registration statements for newly-offered securities;
- Annual and quarterly filings (Forms 10-K and 10-Q);
- Proxy materials sent to shareholders before an annual meeting;
- Annual reports to shareholders;
- Documents concerning tender offers; and
- Filings related to mergers and acquisitions.

CF provides administrative interpretations of the Securities Act, the Exchange Act, and the Trust Indenture Act, and recommends regulations to implement these statutes. Working closely with the Office of the Chief Accountant, CF monitors the activities of the accounting profession, particularly the FASB, that result in the formulation of GAAP. Increasingly, CF also monitors the use of IFRS, issued by the IASB.

CF Staff provides guidance and counselling to registrants, prospective registrants, and the public to help them comply with the law. Finally, CF assists the SEC in enforcement matters involving, among other things, misconduct in securities offerings or company periodic reporting.

Division of Trading and Markets: TM assists the SEC in executing its responsibility for maintaining fair, orderly, and efficient markets. TM Staff provides day-to-day oversight of the major securities market participants such as: brokers; dealers; SROs, including various securities exchanges, FINRA, MSRB, and clearing agencies that help facilitate trade settlement; transfer agents (parties that maintain records of securities owners); securities information processors; and CRAs.

TM also oversees SIPC, which is a private, non-profit corporation that insures the securities and cash in the customer accounts of member brokerage firms against the failure of those firms.

TM's additional responsibilities include:

- Carrying out the SEC's financial integrity program for broker-dealers;
- Reviewing (and in some cases approving, under authority delegated from the SEC) proposed new rules and proposed changes to existing rules filed by the SROs;
- Assisting the SEC in establishing rules and issuing interpretations on matters affecting the operation of the securities markets;
- Assisting the SEC in enforcement matters involving brokers, dealers, SROs, CRAs, clearing agents, and transfer agents; and
- Surveilling the markets.

Division of Investment Management: IM assists the SEC in executing its responsibility for investor protection and for promoting capital formation through oversight and regulation of America's investment management industry. This important part of the U.S. capital markets includes mutual funds and the professional fund managers who advise them; and investment advisers to individual customers.

IM's additional responsibilities include:

- Assisting the SEC in interpreting laws and regulations for the public and SEC inspection and enforcement Staff;
- Responding to no-action requests and requests for exemptive relief;
- Reviewing investment company and investment adviser filings;
- Assisting the SEC in enforcement matters involving investment companies and advisers; and
- Advising the SEC on adapting SEC rules to new circumstances.

Division of Enforcement: The SEC has broad statutory authority under the federal securities laws to investigate whether violations of the federal securities laws have occurred or are about to occur. Enforcement, the SEC's largest Division, assists in executing the SEC's law enforcement function by recommending the commencement of investigations of securities law violations, by recommending that the SEC bring civil actions in federal court or administrative actions before an administrative law judge (ALJ), and by prosecuting these cases on behalf of the SEC. As an adjunct to the SEC's civil enforcement authority, Enforcement works closely with criminal law enforcement agencies in the United States and around the world to bring criminal cases when appropriate.

Enforcement obtains evidence of possible violations of the securities laws from many sources, including market surveillance activities, investor tips and complaints, other divisions and offices of the SEC, the SROs and other securities industry sources, foreign authorities, and media reports.

Offices

Some of the Offices that help carry out the substantive mission of the SEC include:

Office of Compliance Inspections and Examinations: OCIE administers the SEC's nationwide examination and inspection program for SROs, broker-dealers, transfer agents, clearing agencies, CRAs, investment companies, and investment advisers. OCIE conducts inspections to foster compliance with the securities laws, to detect violations of the law, and to keep the SEC informed of developments in the regulated community. Among the more important goals of the examination program is the quick and informal correction of compliance problems. When OCIE finds deficiencies, it issues a "deficiency letter" identifying the problems that need to be rectified and generally reviews the issues during the next examination to assess if compliance has been achieved. Violations that appear too serious for informal correction are referred to Enforcement.

Office of the General Counsel: The General Counsel is the chief legal officer of the SEC, with overall responsibility for the establishment of agency policy on legal matters. The General Counsel serves as the chief legal advisor to the Chairman regarding all legal matters and services performed within, or involving, the agency, and provides legal advice to the Commissioners, the divisions, the offices, and other SEC components as appropriate.

Office of the Chief Accountant: The Chief Accountant is appointed by the Chairman to be the principal adviser to the SEC on accounting and auditing matters. OCA assists the SEC in executing its responsibility under the securities laws to establish accounting principles, for overseeing the private sector standards-setting process and for advising on enforcement matters involving financial reporting and accountants, including the suspension of accountants from appearing and practicing before the Commission. OCA works closely with the FASB, whose standards the SEC has recognized as “generally accepted” for purposes of the Federal securities laws. OCA also is the principal liaison to the IASB and its oversight bodies, and the AICPA.

The SEC is also responsible for the approval or disapproval of auditing rules put forward by the PCAOB, a private-sector regulator established by the Sarbanes-Oxley Act to oversee the auditing profession. The SEC has comprehensive oversight responsibility for all of the activities of the PCAOB, including approval of its annual budget. To assist the SEC in the execution of these responsibilities, OCA is the principal liaison with the PCAOB. OCA is also principal liaison to the IAASB.

Office of Administrative Law Judges (OALJ): The OALJ consists of independent ALJs who conduct hearings and rule on allegations of securities law violations in cases initiated by the SEC. When the SEC initiates a public administrative proceeding, it refers the cases to the Office, where it is assigned to an individual ALJ. The ALJ then conducts a public hearing that is similar to a non-jury trial in the federal courts. An ALJ issues subpoenas, rules on motions, and rules on the admissibility of evidence. At the conclusion of the hearing, the parties submit proposed findings of fact and conclusions of law. The ALJ prepares an initial decision that includes factual findings and legal conclusions that are matters of public record. Parties may appeal an initial decision to the SEC, which can affirm, reverse, modify, set aside or remand for further proceedings. Appeals from SEC action are to a United States Court of Appeals.

Office of Economic Analysis: The Chief Economist, who directs the activities of OEA, is the principal adviser to the SEC on economics matters. OEA advises the SEC and its Staff on the economic aspects of all of the SEC’s regulatory initiatives, including input on the cost-benefit analysis in SEC rulewriting initiatives. It periodically conducts studies on specific rules, and engages in long-term research and policy planning on an ongoing basis. OEA assists the SEC in analyzing the incidence of investor harm in enforcement cases, and evaluates market data and trends to assist in targeting enforcement, examination, and inspection resources on the basis of relative risk.

Office of International Affairs: The SEC works extensively in the international arena to promote cooperation among national securities regulatory agencies, and to encourage the development and maintenance of high regulatory standards worldwide. OIA assists the Chairman and the SEC in the development and implementation of the SEC’s international regulatory and enforcement initiatives. OIA negotiates bilateral and multilateral information-sharing arrangements with foreign counterparts for SEC approval to facilitate regulatory cooperation and enforcement assistance. It assists Enforcement staff in conducting cross-border investigations and proceedings by securing cooperation with foreign regulators, and also handles requests for assistance received from foreign authorities. OIA is responsible for advancing the SEC’s agenda in international meetings and organizations. OIA also conducts a technical assistance program

for countries with emerging securities markets, which includes training both in the United States and abroad.

Office of Risk Assessment: ORA helps the SEC anticipate, identify, and manage risks, focusing on early identification of new or resurgent forms of fraud and illegal or questionable activities. ORA focuses on risk issues across the corporate and financial sector, including issues relevant to corporate disclosure, market operation, sales practices, new product innovation, and other activities of financial market participants. It analyzes information from a variety of sources, such as external experts, domestic and foreign agencies, industry and financial services, empirical data and other market data. ORA also develops and maintains the overall process for risk assessment throughout the SEC and serves as a resource for divisions and other offices in their risk assessment efforts, working closely with them as they work to identify, prioritize and mitigate risks.

Other Offices: Other Offices are discussed in greater detail in connection with the relevant principles.

1.1

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

The criteria for interpreting the SEC's authority are clear and transparent. Rulemaking is the process by which federal agencies implement legislation passed by Congress and signed into law by the President. Major pieces of legislation, such as the Securities Act, the Exchange Act, the Investment Company Act, the Advisers Act, and the Sarbanes-Oxley Act, provide the framework for the SEC's oversight of the securities markets. Generally, these statutes are broadly drafted, establishing basic principles and objectives. To ensure that the intent of Congress is carried out in specific circumstances — and as the securities markets evolve technologically, expand in size, and offer new products and services — the SEC engages in rulemaking.

The SEC's rulemaking is governed by the APA and by other statutes that prescribe the manner in which the SEC may undertake to consider or adopt rules of general applicability. The APA requires that interested parties receive adequate notice of a proposed rulemaking. Generally this occurs through notice in the *Federal Register*, which is usually preceded by an open meeting at which the Commissioners vote to approve a rulemaking proposal. After the SEC publishes notice, it must give interested persons an opportunity to comment on the proposed rulemaking. The SEC maintains public files on rulemakings, in which it places copies of comment letters filed with the SEC as well as other data or information that is important to the SEC's consideration of the rulemaking.

The SEC generally undertakes rulemakings on its own initiative, in response to requests from the public, or at the direction of Congress. The SEC Staff, sometimes at the request of the Chairman or other Commissioners, identifies issues to be addressed by rulemaking and proceeds to formulate proposed rules. These areas may include recurrent issues often handled by no-action letters or by exemptive applications that could be handled more expeditiously through rules.

Congress may also direct that an agency promulgate rules within certain guidelines, and it may set a deadline for those rules.

Rulemaking can involve several steps: concept release, rule proposals and adoption.

Concept Releases

The rulemaking process usually begins with a rule proposal, but sometimes an issue is so unique and/or complicated that the SEC seeks out public input on which, if any, regulatory approach is appropriate. A concept release is issued describing the area of interest and the SEC's concerns and usually identifies different approaches to addressing the problem, followed by a series of questions that seek the views of the public on the issue. The public's feedback is taken into consideration as the SEC decides which approach, if any, is appropriate.

Rule Proposals and Adoptions

The SEC publishes a detailed rule proposal for public comment. Unlike a concept release, a rule proposal advances specific objectives and methods for achieving them. Typically the SEC provides between 30 and 60 days for review and comment. Just as with a concept release, the public comment is considered vital to the formulation of a final rule.

Once the analysis of comments is complete, the Staff considers whether to make a recommendation to the SEC, and the SEC determines whether to adopt the proposed rules. An SEC vote on the adoption of rules generally occurs at an open meeting, although it may occur through seriatim vote. If the SEC approves adoption of the rules, the SEC publishes a release in the *Federal Register*, with an explanation of the reasons for adoption and responses to the more salient issues raised in the comment letters. The rules are, with certain limited exceptions, generally effective no earlier than thirty days after publication in the *Federal Register*.

Interpretations

The SEC also occasionally provides guidance on topics of general interest to the business and investment communities by issuing "interpretive" releases, in which the SEC publishes its views and interprets the federal securities laws and SEC regulations. These interpretations are disclosed to the public via the SEC website and the *Federal Register* and, in some instances, also include a request for comment.

SEC Staff Actions

Additionally, the Staff of the SEC provides written and oral statements made by members of the SEC's Staff on various accounting and legal matters. These Staff interpretations provide guidance to those who must comply with the federal securities laws. However, because they represent the views of the Staff, they are not legally binding. This Staff guidance includes: Staff accounting bulletins; Staff legal bulletins; compliance and disclosure interpretations; and additional Staff no-action and interpretive statements.

1.1

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

The SEC's interpretive process is transparent, precluding situations in which an abuse of discretion can occur. As noted above, the processes for adopting legally binding rules must follow the APA. Moreover, as discussed in response to Question 2.7(d), any person aggrieved by any final order of the SEC may obtain review in the United States Court of Appeals for the Circuit in which the person resides or for the District of Columbia Circuit. Parties may request a rehearing of an adverse decision and rehearing en banc (*i.e.*, before all the judges of the circuit). Affected persons may also seek certiorari before the United States Supreme Court.

The SEC is also subject to the Sunshine Act, which aims to ensure transparent procedures in the disposition of SEC business, including rulemakings. The Sunshine Act generally provides that meetings must be open to the public, unless the subject matter falls within one of several exemptions, and requires the SEC to provide advanced notices of meetings. The Sunshine Act, and SEC rules adopted thereunder, also prescribes certain procedures to be used in closing a SEC meeting from public observation. These closed meetings must be tape recorded or transcripts of the discussion must be prepared; in certain circumstances detailed minutes may be prepared in lieu of transcripts or tape recordings. The SEC tape records all such meetings and these recordings are retained permanently.

The SEC also makes its Rules of Practice and Rules on Fair Fund and Disgorgement Plans available to the public. The Rules of Practice govern the proceedings before the SEC under the statutes that it administers. Among other things, the Rules of Practice set forth: rules regarding the initiation of proceedings and prehearing rules; rules regarding hearings; appeal to the SEC and SEC review; rules relating to temporary orders and suspensions; rules regarding disgorgement and penalty payments; and rules regarding fair fund and disgorgement plans.

Finally, as discussed in response to Question 4.1, the SEC is subject to procedural rules and regulations, including several that govern the SEC's rulemaking activities and interpretations. The SEC is also required to conduct its proceedings with due process (*see* response to Question 2.7(b) for a further discussion of these procedural protections).

1.2

When more than one domestic authority is responsible:

a) Does the legislation ensure that any division of responsibility avoids gaps or inequities in regulation?

As a general matter, only the SEC has the authority to administer and enforce the federal securities laws discussed above. However, aspects of certain types of products, transactions and functions of financial institutions may be subject to the authority of more than one regulator.

Municipal Securities

There is a regulatory gap with respect to the regulation of municipal securities. Currently, the MSRB, a SRO, writes the rules regulating securities firms and banks involved in underwriting, trading and selling municipal securities, but does not have the authority to apply these rules to other professionals and intermediaries in the municipal finance market. Moreover, under a provision of the federal securities laws known as the “Tower Amendment,” the SEC and the MSRB are *prohibited* from requiring state and local government issuers of municipal securities, either directly or indirectly through their underwriters, to establish disclosure requirements or file any document prior to the sale of securities.

Federal vs. State Securities Regulation

There is a clear division of responsibility between federal and state regulation of securities activities. For example, investment advisers with less than \$25 million in assets under management are not required to register with the SEC as investment advisers. Securities offerings made solely within a single state and where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State are not required to be registered pursuant to the provisions of the Securities Act.

1.2

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

Under the current regulatory structure, rights and remedies applicable to the sale of the same or economically similar products depend on, among other things, the type of intermediary selling the product. In a few instances, this has led to the imposition of different regulatory regimes over similar products. For example:

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

The GLBA amended several federal statutes governing the activities and supervision of banks, bank holding companies, and their affiliates. Among other things, it lowered barriers between the banking and securities industries erected by the Glass-Steagall Act. It also altered the way in which the supervisory responsibilities over the banking, securities, and insurance industries are allocated among financial regulators. Among other things, the GLBA repealed most of the separation of investment and commercial banking imposed by the Glass-Steagall Act. The GLBA also revised the provisions of the Exchange Act that had completely excluded banks from broker-dealer registration requirements.

In enacting the GLBA, Congress adopted functional regulation for bank securities activities, with certain exceptions from SEC oversight for specified securities activities. With respect to the definition of “broker,” the GLBA amended the Exchange Act to provide eleven specific exceptions for banks. Each of these exceptions permits a bank to act as a broker or agent in securities transactions that meet specific statutory conditions. In particular, Section 3(a)(4)(B) of

the Exchange Act as amended by the GLBA provides conditional exceptions from the definition of broker for banks that engage in certain securities activities in connection with third-party brokerage arrangements; trust and fiduciary activities; permissible securities transactions; certain stock purchase plans; sweep accounts; affiliate transactions; private securities offerings; safekeeping and custody activities; identified banking products; municipal securities; and a de minimis number of other securities transaction.

Regulation of Derivatives and Securities

Certain economically identical investment products are regulated differently depending on their classification as securities (SEC regulated) or commodities derivatives (CFTC regulated). As trading in commodity derivatives has evolved to include derivatives on non-agricultural commodities and as the SEC has maintained jurisdiction over security options, which economically look like certain commodity derivative products, the lines between securities and commodity derivatives regulation have blurred. This has also led to jurisdictional disagreements between the SEC and CFTC, although the two agencies have a cooperative framework pursuant to various MOUs as discussed in the response to Question 1.3(a).

Additionally, other products resembling securities and commodities derivatives are generally unregulated. For example, certain qualifying transactions among “eligible contract participants” or “eligible commercial entities” for contracts subject to individual negotiation fall within a broad definition of “swaps” and are traded in the OTC market. These swaps, as defined in the CEA and the securities laws, are largely excluded or exempted from regulation by the SEC or CFTC. The anti-fraud and anti-manipulation provisions of the federal securities laws apply to a subset of swap agreements, known as security-based swaps.

Municipal Securities

See discussion provided in response to Question 1.2(a) regarding the current regulation of municipal securities.

1.3

When more than one domestic authority is responsible:

- a) Are there effective arrangements for cooperation and communication of information between responsible authorities through appropriate channels?***

In addition to statutory provisions facilitating the sharing of information with other regulators, there are a variety of informal mechanisms by which domestic authorities with responsibility over a particular activity effectively cooperate and communicate information relevant to their respective missions. As discussed in the response to Question 1.3(b), there are several boards and working groups that coordinate regulatory activity such as the Financial Stability Oversight Board, the President’s Working Group on Financial Markets, and the Federal Housing Finance Oversight Board. In addition, domestic regulators frequently enter into information and regulatory cooperation arrangements for certain activities.

Memoranda of Understanding with Other Federal Regulators

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

For example, in November 2008, the SEC, the Federal Reserve, and the CFTC entered into an MOU establishing a framework for consultation and information sharing on issues related to CDS central counterparties.

The SEC and the Federal Reserve, in July 2008, deepened their information sharing and cooperation by signing an MOU permitting both agencies to better perform their responsibilities. Under the MOU, the SEC and the Federal Reserve share information and cooperate across a number of important areas of common interest including anti-money laundering, bank brokerage activities under the GLBA, clearance and settlement in the banking and securities industries, and the regulation of transfer agents. This MOU built on and formalized the long-standing cooperative arrangements between the SEC and the Federal Reserve, as well as the more recent cooperation on matters including banking and investment banking capital and liquidity following the Federal Reserve's emergency opening of credit facilities to primary dealers.

In July 2008, the SEC and the Department of Labor entered into an MOU making permanent the agencies' longstanding relationship of sharing information on retirement and investments to protect the \$5.8 trillion in retirement assets of American workers, retirees and their families held in employee benefit plans. The MOU between the two agencies formalizes and strengthens cooperation to share information relating to retirement and investments, and to provide investors, benefit plan participants, and plan administrators with better access to more understandable information that they can use to make informed investment decisions.

Additionally, the CFMA gave the SEC and CFTC joint authority for the oversight and regulation of security futures products. In response to this joint authority and in an effort to increase effectiveness and efficiency in joint regulation, on March 17, 2004, the SEC and CFTC signed an MOU regarding the oversight of security futures product ("SFP") trading and the sharing of SFP information. The MOU provides that the SEC and CFTC will notify each other of any planned examinations, advise the other of reasons for an intended examination, provide each other with examination-related information, and conduct examinations jointly, if feasible. The MOU also provides that the SEC and CFTC notify each other of significant issues arising from these markets and share trading data and related information for SFP activity.

In March 2008, the SEC and CFTC entered into a mutual cooperation agreement to establish a closer working relationship between the two agencies. The agreement established a permanent regulatory liaison between the agencies, provided for enhanced information sharing, and set forth several key principles guiding the agencies' consideration of novel financial products that may reflect elements of both securities and commodity futures or options.

1.3

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

As discussed in response to Question 2.2, certain statutory provisions require various government agencies to cooperate and coordinate rulemaking efforts.

The Chairman of the SEC also is required to serve on several boards and other groups.

President's Working Group on Financial Markets

The PWG was created by Executive Order 12631, signed on March 18, 1988 by President Reagan, in response to the market disruption of October 19, 1987. The PWG consists of the Secretary of the Treasury, the Chairman of the Federal Reserve, the Chairman of the SEC, and the Chairman of the CFTC, or their designees. The Secretary of the Treasury serves as the Chairman of the PWG.

The PWG is tasked with giving recommendations to the President for legislative and private sector solutions for enhancing the integrity, efficiency, orderliness, and competitiveness of United States financial markets, and maintaining investor confidence.

Financial Stability Oversight Board

The Financial Stability Oversight Board (FinSOB) was established by the Emergency Economic Stabilization Act of 2008 (EESA) to oversee the Troubled Assets Relief Program (TARP) administered by Treasury's new Office of Financial Stability. The FinSOB is comprised of the heads of five agencies, including the Chairman of the Federal Reserve, the Secretary of the Treasury, the Director of the Federal Housing Finance Agency (FHFA), the Chairman of the SEC, and the Secretary of Housing and Urban Development (HUD). The Chairperson is elected by the members of the FinSOB from among the members other than the Secretary of the Treasury, and Federal Reserve Chairman Ben Bernanke currently serves in this capacity. The FinSOB must meet monthly and report quarterly to Congress.

Federal Housing Finance Oversight Board

The Federal Housing Finance Oversight Board (FHFOB) was established by the Housing and Economic Recovery Act of 2008 to oversee the newly created FHFA, which regulates the housing finance Government Sponsored Enterprises. The FHFOB is comprised of the heads of four agencies, including the Secretary of the Treasury, the Secretary of HUD, the Chairman of the SEC, and the Director of the FHFA. The Director of the FHFA serves as the Chairperson of the FHFOB.

The FHFOB is responsible for advising the Director of the FHFA with respect to overall strategies and policies in carrying out the duties of the Director. The FHFOB must meet at least once every three months and report annually to Congress.

Corporate Fraud Task Force

On July 9, 2002, by Executive Order 13271, President Bush established the Corporate Fraud Task Force within the DOJ. The Task Force was created in response to several high profile corporate accounting scandals. The Deputy Attorney General of the United States serves as the Chair of the Task Force, and the Task Force is comprised of officers within the Department of Justice. In performing its function of making recommendations to the President, however, the Task Force includes the Secretary of the Treasury, the Chairman of the SEC, the Chairman of the CFTC, the Chairman of the Federal Energy Regulatory Commission, and the Chairman of the Federal Communications Commission.

Among its functions, the Task Force is responsible for making recommendations to the President, through the Attorney General, for: action to enhance interagency cooperation; changes in rules, regulations, or policy to improve effective investigation and prosecution of significant financial crimes; and recommendations to Congress on measures the President may judge necessary and expedient relating to significant financial crimes.

Emergency Steel Loan Guarantee Board

The Emergency Steel Loan Guarantee Board (ESLGB) was established by the Emergency Steel Loan Guarantee Act of 1999. The ESLGB is authorized to guarantee loans provided to qualified steel companies by private banking and investment institutions. The Chairman of the Federal Reserve, or a member of the Board of Governors designated by the Chairman, serves as the Chairman of the ESLGB. The other two members of the ESLGB are the Secretary of Commerce and the Chairman of the SEC.

The authority of the ESLGB to make commitments to guarantee loans currently is set to expire on December 31, 2009.

1.3

c) Are cooperation and communication occurring between responsible authorities without significant limitations?

Responsible authorities coordinate and communicate with respect to areas of shared regulatory responsibilities without significant limitations. *See* response to Questions 1.3(a) and 1.3(b) above.

The Regulator – Principle 2

The regulator should be operationally independent and accountable in the exercise of its powers and functions.

Assessment

Fully Implemented.

2.1

Does the securities regulator have the ability to operate on a day-to-day basis without:

a) External political interference?

As discussed in response to Question 1.1(a), the SEC is an independent federal agency headed by a bipartisan five-member commission, comprised of the Chairman and four Commissioners, who are appointed by the President and confirmed by the Senate for staggered five-year terms. By law, no more than three of the Commissioners may belong to the same political party.

Finally, as discussed in response to Questions 1.1(b) and 1.1(c), the SEC's rulemaking is governed by, among other laws, the APA which generally requires that interested parties receive adequate notice of proposed rulemaking and opportunity to comment on the proposed rulemaking. The SEC is also subject to the Sunshine Act, which aims to ensure transparent procedures in the disposition of SEC business, including rulemakings. The Sunshine Act generally provides that certain meetings must be open to the public and requires the SEC to provide advanced notices of such meetings.

2.1

b) Interference from commercial or other sectoral interests?

As discussed in response to Question 5.1, all SEC members and Staff are subject to the federal criminal law conflict of interest statutes, 18 USC 201-216, including a specific prohibition from participating personally and substantially in particular matters that would have a direct and predictable effect on their financial interests or one that is imputed to them. The Exchange Act also expressly prohibits any Commissioner from engaging in any other business, vocation or employment than that of a Commissioner; and prohibits any Commissioner from participating in any stock-market operations or transactions that are subject to regulation by the SEC under that Act.

The SEC members and Staff are also subject to the non-superseded portions of the SEC's Conduct Regulation, 17 CFR 200.735, which includes comprehensive rules regarding the securities holdings and transactions of all SEC Staff, including Commissioners, as well as any employee's spouse, dependent children, or other person residing in the same household who is related to the employee by blood or marriage. This regulation prohibits SEC Staff members from holding financial interests in broker-dealers and investment advisers, selling short, carrying securities on margin, borrowing money for the purpose of buying securities, engaging in transactions in derivative instruments whose value is based on a security, and buying or selling a security subject to a current registration statement. The regulation also prohibits the misuse of non-public information and the purchase of a security that is known to the employee to be involved in SEC litigation or investigation.

The SEC's Conduct regulation also requires SEC members and Staff to report securities transactions, with certain exceptions, within five days of the receipt of confirmation. Certain SEC employees also are subject to government-wide financial disclosure rules, and Commissioners and Senior Officers must file a public financial disclosure report when they assume office, on an annual basis thereafter, and upon termination. Employees who have the greatest risk of creating harm by misusing information or having conflicts of interest must file annually a confidential financial disclosure form.

Finally, federal law, 5 CFR Part 2635, subpart G, prohibits the misuse of one's official position, including the use (or the allowance of others to use) of confidential or non-public information. The SEC's own regulation also prohibits the use of confidential and nonpublic information, 17 CFR 200.735-3(b)(1).

2.2

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

a) Is the consultation process established by law?

As discussed in response to Question 1.1(a), the SEC is the regulator charged with implementing the federal securities laws, including the Securities Act, the Exchange Act, the Trust Indenture Act, the Investment Company Act, the Advisers Act and the Sarbanes-Oxley Act. Thus, generally, the SEC is not required to consult with or obtain approval from a government minister or other authority with respect to the discharge of its statutory responsibilities under the federal securities law. Under the Exchange Act, however, the SEC consults and cooperates with the appropriate regulator agency (ARA) of bank transfer agents and clearing agencies. These ARAs include the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Director of the Office of Thrift Supervision

Notwithstanding the SEC's primary responsibility as the regulator charged with implementing the federal securities laws, the Federal Reserve is vested with targeted rulemaking authority relating to margin in the Exchange Act. Specifically, the Federal Reserve has authority under the

Exchange Act to promulgate rules with respect to the amount of credit that may be initially extended and subsequently maintained on a security.

Additionally, in certain instances, Congress has mandated the SEC to consult with and/or engage in joint rulemaking with respect to a particular matter of regulatory policy. For example, the Financial Services Regulatory Relief Act of 2006 requires that the SEC and the Federal Reserve Board jointly adopt a single set of rules to implement the bank broker exceptions in Section 3(a)(4) of the Exchange Act. Similarly, the GLBA requires that the various financial regulators, including the banking agencies and the SEC, consult with one another regarding rulemaking to implement the GLBA's provisions concerning protection of the security and privacy of customers' non-public information. The GLBA also requires consultation with banking agencies on actions regarding loan loss reserves. The CFMA gives the SEC and CFTC joint authority for the oversight and regulation of security futures products. The SEC is also required to consult with Treasury and the Federal Reserve regarding appointments of members to the PCAOB. Additionally, pursuant to the Small Business Regulatory Enforcement Act of 1996, 5 U.S.C. §§ 801-808, all final SEC rules must be submitted to Congress before they can take effect.

The SEC is also subject to the Paperwork Reduction Act of 1995 (PRA), the purpose of which, according to the legislative history, is to strengthen agency management and encourage more effective public participation with respect to reporting and recordkeeping issues and burdens. Under this statute, the Office of Management and Budget (OMB) must approve each SEC collection of information before it can begin.

The SEC is also subject to the Federal Advisory Committee Act (FACA), a statute regulating the formation and operation of advisory committees by federal agencies. Among other things, FACA requires all meetings of advisory committees be open to the public with adequate prior notice and that all documents that are made available to the advisory committee, as well as transcripts of advisory committee meetings, be made available to the public. Pursuant to an Executive Order, the U.S. General Services Administration has delegated responsibility for implementing FACA and provides advice to SEC and other federal agencies on the establishment and management of federal advisory committees.

2.2.

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

Despite certain requirements to consult with other government authorities concerning certain rulemakings, the SEC has the authority to make day-to-day decisions on technical matters without the need to consult with other government authorities.

For example, the CFMA gives the SEC and CFTC joint authority for the oversight and regulation of security futures products (SFP). Pursuant to this joint authority, the SEC and CFTC have adopted and amended certain rules under the Exchange Act and the CEA relating to securities futures products. Additionally, to implement this joint regulatory authority, the SEC and CFTC voluntarily entered into an MOU concerning SFPs (*see* response to Question 1.2(b)). This MOU provides that the SEC and CFTC will notify each other of any planned examinations, advise the

other of reasons for an intended examination, provide each other with examination-related information, and conduct examinations jointly, if feasible. Under the MOU, the SEC and CFTC will also notify each other of significant issues arising from these markets and share trading data and related information for SFP activity. However, neither the MOU nor the statute imposes on the respective agencies an obligation to consult on day-to-day technical matters.

2.2

- c) Are the circumstances in which such consultation or approval is required or permitted clear and the process sufficiently transparent, or the failure to observe procedures and the regulatory decision or outcome subject to sufficient review, to safeguard its integrity?***

The laws requiring the SEC to consult with other government authorities when making regulatory decisions are clear and the process by which regulatory decisions are made is transparent. For example, the Financial Services Regulatory Relief Act of 2006 explicitly requires that the SEC and the Federal Reserve jointly adopt a single set of rules to implement the bank broker exceptions in Section 3(a)(4) of the Exchange Act, after consultation with the other federal banking regulators concerning the joint proposal. Congress was clear in its direction that the SEC and CFTC engage in such joint rulemaking to implement certain, specific statutory provisions concerning exemptions from the definition of “broker” in the Exchange Act. The rulemaking was subject to the protections mandated by the APA’s rulemaking provisions requiring public notice and comment prior to adopting final rules (*see* response to Question 1.1(b) for further discussion of the APA). Further to the issue of transparency, the SEC is subject to the Sunshine Act, which aims to ensure transparent procedures in the disposition of SEC business, including rulemakings (*see* response to Question 1.1(c) for a further discussion of the Sunshine Act).

As another example, the GLBA requires that the various financial regulators, including the banking agencies and the SEC, consult with one another regarding rulemaking to implement the GLBA’s provisions concerning protection of the security and privacy of customers’ non-public information. The statute is clear on the scope of the cooperation and the provisions that must be implemented. Similarly, the rulemaking process was sufficiently transparent as such rules were promulgated pursuant to the APA rulemaking provisions.

Additionally, the Congressional review process of final SEC rules is clearly and transparently set forth in Small Business Regulatory Enforcement Fairness Act (SBREFA), and has certain safeguards designed to protect the integrity of the process. SBREFA specifies those rules that are subject to Congressional review pursuant to SBREFA as well as the specific information that the SEC must provide Congress in connection with its review. Moreover, the U.S. Government Accountability Office (GAO) must report to Congress on whether the SEC has complied with the required statutory procedures when the SEC submits a major rule to Congress.

Finally, any action taken by the SEC, or any other federal regulator, may be subject to judicial review.

2.3

Does the securities regulator have a stable and continuous source of funding sufficient to meet its regulatory and operational needs?

The SEC's budget is part of the federal budget that is prepared by the President and submitted to Congress. Each year, the SEC prepares a budget estimate, which it forwards to OMB. This document outlines the major program areas of the agency and estimates the resources (including Staff years and expenses such as salary, facilities and supplies) needed to operate them. The OMB reviews the SEC's budget estimate and sets the amount of funding recommended by the President. The SEC's budget is part of the budget request that the President typically submits to Congress in February for the fiscal year that begins the following October. Funding for the SEC is offset by fees collected by the SEC. The target amounts of the fees are set by Congress and, as of 2008, exceed the level of funding appropriated to the SEC, and are used by Congress to offset SEC and other federal spending.

Presently, in light of the turbulent events in the financial markets over the past year, the SEC, the Administration, and the U.S. Congress are engaged in a meaningful reexamination of the SEC's mission and resource needs, especially with regard to the size, complexity, and types of entities subject to SEC regulation. As an example, Chairman Schapiro in her recent appropriations testimony presented the SEC's fiscal 2010 budget request with specific reference to the need for additional resources to match significant growth in the size and complexity of the securities industry, including the broker-dealer and investment advisory industries. *See* June 2, 2009 testimony before the Senate Appropriations Subcommittee on Financial Services and General Government (available at <http://www.sec.gov/news/testimony/2009/ts060209mls.htm>).

2.4

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

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

Significant protections include that the SEC is subject to claims for monetary damages based on constitutional or common law claims only in very limited circumstances. When Staff are acting in a prosecutorial fashion, they are entitled to absolute immunity from constitutional torts, so long as the actions are taken within the scope of their authority. Also, qualified immunity protects government employees from liability for constitutional claims if they have not violated a clearly established statutory or constitutional right of which a reasonable government official would have known.

Finally, with respect to common law claims, the Federal Tort Claims Act (FTCA) provides the exclusive remedy for torts committed by employees of the federal government in the scope of their employment, but claims based on the performance of a discretionary function or arising out of certain intentional torts, including malicious prosecution, abuse of process, libel, slander, misrepresentation, deceit, or interference with contract rights, cannot be brought under the FTCA, 28 U.S.C. 2679-2780. Claims regarding SEC actions rarely fall outside of those protections.

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

With respect to claims for injunctive relief, the SEC has limited protection, but the APA and doctrines such as those allowing only claims that are ripe and properly submitted through administrative channels protect the SEC from injunctive claims that would place an unnecessary and undue burden on the SEC.

2.5

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

As discussed in response to Question 1.1(a), the SEC is an independent federal agency headed by a bipartisan five-member commission. All Commissioners, including the Chairman, are appointed by the President and confirmed by the Senate. The President designates the Chairman, and there can be no more than three members who are members of the same political party.

Commissioners are appointed to serve a five year staggered term. Any Commissioner appointed to fill a vacancy occurring prior to the expiration of the term for which his or her predecessor was appointed is appointed for the remainder of such term. Moreover, the Exchange Act prohibits Commissioners from engaging in any other business, vocation, or employment than that of serving as commissioner, or participating, directly or indirectly, in any stock-market operations or transactions of a character subject to regulation by the SEC pursuant to the Exchange Act. The laws governing the SEC do not provide express criteria for removal of SEC Commissioners.

2.6

With reference to the system of accountability for the regulator's use of its powers and resources:

a) Is the regulator accountable to the legislature or another government body on an ongoing basis?

The SEC is an independent agency. It is not part of any other agency and exercises the authority granted by Congress under the federal securities laws. Nevertheless, the SEC is subject to Congressional oversight, and frequently interacts with the President, executive agencies, Congress, and the courts in order to fulfill its statutory responsibilities. In addition, as discussed above, SEC final rules are subject to a special procedure for Congressional review.

The SEC is subject to the oversight of the U.S. Senate Committee on Banking, Housing and Urban Affairs, and, specifically, the Subcommittee on Securities, Insurance and Investment. The Committee on Banking, Housing and Urban Affairs oversees, among other things, areas relating to banking, insurance, financial markets, securities, housing, urban development and mass transit, international trade and finance, and economic policy. The Subcommittee on Securities, Insurance and Investment has specific oversight responsibility over the SEC and over the following areas: securities, annuities, other financial investments, government securities, financial exchanges and markets, financial derivatives, accounting standards, and insurance.

The SEC is also subject to the oversight of the U.S. House Committee on Financial Services and, specifically, the Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee of that Committee. The House Committee on Financial Services oversees all components of the nation's housing and financial services sectors including banking, insurance, real estate, public and assisted housing, and securities. The Subcommittee reviews laws and programs related to the U.S. capital markets, the securities industry, the insurance industry generally (except for health care), and government-sponsored enterprises, such as Fannie Mae and Freddie Mac. It also oversees the SEC and SROs, such as the New York Stock Exchange and the NASD, that police the securities markets.

The SEC is also accountable to Congress through its relationship with GAO. The GAO is an independent, nonpartisan agency that works for Congress. It investigates how the federal government spends taxpayer dollars and, as stated on its website, the GAO's mission is to support the Congress in meeting its constitutional responsibilities and to help improve the performance and ensure the accountability of the federal government for the benefit of the American people. The GAO's work is done at the request of congressional committees or subcommittees or is mandated by public laws or committee reports. The GAO supports congressional oversight by (1) auditing agency operations to determine whether federal funds are being spent efficiently and effectively; (2) investigating allegations of illegal and improper activities; (3) reporting on how well government programs and policies are meeting their objectives; (4) performing policy analyses and outlining options for congressional consideration; and (5) issuing legal decisions and opinions, such as bid protest rulings and reports on agency rules.

The SEC regularly receives requests for information on various matters from both Congress and the President. These requests may involve testimony before Congress, technical advice to Congress or the Executive on potential legislation, and information on pending enforcement matters of interest to Congress or the Executive. These requests may also involve more informal contacts such as meetings to discuss SEC initiatives. The SEC also receives more than one thousand letters a year from Members of Congress. Responses to letters that seek or necessitate an answer from the entire SEC membership are circulated among the Commissioners for consideration. Other letters may receive, where appropriate, a Staff response or a response from the Chairman.

Additionally, as discussed above in response to Question 2.3, the SEC on an annual basis reports to the President, through the OMB, the major program areas of the SEC and estimates the resources needed to operate them. The OMB then reviews this information and sets the amount of funding recommended by the President. The SEC's budget is part of the budget request that the President submits to Congress in January for the fiscal year that begins the following October.

Moreover, as discussed above in response to Questions 2.2(a) and 2.2(c), all final SEC rules must be submitted to Congress for review before they can take effect.

Finally, as discussed in response to Question 2.7(d), any person aggrieved by any final order of the SEC may obtain review in the U.S. Court of Appeals for the Circuit in which the person resides or for the District of Columbia Circuit. Parties may request a rehearing of an adverse decision and rehearing en banc (*i.e.*, before all the judges of the circuit). Affected persons may also seek certiorari before the United States Supreme Court.

2.6

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

The SEC is required to be transparent in its operations and decision-making. As noted in response to Question 1.1(b), the APA prescribes the manner in which the SEC may undertake to consider or adopt rules of general applicability. The APA requires that interested parties receive adequate notice of proposed rulemaking. Generally this occurs through notice in the *Federal Register*, which is usually preceded by an open meeting at which the Commissioners vote to approve a rulemaking proposal. After the agency publishes notice, it must give interested persons an opportunity to comment on the proposed rulemaking. The SEC maintains public files on rulemakings, in which it places copies of comment letters filed with the SEC as well as other data or information that is important to the SEC's consideration of the rulemaking.

Further to the issue of transparency and as noted in response to Question 1.1(c) the SEC is subject to the Sunshine Act, which aims to ensure transparent procedures in the disposition of SEC business, including rulemakings. The Sunshine Act generally provides that meetings must

be open to the public and requires the SEC to provide advanced notices of such meetings. The SEC videocasts all open SEC meetings on the Internet. The Sunshine Act, and SEC rules adopted thereunder, also prescribes certain procedures to be used in closing a SEC meeting from public observation. These closed meetings must be tape recorded or transcripts of the discussion must be prepared; in certain circumstances detailed minutes may be prepared in lieu of transcripts or tape recordings. The SEC tape records all such meetings and these recordings are retained permanently.

The SEC also makes its operations and use of resources transparent in other manners. For example, the SEC publishes an annual Performance and Accountability Report (PAR), which describes the SEC's many accomplishments and performance results for the relevant fiscal year and presents the SEC's financial picture for that year. Additionally, the SEC makes publicly available on its website a current copy of its current Rules of Practice and Rules on Fair Fund and Disgorgement Plans. These rules, as well as others concerning conduct, ethics, information requests, and delegations of authority, among other things, are contained in the CFR. The SEC's website also publishes the Enforcement Manual, a document designed to be a reference for the Staff of the Enforcement Division in the investigation of potential violations of the federal securities laws. In addition, the SEC and its Staff publish on the website a wide range of interpretive and other useful materials for investors, regulated entities and their advisers.

2.6

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

The SEC's receipt and use of funds are subject to regular audit by the GAO and the SEC's Office of Inspector General (OIG). Most notably, the SEC undergoes an annual audit of its financial statements and internal controls that is conducted by the GAO. The GAO and OIG also conduct regular audits of SEC programs and operations. The results of these audits are reported to agency management, made available to Congress and the Office of Management and Budget, and are generally made public on the Internet. The SEC's most recent annual audits of its financial statement and internal controls, reported in October 2008, resulted in an unqualified audit opinion with no material weaknesses. The SEC is also subject to various requirements—including under the Inspector General Act and OMB Circular A-50—for taking timely and appropriate corrective action on recommendations made by auditors in their audit reports.

In addition to these external audits, the Commission also has a formal program to provide for the regular management review of SEC spending and operations. This includes the process set forth by the Financial Managers' Financial Integrity Act of 1982 (FMFIA) and OMB Circulars A-123 and A-127, which require annual review and reporting on the SEC's internal controls and financial management systems. The SEC has also established a senior management council—the Financial Management Oversight Committee—to assist the Chairman and other senior managers in carrying out their responsibilities under these authorities and in preparing the SEC's annual financial statements.

SEC management also provides regular review and oversight of spending that occurs under the agency's annual operating budget. In addition to continually monitoring spending trends during

the course of the fiscal year, management also conducts a formal “mid-year review” at the half-way point of the fiscal year to review spending-to-date, identify emerging resource needs, and to shift resources as needed.

2.7

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

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

The APA requires an administrative agency such as the SEC to prepare a written decision setting forth the SEC’s findings of fact and conclusions of law and the reasons therefore. The securities laws themselves also require the SEC to issue orders in its administrative proceedings.

2.7

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

The United States Constitution requires administrative agencies like the SEC to conduct their proceedings with due process. 5 USC 554 of the APA specifically requires the SEC to permit interested parties a hearing to submit facts and argument. Hearings in SEC-instituted administrative proceedings are heard in a trial-type proceeding before an ALJ. The ALJs are independent from the SEC. The SEC may not assign duties to ALJs that incompatible with their duties as ALJs, 5 USC 3105. When conducting a hearing, ALJs cannot be subject to supervision or direction of employees engaged in the performance or investigatory or prosecutorial functions, 5 USC 554. They may only be removed for cause after a hearing before the OPM, 5 USC 7521. Under 5 USC 5372, OPM is also responsible for setting the ALJs’ salaries. Under 5 USC 556 of the APA and SEC Rule of Practice 111, the ALJs have a wide-range of powers to oversee proceedings, including the authority to regulate the course of a proceeding and the conduct of parties and their counsel, administer oaths and affirmations, dispose of procedural motions, and issue subpoenas.

Under SEC Rule of Practice 200, the SEC issues an Order Instituting Proceedings, which gives the affected person notice of the facts and violations alleged. The affected person is entitled to representation by counsel.³ The affected person may file an answer and/or a motion seeking a more definite statement of specified matters of fact or law to be determined.⁴ The ALJ will then conduct a pre-hearing conference, among other things, to set the time to exchange witness and exhibit lists and pre-hearing briefs, identify expert witnesses, determine if any matters can be

³ See SEC Rule of Practice 102.

⁴ See SEC Rule of Practice 220.

stipulated to or settled, and set the date for the hearing.⁵ The Division of Enforcement generally must make its investigatory files available to the affected person for inspection and copying before the hearing and produce witness statements.⁶ The parties may seek subpoenas to require the attendance of witnesses and production of documents.⁷

Under Rule of Practice 300, the hearings before the ALJs are public, and the proceedings are recorded.⁸ The witnesses testify under oath.⁹ At the conclusion of the proceedings, the parties submit proposed findings of fact, conclusions of law, and supporting briefs.¹⁰ Thereafter, under Rule of Practice 360, the ALJ prepares an initial decision, which sets forth findings and conclusions and the reasons therefore as to all material issues of fact, law or discretion presented on the record and an order with respect to sanctions. If neither party appeals, the SEC issues a finality notice making the initial decision the final decision of the SEC.¹¹

Either the affected person or Enforcement may appeal an initial decision to the SEC, and the SEC may take review of all or part of the initial decision on its initiative review.¹² The SEC will receive briefs from the parties.¹³ Upon request of the respondent, the SEC will also hear oral argument.¹⁴ Generally, under Rule of Practice 411, the SEC's review is limited to the issues specified in the petition for review or in the briefing schedule order. However, the SEC may at any time determine any other matter it deems material with a notice to the parties and opportunity for oral or written argument.¹⁵

The SEC determines the proceeding on the basis of the record before it, which includes the exhibits, transcripts, pleadings before the ALJ, and the pleadings and argument before the SEC.¹⁶ To be effective, the decision must be approved by a majority of the sitting Commissioners. The

⁵ See SEC Rules of Practice 221, 222.

⁶ See SEC Rules of Practice 230, 231.

⁷ See SEC Rule of Practice 232.

⁸ See SEC Rule of Practice 320.

⁹ See SEC Rule of Practice 325.

¹⁰ See SEC Rule of Practice 340.

¹¹ See SEC Rule of Practice 360.

¹² See SEC Rules of Practice 410, 411.

¹³ See SEC Rule of Practice 450.

¹⁴ See SEC Rule of Practice 451.

¹⁵ See SEC Rule of Practice 411(d).

¹⁶ See SEC Rules of Practice 460, 350.

U.S. Supreme Court has held that violations must be proved by a preponderance of the evidence. Its written decision resolves the contested findings of fact, makes conclusions of law, rules on procedural matters, and makes a determination whether any sanction is appropriate in the public interest and for the protection of investors.

The SEC also receives appeals from disciplinary decisions by a SRO, such as FINRA or an exchange, or the PCAOB. The SRO or PCAOB previously will have conducted a trial-type hearing before a hearing panel, and issued a written decision. The Exchange Act requires the SEC to conduct a de novo review of the SRO's or PCAOB's action. The SEC's review is based on the record certified to the SEC by the SRO or PCAOB, the application for review, and briefs and pleadings of the parties.¹⁷ Under Section 19(e) of the Exchange Act, the SEC determines whether the violations charged were demonstrated by a preponderance of the evidence, whether the SRO's rules were applied in a manner consistent with the purposes of the Exchange Act (or PCAOB's rules were applied in a manner consistent with the purposes of the Sarbanes-Oxley Act), and whether the sanctions are excessive or oppressive or a burden on competition.

5 USC 554 of the APA prohibits ex parte communications and further provides that no person involved in the performance of investigative or prosecutorial functions in a proceeding may advise the decision maker.

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

2.7

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

Affected persons may file an answer; testify and require witnesses to testify under oath; file prehearing submissions and motions; subpoena witnesses and documents; offer relevant evidence; seek and make stipulations; request that official notice be taken of certain facts; and file proposed findings of fact, conclusions of law and briefs before the law judge.¹⁸ The SRO's have similar procedural requirements. *See, e.g.,* FINRA Code of Procedure, Rule 9000, *et seq.*

Before the SEC, an affected party in a SEC-instituted proceeding may seek interlocutory review, petition for review, file briefs, and be heard in oral argument.¹⁹ An affected party in an SRO or PCAOB disciplinary proceeding may file briefs and motions.²⁰ The affected person may also seek to adduce additional evidence before the SEC if that evidence is material and there are

¹⁷ *See* SEC Rule of Practice 460.

¹⁸ *See* SEC Rules of Practice 220, 325, 222, 232, 320, 324, 323, 340.

¹⁹ *See* SEC Rules of Practice 400, 410, 450 and 451.

²⁰ *See* SEC Rule of Practice 450.

reasonable grounds for its not being introduced at an earlier stage of the proceedings.²¹ A person aggrieved by a final decision of the SEC may seek reconsideration of the order.²² The SEC has limited reconsideration to motions to correct manifest errors of law or fact or to introduce newly discovered evidence.

2.7

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

Provisions in the securities laws provide that any person aggrieved by a final order of the SEC may obtain review of the order in the United States Court of Appeals for the circuit in which such person resides or has his principal place of business or in the District of Columbia Circuit. Similarly, any person adversely affected by a rule of the SEC promulgated under certain provisions of the federal securities laws may obtain review of such rule in the United States Court of Appeals for the circuit in which such person resides or has his principal place of business or in the District of Columbia Circuit.

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

2.8

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

The Exchange Act and Advisers Act both contain statutory provisions that are designed to safeguard the confidentiality of information obtained in the course of examinations or investigations. The SEC also has adopted rules under the Exchange Act to permit confidential treatment requests for certain information. Notwithstanding these provisions, Rule 24c-1 under the Exchange Act provides that the SEC may, if it receives appropriate assurances of confidentiality, provide nonpublic information in its possession to certain entities, including other domestic and foreign governmental entities.

Additionally, regulated entities and issuers who are subject to reporting requirements are required to make public filings with the SEC. FOIA requires that the SEC make certain information available to the public, but also provides certain exceptions for, among other things, commercially sensitive material. A regulated entity or issuer can request that certain information

²¹ See SEC Rule of Practice 452.

²² See SEC Rule of Practice 470.

be kept non-public, pursuant to one of these exceptions. FOIA and its exceptions are described further below.

FOIA, 5 U.S.C. § 552, governs public access to certain types of documents. FOIA requires all agencies to: (1) publish certain types of information in the *Federal Register*, such as procedural rules and substantive rules of general applicability; (2) make available for public inspection and copying other types of information such as adjudicative opinions and staff manuals; and (3) make available to the public other types of information upon specific request for that information. FOIA also enables the public to obtain access to agency records unless the record falls under an exception to the general disclosure requirement. The exceptions protect from disclosure: (1) documents that relate solely to personnel rules and practices; (2) trade secrets and confidential commercial or financial information; (3) deliberative or otherwise privileged intra-agency or inter-agency memoranda or letters; (4) law enforcement records the disclosure of which would interfere with law enforcement proceedings; and (5) matter and records related to examinations. The SEC has also promulgated a confidential treatment regulation that permits persons who have submitted records to the SEC to object to their disclosure in response to a FOIA request, 17 C.F.R. § 200.83.

The SEC's FOIA Office responds to requests for records under FOIA and requests for confidential treatment by submitters of records. These responses may be appealed, pursuant to a delegation of authority from the SEC, to OGC, which may grant or deny appeals, or may release records in the exercise of discretion, 17 C.F.R. § 200.80(d)(6). The OGC may also refer appealed matters in appropriate cases to the SEC for its review.

The Regulator – Principle 3

The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.

Assessment

Fully Implemented.

3.1

Are the powers and authorities of the regulator sufficient, taking into account the nature of a jurisdiction's markets and a full assessment of these Principles to meet the responsibilities of the regulator(s) to which they are assigned?

The mission of the SEC is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.

The powers and authorities of the SEC are generally sufficient for it to meet these responsibilities. As discussed in greater detail in response to Principle 1, Question 1(a), the SEC's extensive powers and authorities are delineated in the following federal securities statutes, and in the rules and regulations that the SEC has adopted under these statutes: the Securities Act; Exchange Act; Trust Indenture Act; Investment Company Act; Advisers Act; and the Sarbanes-Oxley Act:

- The Securities Act has various goals: (1) require that investors have access to financial and other significant information concerning securities being offered for public sale (registration); (2) outline the exemptions under which such registration is not required; and (3) prohibit deceit, misrepresentations, and other fraud in the sale of securities.
- The Exchange Act provides for periodic disclosure to be made by registrants and empowers the SEC with broad authority over all aspects of the securities industry, including the power to register, regulate, and oversee brokers, dealers, transfer agents, CRAs, clearing agencies, securities exchanges and securities associations.
- The Trust Indenture Act applies to debt securities such as bonds, debentures, and notes that are offered for public sale. These securities may not be offered for sale to the public unless a formal agreement between the issuer of bonds and the bondholder, known as the trust indenture, conforms to the standards of the Trust Indenture Act.

- The Investment Company Act empowers the SEC to regulate the organization of companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public.
- The Advisers Act empowers the SEC to regulate investment advisers.
- The Sarbanes-Oxley Act mandated a number of reforms to enhance corporate responsibility, enhance financial disclosures and combat corporate and accounting fraud. The Sarbanes-Oxley Act also created the PCAOB to oversee the activities of the auditors of public issuers.

Despite these significant powers and authorities, the recent financial crisis has illustrated the need to modernize consumer and investor protection requirements, expand those requirements to previously unregulated areas, and establish structural mechanisms to ensure that gaps are addressed as soon as new products are developed. For example:

OTC Derivatives

Over-the-counter (OTC) derivatives, such as swap agreements, are largely unregulated in the United States. As noted by the Department of Treasury in its June 18, 2009 paper on Financial Regulatory Reform (Treasury White Paper), regulation of the OTC derivatives market should be designed to achieve four broad objectives: (1) preventing activities in those markets from posing risk to the financial system; (2) promoting efficiency and transparency of those markets; (3) preventing market manipulation, fraud, and other market abuses; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.

Hedge Funds

Hedge funds are significant participants in the securities markets, both as managers of an estimated \$1.5 trillion in assets and as traders of securities. However, their activities, and the activities of other private investment pools, are largely “below the radar.” Under the current regulatory structure, hedge funds are beyond regulatory oversight because they are typically not regulated under the Investment Company Act or the Advisers Act. As a result, the SEC currently lacks authority to institute a regulatory regime over hedge funds. As noted in the Treasury White Paper, requiring registration with the SEC would allow data to be collected that would permit an informed assessment of how such funds are changing over time and whether any such funds have become so large, leveraged, or interconnected that they require regulation for financial stability purposes. This registration would promote greater transparency in the markets, improve the ability to deter and detect fraud, and provide better oversight of the hedge fund industry by regulators and the markets.

Municipal Securities

As noted above, there is a regulatory gap with respect to the regulation of municipal securities. Currently, the MSRB, an SRO, writes the rules regulating securities firms and banks involved in underwriting, trading and selling municipal securities, but does not have the authority to apply

these rules to other professionals and intermediaries in the municipal finance market. Moreover, under a provision of the federal securities laws known as the “Tower Amendment,” the Commission and the MSRB are *prohibited* from requiring state and local government issuers of municipal securities, either directly or indirectly through their underwriters, to establish disclosure requirements or file any document prior to the sale of securities.

Broker-Dealers vs. Investment Advisers

Investment advisers and broker-dealers are regulated by the SEC under different statutory and regulatory frameworks, even though the services they provide often are virtually identical from a retail investor’s perspective. The current laws and regulations are based on antiquated distinctions between the two types of financial professionals that date back to the early 20th century. Retail investors are confused about the differences between investment advisers and broker-dealers and the varying legal duties that financial professionals owe investors. New legislation should bolster investor and consumer protections and bring important consistency to the regulation of these two types of financial professionals. As noted in the Treasury White Paper, the SEC should be permitted to align duties for intermediaries across financial products so that standards of care of all broker-dealers, when providing investment advice, should be raised to the fiduciary standard to align the legal framework with investment advisers.

3.2

With regards to funding:

- a) *Does the regulator’s funding reflect the needs of the regulator in supervising a given market, taking into account the size, complexity and types of functions subject to its regulation, supervision or oversight?*

Presently, in light of the turbulent events in the financial markets over the past year, the SEC, the Administration, and the U.S. Congress are engaged in a meaningful reexamination of the SEC’s mission and resource needs, especially with regard to the size, complexity, and types of entities subject to SEC regulation. As an example, Chairman Schapiro in her most recent appropriations testimony presented the SEC’s fiscal 2010 budget request with specific reference to the need for additional resources to match significant growth in the broker-dealer and investment advisory industries. See June 2, 2009 testimony before the Senate Appropriations Subcommittee on Financial Services and General Government (available at <http://www.sec.gov/news/testimony/2009/ts060209mls.htm>).

Funding for SEC operations is provided by the U.S. Congress through annual appropriations. Since the SEC’s appropriations must be approved by the U.S. House of Representatives and the U.S. Senate and signed by the President, this means that the final budget allocated for SEC operations ultimately reflects the funding level that the House, Senate, and President believe is the right amount for the SEC.

The SEC received \$906 million in spending authority in fiscal 2008, is authorized to spend \$970 million in the current fiscal year, and has requested \$1.026 billion in spending authority for fiscal 2010.

Prior to preparing its annual budget, the SEC first performs an internal self-assessment to evaluate its funding needs for future fiscal years. This self-evaluation is then subject to thorough review by the OMB, and a formal budget request is then submitted to the U.S. Congress as part of the President's annual budget request. The Commission's budget is then subject to a rigorous review by the House and Senate Appropriations Committees, which generally includes appearances by the Chairman at formal hearings, and ultimately consideration and approval by the full House and Senate.

The annual nature of the budget process ensures that the SEC's priorities, programs, and operations undergo regular internal review as well as external evaluation by the Office of Management and Budget and the U.S. Congress. The current budget process also allows for the evaluation of the SEC's near-term resource needs and the alignment of ongoing spending with the agency's long-term strategic goals.

The SEC's current and past budget requests, and accompanying justification, are available on the SEC's web site at <http://www.sec.gov/about.shtml>. In addition, at the end of each fiscal year the Commission publishes an annual report, formally known as the Performance and Accountability Report (PAR) that details the SEC's performance over the past year. The SEC's most recent PAR is available at <http://www.sec.gov/about/secpar/secpar2008.pdf>. Taken together, these annual documents provide a useful overview of the SEC's past performance and future needs.

3.2

b) Can the regulator affect the operational allocation of resources once funded?

As a general matter, the SEC has the authority to allocate resources where needs are most pressing. In doing so, however, it must operate within the parameters set by the U.S. Congress in the annual appropriations law.

The SEC's budget, as approved by Congress, sets aside funds in several major categories of spending called "object classes" that describe general categories of spending. The SEC's largest budget object class, for instance, is for personnel compensation and benefits at \$662 million for fiscal 2009; other major object classes include "rent, communications, and utilities," "equipment," and "travel and transportation of persons." Within any single budget object class, the SEC is afforded flexibility in allocating resources among its particular programs, functions, and organizational units. This enables the SEC, for instance, to reallocate staff positions as needed, since personnel compensation expenditures fall within the same budget object class.

In approving the SEC's budget, the Congress also sets forth rules governing the reallocation of resources from one budget object class to another. In recent years, for instance, the SEC has been allowed the flexibility to reallocate from one object class to another up to \$5 million or 10% of that object class, whichever is less. Outside of these limits, the SEC can seek the permission of the House and Senate Appropriations Committees to reallocate funds from one object class to another by submitting a formal reprogramming request. A reprogramming request is also required for a number of other agency actions, for instance, to create a new program or to

eliminate an existing program, project, or activity. See Section 608 of Public Law 111-8, Fiscal 2009 Omnibus Appropriations Act. It is also worth noting that the SEC has, in the past, sought and successfully obtained permission in this manner to reprogram funds from one object class to another.

3.3

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

The SEC's ability to attract and retain experienced and skilled staff was significantly improved by the 2002 enactment by the U.S. Congress of "pay parity" legislation that authorizes the SEC to create a compensation system similar to the systems of other federal financial regulators. See Section 8 of Public Law 107-123, the Investor and Capital Markets Fee Relief Act. Prior to the enactment of the 2002 pay parity law, in fiscal year 2000, the annual rate of turnover of all SEC staff was 13%. As a result of the SEC's new pay system, the staff turnover rate has diminished significantly, and was 6% for 2008—well below the agency's target of no more than 8%.

At the same time, pay parity has placed challenges on the SEC in seeking budget increases that maintain parity with the personnel compensation levels at other federal financial regulators, such as the Federal Reserve, which are self-funded and not subject to the annual appropriations process. To maintain parity, the SEC has provided compensation increases in three main forms: merit raises, the annual cost-of-living adjustments that are the standard at most federal agencies, and a variety of benefits enhancements.

3.4

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

The SEC University provides a significant amount of training opportunities available to all Staff. Their mission is: "Investing in employee development to achieve organizational excellence and prepare the SEC to anticipate changes in the securities industry." SEC University is designed to operate as a collaborative network that extends into the SEC's divisions, offices, and regions and interfaces with external organizations. This approach ensures that all SEC University activities are grounded in the SEC's goals, the realities of the workplace, and deep expertise in the securities industry and employee development. There is training provided at the SEC that currently falls outside the scope of SEC University. That includes training that is available to specific divisions. It also includes research training provided by LexisNexis, Westlaw, ProQuest and other research service vendors. A calendar of these other training opportunities, as well as SEC University training, is available to Staff through the SEC's intranet.

Division of Corporation Finance

CF organizes training programs for both new and existing employees. With respect to new CF Staff members, all examiners attend a series of programs upon joining CF. These programs are designed to familiarize examiners with the core functions of their job duties and, most

importantly, CF's Filing Review Process (discussed below under Question 14.6.). After this introduction, each examiner then attends a series of programs directed specifically at key accounting or legal concepts, depending on their job function (virtually all examiners are either accountants or lawyers). These new employee training programs are conducted by senior CF Staff members. Throughout this process, and with respect to each matter they are assigned, examiners are provided specific ongoing guidance and learning opportunities from their reviewers until they are ready to review filings on their own.

CF also provides ongoing training for existing CF Staff members. Programs include training for CF Staff as a whole on issues affecting both legal and accounting reviews (*e.g.*, new regulatory initiatives or accounting principles) and more specialized training on issues that affect reviews by one group in ways not affected by the other (*e.g.*, specific interpretive issues). Such ongoing training programs are conducted on both a regular basis and as the need arises. All of CF's Staff are located at the SEC's headquarters building, which facilitates formal and informal training programs. Ongoing training programs are conducted by other SEC Staff members, representatives from accounting firms, outside counsel, members of academia and other governmental bodies.

Division of Investment Management

IM organizes training for both new and existing employees. With respect to new Staff members, IM has organized a set of materials intended to familiarize new employees with the core functions of their job duties. It also works in conjunction with other divisions and offices at the Commission, including OCIE, to provide joint training sessions relevant to IM's functions (*e.g.*, topics related to investment advisers and investment companies). IM also conducts internal ongoing training to enhance the expertise of the Staff. Ongoing training programs are conducted by Commission staff members, outside counsel, members of academia and other governmental/regulatory bodies. In addition, individual offices within IM provide appropriate training to IM Staff (*e.g.*, for the Office of Chief Counsel, training on how to draft a no-action letter; for the Office of Disclosure Review, training on how to review investment company disclosure).

Division of Trading and Markets

TM has a training committee comprised of staff from each TM office that organize training programs on current issues facing TM. The training programs consist of monthly "Hot Topics" programs featuring presentations from TM managers and attorneys on recent rulemaking or other division projects. The hot topics programs also feature outside speakers from the industry discussing major securities law issues, and professional instructors providing training on how the securities markets operate. The training committee coordinates training opportunities from other divisions or offices and reviews and approves staff requests for outside training, such as seminar or classes related to specific division projects.

In addition, each year TM organizes an extensive training program for new staff in which managers explain what their offices do, the rules their offices are responsible for, and the current issues before their offices. Each new staff member also spends two days in New York, where

they visit the New York Stock Exchange, broker-dealers, market makers, and other market participants.

Division of Enforcement

Enforcement has a training program designed specifically to enrich the knowledge and fine tune the skills of the Enforcement Staff. The training program offers seminars and training sessions for new and experienced attorneys, accountants, auditors, market analysts and paralegals nationwide. The training sessions include core subject matter training for all Enforcement Staff as well as specialized training in complex areas. The subject matter training covers various substantive topics including but not limited to: financial fraud, insider trading and Ponzi schemes. The training focuses on investigative techniques including: (i) the best practices for organizing and conducting an investigation; (ii) drafting and negotiating subpoenas; (iii) drafting action memos; (iv) the Wells process; (v) drafting complaints; (vi) information technology forensics; (vii) trial strategies; and (viii) penalty analysis. The program also offers specialized working group training sessions in areas such as Foreign Corrupt Practices Act (FCPA), hedge funds, municipal securities, and subprime. The working group training sessions provide a focused and nationwide training vehicle to facilitate efficient and timely training. The training program also provides training in response to novel issues and financial products.

Enforcement works in conjunction with other divisions and offices at the SEC, other financial regulators and industry representatives to provide independent and joint training sessions. Enforcement's training program conducts ongoing training to enhance the expertise of the Staff. These include: (i) Series 7 training, which covers the solicitation, purchase, and sale of a broad range of investment products, including stocks, bonds, mutual funds, municipal securities and options; (ii) The "Coordination Conference," a program that jointly coordinates training with the CFTC, Federal Bureau of Investigation (FBI), DOJ, U.S. Attorneys Offices and State Securities Regulators; (iii) Certified Fraud Examiners Training, which focuses on fraud prevention, detection and deterrence; and (iv) Testimony/Deposition Workshops, which provides hands on training of mock witness questioning under oath.

OCIE

OCIE has its own training program, consisting of a group of employees dedicated to planning and implementing training specifically aimed toward enhancing the knowledge and expertise of Staff within the examination program. The training group offers programs for new and experienced examiners nationwide. Such programs include core training for examiners as well as specialized training in complex areas. A large focus of the training is on financial products and examination procedures. OCIE's training group provides training through 1) videocast programs to the regional offices, 2) "in-person" programs, and 3) on-line sessions. The training group also hires vendors to develop specialized training programs. These training programs include speakers from the examination program, other divisions and offices at the SEC, other financial regulators, industry representatives, representatives from accounting firms and third-party administrators, outside counsel, and members of academia.

In addition, OCIE's training group has developed recurring projects designed to further enhance examiner training. These include: (i) the development and production of on-line training for new examiners; (ii) "Topical Conference Calls" between examination Staff nationwide and Staff in the SEC's rulemaking groups, designed to provide examiners with up-to-date information on new regulatory initiatives and a forum to discuss recent examination findings and interpretive issues with Staff in the SEC's rulemaking divisions, as well as to provide Staff at headquarters with information about current industry trends; and (iii) "Inside the Rules," a training program for examiners that is designed to provide examiners with in-depth knowledge of rules from the perspective of those who write the rules. Finally, OCIE's training group offers examination program training in response to new areas of regulation. In recent years, this has included fraud detection, money laundering, variable annuities, privacy, and hedge funds.

Ethics Training

Every new employee and Commissioner receives education and training regarding all of these rules. Regulatory requirements regarding ethics training are set forth in an OGE regulation found at 5 CFR Part 2638, subpart G. In addition to these rules, the SEC's Office of the Ethics Counsel has an internal website on the SEC's intranet that provides additional guidance on all of these topics and links to the OGE regulations and disclosure forms. In addition, every two weeks the ethics office posts an Ethics NewsGram on a particular ethics topic, which is then emailed the next day to all employees. The Ethics Office is staffed by a full-time Ethics Counsel, four full-time and one part-time Assistant Ethics Counsel, and Program Managers and Analysts who provide specific ethics guidance. Further, every Division and Office within the SEC contains an Ethics Liaison and Deputy Ethics Liaison Officer who receives additional ethics training and who can provide guidance on certain topics.

Additionally, many SEC staff are lawyers and accountants who are often subject to licensing requirements that require them to attend continuing education classes. Some SEC training programs are designed to assist Staff to fulfill these requirements. Finally SEC training programs may cover other areas such as computer security and rights to privacy.

The Regulator – Principle 4

The regulator should adopt clear and consistent regulatory processes.

Assessment

Fully Implemented.

4.1

Is the regulator subject to reasonable procedural rules and regulations?

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

- A Canon of Ethics, 17 C.F.R. § 200.50-72;
- Responses to information requests, 17 C.F.R. § 200.80-82;
- Privacy of individuals and records maintained by the SEC, 17 C.F.R. § 200.301-313;
- Conduct of its current and former members and employees, 17 C.F.R. § 200.735;
- Public observation of SEC meetings, 17 C.F.R. § 200.400-410;
- Emergency operating procedures, 17 C.F.R. § 200.200-205;
- Facilitating administrative hearings, 17 C.F.R. § 202.4;
- Enforcement activities, 17 C.F.R. § 202.5;
- Rulemaking activities, 17 C.F.R. § 202.6;
- Investigations, 17 C.F.R. § 203.1-8;
- Debt collection, 17 C.F.R. § 204.1-77; and
- Rules of Practice and Rules on Fair Funds and Disgorgement Plans, 17 C.F.R. § 201.

Moreover, as discussed in response to Question 1.1(b), the SEC's rulemaking is governed by the APA and by other statutes that prescribe the manner in which the SEC may undertake to consider or adopt rules of general applicability. The APA sets forth the basic procedural requirements for agency rulemaking and generally requires the SEC when adopting rules to give notice of the proposed rulemaking in the *Federal Register* and seek comment from interested parties on the proposed rule.

The SEC is subject to PRA the purpose of which, according to the legislative history, is to strengthen agency management and encourage more effective public participation with respect to reporting and recordkeeping issues and burdens.

Section 23(a)(2) of the Exchange Act requires the SEC to consider the impact that any rule promulgated under the Exchange Act would have on competition. Moreover, certain rulemakings pursuant to the Securities Act, Exchange Act or the Investment Company Act also

require the SEC to consider whether such rules would promote efficiency, competition and capital formation.

The SEC is subject to the Regulatory Flexibility Act which requires agencies to consider the special needs of small entities in evaluating proposed rules and rule changes for all rules subject to notice and comment under the APA.

As discussed in response to Question 1.1(c), the SEC is subject to the Sunshine Act, which aims to ensure transparent procedures in the disposition of SEC business, including rulemakings.

Finally, as discussed in response to Question 2.7(b), the United States Constitution requires administrative agencies like the SEC to conduct their proceedings with due process.

4.2

Does the regulator:

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

As discussed above and in response to Question 1.1(b), the SEC's rulemaking is governed by the APA which generally requires the SEC when adopting rules to give notice of the proposed rulemaking in the *Federal Register* and seek comment from interested parties on the proposed rule. The SEC maintains public files on rulemakings, in which it places copies of comment letters filed with the SEC as well as other data or information that is important to the SEC's consideration of the rulemaking. The public also is invited to submit comments by e-mail. Submitted comments are available on the SEC's website. After the comment period closes, the SEC completes its analysis of comment letters and considers whether to adopt the rules as proposed or whether provisions should be modified in response to comment letters.

Moreover, the SEC may seek public input through the issuance of a concept release. Such concept release describes the area of interest and the SEC's concerns and usually identifies different approaches to addressing the problem, followed by a series of questions that seek the views of the public on the issue. The public's feedback is taken into consideration as the SEC decides which approach, if any, is appropriate.

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

Finally, the SEC has created and utilized various federal advisory committees pursuant to the FACA, which regulates the formation and operation of advisory committees by federal agencies. Most recently, on June 3, 2009, the SEC announced the formation of an Investor Advisory Committee to give investors a greater voice in the SEC's work. This Committee's charter provides for a broad scope of interest, including:

- Advising the SEC on matters of concern to investors in the securities markets;
- Providing the SEC with investors' perspectives on current, non-enforcement, regulatory issues; and
- Serving as a source of information and recommendations to the SEC regarding the SEC's regulatory programs from the point of view of investors.

4.2

b) Publicly disclose and explain its policies, not including enforcement and surveillance policies, in important operational areas, such as through interpretations of regulatory actions, setting of standards, or issuance of opinions stating the reasons for regulatory actions?

As discussed in response to Question 1.1(b), all final SEC rules are accompanied by a release that is published in the *Federal Register*, with an explanation of the reasons for adoption and responses to the more salient issues raised in the comment letters.

The SEC also occasionally provides guidance on topics of general interest to the business and investment communities by issuing "interpretive" releases, in which the SEC publishes its views and interprets the federal securities laws and SEC regulations. These interpretations are disclosed to the public via the SEC website and the *Federal Register* and, in some instances, also include a request for comment.

Additionally, the Staff may give interpretative and advisory assistance to members of the general public, prospective registrants, applicants and declarants, 17 C.F.R. § 202.2. For example, persons having a question regarding the availability of an exemption may secure informal interpretations of the applicable statute or rule as they relate to the particular facts and circumstances presented. Similarly, persons contemplating filings with the SEC may receive advice of a general nature as to the preparation thereof, including information as to the forms to be used and the scope of the items contained in the forms.

4.2

c) Publicly disclose changes and reasons for changes in rules or policies?

Generally speaking, when the SEC proposes amendments to existing rules or adopts new rules that change current regulatory policies, it gives notice of the proposed rulemaking in the *Federal Register* and seeks comment from interested parties on the proposed rule. Typically, a proposing release will contain an extensive discussion of the reasons underlying a specific rule proposal and will solicit comments on the proposals and often on various alternatives. When the SEC approves adoption of final rules or rule amendments, it publishes a release in the *Federal*

Register, with an explanation of the reasons for adoption and responses to the more salient issues raised in the comment letters.

4.2

d) Have regard, in the formulation of policy, to the costs of compliance with regulation?

The SEC considers the costs of compliance of all rules it adopts, both when the rule is proposed and when the rule is adopted. The considerations of the cost and benefit analysis are publicly disclosed for notice and comment at the proposing state. Additionally, costs and benefits are discussed, including a response to more salient issues related to costs and benefits raised in comment letters, when final rules are adopted.

Moreover, as discussed above in response to Question 4.1, Section 23(a)(2) of the Exchange Act requires the SEC to consider the impact that any rule promulgated under the Exchange Act would have on competition. Moreover, certain rulemakings pursuant to the Securities Act, Exchange Act or the Investment Company Act also require the SEC to consider whether such rules would promote efficiency, competition and capital formation.

The SEC also is subject to the Regulatory Flexibility Act which requires agencies to consider the special needs of small entities in evaluating proposed rules and rule changes for all rules subject to notice and comment under the APA.

4.2

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

As discussed above and in response to Question 1.1(b), the SEC's rulemaking is governed by the APA which generally requires the SEC to give notice of the proposed rulemaking in the *Federal Register* and seek comment from interested parties on the proposed rule. When the SEC approves adoption of final rules, it publishes a release in the *Federal Register*, with an explanation of the reasons for adoption and responses to the more salient issues raised in the comment letters.

The SEC also maintains a public website, www.sec.gov, with a specific page that provides links to releases concerning SEC rulemaking activity, including concept releases, proposed rules, final rules, interpretive releases, and policy statements. It also links to announcements concerning SRO rulemaking, PCAOB rulemaking, instructions for Exchange Act exemptive applications, other SEC notices, and public petitions for rulemaking submitted to the SEC.

4.2

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

17 C.F.R. § 202.6 publicly describes the SEC's procedures for adoption, revision, and rescission of rules and regulations of general application. Specifically, it provides that:

“(a) The procedure followed by the [SEC] in connection with the adoption, revision, and rescission of rules of general application necessarily varies in accordance with the nature of the rule, the extent of public interest therein, and the necessity for speed in its adoption. Rules relating to [SEC] organization, procedure and management, for example, are generally adopted by the SEC without affording public discussion thereof. On the other hand, in the adoption of substantive rules materially affecting an industry or a segment of the public, such as accounting rules, every feasible effort is made in advance of adoption to receive the views of persons to be affected. In such cases, proposals for the adoption, revision, or rescission of rules are initiated either by the [SEC] or by members of the public, and to the extent practicable, the practices set forth in paragraph (b) of this section are observed.

(b) After preliminary consideration by the [SEC] a draft of the proposed rule is published in the *Federal Register* and mailed to interested persons (e.g., other interested regulatory bodies, principal registrants or persons to be affected, stock exchanges, professional societies and leading authorities on the subject concerned and other persons requesting such draft) for comments. Unless accorded confidential treatment pursuant to statute or rule of the [SEC], written comments filed with the [SEC] on or before the closing date for comments become a part of the public record upon the proposed rule. The [SEC], in its discretion, may accept and include in the public record written comments received by the [SEC] after the closing date.

(c) Following analysis of comments received, the rule may be adopted in the form published or in a revised form in the light of such comments. In some cases, a revised draft is prepared and published and, where appropriate, an oral hearing may be held before final action upon the proposal. Any interested person may appear at the hearing and/or may submit written comment for consideration in accordance with the [SEC's] notice of the rulemaking procedure to be followed. The rule in the form in which it is adopted by the [SEC] is publicly released and is published in the *Federal Register*.”

4.3

In assessing procedural fairness:

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

The SEC is subject to both statutory provisions and its own rules that are intended to ensure the fairness of its processes. For example, the SEC is subject to restrictions relating to *ex parte* contacts and is required to maintain a separation of certain functions under both the APA and its own rules. Section 554 of the APA and SEC Rule 120 of the Rules of Practice prohibit *ex parte* communications in the context of adjudications. Specifically, persons presiding over evidentiary hearings, such as ALJs, are not permitted to consult any person or party on a fact in issue unless prior notice and an opportunity for all parties to participate have been given. Similarly, SEC Rule 121 prohibits SEC officers, employees or agents engaged in the performance of

investigative or prosecutorial functions for the SEC to participate or advise in the decision or in the SEC review of such decision made by an ALJ.

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

With respect to the SEC's review of SRO proposed rule changes, there is a statutory scheme designed to ensure that SROs are afforded adequate process.

Finally, as discussed in response to Question 1.1(b) and to other previous questions, the SEC is subject to the APA's public notice and comment provisions concerning rulemaking.

4.3

b) Is the regulator required to give reasons in writing for its decisions that affect the rights or interests of others?

The SEC is required to give written reasons for its decisions affecting the rights and interests of others. With respect to adjudications, Section 557 of the APA requires that the record for such adjudications include all decisions, including initial, recommended, and tentative decisions. These decisions must include a statement of findings and conclusions, and the reasons or basis for such, on all material issues of fact, law, or discretion that are presented on the record. Such decisions must all include a statement of the appropriate rule, order, sanction, relief or denial thereof.

With respect to rulemaking, Section 553 of the APA requires the SEC to publish a notice of such proposal. The notice must state the time, place, and nature of the rulemaking, reference the legal authority for the rule proposal and include the terms or substance of the proposal and a description of the subjects and issues involved. If the SEC determines to adopt a rule after public notice and comment, it is required to incorporate in the rules adopted a concise general statement of their basis and purpose and publish such rule at least 30 days before it becomes effective.

See also responses above to Questions 4.2(b) and 4.2(c).

4.3

c) Are all material actions of the regulator in applying its rules subject to review?

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

4.3

d) Are such decisions subject to judicial review where they adversely affect legal or natural persons?

Provisions in the federal securities laws provide that any person aggrieved by a final order of the SEC may obtain review of the order in the United States Court of Appeals for the Circuit in which such person resides or has his principal place of business or in the District of Columbia Circuit. Similarly, any person adversely affected by a rule of the SEC promulgated under certain provisions of the federal securities laws may obtain review of such rule in the United States Court of Appeals for the Circuit in which such person resides or has his principal place of business or in the District of Columbia Circuit.

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

4.3

e) Are the general criteria for granting, denying, or revoking a license made public, and are those affected by the licensing process entitled to a hearing with respect to the regulator's decision to grant, deny, or revoke a license?

The SEC's criteria and application processes for registration of various entities and products are made public pursuant to SEC rules and regulations promulgated under the statutes the SEC administers and affected persons are entitled to hearings concerning registration. These statutes provide for varying registrations with the SEC, including registrations of public securities offerings, brokers, dealers, transfer agents, clearing agencies, national securities exchanges, national securities associations, nationally recognized statistical ratings organizations, investment advisers, and investment companies. Similarly, licensing regimes for market intermediaries are administered by SROs such as FINRA. These requirements are filed with the SEC for approval, subject to public notice and comment rulemaking, and made available to the public.

With respect to registration of securities offerings, in addition to the rule provisions delineating the information required for registration, persons contemplating filings with the SEC may receive advice of a general nature as to the preparation thereof, including information as to the forms to be used and the scope of the items contained in the forms.

With respect to registration of entities required to be registered in order to engage in regulated activity (e.g., brokers, dealers, transfer agents, national securities exchanges, national securities associations, clearing agencies, investment advisers, and investment companies), SEC rules generally provide affected persons with an opportunity to be heard by the agency. For example, SROs applying for registration as national securities exchanges, national securities associations or clearing agencies are entitled notice of the grounds for denial of such applications under

consideration and opportunity for hearing prior to a denial. Similar procedures of notice and an opportunity for hearing are provided to brokers, dealers, CRAs, and investment advisers applying to register as such. Transfer agent registration applications may be denied, but only if the SEC makes certain findings on the record after notice and opportunity for a hearing.

See also the responses to questions in Principle 21 for additional discussion on licensing.

4.4

If applicable, are procedures for making reports on investigations public consistent with the rights of individuals, including confidentiality and data protection?

The Exchange Act and Advisers Act both contain statutory provisions that are designed to safeguard the confidentiality of information obtained in the course of examinations or investigations. The SEC also has adopted rules under the Exchange Act to permit confidential treatment of requests for certain information. Notwithstanding these provisions, the rule 24c-1 under the Exchange Act provides that the SEC may, if it receives appropriate assurances of confidentiality, provide nonpublic information in its possession to certain entities, including other domestic and foreign governmental entities.

Additionally, the SEC is also subject to the Privacy Act and the RFPA, both discussed below.

The Privacy Act

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

Right to Financial Privacy Act

The RFPA requires government agencies to follow certain procedures when they seek to subpoena records from financial institutions or transfer such records to other government agencies. An agency may obtain financial records of an individual or partnership of five or fewer individuals from a financial institution (such as a bank or savings bank) only if the records are relevant to a legitimate law enforcement inquiry, and the customer has been served with a copy of the subpoena and summons ten days in advance of the release of the records. If a government agency intends to transfer such records to another government agency, the RFPA requires that (1) the transferring agency certify in writing that there is reason to believe that the records are relevant to a legitimate law enforcement inquiry by the receiving agency; and (2) the transferring agency notify the customer about the transfer of the records within fourteen days after the transfer.

4.5

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

The SEC has a designated Office of Investor Education and Advocacy. The Office serves individual investors by seeing to it that their problems and concerns are known throughout the SEC and considered the first priority whenever the agency takes action. The Office has four main functional areas:

- The Office of Policy and Investor Outreach has responsibility for reviewing all formal agency action from the perspective of the individual investor, including conducting investor surveys and focus groups. It plays a leading role in the SEC's efforts to ensure that investor disclosures are written in plain English, as well as the agency's technology initiatives such as providing increasingly more investor information in "interactive data" format.
- The Office of Investor Advocacy has responsibility for acting on investor tips, complaints and suggestions. Tens of thousands of investors contact the SEC each year using the agency's online forms or our (800) SEC-0330 hotline (toll-free in U.S.) to ask questions on a wide range of securities-related topics, to complain about problems with their investments or their financial professionals, or to suggest improvements to the agency's regulations and procedures. Trained SEC specialists and attorneys in the Office of Investor Advocacy provide these investors with information, seek informal resolutions of their complaints, and pass on their good ideas to the SEC and appropriate agency's Staff. Tips concerning possible law violations are passed on to the Enforcement Division for investigation. And trend information from investor reports of illegal or abnormal activity provides critical intelligence to other SEC offices and divisions. Investors can use the agency's online forms to file a complaint or ask a question.
- The Office of Investor Education carries out the SEC's investor education program, which includes producing and distributing educational materials, participating in educational seminars and investor-oriented events, and partnering with federal agencies, state regulators, consumer groups, industry associations, and others on financial literacy initiatives.
- The Office of Public Documents answers public requests for information, including those under FOIA, and executes the agency's responsibilities under the Privacy Act. The Office makes all of the SEC's public records — including registration statements and reports filed by regulated companies and individuals, SEC decisions and releases, Staff manuals, no-action and interpretive letters, and public comments on proposed rules — available through the Public Reference facilities located at SEC Headquarters (and many of these documents are also available on the SEC web site at <http://www.sec.gov>). The Office also handles public requests for non-public records, such as records compiled in investigations, consumer complaints, and Staff comment letters, under FOIA.

Additionally, as discussed in response to Question 10.5, OCIE issues public notices on its website called *ComplianceAlerts* that summarize select areas examiners have recently reviewed during examinations and describe the issues found. OCIE also conducts active outreach to the community through its *CCOutreach* program, which is designed to assist the chief compliance officers of broker-dealers, investment companies, and investment advisers in performing their important responsibilities and, ultimately, to help ensure firms have strong compliance programs for the protection of investors. This program includes national, regional, and interactive broadcast seminars that address current compliance risk areas and developments. Finally, OCIE occasionally issues public reports that evidence its work.

4.6

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

The SEC's exercise of its powers and discharge of its functions are consistently applied.

Regulator – Principle 5

The staff of the regulator should observe the highest professional standards including appropriate standards of confidentiality.

Assessment

Fully Implemented.

5.1

Are the staff of the regulator required to observe legal requirements or a "Code of Conduct" or other written guidance, pertaining to:

a) The avoidance of conflicts of interest?

All Staff, including Commissioners of the SEC, are subject to the criminal law conflict of interest statutes, 18 USC 201-216. One provision in particular, 18 USC 208, prohibits them from participating personally and substantially in particular matters that would have a direct and predictable effect on their financial interests or one that is imputed to them.

This statute has been implemented and supplemented by regulations issued by the U.S. Office of Government Ethics (OGE). The primary regulation is the Standards of Ethical Conduct for Employees of the Executive Branch, 5 CFR Part 2635. Subpart D of this regulation specifically implements section 208 of Title 18; subpart E regulates non-financial conflicts that could create the appearance that the Staff would lack impartiality. Another regulation issued by OGE, 5 CFR Part 2640, sets forth various exceptions to section 208 and details the procedures for granting waivers from its restrictions.

In addition to the Ethical Standards issued by OGE and the SEC's Standards of Ethical Conduct that all SEC employees must follow, the SEC's Division of Enforcement has implemented ethics guidelines specific to Enforcement staff. Enforcement requires its staff to follow a recusal policy that is more stringent than the one that applies to SEC staff in general. Enforcement requires new staff to recuse themselves from cases and /or investigations involving their former employer or clients of their former employer for a period of one year. The one year period starts on the day that persons begins working at the SEC. This policy is broader than the general ethics standards which require new staff to recuse themselves if their former employer is involved or if new staff's former client is involved. This policy is in effect to prevent any questions about impartiality on behalf of Enforcement staff.

OCIE has also implemented ethics guidelines specific to SEC staff in the examination program. Due to the special nature of the examination function, OCIE requires the examination staff to follow ethics guidelines that are more stringent than those applicable to SEC staff in general.

Since staff in the examination program review registrants' practices to determine if they are complying with the law, the ethical guidelines are designed to help examiners avoid even the perception of a conflict of interest. The guidelines do this by discussing various situations that could create such a perception and providing guidance on how to address those situations. The guidelines further discuss some of the most frequently asked ethical questions that arise in examination situations and outline uniform positions applicable to all examination staff. Specific issues discussed include maintaining the confidentiality of information obtained in examinations, the appropriate uses of information obtained during examinations, seeking employment offers, and the acceptance of food or gifts from registrants. In the event that one of the examination staff fails to adhere to one of the more restrictive ethics requirements, senior management in the examination program will take appropriate administrative measures as deemed warranted, generally in conjunction with advice from the SEC's Ethics Office.

OCIE updates the guidelines periodically and ensures that they are provided to each new examination staff member upon hire and to all examination staff on an annual basis in conjunction with specialized examiner ethics training provided by OCIE. All examination staff must acknowledge that they have attended the training or, in the event they could not attend, watched a video of the examiner ethics training.

As another measure to ensure examination staff adhere to high ethical standards, OCIE has implemented an "Examination Hotline," which permits securities firms to call with any questions, comments, complaints, or concerns about an examiner's conduct during an examination. The Examination Hotline (202.551.EXAM) offers the registrant a choice to speak with a senior-level attorney in OCIE in Washington, DC or a staff member in the SEC's Office of Inspector General. This SEC staff member will follow-up on any matter brought to his or her attention. The caller may request anonymity.

Finally, OCIE's ethics guidelines provide that examination staff must go through an exit interview process with an immediate supervisor after giving notice of an intention to terminate employment with the SEC. Prior to the staff's departure, the supervisor must meet with the individual to discuss potential conflicts of interest that the individual may encounter in the new employment based on the individual's work at the SEC. At the conclusion of the exit interview, the employee and the supervisor are required to sign an "Examination Employee Exit Interview Worksheet," which serves to acknowledge that they participated in the exit interview.

5.1

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

In addition to these government-wide regulations, the Staff is also subject to the non-superseded portions of the SEC's Conduct Regulation, 17 CFR 200.735, which includes comprehensive rules regarding the securities holdings and transactions of all Staff, including Commissioners, as well as any employee's spouse, dependent children, or other person residing in the same household who is related to the employee by blood or marriage, 17 CFR 200.735-5. Amongst other provisions, this regulation prohibits the holding of financial interests in broker-dealers and

investment advisers, selling short, carrying securities on margin, borrowing money for the purpose of buying securities, engaging in transactions in derivative instruments whose value is based on a security, and buying or selling a security subject to a current registration statement. The regulation also prohibits the misuse of non-public information and the purchase of a security that is known to the employee to be involved in SEC litigation or investigation. To bolster these requirements, the SEC recently issued new Form 681 requiring employees to certify in writing before any trade that they do not possess any non-public information about the company being traded.

The SEC's regulation requires the reporting of securities transactions, with certain exceptions, within five days of the receipt of confirmation. In addition to this regulation, certain other employees are subject to government-wide financial disclosure rules promulgated by OGE at 5 CFR Part 2634. Commissioners and Senior Officers must file a public financial disclosure report when they assume office, on an annual basis thereafter, and upon termination. Employees who have the greatest risk of creating harm by misusing information or having conflicts of interest must file annually a confidential financial disclosure form.

5.1

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

The OGE Standards of Conduct, at 5 CFR Part 2635, subpart G, prohibit the misuse of one's official position, including the use (or the allowance of others to use) confidential or non-public information. The SEC's own regulation also prohibits the use of confidential and nonpublic information, 17 CFR 200.735-3(b)(1).

5.1

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

The SEC's Conduct Regulation prohibits the unauthorized disclosure of confidential and nonpublic information, 17 CFR 200.735-3(b)(7). In addition, section 24(b) of the Securities Exchange Act of 1934 prohibits the disclosure and misuse of information filed with or otherwise obtained by the SEC, 15 USC 78x. This statutory prohibition is further explained under rules promulgated by the SEC at 17 CFR 240.0-4, 240.24b-2, and 240.24c-1. Other securities laws also contain prohibitions on the disclosure of nonpublic information: Section 45(a) of the Investment Company Act, 15 USC 80a-44; and Section 210 of the Investment Advisers Act of 1940, 15 USC 80b-10. *See also* 17 CFR 230.122 (Rule 122 under the Securities Act of 1933).

5.1

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

As noted above, the OGE Standards, at 5 CFR 2635 subpart E, require impartiality in the performance of official duties. In addition, the SEC's Rules of Practice, 17 CFR Part 201,

establish standards of procedural fairness. An additional protection of procedural fairness may be found at 17 CFR Part 200, subpart F “Code of Behavior Governing Ex Parte Communications Between Persons Outside the SEC and Decisional Employees.”

5.2

Are there:

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

The SEC’s OIG is responsible for monitoring and investigating violations of any of the statutes and regulations described in response to Question 5.1 above.

5.2

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

Violations of the conflict of interest restrictions of Title 18 of the US Code may be enforced either civilly or criminally, 18 USC 216. Violations of administrative rules can result in disciplinary action, including discharge. Willful disclosure of nonpublic information under the Exchange Act is also a criminal offense.

SELF-REGULATORY ORGANIZATIONS

Principles 6 and 7

Self-Regulation – Principle 6

The regulatory regime should make appropriate use of self-regulatory organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence and to the extent appropriate to the size and complexity of the markets.

Assessment

Fully Implemented.

6.1

Are there organizations that:

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

Generally, if an intermediary is located in the United States and solicits or engages in securities transactions in interstate commerce or otherwise participates in key points in effecting securities transactions for customers, such intermediary would be required to register as a broker-dealer and become a member of an SRO. In addition, generally, a foreign intermediary would be required to register as a broker-dealer if it (1) has physical operations in the United States, or (2) effects, induces, or attempts to induce transactions with or for a U.S. person.

Registration with the SEC

Broker-dealers generally must register with the SEC and become members of at least one SRO such as a national securities exchange or a registered securities association.²³ FINRA is currently the only registered securities association. FINRA is the result of the consolidation of the member firm regulatory functions of NYSE and NASD. It is responsible for regulating all securities firms that do business with the public, including with respect to professional training, testing and licensing of registered persons, and arbitration and mediation.

Broker-dealers that have a public customer business must be members of FINRA unless they limit their transactions to securities traded on an exchange of which they are a member. Broker-dealers that limit their activity to government securities or municipal securities (*i.e.*, subsovereign debt) require specialized registration. Broker-dealers may also need to register

²³ By definition, national securities exchanges and registered securities associations (like FINRA) are self-regulatory organizations. See Section 3(a)(26) of the Exchange Act, 15 U.S.C. 78c(a)(26). The rules and regulations promulgated by an SRO can be found on its website, *see e.g.*, www.finra.org (for FINRA rules).

with individual states within the U.S. under each state's applicable laws.²⁴ Information regarding registration requirements of the states, the SEC and FINRA are coordinated through the CRD operated by FINRA.

Section 15(a) of the Exchange Act requires brokers and dealers that effect or solicit transactions by use of a means of interstate commerce to register with the SEC. Section 3(a)(4) of the Exchange Act generally defines the term "broker" as "any person engaged in the business of effecting transactions in securities for the account of others." Section 3(a)(5) of the Exchange Act generally defines the term "dealer" as "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise."²⁵

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

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

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

²⁴ This response does not address the broker-dealer regulation requirements of the states.

²⁵ Discussion of U.S. securities laws generally collapses the terms "broker" and "dealer" into the term "broker-dealer" for simplicity. The term "broker-dealer" is used herein to refer to a broker or a dealer.

registration must generally be disclosed on Form BD. Form BD also requires the applicant to disclose any unsatisfied judgments or liens against the applicant.

The SEC may deny registration if it finds that the applicant has not filed a complete Form BD in accordance with related rules prescribed by the SEC as necessary or appropriate in the public interest or for the protection of investors.²⁶ The SEC may also deny registration if it finds the applicant, or any person associated with the applicant, has filed false information with the SEC, has been convicted within ten years preceding the application of a financial related felony or misdemeanor or substantially equivalent crime by a foreign court. The SEC may also deny registration if it finds the applicant, or any person associated with the applicant, is enjoined by a court from participation in the securities business, has willfully violated, or willfully aided the violation of, the federal securities laws, rules issued by the SEC pursuant to those laws, or the CEA, or has failed to reasonably supervise, with a view to preventing such violations, a person subject to the applicant's, or any person associated with the applicant, supervision.

The SEC may similarly deny registration if it finds the applicant is subject to any final order of a state securities commission (or any agency or officer performing like functions), state authority that supervises or examines banks, savings associations, or credit unions, state insurance commission (or any agency or office performing like functions), an appropriate federal banking agency (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813(q))), or the National Credit Union Administration, that--

- bars such person from association with an entity regulated by such commission, authority, agency, or officer, or from engaging in the business of securities, insurance, banking, savings association activities, or credit union activities; or
- constitutes a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative, or deceptive conduct.²⁷

The SEC may also deny registration if it finds similar findings have previously been made by a foreign financial regulatory authority.²⁸ The SEC may consider criminal, disciplinary and other regulatory judgments of other entities in determining whether to grant registration, place limitations on a broker-dealer's activities, or suspend or revoke a broker-dealer's registration.²⁹ Such matters, and information otherwise available to the SEC, may serve as a basis for denial of registration as a broker-dealer.³⁰ Section 15(b)(1) of the Exchange Act requires the SEC to grant registration, or commence proceedings to determine whether registration should be denied,

²⁶ See Exchange Act Section 15(b)(1), 15 U.S.C. 78o(b)(1).

²⁷ See Exchange Act Section 15(b)(4)(H), 15 U.S.C. 78o(b)(4)(H).

²⁸ See Exchange Act Section 15(b)(4)(G), 15 U.S.C. 78o(b)(4)(G).

²⁹ See Exchange Act Section 15(b)(4)(B), 15 U.S.C. 78o(b)(4)(B).

³⁰ See Exchange Act Section 15(b)(1)(B), 15 U.S.C. 78o(b)(1)(B).

within 45 days of the date of filing of an application for registration unless the applicant consents to a longer period.

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

Registration with SROs

It must be noted that registration with the SEC is not sufficient to begin operations as a broker-dealer. A registered broker-dealer must also be a member of an SRO. In order to trade directly on a particular exchange, a broker-dealer must become a member of that exchange.³¹ Firms that engage in transactions in municipal securities must also comply with the rules of the Municipal Securities Rulemaking Board, or MSRB, an SRO that makes rules governing transactions in municipal securities

SROs complete a comprehensive assessment of each broker-dealer firm before granting membership. A firm may not engage in any securities business at the SRO until it has completed the SRO's membership application process and received the approval of the SRO. During the pre-membership application process, the SRO determines whether the firm is aware of applicable SEC and SRO rules, and determines whether that the firm will be capable of complying with those rules once approval is granted. Consistent with the requirements of the Exchange Act, every SRO must have membership rules. Therefore, each exchange or association decides the general conditions of use and membership pursuant to its own rules. Such rules are considered by the SEC pursuant to the SRO rulemaking process proscribed in Section 19(b) of the Exchange Act.³² Exchange members must satisfy the SRO's membership rules whether they are doing a proprietary business or a customer business. It should be noted that Section 6(b)(5) and Section 15A(b)(6) of the Exchange Act prohibit exchanges and associations from adopting rules that would unfairly discriminate against certain members of an exchange or an association, respectively.

Based upon the types of business in which the firm wishes to engage, the SRO will require broker-dealers to maintain different types of books and records that are necessary to conduct and supervise those types of activity. Further, the SRO will obtain the firm's supervisory procedures for review. The SRO will also evaluate whether the firm has an adequate number of experienced supervisory and other personnel, as well as experienced personnel in key areas, to conduct the types of business in which it wants to engage. FINRA also requires a business plan, compliance guide and an initial interview with the applicable FINRA District Office. An SRO's evaluation typically includes an assessment of, among other things the firm's ability: (i) to meet the SEC's

³¹ See Exchange Act Sections 6(b)(2) and 6(c), 15 U.S.C. 78f(b)(2) and (c).

³² The SRO rulemaking process is described in detail in the response to Question 7.1(d) below.

net capital requirements; (ii) meet books and records requirements; (iii) supervise its activities; (iv) implement a reasonable compliance program; and (v) make disclosures relating to beneficial ownership of the firm. SROs also have access to information in a broker-dealer's Form BD, as well as the information and documents required during the application process.

In addition, SROs require that certain individuals that work at a broker-dealer – “associated persons” (*see* discussion below) – register with them³³ using Form U4. In order to fulfill SRO requirements, certain individuals must prove themselves to be qualified by passing qualifications examinations.³⁴ These examinations test the individuals' knowledge of securities industry laws, regulations, and rules, and are both general and specialized. Any individual seeking to enter the securities industry is required to fill out a Form U4 and submit fingerprints. Generally, the Form U4 contains questions designed to elicit background information about the individual and whether the individual is subject to a statutory disqualification.³⁵ Under FINRA rules, the member firm is responsible for submitting the Form U4 and fingerprints to FINRA. FINRA reviews the application in light of the information contained in the CRD, which is a comprehensive database used by FINRA, state regulators, and the SEC that contains information about anyone who has ever worked in the securities industry and the disciplinary history for that person. In addition, the fingerprints are submitted to the FBI for a criminal background check.

Broker-dealers claiming denial of access may appeal to the SEC for a review.³⁶

Firms with Public Customer Business: Generally, broker-dealers with a public business must be FINRA members. The relevant FINRA provision is summarized below:

A broker-dealer must seek prior approval from FINRA prior to it (or its owners) closing any of the following transactions: a merger or acquisition by or with another FINRA member; an acquisition of substantially all of another member's assets; a change in equity ownership that results in one person or entity owning or controlling twenty-five percent or more of its equity or partnership capital; or a "material change" in its business operations. The required notice to FINRA, which must be accompanied by an application for a continuance of membership, must be filed at least thirty days prior to the closing of any of the listed transactions. FINRA may request additional information and a membership interview. FINRA is required to issue a written decision within thirty days after the membership interview or the submission of additional documents, or, if neither is requested, within forty-five days of the original application. FINRA also requires firms seeking to alter an existing membership agreement to seek approval through the filing of an application.

³³ *See e.g.*, NYSE Rule 301.

³⁴ *See e.g.*, NYSE Rule 304A.

³⁵ *See* Section 6(c)(2) of the Exchange Act, 15 U.S.C. 78f(c)(2).

³⁶ *See* Sections 6(d)(3), 15A(h)(3), and 19(d) of the Exchange Act, 15 U.S.C. 78f(d)(3), 78o-3(h)(3), and 78s(d), respectively.

Registration of Associated Persons with FINRA

Natural persons who are “associated with” a registered broker-dealer do not have to register themselves as broker-dealers.³⁷ However, unless their activities are strictly clerical and ministerial, these persons must register with the appropriate self-regulatory organization (generally, FINRA), and must take the appropriate qualifying examinations. This requirement applies to any securities professional associated with a member firm—including partners, officers, directors, branch managers, department supervisors, and salespersons. The registration application requires information about the individual's prior employment and disciplinary history. FINRA prescribes two levels of qualification and registration:

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

A broker-dealer that is a FINRA member is ordinarily required to have at least two general securities principals.³⁸ If the broker-dealer has fewer than ten non-clerical employees involved in securities activities, FINRA may waive the “two principal requirement,” and require only one registered principal. A broker-dealer that is a FINRA member must have a qualified financial and operations principal responsible for its financial and administrative operations.

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

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

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

³⁷ See Section 15(a) of the Exchange Act, 15 U.S.C. 78o(a).

³⁸ See NASD Rule 1021(e).

6.1

b) Establish and enforce binding rules of trading or business conduct for individuals or firms engaging in securities activities?

In the United States, exchange members are required to comply with their exchange's trading and business conduct rules. Sections 6(b)(1) and 15A(b)(2) of the Exchange Act provide that a registered national securities exchange or association must be able to enforce compliance by its members with, among other things, the rules of the exchange or association. Sections 6(b)(5) and 15A(b)(6) of the Exchange Act provide that the rules of a national securities exchange or association must be designed to prevent fraudulent and manipulative acts and practices to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and in general, to protect investors and the public interest; and must also not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

The SEC also has the authority to enforce compliance with an exchange's rules by its members. Pursuant to Section 21 of the Exchange Act, the SEC may investigate violations and seek sanctions against national securities exchange members that violate an exchange's rules.³⁹

6.1

c) Establish disciplinary rules and/or conduct disciplinary proceedings, which have the potential to impose enforceable fines, or other penalties, or to bar or suspend a legal or natural person from participating in securities activities or professional activities related to securities activities?

SRO Disciplinary Authority

Exchanges and associations must have rules that provide that their members shall be appropriately disciplined for violation of the provisions of the Exchange Act, the rules and regulations thereunder, and the rules of the exchange by expulsion, suspension, limitation of activities, functions and operations, fine, censure, being suspended or barred from being associated with a member or any other fitting sanction. Sections 6(b)(7) and 15A(b)(8) of the Exchange Act require that the rules of an exchange or association must provide for a fair procedure for disciplining members and persons associated with members, denying membership,

³⁹ Section 21(f) of the Exchange Act provides that the SEC shall not bring an action against a person for violation of an exchange's rules unless it appears that (1) such exchange is unable or unwilling to take appropriate action or (2) such action is otherwise necessary or appropriate in the public interest or for the protection of investors.

barring persons from being associated with members, and prohibiting or limiting access to services offered by the exchange or its members.⁴⁰

Clearing agencies must have rules that provide that its participants shall be appropriately disciplined for violation of any provision of the rules of the clearing agency by expulsion, suspension, limitation of activities, functions, and operations, fine, censure or any other fitting sanction. Unlike exchanges and associations, a clearing agency is not charged with disciplining its participants for violations of the Exchange Act and the rules and regulations thereunder. Pursuant to Section 17A of the Exchange Act, clearing agencies must also provide for fair procedures with respect to disciplining participants, denial of participation, and the prohibition or limitation with respect to the access of services.

SEC Disciplinary Authority

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

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

The SEC may censure, place limitations on, suspend for a period not exceeding 12 months, or revoke the registration of any broker-dealer based upon certain factual findings.⁴¹ Similarly, the SEC may censure, place limitations on the activities or functions of, suspend for not more than 12 months, or bar an associated person of a broker-dealer from further association.⁴² The SEC must first find on the record and after notice and opportunity for hearing that (1) such action is in the public interest and (2) the broker-dealer (or person associated with such broker-dealer) has willfully made a false or misleading application or report with the SEC, has been convicted of certain financial related felonies within the last 10 years, has been enjoined from participating in the securities, banking, insurance or futures industries, has willfully violated the U.S. securities laws, or has willfully aided or abetted in the violation of the U.S. securities or futures laws.

⁴⁰ See Sections 6(b)(7) and 15A(b)(8) of the Exchange Act, 15 U.S.C. 78f(b)(7) and 78o-3(b)(8), respectively. See also Sections 6(d) and 15A(h) of the Exchange Act, 15 U.S.C. 78f(d) and 78o-3(h), respectively, which contain additional requirements regarding how an exchange or association may discipline its members.

⁴¹ Exchange Act Section 15(b)(4).

⁴² Exchange Act Section 15(b)(6).

The SEC may also censure, place limitations on or revoke registration based on its finding that the broker-dealer (or person associated with such broker-dealer) is subject to any final order of a State securities commission (or any agency or officer performing like functions), State authority that supervises or examines banks, savings associations, or credit unions, State insurance commission (or any agency or office performing like functions), an appropriate Federal banking agency (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813(q))), or the National Credit Union Administration, that--

- bars such person from association with an entity regulated by such commission, authority, agency, or officer, or from engaging in the business of securities, insurance, banking, savings association activities, or credit union activities; or
- constitutes a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative, or deceptive conduct.⁴³

The SEC may also censure, place limitations on or revoke registration on a finding based on equivalent orders outside the United States.⁴⁴

Civil Federal Court Actions

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

Criminal Actions

Any person who willfully violates any provision of the Exchange Act, or any rule or regulation thereunder, or willfully makes a false or misleading statement in an application for membership to a self-regulatory organization, is subject to criminal penalties under the Exchange Act. Section 32 of the Exchange Act provides for criminal sanctions, upon conviction, not to exceed

⁴³ Exchange Act Section 15(b)(4)(H).

⁴⁴ Exchange Act Section 15(b)(4)(G).

\$1,000,000 (\$2,500,000 for a corporate entity) and/or imprisonment for no more than ten years. The SEC does not have the authority to prosecute criminal actions. Rather, criminal actions are prosecuted by the U.S. Department of Justice.

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

Self-Regulation – Principle 7

SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.

Assessment

Fully Implemented.

7.1

As a condition to authorization, does the legislation or the regulator require the SRO to demonstrate that it:

- a) *Has the capacity to carry out the purposes of governing laws, regulations and SRO rules consistent with the responsibility delegated to the SRO, and to enforce compliance by its members and associated persons subject thereto those laws, regulations and rules?*

Pursuant to Sections 5 and 6 of the Exchange Act, national securities exchanges (hereinafter referred to as an “exchange”) must be registered with, and have their rules reviewed by, the SEC. Similarly, pursuant to Section 15A of the Exchange Act, national securities associations (hereinafter referred to as an “association”) must be registered with, and have their rules reviewed by, the SEC. Sections 6(b)(1) and 15A(b)(2) of the Exchange Act provides that an exchange or association shall not be registered unless the exchange or association is so organized and has the capacity to carry out the purposes of the Exchange Act.⁴⁵ The exchange or association also must be able to enforce compliance with the Exchange Act, the rules and regulations thereunder and the SRO’s own rules by its members and persons associated with its members.⁴⁶ In this regard, the SEC evaluates whether applicants for registration as a national securities exchange have adequate computer system capacity, integrity, and security to support the operation of the exchange. To evaluate whether the exchanges have adequately considered their systems capacity needs, the SEC has put in place the Automation Review Program (ARP). In addition to reviewing the systems capability of an exchange, the SEC will consider whether an exchange has sufficient capital to maintain its automated systems, and staff with technical expertise.

There are several instances in which the SEC may permit exceptions to the SRO regulatory requirements. Under Section 19(g) of the Exchange Act, the Commission, by rule, consistent with the public interest, the protection of investors, and the other purposes of the Exchange Act

⁴⁵ Sections 6(b)(1) and 15A(b)(2) of the Exchange Act, 15 U.S.C. 78f(b)(1) and 78o-3(b)(2), respectively.

⁴⁶ *Id.*

may relieve any SRO of any responsibility under the Exchange Act or the rules or regulations thereunder by any member of such organization or person associated with such member or any class of such members or associated persons. Under Section 17(d)(1) of the Exchange Act, the SEC, by rule or order, as it deems necessary or appropriate in the public interest and for the protection of investors, to foster cooperation and coordination among SROs, or to remove impediments to and foster the development of a national market system and national system for the clearance and settlement of securities transactions may: (A) with respect to a person that is a member of more than one SRO, relieve any such SRO of any responsibility to (i) receive regulatory reports from such person, (ii) to examine such person for compliance with the federal securities laws, or (iii) carry out other specified regulatory functions with respect to such person and (B) allocate among SROs the authority to adopt rules with respect to matters as to which, in the absence of such allocation, such SROs share authority under the Exchange Act. Pursuant to this authority, the SEC adopted Rule 17d-2, which permits two or more SROs to file with the SEC a plan for allocation among the SROs the responsibility to receive regulatory reports, from person who are common members of such SROs, to examine such persons, or to enforce compliance of such persons with the federal securities laws. After appropriate notice and opportunity for comment, the SEC may, by written notice, declare such plan or any part thereof effective, upon finding that such plan or part thereof is consistent with Section 17(d)(1) of the Exchange Act.

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

Similarly, and as discussed in more detail in Principle 25.2(c), clearing agencies are required to be registered with and have their rules reviewed and with limited exceptions approved by the SEC. Pursuant to Section 17A of the Exchange Act and to standards established by the SEC's Division of Trading and Markets, clearing agencies must be able to demonstrate organizational and operational capability that among other things will ensure that the clearing agency has the ability to promote the prompt and accurate clearance and settlement of securities transactions and to assure the safeguarding of securities and funds. The SEC also reviews the systems of clearing agencies under ARP and participated in drafting recommendations for the business continuity plans of clearing agencies so that they would be able to achieve a rapid and timely resumption of critical services following a major disruption to operations.

The provisions of Section 6(b), and their parallel provisions in 15A, for associations, and 17A for clearing agencies, dictate in specific terms what the rules of an exchange must contain.⁴⁷ Most of these provisions are referenced in the responses in paragraphs (b)-(i) below. In addition, Section 6(b) contains the following requirements:

⁴⁷ See Sections 6(b) and 15A(b) of the Exchange Act, , 15 U.S.C. 78f(b) and 78o-3(b), respectively.

- The rules of an exchange must provide that any registered broker or dealer or any natural person associated with a registered broker or dealer, subject to the provisions of Section 6(c),⁴⁸ may become a member of the exchange⁴⁹;
- The rules of an exchange must provide for the equitable allocation of reasonable dues, fees and other charges among its members, issuers and other persons using the exchange's facilities⁵⁰; and
- The rules of an exchange must prohibit the listing of any security that is issued in a limited partnership rollup transaction, unless the transaction was conducted in accordance with procedures designed to protect the rights of limited partners.⁵¹

In addition to satisfying the requirements of Section 6 of the Exchange Act, a prospective exchange must demonstrate its ability to operate as part of the national market system as contemplated in Section 11A of the Exchange Act. In particular, an applicant exchange must satisfy the national market system requirements set forth in Regulation NMS. Regulation NMS contains rules that govern quotations in the national market system, including quotation collection and reporting requirements, firm quotation requirements, and quotation access and trade-through prevention requirements. Specifically, Regulation NMS addresses four main areas: (i) trade throughs; (ii) market access; (iii) sub penny pricing; and (iv) market data. The Order Protection Rule⁵² requires trading centers to establish policies and procedures reasonably designed to prevent the execution of trades at prices inferior to automated quotations that are the best quote of another exchange, subject to applicable exceptions. The Access Rule⁵³ requires fair and non-discriminatory access to quotations, establishes a limit on access fees to harmonize the pricing of quotations across different trading centers, and requires rules addressing locked and crossed markets. The Sub-Penny Rule⁵⁴ prohibits market participants from accepting, ranking, or displaying orders for securities priced \$1.00 or more in increments smaller than a penny. The market data provisions, among other things, modify the way the markets allocate data revenues

⁴⁸ Generally, Section 6(c) of the Exchange Act, 15 U.S.C. 78f(c), provides that an exchange must deny membership to persons who are not registered broker-dealers (or persons associated with registered broker-dealers) and that it may deny membership to registered broker-dealers and persons associated with registered broker-dealers who: (i) are subject to a statutory disqualification; (ii) who do not meet certain financial responsibility or operational capacity standards; (iii) who do not meet standards of training, experience, and competence; and (iv) who have engaged in and are reasonably likely to engage in acts or practices inconsistent with just and equitable principles of trade.

⁴⁹ See Section 6(b)(2) of the Exchange Act.

⁵⁰ See Section 6(b)(4) of the Exchange Act.

⁵¹ See Section 6(b)(9) of the Exchange Act.

⁵² 17 CFR 242.611.

⁵³ 17 CFR 242.610.

⁵⁴ 17 CFR 242.612.

to reward aggressive quoting and reduce distortions caused by the existing formulae. In addition, Regulation NMS rules govern transaction reporting, and require the publication of order execution quality statistics.

7.1

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

Pursuant to Sections 6(b)(2), 15A(b)(3), and 17A(b)(3)(B) of the Exchange Act, a national securities exchange, national securities association, or clearing agency must have rules that permit any registered broker-dealer or natural person associated with a broker-dealer to become a member of the exchange or association.⁵⁵ In addition, pursuant to Sections 6(b)(5), 15A(b)(6), 15B(b)(2)(C), and 17A(b)(3)(F) of the Exchange Act, the rules of an SRO must not be designed to permit unfair discrimination between customers, issuers, broker or dealers or regulate by virtue of the Exchange Act matters not related to the purposes of the Exchange Act or the administration of the SRO.

Membership Access

An exchange's or association's ability to deny membership to a person is limited pursuant to Sections 6(c) and 15A(g) of the Exchange Act, respectively. This statute provides that an exchange or association, generally, must deny membership to any non-registered broker-dealer and may deny membership to any broker-dealer that is subject to a "statutory disqualification."⁵⁶ A denial on the grounds of a statutory disqualification must be reported to the SEC. Further, an exchange or association may deny membership to a broker-dealer that does not meet financial responsibility or operational capability standards, or that does not have the minimum level of training, experience or competence prescribed by the exchange's rules. In addition, an exchange

⁵⁵ The term "member" is defined with respect to a national securities exchanges as "(i) any natural person permitted to effect transactions on the floor of the exchange without the services of another person acting as broker, (ii) any registered broker or dealer with which such a natural person is associated, (iii) any registered broker or dealer permitted to designate as a representative such a natural person, and (iv) any other registered broker or dealer which agrees to be regulated by such exchange and with respect to which the exchange undertakes to enforce compliance with the provisions of this chapter, the rules and regulations thereunder and its own rules." See Section 3(a)(3)(A) of the Exchange Act, 15 U.S.C. 78c(a)(3)(A).

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

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

⁵⁶ See Exchange Act Section 3(a)(39).

or association may deny membership to a broker-dealer that has engaged or is likely to engage in acts or practices that are inconsistent with just and equitable principles of trade.

Each national securities exchange or association has rules that prescribe the means by which a registered broker-dealer may apply to become a member. Rules for admission to a national securities exchange and a registered securities association are reviewed by the SEC pursuant to Section 19(b) of the Exchange Act. While exchanges and associations are free to have reasonable standards for access, such standards should act to prohibit unreasonably discriminatory denials of access. In addition to not permitting an exchange or association to exclude any registered broker-dealer,⁵⁷ the exchange's or association's rules may not be designed to permit unfair discrimination between broker-dealers⁵⁸ and may not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.⁵⁹ Further, Sections 6(b)(4) and 15A(b)(5) of the Exchange Act require that the rules of an exchange or association provide for an equitable allocation of reasonable dues, fees, and other charges among its members and other persons using its facilities. The SEC has plenary authority to review rules that govern the admission of members pursuant to Section 19 of the Exchange Act. Section 6(d)(3), Section 15A(h)(3), and Section 19(d) of the Exchange Act provide that the SEC may review denials of membership in, or access to, an SRO.

If an exchange or association denies membership or participation to an applicant, it must provide the SEC of notice of such action.⁶⁰ A denial of membership or participation by an exchange or association is reviewable by the SEC.⁶¹ The SEC will dismiss an appeal if the SEC finds that the SRO's action is based on fact and that the rules were applied in a manner that is consistent with the Exchange Act.⁶² If the SEC cannot make such a finding, it will set aside the SRO's action and require it to admit the applicant to membership or participation.⁶³

Accordingly, the ability to trade on a national securities exchange is readily attainable by those qualified, registered broker-dealers who seek membership. In recent years, many markets have demutualized and moved away from a floor-based, "membership" structure to a trading permit structure, making the opportunities to access to such exchanges greater; unlike with floor-based exchanges historically, there is typically no limit on the number of trading permits that a fully

⁵⁷ Other than pursuant to Sections 6(c) and 15A(g) of the Exchange Act, 15 U.S.C. 78f(c) and 78o-3(g), as discussed above.

⁵⁸ Sections 6(b)(5) and 15A(b)(6) of the Exchange Act, 15 U.S.C. 78f(b)(5) and 78o-3(b)(6).

⁵⁹ Sections 6(b)(8) and 15A(b)(9) of the Exchange Act, 15 U.S.C. 78f(b)(8) and 78o-3(b)(9).

⁶⁰ Section 19(d)(1) of the Exchange Act, 15 U.S.C. 78s(d)(1). See Rule 19d-1, 17 CFR 240.19d-1, for the required contents of the notice that a SRO must make to the SEC.

⁶¹ Section 19(d)(2) of the Exchange Act, 15 U.S.C. 78s(d)(2).

⁶² Section 19(f) of the Exchange Act, 15 U.S.C. 78s(f).

⁶³ *Id.*

electronic exchange issues. However, some exchanges that still have trading floors, though demutualized, have retained their limits on access.⁶⁴ Generally, exchanges are permitted to increase the number of memberships for their markets, but they are not allowed to decrease market access below membership levels in effect at the time of exchange registration or May 1, 1975.⁶⁵ The SEC, however, may increase or remove limitations on the number of memberships for an exchange if it finds that such limitations impose burdens on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.⁶⁶

The requirements for registered clearing agencies are in many ways similar to those for exchanges and national associations. Pursuant to Section 17A(b)(4), a clearing agency may deny participation to any person subject to a statutory disqualification or if any such person does not meet such standards of financial responsibility, operational capability, experience, and competence as are prescribed by the rules of the clearing agency. The clearing agency may examine and verify the qualifications of a person in accordance with its rules or procedures. In addition, the rules of a clearing agency—including those applicable to membership requirements and access—must not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Levels of Access

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

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

Paragraph (c) of Rule 610 limits the amount of fees that may be charged by a trading facility to access its best bids and offers. Generally, the rules provide that a trading center may not impose

⁶⁴ NYSE is an example of this.

⁶⁵ *See* Section 6(c)(4) of the Exchange Act, 15 U.S.C. 78f(c)(4).

⁶⁶ *Id.*

a fee for the execution of an order against a “protect quotation,” as defined, of the trading center that exceed or accumulate to more than \$0.003 per share or for a stock priced less than \$1.00, that exceed or accumulate to more than 0.3% of the quotation price.

Clearing agencies also may not permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency. Many firms in the U.S. securities industry are not direct participants of a clearing agency but clear their transactions through another broker-dealer that is a direct participant (*i.e.*, a “clearing firm”). The rules of a clearing agency do not extend to the customers of their participants, however, the rules may not impose any schedule of prices, or fix rates or other fees, for services rendered by its participants.

7.1

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

Statutory Requirements

Sections 6(b)(5), 15A(b)(6), and 15B(b)(2)(C) of the Exchange Act require that the rules of an SRO (other than a clearing agency) must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling and processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and in general protect investors and the public interest. In addition, the rules of an exchange or association, as well as the MSRB, must be designed as to not permit unfair discrimination between customers, issuers, brokers, or dealers. Moreover, an exchange’s or association’s rules must provide for the equitable allocation of reasonable dues, fees and other charges among its members and issuers and other persons using its facilities.⁶⁷

Section 17A of the Exchange Act recognizes that the operating efficiencies and enhanced risk management that are the core services offered by a clearing agency are necessary for the protection of investors. Section 17A, therefore, directs the Commission to facilitate a national system for the prompt and accurate clearance and settlement of securities transactions and to facilitate the establishment of linked or coordinated facilities for clearance and settlement of transactions in securities.

The SEC reviews all prospective exchange, association, MSRB, and clearing agency rules to evaluate whether they satisfy these standards. Further, the SEC reviews the prospective rules of the markets to evaluate whether the members of the markets have unfair trading advantages over non-members, or investors generally. For example, the SEC carefully reviews the operations of the SROs’ trading systems to evaluate whether investor orders are able to compete freely with orders of market professionals and are executed on an equitable basis, such as price/time

⁶⁷ Exchange Act Sections 6(b)(4) and 15A(b)(5), 15 U.S.C. 78f(b)(4) and 78o-3(b)(5), respectively.

priority.⁶⁸ SROs also have specific rules that govern how a broker-dealer may trade for its own account when representing customer orders. Pursuant to these SRO rules, broker-dealers are generally prohibited from trading for their own account when they hold an order for the same security that may be executed at the same price.⁶⁹ Failure to execute the customer's order first can result in a violation of SRO rules. The SEC carefully reviews any changes to these rules to evaluate whether investor protection are affected. Clearing agencies are required to have rules that promote the prompt and accurate clearance and settlement of securities transactions and that assure the safeguarding of securities and funds. As a result, the SEC reviews the proposed rules of clearing agencies with respect to risk margin and collateral requirements to determine whether the clearing agency applies its collateral requirements equally to all participants and whether the clearing agency has sufficient requirements to protect the interests of the clearing agency and its participants in the event of a participant default.

In addition, the SEC has adopted its own rule geared at ensuring that the public orders are represented in the markets. Specifically, Rule 604 of Regulation NMS provides that exchange specialists and over-the-counter market makers must display public customer limit orders that improve the bid or offer of the specialist or market maker.⁷⁰ In addition, specialists and market makers must include the size of public customer limit orders that are priced equal to the specialist's or market maker's bid or offer. This rule helps to ensure that public customer orders are able to compete in the market for quality executions.

As noted above, the SEC carefully considers prospective exchange rules to evaluate whether they provide members with unfair trading advantages. Specifically, the SEC considers carefully the implications of any proposed rule that gives a member a trading advantage against the obligations the member has to the market. For example, exchange specialists and market makers are permitted to trade for their own account ahead of public orders, in certain instances, in order to fulfill their obligations to maintain a fair and orderly market.⁷¹

The Exchange Act contains several other specific provisions to protect investors that must be complied with by a prospective exchange. An exchange must demonstrate that its members are not permitted to trade for their own accounts, for the accounts of associated person, or for accounts with respect to which an associated person exercises investment discretion, unless such trading is consistent with the exemptions set forth in Section 11(a) of the Exchange Act and the

⁶⁸ The SEC has stated that it believes that it is beneficial for orders in the same securities directed to an exchange to interact with each other as it promotes efficient trading and protects investors by assuring that orders executed pursuant to a single set of priority rules that are consistently and fairly applied. *See e.g.*, Securities Exchange Act Release No. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (Order approving the application of the Nasdaq Stock Market LLC as a national securities exchange).

⁶⁹ *See e.g.*, NYSE Rule 92.

⁷⁰ 17 CFR 242.604.

⁷¹ *See e.g.*, Securities Exchange Act Release No. 53539 (March 22, 2006), 71 FR 16353 (March 31, 2006) (Order approving NYSE Hybrid). *See also* Section 11(b) of the Exchange Act, 15 U.S.C. 78k(b), and Rule 11b-1 thereunder, 17 CFR 240.11b-1.

rules thereunder. There are statutory exceptions to these prohibitions, including an exception to allow trading by a dealer acting as a market maker.⁷² The SEC also excepted by rule, certain classes of transactions from these prohibitions.⁷³

The federal securities laws also prohibit fraudulent or deceptive conduct and insider trading. Specifically, the prominent anti-fraud and anti-manipulation provisions are found in Sections 9(a) and 10(b) of the Exchange Act, and Rule 10b-5 thereunder. Exchange Act Section 9(a) addresses manipulation of securities listed on a national securities exchange and is complemented by Exchange Act Section 10(b), which provides a regulatory umbrella for all over the counter listed securities. Additional prohibitions are found in Sections 17(a) of the Securities Act, and in Sections 14(e) and 15(c) of the Exchange Act. Section 17(a) of the Securities Act bars fraudulent conduct in the “offer or sale” of securities. With regard to tender offers, Section 14(e) of the Exchange Act prohibits untrue statements of material fact or the misleading omission of material facts, or any fraudulent, deceptive, or manipulative acts or practices. Section 15(c) of the Exchange Act prohibits broker-dealers from effecting any transaction in securities by means of any manipulative, deceptive, or other fraudulent device or contrivance. Under Sections 6(b)(5), 15A(b)(6), and 15B(b)(2)(C) of the Exchange Act, SROs must have rules that are designed, among other things to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and in general to protect investors and the public interest.⁷⁴ SRO rules generally require members and associated persons of members to arbitrate any eligible dispute upon a customer’s request.⁷⁵ SROs’ arbitration rules are designed to facilitate the resolution of disputes involving members, associated persons of members, and customers.⁷⁶ The SEC reviews SRO arbitration rules pursuant to Section 19(b) of the Exchange Act, before they can become effective. The SEC’s review considers, among other things, whether such rules are consistent with the SRO’s obligation to have rules that are

⁷² See Section 11(a)(1), 15 U.S.C. 78k(a)(1).

⁷³ Generally, if a member (except a specialist) wants to execute a transaction of a physical exchange floor for its own account, the member would have to yield priority to all non-members who seek execution at the same price. Section 11(a)(1)(G) of the Exchange Act, 15 U.S.C. 78k(a)(1)(G), and Rule 11a1-1(T) thereunder, 17 CFR 240.11a1-1(T). This section is intended to prevent members of an exchange from having an advantage over non-members by virtue of their time and place opportunities on an exchange. This section does not generally apply to electronic, off-floor orders. See Rule 11a2-2(T) under the Exchange Act, 17 CFR 240.11a2-2(T). As the markets have moved to more electronic models, the time/place advantages of members that Section 11(a) of the Exchange Act was intended to address have lessened.

⁷⁴ See also Section 9, 10, and 15(c) of the Exchange Act, 15 U.S.C. 78i, j, o, (the anti-manipulation and anti-fraud provisions of the Exchange Act) and also Rule 10b-5 under the Exchange Act, 17 CFR 240.10b-5.

⁷⁵ See e.g., FINRA Rule 12200.

⁷⁶ See e.g., FINRA Rule 12000 Series for the Code of Arbitration Procedure for Customer Disputes and FINRA Rule 13000 Series for the Code of Arbitration Procedure for Industry Disputes. FINRA also conducts arbitrations on behalf of other SROs. See e.g., Securities Exchange Act Release No. 56208 (Aug. 6, 2007), 72 CFR 45077 (Aug. 10, 2007) (order approving changes to NYSE arbitration rules to conform to the arbitration rules for FINRA, f/k/a NASD, to reflect FINRA’s regulation of mutual NYSE and FINRA members).

designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and in general protect investors and the public interest.

Best Execution

A broker-dealer has a legal duty to seek to obtain best execution of customer orders.⁷⁷ A broker-dealer's duty of best execution derives from common law agency principles and the fiduciary obligations that arise from the agency relationship, and is incorporated in SRO rules and, through judicial and SEC decisions, the antifraud provisions of the federal securities laws.⁷⁸ The duty of best execution requires broker-dealers to execute customers' trades, in accordance with the conditions of the order, at the most favorable terms available under the circumstances, *i.e.*, at the best reasonably available price.⁷⁹ The SEC has not viewed the duty of best execution as inconsistent with the automated routing of orders or requiring automated routing on an order-by-order basis to the market with the best quoted price at the time. Rather, the duty of best execution requires broker-dealers to periodically assess the quality of competing markets to assure that order flow is directed to the markets providing the most beneficial terms for their customer orders. Broker-dealers must examine their procedures for seeking to obtain best execution in light of market and technology changes and modify those practices if necessary to enable their customers to obtain the best reasonably available prices. In doing so, broker-dealers

⁷⁷ See *e.g.*, *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 269-270 (3d Cir.), *cert. denied*, 525 U.S. 811 (1998) ("Newton"); *Certain Market Making Activities on Nasdaq*, Exchange Act Release No. 40900 (January 11, 1999)(settled case)(citing *Sinclair v. SEC*, 444 F.2d 399 (2d. Cir. 1971); *Arleen Hughes*, 27 SEC 629, 636 (1948), *aff'd sub nom. Hughes v. SEC*, 174 F.2d 969 (D.C. Cir 1949). See also Order Execution Obligations, Securities Exchange Act Release No. 37619A (Sept. 6, 1996), 61 FR 48290 (Sept. 12, 1996) ("Order Handling Rules Release"). See Regulation NMS, Securities Exchange Act Release No. 51808, 70 FR 37496 (June 29, 2005) ("Regulation NMS Release").

⁷⁸ See Regulation NMS Release at note 338. See also Order Handling Rules Release, 61 FR at 48322. See also *Newton*, 135 F.3d at 270. Failure to satisfy the duty of best execution can constitute fraud because a broker-dealer, in agreeing to execute a customer's order, makes an implied representation that it will execute it in a manner that maximizes the customer's economic gain in the transaction. See *Newton*, 135 F.3d at 273 ("[T]he basis for the duty of best execution is the mutual understanding that the client is engaging in the trade—and retaining the services of the broker as his agent—solely for the purpose of maximizing his own economic benefit, and that the broker receives her compensation because she assists the client in reaching that goal."); *Marc N. Geman*, Securities Exchange Act Release No. 43963 (Feb. 14, 2001) (citing *Newton*, but concluding that respondent fulfilled his duty of best execution). See also Securities Exchange Act Release No. 34902 (Oct. 27, 1994), 59 FR 55006, 55009 (Nov. 2, 1994) ("Payment for Order Flow Final Rules"). If the broker-dealer intends not to act in a manner that maximizes the customer's benefit when he accepts the order and does not disclose this to the customer, the broker-dealer's implied representation is false. See *Newton*, 135 F.3d at 273–274.

⁷⁹ See Regulation NMS Release at note 341, citing *Newton*, 135 F.3d at 270. *Newton* also noted other certain factors relevant to best execution – order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market *Id.* at 270 n. 2 (citing Payment for Order Flow, Exchange Act Release No. 33026 (Oct. 6, 1993), 58 FR 52934, 52937–38 (Oct. 13, 1993) (Proposed Rules)). See *In re E.F. Hutton & Co.* ("Manning"), Securities Exchange Act Release No. 25887 (July 6, 1988). See also Payment for Order Flow Final Rules, 59 FR at 55008–55009.

must take into account price improvement opportunities, and whether different markets may be more suitable for different types of orders or particular securities.⁸⁰

The duty of best execution is an important protection for investors in the United States. This duty is generally codified in SRO rules. These rules are disclosed to the regulator and to market participants through the rule filing process under Section 19(b) of the Exchange Act, as described in the response to Question 7.1(d). OCIE conducts examinations of SROs and broker-dealers to evaluate compliance with the federal securities laws and SRO rules, including rules regarding best execution. OCIE reviews order matching and execution systems to evaluate compliance with the applicable statutory standards as stated in Section 6 of the Exchange Act for national securities exchanges, and Section 15A for registered securities associations. OCIE also examines broker-dealers to assess their order matching systems, algorithmic trading platforms, or other order execution systems for compliance with best execution and other obligations.

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

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

The SEC has adopted its own rules under Regulation NMS to support a broker-dealers' duty of best execution. Rule 611 under Regulation NMS requires a trading center to establish, maintain, and enforce policies and procedures that are reasonably designed executions of trades at prices worse than the best protected quotations, as defined,⁸¹ across the markets. Rule 611 helps to ensure that investors' orders are not executed at inferior prices.

Furthermore, other rules under Regulation NMS are designed to enhance the disclosure of order routing and execution practices. These disclosure rules are intended to promote fair and

⁸⁰ See Regulation NMS Release at 37538.

⁸¹ See Rule 600(a)(58), 17 CFR 242.600(a)(58).

vigorous competition among broker-dealers and among market centers. Under Rule 605 of Regulation NMS, market centers that trade national market system securities are required to make available to the public monthly electronic reports that include uniform statistical measures of execution quality. Under Rule 606 of Regulation NMS, broker-dealers that route customer orders in equity and option securities are required to make publicly available quarterly reports that, among other things, identify the venues to which customer orders are routed for execution. In addition, broker-dealers are required to disclose to customers, on request, the venues to which their individual orders were routed. The rules reveal if broker-dealers are routing a significant volume of orders to market centers that execute orders at prices substantially inferior to those available at other market centers trading the same security. This improved visibility, in turn, could shift order flow to those market centers that consistently generate the best prices for investors. Finally, by facilitating comparisons among securities traded in different market structures, the disclosures required by the rules may bring competitive forces more directly to bear on broader market structure issues, such as by prompting investors and issuers to choose markets with more efficient structures.

7.1

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

Pursuant to Section 19(b)(1) of the Exchange Act, an SRO must file any proposed change in, addition to, or deletion from the rules of the SRO⁸² (“proposed rule change”) electronically on a Form 19b-4, submitted to the SEC through the Electronic Form 19b-4 Filing System, which is a secure Web site operated by the SEC.⁸³ In some cases, particularly where novel or complex issues are involved, the SRO may first provide its proposed rule change to SEC staff in draft form submitted on a confidential basis. This informal process allows for consultation between SEC staff and the SRO prior to a formal rule filing. Once filed, the SEC must publish a notice of the filing in the Federal Register, which notice must include the SRO’s description of the terms of substance of the proposed change, the purpose of the proposal, and the statutory basis for the proposal, and give the public an opportunity to submit comments on the proposed rule change. Thereafter, if the proposed rule change was filed pursuant to Section 19(b)(2) of the Exchange Act, the SEC must, within 35 days of publication of the notice (or within such longer period as the SEC may designate up to 90 days of such date if the SEC finds such longer period appropriate and publishes its reason for so finding or as to which the SRO consents), approve the proposed rule change by order or institute proceedings to determine whether the proposed rule change should be disapproved. After publication, if comment letters received by the SEC raise significant issues, the Staff may request the SRO’s consent to extend the 35-day period and may

⁸² 15 U.S.C. 78s(b)(1).

⁸³ The SRO must also post the proposed rule change and any amendments to it on its Web site. See Rule 19b-4(l), 17 CFR 240.19b-4(l).

request that the SRO respond to comments by submitting a comment letter or amending the proposal.

As noted in Section 19(b)(1) of the Exchange Act, “[n]o proposed rule change shall take effect unless approved by the SEC or otherwise permitted in accordance with the provisions of this subsection.” The SEC must approve a proposed rule change if it finds that the proposed rule change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to the exchange. If the SEC cannot make such a finding, it must disapprove the proposed rule change. In making this determination, the SEC also must consider whether the proposed rule change will promote efficiency, competition and capital formation.⁸⁴

There are certain proposed rule changes that may be filed under Section 19(b)(3)(A) of the Exchange Act and take effect upon filing (*i.e.*, without need for SEC approval).⁸⁵ The proposed rule changes that may take effect upon filing under this section of the Exchange Act include: (i) those that constitute a stated, policy, practice or interpretation with respect to the enforcement of an existing rule of the exchange;⁸⁶ (ii) those that establish or change a due, fee, or other charge imposed by the exchange; (iii) those that are concerned solely with the administration of the exchange, or other matters which the SEC, by rule, consistent with the public interest and the purposes of this subsection, may specify.⁸⁷

Pursuant to its authority under Section 19(b)(3)(A) of the Exchange Act, the SEC adopted Rule 19b-4(f) to expand the types of proposed rule changes that may become effective upon filing. Specifically, an exchange may file a proposed rule change that is effective upon filing if the proposal effects a change to an existing order entry or trading system that (i) does not significantly effect the protection of investors or the public interest; (ii) does not impose a significant burden on competition; and (iii) does not have the effect of limiting the access or availability of the system.⁸⁸ In addition, Rule 19b-4(f)(6) permits SROs to file certain “non-controversial” changes to their rules that may take effect upon filing so long as they: (i) do not significantly affect the protection of investors or the public interest; (ii) do not impose any significant burden on competition; and (iii) do not become operative for 30 days after the date of filing and the SRO has given written notice of the proposal, including a brief description and rule text, at least five business days prior to filing.⁸⁹ With respect to clearing agencies, the Commission adopted Rule 19b-4(f)(4) that permits a proposed rule change to become effective

⁸⁴ See Section 3(f) of the Exchange Act, 15 U.S.C. 78c(f).

⁸⁵ The SEC has the authority to abrogate any proposed rule change submitted as effective upon filing. See Section 19(b)(3)(A) of the Exchange Act, 15 U.S.C. 78s(b)(3)(A) and further discussion below.

⁸⁶ See Rule 19b-4(b), 17 CFR 240.19b-4(b), for a definition of “state policy, practice or interpretation.”

⁸⁷ See Section 19(b)(3)(A) of the Exchange Act, 15 U.S.C. 78s(b)(3)(A).

⁸⁸ Rule 19b-4(f)(5), 17 CFR 240.19b-4(f)(5).

⁸⁹ See Rule 19b-4(f)(6), 17 CFR 240.19b-4(f)(6).

upon filing if it effects a change in an existing service of a registered clearing agency that (i) does not adversely affect the safeguarding of securities or funds in the custody or control of the clearing agency or for which it is responsible; and (ii) does not significantly affect the respective rights or obligations of the clearing agency or persons using the service.⁹⁰ Although rule changes filed under Section 19(b)(3)(A) are immediately effective, the SEC is required to publish them for notice and comment. The SEC may abrogate such a rule within 60 days of the date of filing if necessary or appropriate in the public interest, for the protection of investors or otherwise in furtherance of the purposes of the Exchange Act.⁹¹ A rule abrogated by the SEC may be re-filed by the exchange for review and publication under the regular notice and comment process, described above.

Under Section 19(b)(3)(B) of the Exchange Act,⁹² the SEC may put into effect summarily a proposed rule change, if it appears to the SEC that such action is necessary for the protection of investors, the maintenance of fair and orderly markets, or the safeguarding of securities or funds. Any proposed rule change so put into effect must be filed promptly thereafter in accordance with the provisions of Section 19(b)(1) of the Exchange Act.

7.1

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

Currently, all U.S. exchanges and FINRA are members of the Intermarket Surveillance Group. The Intermarket Surveillance Group (ISG) is an industry organization created in 1983 to coordinate intermarket surveillance among the SROs by cooperatively sharing regulatory information pursuant to a written agreement between the parties.⁹³ The goal of the ISG's information sharing is to coordinate regulatory efforts to address potential intermarket trading abuses and manipulations. Although the ISG Agreement was not established under Section 11A or 17(d) of the Exchange Act the SEC has required new SROs to become ISG members as a condition of operation.⁹⁴ As the members of the ISG are SROs, the SEC has direct oversight of the regulatory procedures that these SROs have developed, individually and jointly, including those developed for preventing insider trading and certain types of market manipulation.

⁹⁰ See Rule 19b-4(f)(4), 17 CFR 240.19b-4(f)(4).

⁹¹ 15 U.S.C. 78s(b)(3)(C).

⁹² 15 U.S.C. 78s(b)(3)(B).

⁹³ See Concept Release Concerning Self-Regulation, Exchange Act Release No. 50700 (November 18, 2004), 69 FR 71255, 71265 (December 8, 2004).

⁹⁴ See e.g., Securities Exchange Act Release No. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) ("Nasdaq Exchange Order").

Section 11A(a)(2) of the Exchange Act⁹⁵ directs the SEC, having due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets, to use its authority under the Act to facilitate the establishment of a National Market System (NMS) for securities in accordance with the Congressional findings and objectives set forth in Section 11A(a)(1) of the Act. Among those findings and objectives is the “linking of all markets for qualified securities through communication and data processing facilities.”⁹⁶ In this regard, there are several national market system plans that the SEC has approved and oversees which coordinate the application of the Exchange Act and SEC rules. Examples include the Intermarket Trading System Plan and the Plan for the Purpose of Creating and Operating an Intermarket Options Linkage, which plans coordinate the routing of orders among the equity and options markets, pursuant to Exchange Act and the rules thereunder. The Consolidated Tape Association Plan/Consolidated Quotation Plan and Options Price Reporting Authority Plan coordinate the reporting of quotes and transaction information in accordance with the requirements of the Exchange Act and rules thereunder. The options exchanges have also all agreed to the Options Regulatory Surveillance Authority Plan, whereby they share the administration, operation and cost of a regulatory surveillance program for detecting the misuse of insider information and share their regulatory information.

In addition, certain SROs have elected to enter into agreements, pursuant to Exchange Act Section 17(d) and Rule 17d-2 thereunder, to coordinate among themselves the allocation of regulatory responsibility regarding the receipt of regulatory reports from their mutual members or participants, the examination of such persons for compliance, and the enforcement of compliance for such persons. All such agreements must be filed with the SEC and, after public notice and comment, may be declared effective by the SEC.

Clearing agencies are not charged with disciplining their participants for violations of the Exchange Act and the rules and regulations thereunder. The Exchange Act requires, however, that a clearing agency have the capability to enforce its own rules with respect to its participants. The rules of DTC, NSCC, and FICC provide that each clearing agency will cooperate and share data with other regulatory and SROs for regulatory purposes.

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

⁹⁵ See http://www.sec.gov/rules/final/34-42212.htm#P25_2894#P25_2894.

⁹⁶ See Section 11A(a)(1)(D) of the Exchange Act, 15 U.S.C. 78k-1(a)(1)(D).

7.1

f) Imposes appropriate sanctions for non-compliance with its own rules?

Sections 6(b)(6) and 15A(b)(7) of the Exchange Act provides that an exchange or association must have rules that provide for the appropriate discipline of members and persons associated with members for violations of the exchange's or association's rules as well as the Exchange Act and the rules and regulations thereunder. Section 17A(b)(3)(G) of the Exchange Act provides that a clearing agency must have rules to provide for the appropriate discipline of participants who violate the rules of the clearing agency. These sections state that members should be appropriately disciplined by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member or any other fitting sanction. In addition, the disciplinary procedures set forth in the rules of an exchange, association, or clearing agency must be fair.⁹⁷

Once an exchange, association, or clearing agency has imposed a final disciplinary sanction against a member or person associated with a member, the exchange must promptly file notice with the SEC of its action.⁹⁸ A final disciplinary sanction imposed by a SRO is reviewable by the SEC.⁹⁹ The SEC may, by order, affirm or modify the sanction of the SRO, remand the matter to the SRO for further proceedings, or set aside the sanction.¹⁰⁰

If the SEC, as the appropriate regulatory agency, finds that an exchange, association, or clearing agency¹⁰¹ has failed, without reasonable justification or excuse, to enforce compliance with any such provision by a member or person associated with a member, it may impose sanctions against the exchange or association under Section 19(h) of the Exchange Act. Under this statute, the SEC has the authority to suspend for a period not to exceed twelve months, revoke a SRO registration, or censure or impose limitations upon the activities, functions, and operations of a SRO, if the SEC finds that the SRO has violated or is unable to comply with the provisions of the Exchange Act, the rules or regulations thereunder, or its own rules.¹⁰²

⁹⁷ Sections 6(b)(7), 15A(b)(8), and 17A(b)(3)(H) of the Exchange Act, 15 U.S.C. 78f(b)(7), 78o-3(b)(8), and 78q-1(b)(3)(H).

⁹⁸ Section 19(d)(1) of the Exchange Act, 15 U.S.C. 78s(d)(1). The SEC adopted Rule 19d-1 to, among other things, proscribe the contents of the required notice to the Commission. 17 CFR 240.19d-1.

⁹⁹ Section 19(d)(2) of the Exchange Act, 15 U.S.C. 78s(d)(2).

¹⁰⁰ Section 19(e) of the Exchange Act, 15 U.S.C. 78s(e).

¹⁰¹ The Depository Trust Company (DTC) is registered with the SEC as a clearing agency but its appropriate regulatory agency is the Board of Governors of the Federal Reserve System.

¹⁰² Section 19(h) of the Exchange Act, 15 U.S.C. 78s(h). The decision to suspend, revoke or censure a SRO must be made by order and based on a finding by the SEC on the record after notice and hearing.

Furthermore, if an SRO fails to take appropriate disciplinary action against a member, the SEC has its own authority to take action against such member under Section 15(b)(4) of the Exchange Act. Under this statute, if the SEC finds, on the record after notice and hearing, that the member or participant has willfully violated any provision of the Securities Act of 1933, the Investment Advisors Act of 1940, the Investment Company Act of 1940, the Exchange Act, or the rules or regulations under any of such statutes or engaged in other prohibited behavior, the SEC may, by order, suspend for a period not exceeding twelve months. A sanction under Section 15(b)(4) or 15(b)(6) of the Exchange Act could result in the loss of SRO membership under Sections 19(h)(2) and (3) of the Exchange Act.

7.1

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

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

To this end, the SEC has generally approved for SROs other than clearing agencies 20% member representation on SRO boards of directors and on SRO committees dealing with trading rules and member discipline, affairs which go directly to member interests. With respect to registered clearing agencies, the SEC evaluates the procedures of each clearing agency for meeting the fair representation requirement on a case-by-case basis. However, the boards of directors of all operational clearing agencies in the U.S. today consist primarily of clearing agency participants. This arrangement meets the requirements of the Exchange Act with respect to registered clearing agencies and fits the model of U.S. clearing agencies which are participant-owned organizations that act as industry utilities and that mutualize losses among all participants.

Section 15B(b)(2)(B) of the Exchange Act provides that the rules of the Municipal Securities Rulemaking Board shall provide that the membership of the MSRB (currently 15 members) shall at all times be equally divided among public representatives, broker-dealer representatives, and bank representatives, and that the public representatives shall be subject to approval by the Commission to assure that no one of them is associated with any broker, dealer, or municipal securities dealer and that at least one is representative of investors in municipal securities and at least one is representative of issuers of municipal securities. The Board proposes and adopts rules with respect to transactions in municipal securities.

7.1

h) Avoids rules that may create anti-competitive situations as defined in the Explanatory Note?

Sections 6(b)(8), 15A(b)(9), 15B(b)(2)(C), and 17A(b)(3)(I) of the Exchange Act require that the rules of an exchange, association, MSRB, or clearing agency must not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. When reviewing an SRO's proposed rule, the SEC analyzes the rule's burden on competition.

7.1

i) Avoids using the oversight role to allow any market participant unfairly to gain an advantage in the market?

The SEC reviews proposed changes to the ownership and regulatory structure of an exchange or association to evaluate the exchange or association's ability to fulfill its statutory obligations, including competitive concerns. Consistent with the requirements of fair representation under Section 6 of the Exchange Act, equity ownership of an exchange or association has not been concentrated in a limited number of individuals or entities because of the potential conflict of interest that may arise for persons or entities that could be both the regulator and a participant in the same market. To this end, when an exchange or association is owned by entities or persons, the SRO has adopted specific ownership/concentration limits for entities that will be both participants in that particular market and a shareholder owner. The SEC has also approved exchange rules that separate the regulatory function from the business function and rules that relate to the listing of an exchange or association's shares on its own market. The SEC also has taken steps to ensure that it has effective tools to oversee an exchange that is controlled by an entity not fully subject to its jurisdiction. In this regard, the SEC has approved exchange rules that include commitments in corporate documents by holding companies that own exchanges relating to voting and ownership limits, maintenance of books and records, and consent to personal jurisdiction.

The SEC has also stated that persons responsible for operating an SRO that is an exchange should not have a disciplinary history and, with respect to founders and/or prospective managers of an applicant, they should not be subject to a "statutory disqualification," as defined in Section 3(a)(39) of the Exchange Act.¹⁰³ In general, a person is subject to a statutory disqualification if he/she has been expelled or suspended from membership in an SRO, or is subject to an order by the SEC or other appropriate regulatory agency denying, suspending or revoking his/her registration as a broker or dealer. In addition, proposed directors, officers or managers of a national securities exchange must not have willfully violated the federal securities laws or have been convicted of a felony or misdemeanor (or substantially equivalent foreign crime) involving

¹⁰³ 15 U.S.C. 78c(a)(39).

misappropriation of funds, or securities fraud, larceny, robbery, extortion, or other related crimes within the past ten years.¹⁰⁴

Clearing agencies provide post-trade processing services and the losses of the clearing agency due to the default of a participant are mutualized across all participants. Clearing agencies are independent from the securities markets and are not affiliated with any one exchange or trading system. Nevertheless, the provision of Section 17A of the Exchange Act help to prevent the unfair advantage of any one clearing agency participant by requiring that the clearing agency be so organized and have the capacity to enforce its rules against participants and that the shareholders or participants of the clearing agency have fair representation in the selection of the clearing agency's directors and in the administration of its affairs. In addition, the rules of the clearing agency must provide for the appropriate discipline of participants who violate the clearing agency's rules. The rules of the clearing agency also must not discriminate among participants in the use of the clearing agencies.

7.2

Does the regulator:

a) Have in place an effective on-going oversight program of the SRO, which may include:

i) Inspection of the SRO;

The SEC has a vigorous surveillance, examination, and enforcement program to oversee the activities of the SROs, including exchanges, associations, and clearing agencies. Section 19(g) of the Exchange Act provides the standards against which the SEC directly assesses the continuing compliance of an SRO with its self-regulatory obligations. Specifically, Section 19(g)(1) mandates that every SRO comply with and enforce compliance with the provisions of the Exchange Act and the rules and regulations thereunder and the SRO's own rules, "absent reasonable justification or excuse." The SEC assesses an SRO's continuing compliance with these obligations by several means as described below.

OCIE administers the SEC's nationwide examination and inspection program. Examiners in Washington DC and in the SEC's 11 regional offices conduct examinations of the nation's registered entities, including the SROs. The purpose of examinations is to detect fraud and other violations of the securities laws, foster compliance with those laws, and help ensure that the SEC is continually made aware of developments and areas of potential risk in the securities industry. The examination program plays a critical role in encouraging compliance within the securities industry, which in turn also helps to protect investors and the securities markets generally.

¹⁰⁴ The SEC has stated it would apply the same standards to an applicant or applicants seeking approval to operate a registered securities association. In addition, an ATS that chooses to register as a broker-dealer (rather than an exchange), and to comply with Regulation ATS, is subject, as are all broker-dealers, to the SEC's statutory disqualification rules. See Sections 6(c)(2) and 15A(g)(2) of the Exchange Act, 17 U.S.C. 78f(c)(2) and 78o-3(g)(2).

The Staff conducts several types of examinations and inspections: (i) routine or cycle examinations and inspections, which test an entity's compliance with applicable laws and regulations; (ii) cause examinations and inspections, which focus on entities or issues that examiners learn of through complaints, tips, press reports, or other information indicating an entity might be engaged in possible fraudulent activities or otherwise be potentially violating the securities laws; and (iii) risk-targeted examination sweeps, that focus on particular compliance risks.

The Staff conducts inspections of the SROs to evaluate whether they and their members comply with applicable federal securities laws and SRO rules. These inspections focus on the SRO's regulatory programs, including: market surveillance, investigative and disciplinary programs, member examination programs, and listing and arbitration programs, among others. Staff may also examine an SRO's disciplinary action against a member, and denials of membership in, or access to, the SRO. The types of issues the Staff focuses on during SRO inspections are discussed in more detail in response to Question 10.1.

7.2(a)

ii) Periodic reviews;

The SEC has implemented an Automation Policy Review (ARP) Program, through which the staff conducts reviews of the information technology systems operated by the SROs to evaluate whether the systems have sufficient capacity and resiliency to accommodate conditions of increased volume and disruptions to normal operations. The ARP Program is part of TM and is staffed by information technology experts who regularly confer and meet with members of the SROs' information technology staff.

The SEC has issued two Automated Review Policy statements that set forth the SEC's view that the SROs, on a voluntary basis, should establish comprehensive planning and assessment programs to determine their systems' capacity and vulnerability.¹⁰⁵ In ARP I, the SEC recommended that the SROs' programs should have three objectives: (1) each SRO should establish current and future capacity estimates; (2) each SRO should conduct capacity stress tests periodically; and (3) each SRO should obtain an annual assessment of whether the affected systems can perform adequately in light of estimated capacity levels and possible threats to the systems. In ARP II, the SEC set forth its views on: (1) the nature of the reviews that SROs are encouraged to obtain with respect to their automated trading and information dissemination systems; (2) the contents of SROs' annual reports on major systems changes and a process for provision of notifications of material systems changes; and (3) notifications of significant systems problems. The ARP Staff participates actively in industry-wide business continuity planning exercises, the most recent of which was conducted in the fall of 2007.

¹⁰⁵ See Exchange Act Release Nos. 27445 (November 16, 1989)("ARP I") and 29185 (May 9, 1991)("ARP II").

The ARP program has been enhanced since it was first created. In 2005 the SEC added to the ARP program's capabilities by creating a cyber security lab, which permits the Staff to independently determine whether an SRO is enforcing its information security policies. In addition, the ARP Program Staff also handle reviews for compliance with the *Interagency White Paper* (April 2003), the SEC's *Policy Statement on Business Continuity Planning for Trading Markets* (September 2003), and other business continuity planning issues.

The ARP Program Staff conduct annual risk assessments and perform routine inspections of SROs to evaluate whether the ARP principles are being adequately addressed. Presently, an ARP examination includes a comprehensive review of the following areas: (1) Business Continuity Planning; (2) Software Development Methodology, Computer Operations, Application Review; (3) Networking; (4) Information Security: Architecture Review, Web Server security, Wireless Security, System Security, and Device Security. A general description of the methodology used by ARP program examiners is as follows: First, security engineers reviews an SRO's security policy and procedures and conducts detailed architecture review, to gain a thorough understanding of an SRO's business functions and the IT infrastructure that supports those functions. Second, the examiners conduct security testing to identify vulnerabilities in SRO systems and to verify whether SRO's are complying with their own policies and procedures. Finally, the examiners compare the test results with the SRO's policies and procedures and industry best practices in order to make findings and recommendations. This methodology enables the ARP Program to verify the confidentiality, integrity, and availability of SRO data and to ensure that there are fair and efficient markets. In addition to routine examinations, the ARP Program Staff may perform for cause or special focus inspections. TM has also incorporated the review of Section 31 fees processing and enforcement-related databases into the ARP inspection process.¹⁰⁶

7.2(a)

iii) Reporting requirements;

A registered exchange or association is required to submit to the SEC updates and amendments to its initial registration application on an ongoing, periodic basis. For a national securities exchange, Rule 6a-2(a) requires the exchange to submit amendments to its Form 1 registration, including the nature and effective date of the action taken, any new information, and corrections to inaccurate information, within 10 days, for information contained in certain exhibits to the Form 1.¹⁰⁷ In addition, each year a national securities exchange must file amendments to certain other Form 1 exhibits relating to exchange financial information, ownership, membership, and

¹⁰⁶ See Section 31 of the Exchange Act, 15 U.S.C. 78ee, which requires SROs to pay transaction fees to the SEC based on the volume of securities that are sold on their markets.

¹⁰⁷ Specifically, Exhibits C (information relating to the operators of exchange trading systems), F (membership forms), G (forms that relate to members financial responsibilities), H (listing applications), J (lists of officers, directors and committee members), K (lists of certain shareholders and partners) and M (member lists) and the Execution Page must be updated within 10 days of the action taken that rendered the Form 1 exhibit outdated or inaccurate.

listed securities.¹⁰⁸ Further, an exchange must file every three years completely updated information on the exchange's governing documents, managers, and facility operators.¹⁰⁹ In lieu of making annual or periodic filings, an exchange may make the required information available through several alternatives. For example, it could identify a publication that contains the required information and certify as to the accuracy of such information as of its publication date.¹¹⁰ An exchange may also keep its information up-to-date and make it available to the SEC and the public upon request so long as the exchange certifies as to its availability and accuracy or keep the information available on a web site that the exchange certifies is accurate.¹¹¹ Finally, an exchange could make its information available continuously on an Internet Web site controlled by the exchange, as long as it indicates the location of the Web site and certifies that the information is accurate as of its date.¹¹² Rule 6a-3 requires registered exchanges to submit certain supplemental information, including notices, circulars, bulletins, lists or periodicals that the exchange issues or makes generally available to members, participants or subscribers, to the SEC.

For a national securities association, Rule 15Aj-1 requires the association to submit updates to its Form X-15AA-1 registration promptly after the discovery of any inaccuracy in the registration statement (or any amendment or supplement thereto) and after any change which renders the information in the registration statement (or any amendment or supplement thereto) inaccurate. In addition, each year a national securities association must file an annual consolidated supplement on a Form X-15AJ-2.¹¹³ Further, an association must file every three years a complete Exhibit A.¹¹⁴ In lieu of submitting the annual or periodic filings, an association may identify a publication that contains the required information and certify as to the accuracy of such information as of its publication date.¹¹⁵

¹⁰⁸ Specifically, an exchange must submit amendments containing information for Exhibits D (unconsolidated financial statements for each subsidiary and affiliate) and I (audited financial statements for the exchange) as of the end of each fiscal year, and for Exhibits K (lists of certain shareholders and partners), M (member lists), and N (schedule of securities traded on the market) as of the period within 3 months of the date of the amendment.

¹⁰⁹ Specifically, updated Exhibits A, B, C, and J are required. Exhibit A includes the corporate documents and rules of the exchange. Exhibit B includes any written rulings, practices or interpretations of the exchange. Exhibit C includes information relating to the operators of exchange trading systems. Exhibit J includes the lists of officers, directors and standing committee members.

¹¹⁰ Rule 6a-2(d)(1), 17 CFR 240.6a-2(d)(1).

¹¹¹ Rule 6a-2(d)(2), 17 CFR 240.6a-2(d)(2).

¹¹² Rule 6a-2(d)(3), 17 CFR 240.6a-2(d)(3).

¹¹³ Rule 15Aj-1(c)(1), 17 CFR 240.15Aj-1(c)(1).

¹¹⁴ Rule 15Aj-1(c)(1)(ii), 17 CFR 240.15Aj-1(c)(1)(ii).

¹¹⁵ Rule 15Aj-1(c)(1)(i) and (ii), 17 CFR 240.15Aj-1(c)(i) and (ii).

With respect to clearing agencies, Rule 17Ab2-1 requires that if certain information on the clearing agency's registration Form CA-1 becomes inaccurate, misleading, or incomplete for any reason, the clearing agency must promptly file an amendment to the Form CA-1. In addition, TM's standards for registered clearing agencies require that clearing agencies provide annual audited financial statements and quarterly unaudited financial statements to the SEC and to participants. Clearing agencies are also required to provide the SEC and participants with an annual report on internal controls that is prepared by an independent accountant.

Exchanges and associations also have transaction reporting obligations related to the regulatory fees that the SEC are authorized recover from them under Section 31 of the Exchange Act. Pursuant to Exchange Act Rule 31, each covered SRO must submit to the SEC a monthly Form R1, which provides the aggregate transaction information for covered sales on that market. The clearing agency designated for each SRO must then calculate that SRO's owed regulatory fee, based on the amount and value of their transactions for that month, in accordance to a fee rate established by the SEC and adjusted from time to time. SROs must then pay to the SEC the sum of their monthly fees for each year, semi-annually.

In addition to the on-going supervision that occurs pursuant to the continuing review of the registration statements of registered exchanges, associations, and clearing agencies, the SEC supervises the registered exchanges, associations, and clearing agencies pursuant to the rule filing process, as described in the response to Question 7.1(d) above.

7.2(a)

iv) Review and revocation of SRO governing instruments and rules;

The SEC has authority to modify an SRO's governing instruments¹¹⁶ and rules pursuant to Section 19(c) of the Exchange Act, with the exception of the governing instruments of registered clearing agencies. Section 19(c) provides that the SEC "by rule, may abrogate, add to, and delete from [the] rules of a SRO (other than a registered clearing agency) [as] the SEC deems necessary or appropriate to insure the fair administration of the SRO, to conform its rules to the requirements of [the Exchange Act] and the rules and regulations thereunder applicable to such organization...." The rules of the SRO are filed with the Commission for review pursuant to the Section 19(b) rule filing process, as discussed in the response to Question 7.1(d) above.

Section 19(h) of the Exchange Act also generally provides the SEC, as the appropriate regulatory agency, with the authority to impose penalties on SROs and their members for certain violations of the federal securities laws and/or exchange rules.¹¹⁷ Specifically, the SEC has the authority,

¹¹⁶ The definition of "rules of exchange", "rules of an association", or "rules of a clearing agency" includes the constitution, articles of incorporation, bylaws, and rules, or instruments corresponding to the foregoing. See Section 3(a)(27) of the Exchange Act, 15 U.S.C. 78c.

¹¹⁷ The term "appropriate regulatory agency" is defined in Section 3(a)(34) of the Exchange Act. See 17 U.S.C. 78c(a)(34). The appropriate regulatory agency for the Depository Trust Company (DTC) is the Board of Governors of the Federal Reserve System and not the SEC.

as the appropriate regulatory agency, (a) to suspend or revoke the registration of an SRO; (b) to censure or impose limitations on its activities; and (c) remove from office or censure officers or directors of an SRO for violations of the Exchange Act or the SRO's rules.¹¹⁸

Additionally, the SEC has the authority under Section 19(a)(3) of the Exchange Act to cancel, suspend, or revoke an SRO's registration. Section 19(a)(3) states that "[a] self regulatory organization may, upon such terms and condition as the SEC, by rule, deems necessary or appropriate in the public interest or for the protection of investors, withdraw from registration by filing a written notice of withdrawal with the SEC. If the SEC finds that any SRO is no longer in existence or has ceased to do business in the capacity specified in its application for registration, the SEC, by order, shall cancel its registration."

7.2(a)

v) The monitoring of continuing compliance with the conditions of authorization or delegation.

The substantive criteria for registration as an exchange under Section 6 of the Exchange Act, as an association under Section 15A of the Exchange Act, or as a clearing agency under Section 17A of the Exchange Act are ongoing mandates; the SEC does not conduct a "one time only" evaluation of the exchange, association, or clearing agency's ability to meet these statutory standards. Section 19(g)(1) of the Exchange provides that "[e]very SRO shall comply with provisions [of the Exchange Act] the rules and regulations thereunder, and its own rules [absent] reasonable justification or excuse...." Each SRO's operations are subject to SEC inspection and oversight through the OCIE, as discussed more fully below, and the SRO's rules are subject to Commission oversight through the Section 19(b) rule filing process, as discussed in the response to Question 7.1(d) above.

In addition, there are several other statutory provisions that provide the SEC with additional authority to act on an SRO's compliance or non-compliance with applicable regulatory standards. The SEC also has the authority under Section 19(h) of the Exchange Act to suspend for a period not exceeding twelve months or revoke the registration of an SRO, or to censure or impose limitations upon the activities, functions, and operations of such SRO for failure to comply with the federal securities laws, including the rules of the SRO, if such action is "necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the [Exchange Act]."¹¹⁹ Section 19(a)(3) of the Exchange Act provides the SEC with the authority to cancel the registration of an SRO if the SEC finds that the SRO has ceased to do business in the capacity specified in its application for registration. Section 21(a) of the Exchange Act also states that the SEC may undertake at its own initiative

¹¹⁸ Section 19(h)(1) of the Exchange Act, 15 U.S.C. 78s(h)(1).

¹¹⁹ Note, however, that Section 19(g)(2) of the Exchange Act also generally provides that the SEC, by rule, may relieve any SRO of any responsibility under the Exchange Act to enforce compliance with any specified provision of the Exchange Act, or the rules thereunder, by member of an SRO, provided the rule adopted by the SEC is consistent with the public interest, the protection of investors, and the other purposes of the Exchange Act.

special investigations to determine whether any person is violating or about to violate an SRO rule.

7.2

b) Retain full authority to inquire into matters affecting the investors or the market?

The SEC has the authority to suspend or expel any member or person associated with a member from an SRO for violations of the federal securities laws or rules.¹²⁰ Under Sections 21(d) and (e) of the Exchange Act, the SEC has the authority to enforce an SRO's rules. The SEC also has the authority to inspect both the SROs and market participants to evaluate whether the various federal anti-fraud, anti-manipulation and reporting regulations are being observed. To this end, the SEC can obtain surveillance and/or trading data from the SROs.

7.2

c) Take over an SRO's responsibilities where the powers of an SRO are inadequate for inquiring into or addressing particular misconduct or allegations of misconduct or where a conflict of interest necessitates it?

Under Sections 21(d) and (e) of the Exchange Act, the SEC has the authority to enforce an SRO's rules and to compel an SRO to enforce its rules with regard to its members by filing an action in federal court; relief available includes, among other things, monetary penalties, injunctive action, and any form of equitable relief. Section 21(f) of the Exchange Act allows the SEC to bring such actions when it appears that an SRO is unable or unwilling to take appropriate action against a person in the public interest and for the protection of investors, or when such action is otherwise necessary or appropriate in the public interest for the protection of investors. The authority could be exercised in the event that an SRO fails to carry out its responsibilities with regards to addressing misconduct or in the event of a conflict of interest, or it can be exercised concomitantly with an SRO's own investigation and enforcement.

7.3

Does the law or regulator require the SRO to follow similar professional standards of behavior as would be expected of a regulator:

a) On matters relating to confidentiality and procedural fairness?

SROs generally have internal policies or rules regarding ethical conduct on the part of their staff, including the preservation of the confidentiality of material accessible by them and not publicly available, and proscribe the use thereof for personal benefit. In addition, SROs are required to comply with Section 10(b) of the Exchange Act and the rules thereunder, particularly Rules 10b-5 and 10b5-1, which prohibit any person that receives material, non-public information in a duty

¹²⁰ Section 19(h)(2) and (3) of the Exchange Act, 15 U.S.C. 78s(h)(2) and (3).

of trust or confidence from breaching that duty, causing the trading of securities on the basis on non-public information (insider trading).

Regarding procedural fairness, Sections (6)(b)(7), 15A(b)(8), and 17A(b)(3)(H) of the Exchange Act requires that the rules of an exchange, association, and clearing agency must provide for a fair procedure for disciplining members and persons associated with members, denying membership, and prohibiting or limiting access to services, and for exchange and associations barring persons from being associated with members. An exchange, association, or clearing agency must notify the member of the specific charges and give the member an opportunity to defend him/herself against such charges, and keep a record of the proceeding. If the exchange, association, or clearing agency determines to impose a disciplinary sanction against the member, the sanction must be supported by a statement that sets forth: (a) the act or practice in which such member has been found to be engaged or to have omitted; (b) the specific provision of the Exchange Act, rule or regulation or exchange rule that the act or omission is deemed to violate; and (c) the sanction imposed and reasons therefore.

7.3

b) On the appropriate use of information obtained in the course of the SRO's exercise of its powers and discharge of its responsibilities?

SROs must act in manner consistent with the Exchange Act. Furthermore, as noted in the response to Question 7.3(a) above, SROs, entrusted with material, nonpublic information, have a duty of trust and confidence and, therefore, are liable for any breaches of that duty and the results thereof, under Section 10(b) of the Exchange Act and the rules thereunder, particularly Rules 10b-5, 10b5-1, and 10b5-2. Finally, as noted in response to Question 8.7(d), SROs have implemented other measures to assure that information obtained during the course of carrying out SRO regulatory functions is not misused.

7.4

Does the law or regulator assure that potential conflicts of interest at the SRO are avoided or resolved?

Inherent in a self-regulatory model is concern about conflicts of interest, including conflicts an SRO may have between regulating its members and operating its business. The SEC reviews SRO proposal and examines SRO operations to evaluate any potential harmful impact conflicts of interest may have on the effective oversight of the securities markets.¹²¹ In particular, the SEC's review of proposed changes to an SRO's ownership and regulatory structure, pursuant to the 19(b) process described in the response to Question 7.1(i) above, is aimed at addressing conflicts of interest at the SRO.

¹²¹ See e.g., Securities Exchange Act Release No. 56145 (July 26, 2007), 72 CFR 42169 (Aug. 1, 2009) (order approving the consolidation of member firm regulatory functions of FINRA and NYSE Regulation).

ENFORCEMENT

Principles 8-10

Enforcement – Principle 8

The regulator should have comprehensive inspection, investigation and surveillance powers.

Assessment

Fully Implemented.

8.1

Can the regulator inspect a regulated entity’s business operations, including its books and records, without giving prior notice?

The SEC and its representatives have statutory authority to conduct examinations, some of which have come to be known as inspections, of all entities registered with the SEC (“registrants”).¹²² The SEC’s examination authority is drawn from three statutes: the Exchange Act, the Investment Company Act and the Advisers Act. These statutes do not require that the Staff provide prior notice to registrants before exercising its examination authority.

Statutory Authority

Section 17(b)(1) of the Exchange Act authorizes Staff to examine the books and records maintained by the entities enumerated in Section 17(a) of the Exchange Act. Such entities include, among others, registered brokers or dealers, national securities exchanges, registered securities associations, registered clearing agencies, and registered transfer agents.¹²³ Section 204(a) of the Advisers Act authorizes Staff to examine the books and records maintained by investment advisers, and Sections 31(a) and 31(b) of the Investment Company Act, together, authorize Staff to examine the books and records of the following entities: registered investment companies; underwriters, brokers, dealers and investment advisers that are majority-owned subsidiaries of an investment company; and investment advisers (that are not majority-owned subsidiaries of a registered investment company), depositors, and the principal underwriters of investment companies other than closed-end companies, in regards to their transactions with

¹²² The Staff uses the term “inspections” merely as a way to distinguish certain of its examinations, such as those focused on SROs and registered investment companies.

¹²³ The remaining entities enumerated in Section 17(a) of the Exchange Act are members of national securities exchanges, brokers or dealers transacting a business in securities through the medium of a member of a national securities exchange, registered municipal securities dealers, registered securities information processors, and the Municipal Securities Rulemaking Board.

investment companies. The types of books and records required to be maintained by the various regulated entities listed above are described in response to Question 8.4.

The Staff may exercise its authority to conduct examinations at any time, and the SEC has taken the position that the statutory grant of authority contained in Section 17 “is unconditional except for the requirement that any such record examination be ‘reasonable.’”¹²⁴

The SEC’s Examination and Inspection Program

OCIE administers the SEC’s nationwide examination and inspection program. Staff in Washington, D.C. and in the SEC’s 11 regional offices conducts examinations of the nation’s registered entities. The purpose of examinations is to detect fraud and other violations of the securities laws, foster compliance with those laws, and help ensure that the SEC is continually made aware of developments and areas of potential risk in the securities industry. The examination program plays a critical role in encouraging compliance within the securities industry, which in turn also helps to protect investors and the securities markets generally.

During examinations and inspections, Staff reviews the books and records of regulated entities, interviews management and firm employees, and analyzes the entity’s operations. In most cases, examinations include an on-site visit to the registrant’s offices by Staff. However, Staff also conducts examinations that do not include on-site visits. In certain circumstances, the Staff may not provide notice to a registrant in advance of an on-site visit. Under those circumstances, Staff may arrive unannounced, thus providing a candid look at the registrant’s operations. In addition, even when a registrant is contacted in advance of an examination, notice of the areas on which the Staff intends to focus may not be provided in order to ensure that books, records and activities are not altered or destroyed to prevent the Staff from detecting problems.

8.2

Can the regulator obtain books and records and request data or information from regulated entities without judicial action, even in the absence of suspected misconduct, in response to:

a) A particular inquiry?

In general, neither judicial action nor the presence of suspected misconduct is required for Staff to obtain books and records from entities registered with the SEC. This is true regardless of whether the records are being sought by examination Staff in response to a particular inquiry or as part of a routine examination. Registrants must make available, even without a subpoena, the books and records requested by Staff pursuant to the SEC’s examination and inspection authority.

¹²⁴ *Recordkeeping and Record Production Obligations of National Securities Exchanges and Registered Securities Associations*, Securities Exchange Act Release No. 16728 (October 12, 1979), 18 SEC Docket 670, 671.

Types of Examinations Conducted in the Examination and Inspection Program

Routine or cycle examinations and inspections: OCIE conducts routine or cycle examinations of the largest broker-dealer firms.¹²⁵ OCIE also conducts routine or cycle examinations of investment advisers, investment companies, transfer agents and NRSROs, as well as cyclical reviews of third-party administrators of investment companies. These examinations are designed to periodically test a registrant's compliance with applicable laws and regulations. When conducting such examinations, examination Staff generally request books and records relating to multiple aspects of the registrant's operations.

OCIE also conducts routine or cycle inspections of SROs to assess the adequacy of the SRO's regulatory programs and compliance with its regulatory duties. These inspections typically focus on specific regulatory program areas. When conducting SRO inspections, the Staff generally requests only records relevant to the program areas that are the subject of the inspection. Routine examinations and inspections are discussed in more detail in response to Question 10.1.

Cause examinations: OCIE conducts cause examinations to focus on registrants that are the subject of complaints, tips, press reports, or other information examiners may receive indicating that a registrant might be engaged in possible fraudulent activities or otherwise be potentially violating the securities laws. During a cause examination, the Staff generally requests only records that are relevant to the suspected violations and issues noted in the complaint, tips, press reports or other information.

Risk-targeted sweep examinations: OCIE conducts risk-targeted sweep examinations to focus on particular compliance risks and to determine the extent, scope, and danger of emerging risks in the regulated community. During risk-targeted sweep examinations, the Staff reviews risk conditions and responsive compliance controls at a sample of firms. This approach allows the Staff to obtain a more comprehensive view of any particular risk, assess the gravity of the risk, evaluate the compliance performance of individual firms and compare it with that of their peers and recommend regulatory solutions. When conducting risk-focused sweep examinations, Staff generally request only records relevant to the specific activity, control, or compliance area that are the focus of the sweep examinations.¹²⁶

Recent focus areas during examinations have included, for example:

- Valuation of illiquid or difficult to price securities;
- Manipulative rumors;
- Sales of securities to seniors;

¹²⁵ Additionally, FINRA and other SROs conduct routine examinations of their member firms.

¹²⁶ When conducting risk-focused sweep examinations, Staff may expand an examination beyond the initial focus of the examination if they find serious issues. In such cases, the Staff may request additional records from the registrant as warranted by the circumstances.

- Controls over non-public information and to prevent insider trading;
- Adequacy of advisers and funds' compliance programs, supervision and governance;
- Undisclosed payments for business;
- Supervision and compliance over branch offices;
- Suitability of sales of complex structured products to retail investors;
- Advisers' performance claims;
- Sales practices in sales of variable annuity products and variable life insurance;
- Pricing, mark-ups, disclosure, suitability, and underwriting of fixed-income securities;
- Auction rate securities;
- Compliance with the net capital rule;
- Best execution, and execution quality of algorithmic and automated trading systems;
- Compliance with short sale rules;
- Broker-dealers' sales of microcap securities;
- Controls for information security and the prevention of identity theft;
- Anti-money laundering programs; and
- Business continuity planning.

Failure to Produce Books and Records in Response to Examinations and Inspections

If a registrant fails to produce books and records in response to an SEC examination request, Staff in OCIE may refer the registrant to Staff in Enforcement for further action against the registrant. With respect to a particular inquiry, the SEC may, without judicial action, issue orders pursuant to Section 21(a)(1) of the Exchange Act which provides a mechanism to require and quickly obtain written statements under oath from any person as to "all the facts and circumstances" of a matter. In addition, Section 21(b) of the Exchange Act provides authority for any member of the SEC or any officer designated by it, typically Enforcement Staff, to direct subpoenas to any person to obtain testimony and documents, even in the absence of suspected misconduct by the recipient or anyone else. As a law enforcement agency, the SEC may obtain

information under 21(b) to satisfy its “official curiosity” that behaviour is consistent with the law and the public interest.¹²⁷

Certain provisions under the Securities Act, Advisers Act and Investment Company Act parallel the authority to compel the production of testimony and documents provided under Section 21(b).¹²⁸ Thus, in addition to being able to obtain testimony and documents from any person, the SEC has broad authority to look into any and all conduct covered by these titles.

8.2

b) On a routine basis?

As noted in response to Question 8.2(a), the SEC has the authority to obtain books and records regardless of whether it needs to obtain such books and records to carry out a routine inquiry or in relation to a specific inquiry.

8.3

Does the regulator have the power to supervise its authorized exchanges and regulated trading systems through surveillance?

The SEC has the power to supervise authorized exchanges and regulated trading systems through its authority to conduct SRO inspections and broker-dealer examinations. Subject to the SEC’s oversight, SROs have the frontline responsibility for overseeing daily trading activities and regulatory compliance on the exchanges.

SROs have congressionally mandated market surveillance responsibilities and have primary surveillance authority over their marketplaces. Under Section 19(g)(1) of the Exchange Act, SROs are obligated to comply with the Exchange Act and the rules and regulations thereunder, as well as the SRO’s own rules. SROs are also required under Section 19(g)(1) to enforce compliance with the securities laws by member firms and persons associated with those members. The SEC has stated that Section 19(g)(1) obligates the exchanges, as SROs, to “be vigilant in surveilling for, evaluating, and effectively addressing issues that could involve violations” of the securities laws, including trading violations.¹²⁹

The Office of Market Surveillance (OMS), located within Enforcement, works daily with the SROs to detect, as early as possible, any anomalous market activity, including suspect trading by particular persons or entities. SROs and OMS routinely surveil for, among other suspect

¹²⁷ See *US v. Morton Salt Co.*, 338 U.S. 632 (1950) and its progeny.

¹²⁸ See Sections 19(c) of the Securities Act, 209(b) of the Advisers Act and 42(b) of the Investment Company Act.

¹²⁹ *In re National Ass’n of Securities Dealers, Inc.*, Exchange Act Rel. No. 37538, at 3 (Aug. 8, 1996); *In re American Stock Exchange, LLC*, Exchange Act Rel. No. 55507 (Mar. 22, 2007).

activity, anomalous price and volume movements and potential insider trading. While the SROs focus surveillance on their respective marketplaces, the SEC's surveillance program covers all domestic equity and options markets. Data collected by the SRO and OMS surveillance programs provide an important and effective tool for SEC and SRO enforcement to timely investigate potential violations of securities laws and, where warranted, bring an enforcement action.

In addition, OCIE reviews the surveillance activity conducted by the SROs, including SRO surveillance of trading that occurs on the exchanges. The Staff may also request and obtain copies of SRO surveillance reports as necessary to assess an exchange's market activity on a specified date or in a particular security. The various automated surveillance programs used by the SROs are discussed in more detail in response to Question 10.2.

OCIE further reviews trading systems through examinations of broker-dealers that operate as an Alternative Trading System (ATS) or as an Electronic Communications Network (ECN). ATS and ECN systems, while not regulated as exchanges, are venues for matching the buy and sell orders of their subscribers. OCIE's examinations of ATS and ECN operations are discussed in more detail in Principle 10.1.¹³⁰

8.4

Does the regulator have record-keeping and record retention requirements for regulated entities?

The statutory recordkeeping and record retention requirements applicable to entities regulated by the SEC are contained in three separate statutes: the Exchange Act, the Investment Company Act and the Advisers Act. These provisions and their implementing rules and regulations are described below.

The Exchange Act and rules thereunder require national securities exchanges, national securities associations, registered clearing agencies and the Municipal Securities Rulemaking Board to maintain copies of all documents, including all correspondence, memoranda, papers, books, notices, accounts, and other such records they make or receive in the course of their business and self-regulatory activity.¹³¹ They also require members of a national securities exchange and brokers and dealers to make and keep extensive records relating to their businesses. Exchange Act Rule 17a-3 sets forth the basic recordkeeping requirements applicable to these entities. Examples of records required to be made and kept current under Exchange Act Rule 17a-3 include records of trades, receipts or deliveries of securities; records of positions held in various securities; records of disbursements of cash and other debits or credits; certain account balances;

¹³⁰ Additionally, as discussed in the response to Question 7.2(a)(ii), TM's Automation Review Program (ARP) group conducts reviews of the information technology systems operated by the exchanges, clearing agencies, and certain high-volume ATSs to ensure that the systems have sufficient capacity and resiliency to accommodate conditions of increased volume and disruptions to normal operations.

¹³¹ Exchange Act Rule 17a-1.

computations of the firm's net capital and indebtedness; financial statements; trade confirmations; communications received or sent by the firm which relate to the firm's business; customer complaints; compliance records; and other records. The retention requirements applicable to such records vary depending on record type.¹³²

Investment companies are required under Section 31(a) of the Investment Company Act to maintain records as the SEC prescribes by rules and regulations, as necessary or appropriate in the public interest or for the protection of investors. The SEC has implemented Section 31(a) by adopting Investment Company Act Rules 31a-1 and 31a-2. Some examples of records investment companies must maintain and keep current under Investment Company Act Rule 31a-1 include: records of purchases or sales of securities (including redemptions); records of portfolio securities positions and securities positions carried by the investment company for its own account; corporate organizational documents of the investment company; records of brokerage orders; and investment advisory material received from the investment company's investment adviser. The required retention periods for records required to be kept by investment companies vary depending on record type.¹³³ For additional discussion of recordkeeping and record retention requirements that are applicable to investment companies, see responses to Questions 17.11 and 18.8.

Investment Advisers are required under Section 204(a) of the Advisers Act to make and keep certain records as prescribed by the SEC, as necessary or appropriate in the public interest or for the protection of investors. The SEC has implemented Section 204(a) by adopting Investment Company Act Rule 204-2, which requires registered investment advisers to maintain certain books and records that relate to the adviser's advisory business, and sets forth the applicable retention periods for such records. Examples of the books and records that are required under Rule 204-2 are: records of cash receipts and disbursements; check books; bank statements; bills; certain written communications received or sent by the investment adviser; financial statements; records of accounts in which the investment adviser is vested with discretionary power with respect to the funds, securities or transactions of a client; powers of attorney; client agreements; and the investment adviser's code of ethics and records relating to violations thereof.

If the investment adviser has custody or possession of funds or securities of any client, it is required to keep certain additional records, such as: records of purchases or sales of securities for such clients and copies of trade confirmations; and records of securities in which each such client has a position and the location of such securities.

In general, records required to be made under Advisers Act Rule 204-2 must be maintained and preserved in an easily accessible place for at least five years (the first two years in an appropriate office of the investment adviser).

¹³² The basic retention rules applicable to records required to be maintained by brokers, dealers and national securities exchanges are set forth in Exchange Act Rule 17a-4.

¹³³ The basic rule setting forth the retention periods applicable to investment companies is Investment Company Act Rule 31a-2.

Pursuing Violations of the SEC's Books and Records Rules

The SEC has authority to pursue violations of the recordkeeping and record retention requirements in enforcement actions. With such actions, the SEC can seek, among other relief, injunctive, remedial and other sanctions, including penalties to deter future violations of these requirements. For example, in November 2008, in an action brought solely based on violations of books and records requirements, the SEC successfully obtained civil monetary penalties of \$100,000 against a broker-dealer, and \$30,000 against its Chief Compliance Officer for aiding and abetting the violations.¹³⁴

8.5

Are regulated entities required:

a) To maintain records concerning client identity?

Registrants are required to maintain certain records concerning client identity pursuant to certain regulations promulgated under the Bank Secrecy Act (BSA),¹³⁵ as amended, and the Patriot Act.¹³⁶ The BSA, initially adopted in 1970, established the basic framework for anti-money laundering obligations imposed on financial institutions. Among other things, it authorizes the Secretary of Treasury to issue regulations requiring financial institutions to keep records and file reports on financial transactions that may be useful in investigations and prosecuting money laundering and other financial crimes. Section 326 of the Patriot Act amended BSA to require financial institutions to establish written customer identification programs (CIP).

Under 31 C.F.R. §103.122, registered broker-dealers must establish, document and maintain a CIP appropriate for the broker-dealer's size and business that, at a minimum, includes:

- risk-based procedures for verifying the identity of each customer to the extent reasonable and practicable;
- procedures for opening an account that specify identifying information that will be obtained from each customer, including the name, date of birth (for an individual), address and identification number (*e.g.*, a tax identification number) of the customer;
- procedures for making and maintaining a record of all information obtained pursuant to prescribed CIP procedures;
- procedures for determining whether a customer appears on any list of known or suspected terrorists or terrorist organizations issued by any federal government agency; and

¹³⁴ *In the Matter of vFinance Investments, Inc., et al.*, 2008 SEC LEXIS 3159, available at www.sec.gov/litigation/aljdec/2008/id360rgm.pdf.

¹³⁵ The Bank Secrecy Act is codified at 31 U.S.C. §§ 5311 *et seq.*

¹³⁶ Pub. L. No. 107-56, 115 Stat. 296 (2001).

- procedures for providing customers with adequate notice that the broker-dealer is requesting information to verify their identities.

The books and records rules under Exchange Act Rule 17a-3 also require brokers and dealers to make and keep current account records including the customer's or owner's name, tax identification number, address, telephone number, date of birth, employment status, annual income, net worth and the account's investment objectives.

The Treasury has determined that mutual funds should be considered "financial institutions" for certain purposes and thus specified BSA rules are applicable to mutual funds.¹³⁷ Under 31 C.F.R. §103.131, mutual funds¹³⁸ are also required to implement a CIP appropriate for the fund's size and type of business that, at a minimum, includes:

- for a mutual fund relying on documents to identify the identity of the customer, procedures that set forth the documents that the mutual fund will use;
- for a mutual fund relying on non-documentary methods to identify the identity of the customer, procedures that describe the non-documentary methods the mutual fund will use;
- based on the mutual fund's risk assessment of a new account opened by a customer that is not an individual, procedures for obtaining information about individuals with authority or control over such account, including persons authorized to effect transactions in the shareholder of record's account, in order to verify the customer's identity;
- procedures for responding to circumstances in which the mutual fund cannot form a reasonable belief that it knows the true identity of a customer.
- procedures for making and maintaining a record of all information obtained pursuant to certain rules relating to the CIP;
- procedures for determining whether a customer appears on any list of known or suspected terrorists or terrorist organizations issued by any federal government agency; and
- procedures for providing customers with adequate notice that the investment company is requesting information to verify their identities.

The books and records rules under Advisers Act Rule 204-2 require investment advisers to make and keep current records that have the effect of maintaining clients' identities, including a list of

¹³⁷ Interim Final Rule of the Department of the Treasury: 67 Fed. Reg. 21117 (April 29, 2002). The implementing CIP rules under the Patriot Act are located in Part 103 of Title 31 of the Code of Federal Regulations.

¹³⁸ Under 31 C.F.R. § 103.131, a mutual fund is defined as an investment company that is an "open-end company" under Section 5 of the Investment Company Act, that is registered with the SEC under Section 8 of the Investment Company Act.

all accounts over which the adviser has discretionary authority, and copies of all written agreements entered into with clients.

Pursuant to Section 17(a) of the Exchange Act and Rule 17a-8 thereunder, the SEC may bring enforcement actions for violations of certain reporting, recordkeeping and record retention requirements promulgated under BSA, including those that relate to a broker-dealer's CIP. In 2008, for example, the SEC successfully filed and settled an action against one of the world's largest online broker-dealers and its affiliated clearing firm for failure to comply with the CIP rule of BSA and the broker-dealer's own documented CIP. In settlement, the firms agreed to the imposition of a censure and cease-and-desist order, payment of civil money penalties in the total amount of \$1 million, and the engagement of an independent compliance consultant to review and test the CIP to ensure compliance with applicable regulatory requirements.¹³⁹

8.5

b) To maintain records that permit tracing of funds and securities in and out of brokerage and bank accounts related to securities transactions?

As discussed in the response to Question 8.4, under Exchange Act Rule 17a-3, brokers and dealers are required to keep and maintain records showing cash positions and securities purchased, sold, received or transferred to or from customer accounts. Additionally, several BSA rules under Part 103 of Title 31 of the Code of Federal Regulations require broker-dealers to obtain and keep certain records relating to the transfer of funds to or from the firm. Certain key provisions of those requirements are discussed below.

First, the "Joint Rule," 31 C.F.R. § 103.33(f), requires broker-dealers to obtain and keep certain information concerning the transmitter and the recipient of a transfer or transmittal of funds totaling \$3,000 or more when the broker-dealer is acting as either the transmitter's financial institution or the recipient's financial institution.¹⁴⁰

Second, the "Travel Rule," 31 C.F.R. § 103.33(g), requires broker-dealers to ensure that certain information "travel with" the transmittal order for all wire transfers of \$3,000 or more.¹⁴¹

¹³⁹ *In the Matter of E*Trade Clearing LLC and E*Trade Securities LLC* (Administrative Proceeding 3-13106, July 30, 2008), available at <http://www.sec.gov/litigation/admin/2008/34-58250.pdf>

¹⁴⁰ 31 C.F.R. § 103.33 provides for exemptions from the Joint Rule for certain transactions, including transactions where the broker-dealer is either a transmitter to, or a recipient from, another broker-dealer, bank, domestic subsidiary of a bank chartered in the United States, domestic subsidiary of a broker-dealer, federal agency or instrumentality, or a state or local government.

¹⁴¹ 31 C.F.R. § 103.33 provides for exemptions from the Travel Rule for certain transactions, including transactions where the broker-dealer is either a transmitter to, or a recipient from, another broker-dealer, bank, domestic subsidiary of a bank chartered in the U.S., domestic subsidiary of a broker-dealer, federal agency or instrumentality, or a state or local government.

Broker-dealers are also required under 31 C.F.R. §§ 103.33(b) and 103.33(c) to retain a record of each advice, request or instruction received or given regarding any transaction resulting in, or intended to result in, the transfer of currency or other monetary instruments, funds, checks, investment securities, or credit of more than \$10,000 to or from any person, account, or place outside of the United States.

Under 31 C.F.R. § 103.35(b)(3), broker-dealers are required to retain a record of any remittance or transfer of funds, or of currency, checks, other monetary instruments, investment securities, or credit, of more than \$10,000 to a person, account, or place, outside the United States.

Under 31 C.F.R. § 103.23, broker-dealers are required to report and keep records regarding transactions where the firm is either importing or exporting currency or monetary instruments in an amount exceeding \$10,000. Specifically, each person (including a broker-dealer) who physically transports, mails, or ships currency or monetary instruments in excess of \$10,000 at one time out of or into the United States (and each person who causes such transportation, mailing, or shipment), must file a Report of International Transportation of Currency or Monetary Instruments.

Lastly, 31 C.F.R. § 103.35(b)(4) requires firms to retain a record of any receipt of currency, other monetary instruments, checks, or investment securities and of each transfer of funds or credit, of more than \$10,000 received on any one occasion directly and not through a domestic financial institution, from any person, account or place outside the United States.

8.5

c) To put in place measures to minimize potential money laundering?

Anti-Money Laundering Program Requirements

Currently, as a result of the Patriot Act and its implementing rules, there are a number of AML obligations that are applicable to broker-dealers, mutual funds, and registered trust companies such as DTC. Under Section 352 of the Patriot Act, those obligations include: (1) the development of internal policies, procedures, and controls; (2) the designation of a compliance officer; (3) an ongoing employee training program; and (4) an independent audit function to test programs. Broker-dealers can satisfy the AML requirements under Section 352 by implementing and maintaining an AML compliance program that complies with the applicable requirements of the SRO governing such programs.¹⁴²

NASD Rule 3011 and NYSE Rule 445 require their member organizations to establish risk-based AML compliance programs. Under both NASD Rule 3011 and NYSE Rule 445, a member (broker-dealer) organization's AML program must be in writing and include, at a minimum: (1) policies, procedures, and internal controls reasonably designed to achieve compliance with BSA and its implementing rules; (2) policies and procedures reasonably

¹⁴² 31 C.F.R. § 103.120(c) (2009).

expected to detect and cause the reporting of suspicious transactions required to be filed by financial institutions under certain provisions of BSA, as amended, and their implementing regulations (see below for further discussion regarding suspicious activity reporting requirements applicable to financial institutions); (3) the designation of an AML compliance officer, including notification to the SROs; (4) ongoing AML employee training; and (5) an independent test of the firm's AML program, annually for most firms.

Under Investment Company Act Rule 0-11,¹⁴³ mutual funds are subject to the CIP requirements under BSA and their implementing regulations. Those regulations require mutual funds to develop and implement a written AML program reasonably designed to: prevent the mutual fund from being used for money laundering or the financing of terrorist activities; achieve and monitor compliance with the applicable BSA requirements and implementing regulations promulgated thereunder by Treasury.¹⁴⁴ The AML program must, at a minimum: (1) establish and implement policies, procedures, and internal controls reasonably designed to prevent the mutual fund from being used for money laundering or the financing of terrorist activities and to achieve compliance with the applicable provisions of BSA and the implementing regulations thereunder; (2) provide for independent testing for compliance to be conducted by the mutual fund's personnel or by a qualified outside party; (3) designate a person or persons responsible for implementing and monitoring the operations and internal controls of the program; and (4) provide ongoing training for appropriate persons.

Additionally, Investment Company Act Rule 38a-1(a)(1) requires registered investment companies and business development companies to adopt and implement written policies and procedures "reasonably designed to prevent violation of the Federal Securities Laws by the fund."¹⁴⁵ The Rule defines the "Federal Securities Laws" as including BSA as it applies to funds, and any rules adopted thereunder by the SEC or Treasury.¹⁴⁶

Although investment advisers are not currently subject to AML requirements under BSA, FinCEN, a bureau within Treasury, which is the administrator of BSA, has stated that it is in the process of considering whether and to what extent it should impose BSA requirements on investment advisers and similar entities.¹⁴⁷ Additionally, FinCEN has stated that, because

¹⁴³ 17 C.F.R. § 270.0-11 (2009).

¹⁴⁴ 31 C.F.R. § 103.130 (2009).

¹⁴⁵ 17 C.F.R. § 270.38a-1(a)(1) (2009).

¹⁴⁶ 17 C.F.R. § 270.38a-1(e)(1) (2009).

¹⁴⁷ In May 2003, FinCEN issued a proposed rulemaking that would have required certain investment advisers to implement anti-money laundering programs under BSA. *FinCEN Proposed Rulemaking: Anti-Money Laundering Programs for Investment Advisers*, 68 Fed. Reg. 23647 (May 5, 2003). However, in June 2007, FinCEN announced that it would be taking a fresh look at BSA regulation to ensure that it is being applied efficiently and effectively across the industries that FinCEN regulates and the industries FinCEN has proposed to regulate. As part of that initiative, FinCEN decided to withdraw its May 2003 rule proposal while it considers whether and to what extent it should impose requirements under BSA on investment advisers and similar entities. *FinCEN Withdrawal of Notice*

investment advisers must conduct financial transactions for their clients through other financial institutions that are subject to BSA requirements, “their activity is not entirely outside the current BSA regulatory regime.”¹⁴⁸

Suspicious Activity Reporting Requirements

Section 356 of the Patriot Act amended BSA to require financial institutions to monitor for, and report, certain Suspicious Activity Report (SAR) reporting to FinCEN. Under Treasury’s SAR rules, broker-dealers¹⁴⁹ and mutual funds¹⁵⁰ are required to file a suspicious activity report if: (1) a transaction is conducted or attempted to be conducted by, at, or through the broker-dealer or a mutual fund; (2) the transaction involves at least \$5000; and (3) the broker-dealer or mutual fund knows, suspects, or has reason to suspect that the transaction involves funds from an illegal activity, is designed to evade requirements of BSA, has no business or apparent lawful purpose, and the broker-dealer or mutual fund knows of no reasonable explanation for the transaction after examining the available facts, or involves the use of the broker-dealer or mutual fund to facilitate criminal activity.

Broker-dealers and mutual funds must report the suspicious activity using a form Treasury has issued for the securities and futures industry, the SAR-SF. In situations involving violations that require immediate attention, however, firms must immediately telephone an appropriate law enforcement authority in addition to filing a SAR.

OCIE, along with Enforcement, created the SEC’s SAR Alert Message Line to centralize calls made to the SEC about SAR filings. Additionally, firms wishing to voluntarily report suspicious transactions that may relate to terrorist activity can call Treasury’s FinCEN hotline. Calling the SEC SAR Alert Message Line does not alleviate a firm’s obligation to file a SAR or notify an appropriate law enforcement authority.

Anti-Money Laundering Reviews Conducted by the SEC

As part of the SEC’s examination program, OCIE reviews all types of records registrants are required to keep under the anti-money laundering rules. In addition to conducting anti-money laundering reviews as part of its routine oversight examinations of registrants, OCIE has also conducted special anti-money laundering examinations that focus on anti-money laundering across a sample of firms. Staff may also conduct cause examinations where there have been specific indications of wrong-doing which may involve money-laundering.

of Proposed Rulemaking; Anti-Money Laundering Programs for Investment Advisers, 73 Fed. Reg. 65568 (Nov. 4, 2008).

¹⁴⁸ FinCEN Withdrawal of Notice of Proposed Rulemaking; Anti-Money Laundering Programs for Investment Advisers, 73 Fed. Reg. 65568 (Nov. 4, 2008).

¹⁴⁹ 31 C.F.R. § 103.19 (2009).

¹⁵⁰ 31 C.F.R. § 103.15 (2009).

Enforcement and OCIE review, in both the enforcement and examination contexts, all new SAR-SF forms that are filed. SARs are reviewed by the SEC for three primary purposes: (1) to identify any information that may relate to existing Enforcement investigations or OCIE examinations; (2) to identify any ongoing matters that should be referred for a possible new Enforcement investigation or OCIE examination; and (3) to identify any ongoing securities fraud matters that merit further investigation or examination by FINRA or a state or federal law enforcement agency.

The SEC's proactive review of SARs has resulted in a number of new investigations and examinations and has assisted in many active investigations and examinations.

Both the SROs and the SEC vigorously enforce compliance with securities laws and rules directed at minimizing potential money laundering.

8.6

Does the regulator have the authority to determine or have access to the identity of all customers of regulated entities?

The SEC has the authority to determine or access the identity of all customers of registrants pursuant to SEC rules requiring registered entities to maintain specified books and records and the SEC's statutory authority to examine such books and records.

Specifically, Section 17(a) of the Exchange Act provides that certain registrants, including brokers and dealers, must make and preserve such records as the SEC, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the securities laws.¹⁵¹ Exchange Act Rule 17a-3 requires registered brokers and dealers to make and keep current account records including the customer's or owner's name, tax identification number, address, telephone number, date of birth, employment status, annual income, net worth and the account's investment objectives. Additionally, Exchange Act Rule 17a-8 requires registered brokers and dealers to comply with the reporting, recordkeeping and record retention requirements of BSA,¹⁵² which includes the previously discussed rules requiring broker-dealers to establish, document and maintain a written CIP. Thus, under Exchange Act Section 17(a) and 17(b), and Exchange Act Rules 17a-3 and 17a-8, the SEC has access to the identities of customers of brokers and dealers.

Similarly, the SEC has access to the identities of customers of registered investment companies. Section 31(a) of the Investment Company Act requires registered investment companies, among other entities, to maintain and preserve such records as the SEC prescribes by rule. Mutual funds

¹⁵¹ See also, *Recordkeeping and Record Production Obligations of National Securities Exchanges and Registered Securities Associations*, Securities Exchange Act Release No. 16728 (October 12, 1979), 18 SEC Docket 670, 671.

¹⁵² 31 C.F.R. Part 103.

must maintain records regarding the identity of their clients because, under Investment Company Act Rule 0-11, mutual funds are subject to BSA's CIP requirements.¹⁵³ Additionally, the previously-discussed CIP rules applicable to mutual funds under BSA were adopted by the SEC.¹⁵⁴ As such, SEC staff may examine all records containing the identities of a registered investment company maintained under those rules.¹⁵⁵

Finally, the SEC has access to the identities of customers of registered investment advisers pursuant to its examination authority under Section 204(a) of the Advisers Act. Although investment advisers are not subject to the CIP requirements under BSA, under Rule 204-2 of the Advisers Act, an investment adviser must maintain certain records that, as practical matter, include the identities of its clients. For example, under Rule 204-2, investment advisers are required to maintain records of all accounts in which the investment adviser is vested with any discretionary power with respect to the funds, securities or transactions of any client; copies of written agreements entered into by the adviser with any client; powers of attorney granting any discretionary authority by any client; and statements sent to any client or prospective client.

We note that Section 210(c) generally permits investment advisers engaged in rendering investment supervisory services to maintain the confidentiality of the identity of its clients, even during examinations by SEC staff.¹⁵⁶ Pursuant to its authority under Section 210(c), the SEC provided in Rule 204-2(d) of the Advisers Act that any books or records required under Rule 204-2 may be maintained by the investment adviser "in such a manner that the identity of any client to whom such investment adviser renders investment supervisory services is indicated by numerical or alphabetical code or some other designation." However, an investment adviser may not rely on Rule 204-2(d) to avoid disclosure of a client's identity during an examination unless it has maintained records in a manner that is consistent with the rule in the ordinary course of its business.¹⁵⁷ Furthermore, based on our experience, investment advisers rarely seek to avoid disclosure of a client's identity by relying on Section 210(c) of the Advisers Act or Rule 204-2(d) thereunder.

¹⁵³ *Customer Identification Programs for Mutual Funds*, Investment Company Act Release No. 26031 (April 29, 2003), 67 Fed. Reg. 48,318 (May 9, 2003).

¹⁵⁴ *Id.*

¹⁵⁵ In addition, Investment Company Act Rule 38a-1 requires each registered investment company and business development company to maintain a copy of the policies and procedures adopted by such registrant under the rules that are currently in effect, or were in effect at any time within the past five years. The rule covers, among other things, records relating to policies and procedures adopted by a registrant under BSA that are reasonably designed to prevent violations of the Federal Securities Laws by the registrant. Rule 38a-1 defines the "Federal Securities Laws" as including BSA as it applies to funds, and any rules adopted thereunder by the SEC or Treasury.

¹⁵⁶ Section 210(c) of the Advisers Act states "no provision of this title shall be construed to require, or to authorize the Commission to require an investment adviser engaged in rendering supervisory services to disclose the identity of any client of such adviser...". However, Section 210(c) also provides for an exception when such disclosure may be necessary or appropriate in an enforcement investigation or proceeding.

¹⁵⁷ Brief of the SEC, Appellee at 38-39, *Barr Financial Group, Inc. v. SEC*, No. 99-12027 (11th Cir. June 6, 2000).

As with all documents required to be kept by regulated entities under Sections 17(a) and (b) of the Exchange Act, Section 204 of the Advisers Act, Section 31 of the Investment Company Act, and the rules thereunder, SEC enforcement staff is able to, without subpoena, obtain documents relating to the identity of customers and clients of regulated entities. The SEC may seek to enforce its right to inspect or obtain such required documents with the filing of a civil injunctive action. Thereafter, continuance of failures to permit examination or production of required documents may result in civil and/ or criminal sanctions for contempt of court.

The SEC also has the authority to determine or access the identity of all customers or clients of regulated entities under its powers of subpoena. Section 21(b) of the Exchange Act provides authority for any member of the Commission or any officer designated by it to direct subpoenas to any person to obtain testimony and documents. As noted in response to Question 8.2, in practice, Section 21(b) authorizes the SEC to designate specific staff as officers of the Commission, empowered to administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, or other records deemed relevant or material to the inquiry.

As discussed in response to Question 8.2, certain provisions under the Securities Act, Advisers Act and Investment Company Act parallel the authority to compel the production of testimony and documents provided under Section 21(b).¹⁵⁸

8.7

Where a regulator out-sources inspection or other regulatory enforcement authority to an SRO or a third party:

a) Does the regulator supervise the outsourced functions of third parties?

The SEC does not outsource inspection or other regulatory enforcement authority to SROs or third parties. Rather, SROs regulate certain types of entities that are also subject to oversight regulation by the SEC. While broker-dealers are primarily regulated by the SROs of which they are members, they are also regulated by the SEC both directly (through oversight examinations and enforcement actions) and indirectly through the SEC's regulation of the SROs which regulate broker-dealers.

Under Sections 5, 6 and 15A of the Exchange Act, national securities exchanges and national securities associations are required to be registered with the SEC (except for those which the SEC exempts from registration pursuant to certain provisions under the Exchange Act). Neither an exchange nor a securities association can be registered unless the SEC determines that its rules are designed, among other things, "to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade," and to provide for appropriate

¹⁵⁸ See Sections 19(c) of the Securities Act, 209(b) of the Advisers Act and 42(b) of the Investment Company Act.

discipline of its members for any violation of its own rules or the securities laws.¹⁵⁹ Additionally, Section 19(g)(1) of the Exchange Act requires each SRO to comply with, and enforce compliance with, the provisions of the Exchange Act, the rules and regulations thereunder, and the SRO's own rules.

The SEC oversees an SRO's continuing compliance with these obligations through a variety of means. First, OCIE conducts oversight examinations of broker-dealers, during which examination Staff analyze and sample a broker-dealer's records from the same time period and focus areas that the SRO reviewed during its examination. These examinations serve the dual purposes of evaluating the quality and effectiveness of an SRO's examination of its member firms, as well as detecting violations or compliance risks at broker-dealers. In addition to conducting oversight examinations of broker-dealers, OCIE conducts comprehensive inspections of the SROs' regulatory programs. During these inspections, OCIE reviews the SROs' examination and surveillance programs for member financial responsibility and operational compliance, the SROs' regulatory programs for monitoring trading activity; and disciplinary, listing, membership and arbitration programs. OCIE's SRO inspections and broker-dealer oversight examinations are discussed in more detail in response to Question 10.1(a).

In some cases, an SRO may enter into a Regulatory Services Agreement (RSA) with a registered third-party SRO whereby the third-party SRO agrees to perform certain regulatory obligations of the procuring SRO. In such cases, the procuring SRO remains responsible for meeting its regulatory obligations under the Exchange Act. As such, OCIE conducts inspections that focus on the procuring SRO to ensure that it is appropriately overseeing compliance for all activities on its exchange, including those activities directly monitored by the third-party SRO pursuant to the RSA, as well as inspections that focus on the third-party SRO to ensure that it is appropriately administering its contracted regulatory obligations.

Additionally, under Exchange Act Rule 17d-2, any two or more SROs may file with the SEC a plan to allocate among the SROs the regulatory responsibilities of such SROs specified in the Exchange Act. If declared effective by the SEC, any SRO which is a party to the plan is relieved of its regulatory responsibility to the extent that such responsibility is allocated under the plan to another SRO. Currently, SROs have several Rule 17d-2 agreements in effect, including agreements to allocate examination and regulation of members, agreements to allocate surveillance and oversight of firms' options exercise advices on expiration date, as well as to monitor for compliance with the SEC's rules regarding options position limits and exercise limits.

The SEC may bring an enforcement action against an SRO for failure to act or adequately perform required functions. For example, the SEC has brought actions against SROs for, among other violations, failures to: safeguard its participants' funds,¹⁶⁰ adequately respond to

¹⁵⁹ Exchange Act §§ 6(b), 15A.

¹⁶⁰ *In the Matter of Stock Clearing Corporation of Philadelphia and Philadelphia Depository Trust Company*, Securities Exchange Act of 1934 Release No. 38918, August 11, 1997, available at www.sec.gov/litigation/admin/3-9360.txt.

misconduct by its members,¹⁶¹ discipline members and improve surveillance capabilities to match increase in trading volume,¹⁶² and to develop and implement adequate procedures of surveillance to prevent trading ahead of customer orders.¹⁶³

The SEC is also authorized to bring enforcement action for violations of, or to command compliance with, SRO rules under Section 21(f) of the Exchange Act, where it appears to the SEC that the SRO is unable or unwilling to take appropriate action in the public interest and for the protection of investors, or where such action is “necessary or appropriate in the public interest or for the protection of investors.”¹⁶⁴

8.7

b) Does the regulator have full access to information maintained or obtained by the third parties?

Exchange Act Rule 17a-1(c) requires that SROs, upon request of any representative of the SEC, promptly furnish to such representative copies of any documents the SRO makes or receives in the course of its business as such and in the conduct of its self-regulatory activity. Because there are currently no third parties other than SROs performing regulatory services, the SEC has full access to information maintained by all third-parties.

Consistent with its comprehensive oversight of SROs, SEC enforcement also has full access to information maintained or obtained by an SRO in connection with the SRO’s examination or enforcement functions. Further, the SEC can also subpoena documents from any person pursuant to its subpoena powers described in response to Question 8.2.

8.7

c) Can the regulator cause changes/improvements to be made in the third parties’ processes?

OCIE conducts inspections of SROs to assess their compliance with federal securities laws, rules and regulations and to evaluate the SRO’s programs for overseeing, enforcing, and disciplining

¹⁶¹ *In the Matter of National Association of Securities Dealers, Inc.*, Securities Exchange Act Release No. 37538, August 8, 1996, available at www.sec.gov/litigation/admin/3437538.txt.

¹⁶² *In the Matter of the Chicago Stock Exchange*, Securities and Exchange Act Release No. 48566, September 30, 2003, available at www.sec.gov/litigation/admin/34-48566.htm.

¹⁶³ *In the Matter of Boston Stock Exchange, Inc. and James B. Crofwell*, (action against the SRO and its President) Securities Exchange Act Release No. 56352, September 5, 2007, available at www.sec.gov/litigation/admin/2007/34-56352.pdf.

¹⁶⁴ *See SEC v. Credit Suisse First Boston Corporation*, 02 CV 00090 (RWR) (D.D.C.), SEC Litigation Release No. 17327, January 22, 2002 available at <http://www.sec.gov/litigation/litreleases/lr17327.htm>.

its members for compliance with federal securities laws and rules, and the SRO's own rules. If during an inspection OCIE identifies violations of federal securities laws by an SRO, or deficiencies in an SRO's programs for regulating its members, OCIE recommends to the Commission that it authorize the Staff to issue an inspection report to the SRO noting the deficiencies and recommending that the SRO take corrective action. The SRO must submit a written response describing the corrective measures it plans to implement with respect to each deficiency noted in OCIE's inspection report.

If OCIE identifies inconsistencies between the SRO's practices and its rules, OCIE may refer the matter to TM for a determination whether the SRO should implement new rules or amend its existing rules. Further, if OCIE identifies significant deficiencies in an SRO's regulatory programs that prevent the SRO from fairly and meaningfully enforcing compliance by its members with federal securities statutes, SEC rules or the SRO's rules, OCIE may refer the matter to Enforcement for further action against the SRO.

Referrals to the Division of Trading and Markets

Under Section 19(b)(3)(B) of the Exchange Act, the SEC has the authority to put into effect summarily a proposed rule change, if it appears to the SEC that such action is necessary for the protection of investors, the maintenance of fair and orderly markets, or the safeguarding of securities or funds. In addition, pursuant Section 19(c) of the Exchange Act, the SEC, by rule, may abrogate, add to, and delete from the rules of a registered exchange as the SEC deems necessary or appropriate to insure the fair administration of the registered exchange, to conform its rules to requirements of the Exchange Act and the rules and regulations thereunder applicable, or otherwise in furtherance of the purposes of the Exchange Act.

The SEC can also cause changes/improvements to be made in SRO processes by utilizing its authority to review SRO rule-change filings under Section 19(b) of the Exchange Act and Rule 19b-4 thereunder. Under Section 19(b)(1) of the Exchange Act, an exchange must file any proposed change in, addition to, or deletion from the rules of the exchange with the SEC. Once filed, the SEC must publish a notice of the filing for public comment in the Federal Register. Thereafter, if the proposed rule change was filed pursuant to Section 19(b)(2) of the Act, the SEC must, within 35 days of publication of the notice, approve the proposed rule change by order or institute proceedings to determine whether the proposed rule change should be disapproved. After publication, if comment letters received by the SEC raise significant issues, the Staff will try to obtain the registered exchange's consent to extend the 35-day period and may request that the exchange respond to comments by submitting a comment letter or amending the proposal. The SEC must approve a proposed rule change if it finds that the proposed rule change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to the exchange. If the SEC cannot make such a finding, it must institute proceedings to determine whether such proposed rule change should be disapproved.

There are also certain proposed rule changes that may be filed under Section 19(b)(3)(A) of the Exchange and take effect upon filing (*i.e.*, without need for specific SEC approval). Although rule changes filed under Section 19(b)(3)(A) are immediately effective, the SEC may abrogate

the rule within 60 days of the date of filing if necessary or appropriate in the public interest, for the protection of investors or otherwise in furtherance of the purposes of the Exchange Act.

Action by the Division of Enforcement

In the context of an enforcement action, the SEC can obtain remedies resulting in changes and improvements to SRO processes. For example, one SEC Order making findings and imposing remedial sanctions against an SRO, required the SRO to, among other changes and improvements:¹⁶⁵

- enhance training programs for all members of the regulatory staff responsible for surveillance, investigation, examination and discipline, that addresses compliance with the federal securities laws and the SRO's own rules; and
- retain a third party auditor not unacceptable to the SEC staff to conduct a comprehensive audit of the SRO's surveillance, examination, investigation and disciplinary programs. The SRO was required to fully cooperate with the audit, and develop a written plan of corrective action to implement recommendations within a specified time period. All results of the audit were required to be reported to the SEC within a specified time period and the SEC retained full access to the work of the auditor.

In another example, an SEC order required the SRO to, consistent with parameters set out in the Order, create a "Regulatory Oversight Committee" to advise the SRO's Board of Governors about regulatory, compliance and enforcement matters.¹⁶⁶

8.7

d) Are these parties subject to disclosure and confidentiality requirements that are no less stringent than those applicable to the regulator?

FINRA and other SROs that are responsible for regulating registrants are subject to confidentiality requirements with respect to records and information that the SEC shares with them pursuant to MOUs or access request letters (see responses to Questions 12.5 and 12.6 for additional discussion regarding the SEC's use of MOUs and access request letters). In general, records and information the SEC shares with SROs are nonpublic. The MOUs and access request letters require the SROs to protect the confidentiality of such records and information from further disclosure or dissemination.

¹⁶⁵ *In the Matter of Boston Stock Exchange, Inc. and James B. Crofwell*, (action against the SRO and its President) Securities Exchange Act Release No. 56352, September 5, 2007, available at www.sec.gov/litigation/admin/2007/34-56352.pdf.

¹⁶⁶ *In the Matter of the Chicago Stock Exchange*, Securities and Exchange Act Release No. 48566, September 30, 2003, available at www.sec.gov/litigation/admin/34-48566.htm.

While SROs are not subject to specific statutory or rule-based confidentiality or disclosure requirements, SROs generally require their employees to adhere to written confidentiality and disclosure policies and procedures. In cases where an SRO performs regulatory functions for a third-party SRO pursuant to a Regulatory Services Agreement (RSA), the parties to the RSA are generally subject to confidentiality and disclosure requirements contained in the RSA or a separate confidentiality agreement.

Enforcement – Principle 9

The regulator should have comprehensive enforcement powers.

Assessment

Fully Implemented.

9.1

Does the regulator or other competent authority within the jurisdiction have the investigative and enforcement power to enforcement compliance with the laws and regulations relating to securities activities?

The SEC enforces compliances with the laws and regulations relating to securities activities by conducting investigations and bringing enforcement actions where appropriate.

Investigative Powers

The SEC has broad authority to investigate actual or potential violations of the federal securities laws and to determine the scope of its investigations and the persons and entities subject to investigation.¹⁶⁷ An SEC investigation can be conducted through one of two methods. The SEC can rely on the voluntary cooperation of individuals and entities to obtain information through documents or testimony. If the SEC relies on voluntary cooperation, it cannot issue subpoenas or require or administer oaths or affirmations. Alternatively, the SEC can authorize a formal order of investigation, which grants the SEC staff the power to issue subpoenas and administer oaths, take testimony and compel the production of documents.

SEC investigative proceedings are non-public. The SEC's Rules Relating to Investigations provide witnesses certain procedural protections, such as the right to have a lawyer present when testifying, and to review the Commission's formal order of investigation. A witness can also assert his or her Fifth Amendment protection against self-incrimination.

¹⁶⁷ The following statutes authorize the SEC's investigative powers: Section 20(a) and Section 8 of the Securities Act; Section 21(a)(1) of the Exchange Act, Section 209(a) of the Advisers Act, and Section 42(a) of the Investment Company Act.

Enforcement Powers

At the end of an investigation, the SEC has several options. It can seek injunctive relief,¹⁶⁸ authorize an administrative proceeding,¹⁶⁹ or refer the matter to DOJ for criminal prosecution; or conclude the investigation without recommending an enforcement proceeding.

Among other enforcement powers, the SEC can suspend trading in a security pursuant to Exchange Act Section 12(k), discussed in more detail in response to Question 9.2, and, pursuant to Section 8(d) of the Securities Act, can issue a stop order suspending the effectiveness of a registration statement if it contains incomplete, inaccurate or false or misleading information.

In its civil actions, the SEC can obtain disgorgement, which is an equitable remedy by which a wrongdoer is required to give up any illegal profits gained as a result of violations of the federal securities laws. The SEC has the authority to seek civil monetary penalties in civil actions pursuant to Exchange Act Section 21(d)(3). In fiscal year 2008, the SEC obtained orders in judicial and administrative proceedings requiring securities laws violators to disgorge illegal profits of \$774 million and to pay civil penalties of \$256 million.

Additionally, the SEC has the enforcement power to bar individuals from serving as officers and directors of public companies pursuant to Exchange Act Section 21(d)(2). In fiscal year 2008, the SEC sought orders barring 132 defendants and respondents from serving as officers or directors of public companies.

In addition to civil actions, the SEC can commence administrative proceedings, which can be brought against regulated persons and entities (e.g., broker-dealers and investment advisers). Remedies that may be obtained by the SEC against regulated persons include suspensions or bars from the industry, undertakings, disgorgement, and penalties.

The SEC can also file cease-and-desist proceeding, which can be instituted against any person or entity. A cease-and-desist order can also be filed jointly with an administrative proceeding against a regulated entity.

Also in fiscal year 2008, the SEC sought emergency relief from federal courts in the form of TROs to halt ongoing fraudulent conduct in 39 actions, and sought asset freezes in 46 actions. SEC authority in the context of TROs and emergency action is discussed in more detail in response Question 9.2.

¹⁶⁸ The SEC may seek injunctive relief pursuant to Section 20(b) of the Securities Act; Section 21(d) of the Securities Exchange Act; Section 42(d) of the Investment Company Act; and Section 209(d) of the Investment Advisers Act.

¹⁶⁹ The SEC has the authority to authorize administrative proceedings pursuant to various statutory provisions.

9.2

Does the regulator or other competent authority within the jurisdiction have the following powers?

- a) Power to seek orders, to refer matters for civil proceedings or to take other action to ensure compliance with regulatory, administrative and investigative powers?*
- b) Power to impose administrative sanctions?*
- c) Power to initiate or to refer matters for criminal prosecution.*
- d) Power to order the suspension of trading in securities as well as other appropriate actions?*

The SEC does have the powers listed in Question 9.2 (a)-(d). The SEC is responsible for non-criminal enforcement of the federal securities laws and prosecutes cases in U.S. federal courts and in administrative proceedings. If the SEC decides to institute enforcement proceedings, it has several options. First, the SEC may bring a civil injunctive action against a person or an entity that the SEC believes has violated or is about to violate the federal securities laws. This type of enforcement action is filed in federal district court. Second, the SEC has the authority to bring an Administrative action.

Civil Actions

In a civil injunctive action, the SEC seeks a court order compelling the defendant to obey the law in the future. Violating such an order can result in civil or criminal contempt proceedings. Civil contempt sanctions, brought by the SEC, are remedial rather than punitive in nature and serve one of two purposes: to compensate the party injured as the result of the violation of the injunction, or to coerce compliance with the injunction terms. The SEC can also refer the matter to the criminal authorities. A criminal contempt sanction is punitive in nature and is often characterized by the imposition of a fixed jail sentence or fixed fine.

In its civil actions, the SEC may also seek ancillary relief (such as an accounting from a defendant), disgorgement of ill-gotten gains where a defendant has profited from a violation of law, pre-judgment interest, civil money penalties, a bar from serving as an officer or director of a public company or from participating in a public offering. The SEC may also seek, and any Federal court may grant, any other equitable relief that may be appropriate or necessary for the benefit of investors, pursuant to Exchange Act Section 21(d)(5).

When appropriate, the SEC also may ask a federal court for emergency relief, generally in the form of a TRO. In seeking a TRO, the SEC often requests that a court issue an order that has the effect of freezing illegally obtained money so that, at the successful conclusion of the case, the assets may be returned to defrauded investors.

Administrative Proceedings

The SEC has the ability to institute various types of administrative proceedings against a person or an entity that it believes has violated the law. This type of enforcement action is brought by Enforcement and is litigated before an SEC administrative law judge (ALJ). The ALJ's decision is subject to appeal directly to the SEC, and the SEC's decision is in turn subject to review by a U.S. Court of Appeals.

Administrative proceedings provide for a variety of relief. For regulated persons and entities, such as broker-dealers and investment advisers and persons associated with them, sanctions include censure, limitation on activities, suspension of up to twelve months, and bar or revocation of registration. For professionals such as attorneys and accountants, the SEC can order in Rule 102(e) proceedings that the professional be censured, suspended, or barred from practicing before the SEC.¹⁷⁰ Against any person who violates or is a cause of a violation of a provision of the Federal Securities laws, the SEC may impose a cease and desist order. The SEC can obtain disgorgement and civil money penalties in administrative proceedings.

Referral of Matters for Criminal Prosecution

The SEC has the authority to refer cases to the criminal law enforcement authorities (DOJ and the individual U.S. Attorney's offices). In addition, the SEC provides assistance to U.S. Attorneys by, among other things, providing access to SEC investigative files where appropriate and appointing SEC staff to serve as Special Assistant U.S. Attorneys. A criminal prosecution does not preclude the SEC from taking civil action for the same conduct, and similarly, SEC action does not preclude a subsequent criminal prosecution.

Trading Suspensions

The SEC may issue an order suspending trading in the securities of an issuer for up to ten days pursuant to Section 12(k) of the Exchange Act, if, in the SEC's opinion, the public interest and the protection of the investors so requires. Reasons for suspending trading may include a lack of adequate and accurate public information about a security.

Additionally, securities exchanges have the authority to halt and delay trading in a security. A trading halt—which typically lasts less than an hour but can be longer—is called during the trading day to allow a company to announce important news or where there is a significant order imbalance between buyers and sellers in a security. A trading delay (or “delayed opening”) is called if either of these situations occurs at the beginning of the trading day.

¹⁷⁰ See the SEC Rules of Practice, 17 C.F.R. § 201.102(e).

9.3

Does the regulator or other competent authority have the investigative and enforcement power to require from any persons involved in the relevant conduct or who may have information relevant to a regulatory or enforcement inquiry/investigation:

- a) *Data?*
- b) *Information?*
- c) *Documents?*
- d) *Records?*
- e) *Statements and testimony?*

Pursuant to Exchange Act Section 21(a) and other provisions, the SEC may, in its discretion, investigate as it deems necessary to determine whether any person has violated, is violating, or is about to violate any provision of the federal securities laws. As noted in response to Question 9.1, the SEC may issue a formal order of investigation, which gives designated Enforcement staff the power to administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, or other records which the SEC deems relevant or material to the investigation. The attendance of witnesses and the production of any records may be required from any place in the U.S. or any state at any designated place of hearing. If persons from whom information is sought fail to comply with subpoenas issued by the SEC, the SEC may seek to have a federal district court enforce compliance with the subpoena.

9.4

Can private persons seek their own remedies for misconduct relating to the securities laws?

The SEC's enforcement powers do not compromise private rights of action seeking remedies under the federal securities laws.

The federal securities laws provide for express remedies in favor of private parties who claim damages as result of specific violations of the federal securities laws. Among others, Section 11 of the Securities Act imposes liability for misstatements or omissions in registration statements; Section 12 of the Securities Act imposes liability for the sale of unregistered securities and for fraud in the sale of securities; and Section 15 of the Securities Act imposes liability on controlling persons. Additionally, private persons can seek remedies pursuant to Section 9 of the Exchange Act, which imposes liability for specified manipulations of exchange-traded securities. Moreover, Section 16 of the Exchange Act imposes liability for "short-swing" profits, and Section 18 of the Exchange Act imposes liability for misleading statements in periodic reports filed with the Commission. Additionally, private persons can seek remedies pursuant to Section

20 of the Exchange Act, which imposes liability on controlling persons, and under Section 20A of the Exchange Act, which imposes insider trading liability on contemporaneous traders.

Federal courts have implied private rights of action under certain statutory provisions that, on their face, do not provide actions for monetary damages.¹⁷¹ The most significant of these is the implied private right of action under Exchange Act Section 10(b) for securities fraud. To state a claim for securities fraud a plaintiff must prove: (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.

9.5

Where an authority other than the regulator must take enforcement or other corrective action, can the regulator share information obtained through its regulator or investigative activities with that authority?

The SEC maintains non-public information in its files and adheres to strict rules of confidentiality to ensure that the information remains non-public. Under Section 24(c) of the Exchange Act, however, the SEC can make non-public information and records in its possession available to persons the SEC deems appropriate, including domestic and foreign counterparts, if they have a need for the information and make appropriate assurances of confidentiality. The SEC has adopted Rule 24c-1 under Section 24(c), which provides that the SEC can provide non-public information to a federal, state, local or foreign government, or to a foreign financial authority, among others.

Under Section 21(a)(2) of the Exchange Act, the SEC can assist a foreign securities authority if the foreign authority states that it is conducting an investigation to determine if its laws have been violated. The SEC may provide information in its public files, and, under Section 21(a)(2), it may collect information and evidence requested by the foreign securities authority. The SEC, for example, may compel the production of evidence and testimony on behalf of the foreign securities authority.

¹⁷¹ Courts have also implied private right of actions under Exchange Act § 14(a), 15 U.S.C. § 78n(a) and Rule 14a-9 thereunder, 17 C.F.R. § 240.14a-9, which prohibits fraud in connection with the solicitation of proxies; Exchange Act § 14(e), 15 U.S.C. § 78n(e) and Rule 14e-3 thereunder, 17 C.F.R. § 240.14e-3, which prohibits fraud in connection with tender offers; and Exchange Act § 13(e)(1), 15 U.S.C. § 78m(e)(1), which prohibits fraud in connection with an issuer's repurchase of its own shares. The express and implied private rights found in the Securities Act and Exchange Act are cumulative. *See Herman & MacLean v. Huddleston*, 459 U.S. 375, 380-87 (1983).

9.6

Where the regulator is unable to obtain information in its jurisdiction necessary to an investigation is there another authority that can obtain the information?

As set out in the response to Question 9.1, the SEC has broad investigative powers, including the power to compel testimony and documents. As a result, the SEC can always obtain information in its jurisdiction necessary to an investigation.

9.7

If yes, can that authority share the information with the regulator for the regulator's use in investigations and proceedings?

Not applicable.

Enforcement – Principle 10

The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.

Assessment

Fully Implemented.

10.1

Is there an effective system of inspection in place whereby the regulator carries out inspections:

a) On a routine periodic basis?

OCIE conducts routine or cycle examinations designed to periodically test a registrant's compliance with applicable laws and regulations. OCIE also conducts "cause examinations," which are examinations initiated based upon complaints, tips, press reports or other information suggesting a registrant might be violating securities laws, rules or regulations. Further, OCIE conducts risk-targeted sweep examinations, in which the Staff focuses on particular compliance risks and assesses the extent, scope, and danger of emerging risks in the regulated community.

Examinations of Investment Advisers, Investment Companies, and Mutual Fund Transfer Agents

OCIE uses a scoring process to risk-rate investment advisers, as described in response to Question 10.1(b) below. Advisers with a "higher risk" profile are placed on a three-year examination cycle. Other investment advisers are chosen by random selection for routine examinations and are also examined as part of cause examinations, sweep examinations, or special purpose examinations, discussed in more detail below.

Cyclical investment adviser examinations may include a review of, among other issues, the registrant's fees and the adviser's compensation structure, potential conflicts of interest inherent in the entity's business operations or arrangements with affiliates, the appropriateness of the adviser's disclosures of conflicts of interest, pricing and valuation of assets, and verification of custody of client securities and funds. OCIE generally examines investment companies, such as mutual funds, in conjunction with an examination of the funds' investment adviser and on a cyclical basis in certain instances. OCIE also examines mutual fund transfer agents affiliated with an investment company complex in conjunction with an examination of the affiliated fund complex. OCIE examines all other mutual fund transfer agents periodically, with a goal of examining them at least once every three years.

Examinations of Broker-Dealers

OCIE examines the largest broker-dealers' risk management and compliance controls covering market, credit, operational, and legal risks on a cyclical basis. During cyclical examinations, staff may focus on issues such as a firm's compliance with net capital requirements, margin and securities lending practices, sales practices, custody arrangements, and clearing operations (if applicable). Such examinations may also focus on a broker-dealer's order matching systems, algorithmic trading platforms, or other order execution systems to assess compliance with best execution obligations. OCIE also selects broker-dealers for examinations through a risk-based process, discussed in more detail in response to Question 10.1(b) below. In such risk-based examinations, Staff generally focuses on one or more specific issues that have been identified as high risk at certain firms.

OCIE further examines broker-dealers that operate as an Alternative Trading System (ATS), and other types of trading venues such as a market-maker operation or an order-crossing system. As defined in Regulation ATS,¹⁷² an ATS is, among other things, any organization that provides a marketplace, or facilities for bringing together purchases and sellers of securities or for otherwise performing the functions commonly performed by a stock exchange while not setting rules governing the conduct of subscribers. SEC rules permit an ATS to register as a broker-dealer that becomes subject to additional requirements specified in SEC rules. Alternatively, the rules would require the ATS to register as a national securities exchange and subsequently become subject to all of the regulatory requirements of such entities. For further discussion of the regulation of national securities exchanges, see responses to Questions 6, 7, 8.3, 8.7, and 10.2.

ATSs that register as broker-dealers must: (1) file operation reports and quarterly reports with the Commission; (2) maintain certain additional books and records; (3) establish adequate safeguards and procedures to protect subscribers' confidential trading information; and (4) refrain from using the words "exchange", "stock market", or other similar words in their name. Regulation ATS is a progressive regulatory framework that imposes additional regulatory requirements on entities that exceed certain volume thresholds. ATSs that meet the volume thresholds in the rules must publicly disseminate their best priced orders, limit the fees they charge, provide fair access to their system, and satisfy certain system capacity, integrity, and security standards.

In examinations of ATSs, OCIE reviews the functionalities of an ATS's trading systems to determine whether the ATS operates as described in filings made with the Commission. OCIE particularly focuses on the ATS's procedures to protect confidential trading information, and whether the ATS is maintaining the additional required books and records. OCIE also reviews whether the ATS meets any of the volume thresholds in the rules, and if so, OCIE will review whether the ATS is complying with the additional regulatory requirements.

During an examination of an ATS, OCIE reviews the ATS's compliance with the additional requirements imposed under Regulation ATS. During such examinations, OCIE may review, as applicable, a firm's algorithmic trading system or proprietary trading systems to ensure they

¹⁷² See 17 C.F.R. §§ 242.300 – 242.303.

fairly allocate and execute orders, do not discriminate among certain types of orders, and do not use non-public information about order flow obtained through the firm's other business activities to benefit the firm's own account. Such reviews may also focus on the firm's order handling practices and processes for selecting trading venues for order execution.

Finally, OCIE oversees the compliance of broker-dealers through oversight examinations of broker-dealers to assess the effectiveness of examinations by the primary SRO responsible for regulating those broker-dealers.

SRO Examinations of Member Broker-dealers and SEC Oversight Examinations

SROs, as regulators, are primarily responsible for establishing standards under which their members conduct business and have the front line responsibility for overseeing broker-dealers for compliance with federal securities laws as well as SRO rules. SROs examine their member broker-dealers on cycles varying from annually to once every four years, depending on the type of member firm. While many broker-dealers are members of multiple exchanges and therefore subject to regulation by multiple SROs, the vast majority of broker-dealers are subject to examination by FINRA.¹⁷³ Since FINRA is the SRO primarily responsible for examinations of broker-dealers, the response to Question 10.1 focuses on FINRA's examination processes. FINRA's process for selecting broker-dealers for examination is discussed in more detail in response to Question 10.1(b) below.

Because SROs such as FINRA serve an essential role in overseeing their members' compliance with federal securities laws and SRO rules, OCIE's oversight examinations of broker-dealers to evaluate the responsible SRO's examination work is a critical component of the SEC's examination program. OCIE's oversight examinations serve the dual purpose of evaluating the quality and effectiveness of an SRO's examinations of its member firms, as well as detecting potential violations or compliance risks at broker-dealers. During an oversight examination, SEC examiners analyze and sample a broker-dealer's records from the same time period and focus areas that the SRO reviewed during its examination. Particular emphasis is placed on certain identified risk areas that may include financial and net capital, sales practice and supervision, books and records, customer complaints, arbitrations, litigation, and anti-money laundering. In addition to the above, Staff may review the firm's activities following the SRO examination to identify new problematic behavior or additional risks. Staff may also review the firm's current activities to determine whether it implemented any corrective measures recommended by the SRO.

If Staff identifies deficiencies that the SRO may have overlooked during the SRO's examination, the Staff issues a deficiency letter to the SRO outlining these issues and requests that the SRO respond to the comments and improve its examination program accordingly. In 2008, the SEC's regional offices reviewed a representative sample of SRO examinations, including FINRA examinations.

¹⁷³ Firms that are members of multiple exchanges have a single designated examining authority (DEA), a SRO, that is primarily responsible for the firm's regulation. SROs have entered into an agreement under Exchange Act Rule 17d-2 to allocate DEA responsibility for such members.

Inspections of National Securities Exchanges and FINRA (Registered Securities Association)

The SEC oversees compliance with the securities laws by national securities exchanges and FINRA through OCIE's SRO inspections. OCIE conducts inspections of SROs on a routine cyclical basis to assess the adequacy of the SRO's regulatory programs. Rather than inspecting all of an SRO's programs at one time, each inspection generally focuses on particular program areas.

For example, an inspection might focus on an SRO's surveillance, investigative, and disciplinary programs related to trading on the relevant exchange. During such inspections, Staff reviews select surveillance programs to assess whether they adequately identify violations of the federal securities laws and the SRO's rules related to trading. Staff also reviews SRO investigations and disciplinary actions resulting from surveillance alerts to evaluate whether the SRO fairly and consistently applied its rules to all member firms and other broker-dealers that trade on the relevant exchange.

Similarly, an inspection might focus on an SRO's listing program. Each exchange has listing requirements for companies to become and remain listed on its exchange. The listing requirements are quantitative (financial criteria, such as minimum stockholders' equity) or qualitative (corporate governance requirements, such as requirements that companies maintain independent audit committees). OCIE inspects the exchange's listing program to evaluate whether the exchange is following its rules and procedures for listing securities.

OCIE's inspections also focus on SROs' examination, investigation, enforcement, arbitration and other regulatory programs. To assess the effectiveness of an SRO's examination program, OCIE reviews the SRO's oversight of its members' compliance with financial responsibility and customer protection rules, as well as its members' sales practices, among others. For example, OCIE routinely inspects FINRA's Member Regulation and Department of Enforcement divisions. These divisions are headquartered and administered in Washington DC with personnel located in FINRA's fifteen district offices. OCIE regularly conducts routine inspections of each district office. During these inspections, Staff reviews FINRA's examinations of and disciplinary actions against its member firms (broker-dealers), disciplinary investigations and enforcement actions taken against members, and seeks to assess whether FINRA fairly and consistently handled the matters, and enforced the federal securities laws and its own rules and procedures. Similarly, when OCIE inspects FINRA's arbitration program, Staff seeks to determine whether FINRA properly handled the arbitrations in accordance with the arbitration rules, fairly and consistently and to ensure that FINRA keeps relevant information current and follows-up on any complaints regarding the arbitration process.

Examinations of NRSROs

After the CRA Act gave the SEC authority to regulate NRSROs, the SEC implemented rules regulating such entities, which generally provide opinions on the creditworthiness of financial obligations (such as, bonds, preferred stock, and commercial paper, among others). Beginning in

fiscal year 2008, following the effectiveness of the SEC's rules, OCIE and other Staff conducted examinations of the three largest NRSROs related to their ratings of certain products and the SEC issued a public report detailing its findings. In fiscal year 2009, OCIE implemented a routine examination program for NRSROs.

Examinations of Non-Mutual Fund Transfer Agents

OCIE examines non-mutual fund transfer agents on a cycle ranging from annually to once every five years depending on the size of the firm and a risk-based analysis. During such examinations, Staff review issues such as, among others, turnaround compliance for routine and non-routine items transfer; master securityholder files for recordkeeping and control book compliance; compliance of lost securityholder searches; and the safeguarding of shareholder funds and securities against loss or misuse.

Examinations of Clearing Agencies

Virtually all transactions on national securities exchanges and in the over-the-counter securities market are cleared and settled through registered clearing agencies. The U.S. securities markets operate using a "centralized clearing" model. Three major registered clearing agencies – DTC, NSCC, and the Fixed Income Clearing Corporation - handle the clearance and settlement functions for the equities, debt, mortgaged-backed, and government securities traded in the U.S. markets. Since 2001, these entities have been integrated under the umbrella of the DTCC. The DTCC complex also provides clearing-related functions for institutional and mutual fund transactions. The Options Clearing Corporation is the single clearing agency for the options markets. In addition, there are other entities that provide clearing services that are examined on a risk-based schedule.

Clearing agency examinations include regular cycle and special examinations. The primary focus of a clearing agency examination is to assess the overall safety, reliability, and efficiency of the clearing agency and its operations. This approach reflects the focus contained in Section 17A of the Exchange Act on matters relating to safety (*i.e., the safeguarding of securities and funds in the possession or control of a clearing agency*) and reliability and efficiency (*i.e., the prompt and accurate clearance and settlement of securities transactions*).

Registered Population Subject to the Commission's Examination Oversight

As of the end of 2008, the registered population consisted of approximately 11,300 investment advisers; 950 fund complexes (representing over 4,600 registered funds); 5,500 broker-dealers (including 174,000 branch offices and 676,000 registered representatives); and 600 transfer agents. It also included eleven exchanges, five clearing agencies, ten NRSROs, FINRA, the Municipal Securities Rulemaking Board and the PCAOB,¹⁷⁴ of which are examined by Staff. In 2008, OCIE conducted 1,521 investment adviser examinations (approximately 14% of registered

¹⁷⁴ The SEC has oversight and enforcement authority over the PCAOB. The PCAOB is treated like a registered securities association for SEC examination and recordkeeping purposes. Section 107(a) of the Sarbanes Oxley Act of 2002. *See also* Sections 17(a)(1) and 17(b)(1) of the Exchange Act.

investment advisers), 219 fund complex examinations (approximately 23%), 135 transfer agent examinations (approximately 22%); and 720 broker-dealers examinations (approximately 13% of registered broker-dealers, however, when both SEC and SRO examinations are considered, approximately 57% of registered broker-dealers were examined). Of the examinations conducted in 2008, 38% of the fund/advisers examinations had significant findings (deficiencies that may cause harm to customers or clients of a firm, have a high potential to cause harm, or reflect recidivist misconduct) and 42% of the broker-dealer examinations had significant findings.

The SEC has 425 examination Staff for oversight of more than 11,000 advisers, including registered hedge fund managers, and the entire mutual fund industry. Further, the SEC has just over 300 examination staff for examinations of broker-dealers, markets, transfer agents, SROs, clearing agencies, credit rating agencies, and other types of firms. This makes it critical for the SEC to consider the best use of its examination resources in order to effectively protect investors.

In addition, the recent financial crisis has illustrated the need to further enhance the examination program in various ways. The SEC has already begun to implement many initiatives to enhance its examination program so that Staff can more readily identify risk areas, such as fraud, and more effectively allocate examination resources. For example, the examination program is: (a) enhancing examiners' training and expertise in fraud detection; (b) enhancing examiners' expertise in complex financial products, trading and other areas, (c) conducting focused examinations of firms with higher potential fraud risk profiles; (d) improving the tools available to examiners to detect fraud, and leveraging the work performed by the firm's independent auditor; (e) improving surveillance to enable examination staff to better identify and focus attention on firms and issues presenting the most risk; and (f) improving our handling of tips and complaints inside the SEC.

10.1

b) Based upon a risk assessment?

Given the growth in the number of entities registered with the SEC, and the need to use SEC resources the most effectively, with SEC guidance OCIE has developed a risk-based program for selecting firms and activities for examination. The methodology used in this program has several components: (1) a risk-based methodology for selecting investment advisers for priority examination; (2) a methodology for identifying higher risk activities at registered securities firms; (3) cause examinations to target firms where specific indications of wrongdoing have been identified; and (4) risk-targeted sweep examinations that focus on examining a particular risk across firms. The purpose of this risk-based approach is to prioritize registrants for examination and to assign Staff to those registrants and particular issues that appear to present the greatest potential for having an adverse impact on investors.

Selecting Investment Advisers for Priority Examination

OCIE uses a risk-based scoring process to select investment advisers for priority, cyclical examination. To assess the relative risks and thereby prioritize advisory firms for examination,

all investment advisers' filing with the SEC on Form ADV, Part I, as well as results of any past examinations, are analyzed each year. Characteristics that may indicate heightened risk include, whether an adviser: receives performance based fees; sells products or services other than investment advice to its advisory clients; engages in principal transactions or cross transactions; compensates persons for client referrals; has custody of advisory cash and/or securities; and has a disciplinary history. Advisers that are designated "higher risk" are placed on a three-year examination cycle. Approximately 10% of advisers are in this "higher risk" category. Finally, OCIE selects a sample of advisers for examination each year using random selection techniques. Among other things, these examinations allow the staff to monitor and assess the effectiveness of the risk-based scoring process.

Identifying Higher Risk Activities at Registered Securities Firms

In addition, as part of its risk assessment process, OCIE uses a database application called RADAR, which automates the examination program's risk assessment process. RADAR is a software tool that allows examiners to identify the risks they have observed in examinations, assess the risk's probability of occurrence and potential impact, and recommend possible responsive actions. RADAR allows the Staff to see and prioritize compliance risks for examination attention, investor education efforts, or other regulatory attention. Every examiner participates in the RADAR process and then risk personnel in OCIE, working with the SEC's ORA, sort and analyze the risks identified in RADAR to prioritize them. At the conclusion of the RADAR process, at the beginning of each fiscal year, focus areas are identified internally to the SEC and other Staff as part of the examination program's annual goals. These and other focus areas are examined in sweep examinations of a number of registrants at once, or in routine examinations. The use of RADAR has helped the examination program to identify a large number of risks and to more effectively focus examination resources.

Sweep Examinations Focusing on Particular Risks

OCIE also conducts risk-targeted sweep examinations to determine the extent, scope, and danger of emerging risks in the regulated community. During such examinations, the Staff reviews risk conditions and responsive compliance controls at a sample of registrants. This approach allows Staff to obtain a more comprehensive view of any particular risk, assess the gravity of the risk, evaluate the compliance performance of individual firms and compare it with that of their peers, and recommend regulatory solutions.

SRO Examinations of Broker-dealers

FINRA uses risk assessments to identify and prioritize broker-dealers for examination and to help develop a risk-based examination scope for an examination of a firm. For purposes of identifying and prioritizing broker-dealers for examination, FINRA uses models to measure each firm's impact, or scale of operations, and also measures certain aspects of a firm's associated persons, financial and operational information, and business activities, among other things, to derive risk measures. FINRA uses the risk assessment to determine the frequency of examinations of broker-dealer sales practices and financial operations. The risk models also provide examiners with an initial risk-based examination scope, and pre-examination work then

further refines the initial risk-based examination scope. This pre-examination risk-assessment work is conducted by Coordinators, who are responsible for the day-to-day monitoring of broker-dealer member firms, and examiners.

10.1

c) Based upon a complaint associated with an inspected entity?

As noted above, OCIE conducts cause examinations of registrants when Staff has reason to believe that the registrant has violated federal securities laws, rules or regulations. Staff may initiate cause examinations in response to press reports, complaint letters, information provided by other regulators, tips from employees of entities allegedly engaged in fraud or other misconduct, and at times, anonymous sources. OCIE may also conduct cause examinations based on information learned in another examination or inspection. Finally, cause examinations may result from complaints or information referred to OCIE Staff from other divisions or offices within the SEC, such as Enforcement Staff.

10.2

Is there an automatic system which identifies unusual transactions on authorized exchanges and regulated trading systems?

SEC Approach to Surveillance and Monitoring

The SEC, based on a mandate from Congress, operates under the SRO model of Market Surveillance. The SEC has dedicated automatic real-time and after fact systems that identify unusual transactions on authorized exchanges and regulated trading systems. SROs have congressionally mandated market surveillance responsibilities and have primary surveillance authority over their marketplaces. The SEC's Office of Market Surveillance (OMS), located within Enforcement, coordinates daily with the SROs to timely detect any anomalous market activity, including suspect trading by particular persons/entities. While the SROs focus surveillance on their respective marketplaces, the OMS surveillance program covers all domestic equity and options markets.

In addition to coordinating with the OMS, the SROs also work cooperatively and effectively with each other. For example, in the area of insider trading, the options exchanges entered into a joint industry plan to coordinate insider trading surveillance and reviews. This plan facilitates the investigative process by having one central authority reviewing trading on all marketplaces as opposed to each market doing their own reviews and potentially missing related trading. The equities exchanges entered into a similar plan pursuant to which they allocated responsibility for insider trading surveillance. As a result, both the equities exchanges and options exchanges have developed a system of consolidated insider trading surveillance. *See* response to Question 10.3(b).

The SEC has full authority to use information from SRO's in enforcing the federal securities laws. Surveillance information gathered by each SRO is routinely shared with the SEC and between SROs for effective and timely detection of possible breaches of the securities laws. In

addition to using data collected by OMS as a basis for a possible referral to Enforcement, the SEC can, at anytime and on a timely basis, obtain trading information maintained by the SRO, such as audit trails, Market Maker price movement reports, and Equity Clearing runs to investigate possible violations of the federal securities laws.

The SEC and SROs each use surveillance information to investigate and, where warranted, take action where a breach of the law is identified. Enforcement actions may be brought by an SRO and/or the SEC individually or in cooperation with each other. If the violative conduct detected by the SRO is not under their jurisdiction, they will refer the matter to the SEC, specifically to OMS. In the fiscal years for 2007 and 2008, SROs made approximately 1300 referrals to Enforcement.

The SEC also has a group within TM called MarketWatch that conducts market monitoring. The group looks at overall market conditions and patterns for potential disruption in the markets. The group also monitors foreign securities markets and in some instances individual stocks. MarketWatch has a variety of monitoring systems including Bloomberg, Reuters, a Nasdaq workstation, feeds from Archipelago, and feeds from all of the newswires. In the event of a market disruption, the MarketWatch room serves as an emergency response center. Additionally, if, through its monitoring, the group learns of trading that might violate the federal securities laws, the group would notify Enforcement for further investigation.

Also, OEA assists with surveillance upon request from another office or division. For example, OEA may assist OCIE with analyzing a set of trading data to identify any unusual transactions or potential market abuse. OEA also reviews academic literature regarding manipulation and other types of market abuse and will notify Enforcement of cases of potential market abuse. Additionally, OEA performs studies on a variety of topics related to the securities markets, and will notify Enforcement or OCIE if unusual transactions or potential market abuse are identified.

Surveillance of Equities Markets and Fixed Income Markets

Each SRO uses similar surveillance techniques to monitor trading activity on the exchange for which it provides regulatory oversight. Such surveillance techniques include those designed to detect various types of manipulative trading, such as pre-arranged trading or wash trading, in which transactions with no change in beneficial ownership occur with the apparent purpose of manipulating the price of a security or creating a false impression of volume and liquidity. SROs also generally apply automated surveillance techniques to detect violations of order handling rules such as rules requiring a firm to honor its quoted bid or offer or requiring a firm to display a customer's limit order. Surveillance performed by FINRA and the NYSE is discussed below as an example of the types of surveillance that SROs perform.

FINRA Surveillance: FINRA's Market Regulation department has developed sophisticated market surveillance systems to surveil for unusual market activity.¹⁷⁵ FINRA runs numerous

¹⁷⁵ Pursuant to a Regulatory Services Agreement with NASDAQ, FINRA performs surveillance of the NASDAQ markets. With respect to fixed income securities, FINRA surveils corporate bond transactions reported through its own Trade Reporting and Compliance Engine, and municipal securities transactions reported through the

surveillance “patterns” to monitor equities, fixed income, and options trading. Some patterns are designed to identify potential fraud and insider trading by looking for such things as aberrant price movements, while others are designed to identify compliance with specific regulatory requirements such as whether limit orders are being displayed within 30 seconds.

Among other things, FINRA uses an automated fraud surveillance tool to surveil for potential fraud and insider trading by looking for deviations in stock trading relative to historical norms and potential breaking news. A small selection of additional FINRA surveillance systems for the equities market include: wash sales; frontrunning (trading on nonpublic order information); marking-the-close (a form of manipulative activity); locked/crossed markets (monitoring for violations of rules prohibiting the entry of bids and offers that lock or cross a market); and limit order display (reviewing for compliance with rules requiring the display of certain limit orders within a specific period of time following their receipt). FINRA conducts some surveillance on a T+1 (one day after the trade date) basis, and FINRA’s Market Surveillance systems produce some surveillance patterns or alerts in batches on a cycle basis and some on a real-time basis.

FINRA’s automated fraud surveillance program prioritizes the alerts generated by the surveillance system. FINRA manages the initial triage the alerts and assigns them to FINRA analysts for further review or investigation as warranted. The review or investigation could include blue sheeting and other various measures to determine if there are potential violations of SRO rules or federal securities laws, and then memorializes his or her review and findings in writing. FINRA management reviews the findings to ensure proper resolution of the matter. If an investigation develops evidence of potential misconduct, the matter will be referred to the FINRA Market Regulation legal department for further action. In some instances, such as those in which the potential wrongdoer is not a FINRA member, FINRA refers the matter to Enforcement. FINRA analysts also look at surveillance data to assist in the reviews of complaints, examinations, and in the performance of other regulatory functions.

NYSE Surveillance: NYSE Regulation’s Market Surveillance Division (“Market Surveillance”) monitors trading on the exchange, investigate trading abuses, recommends formal or informal disciplinary actions and, where evidence warrants, refers matters to NYSE Regulation’s Division of Enforcement or to Enforcement for further investigation and possible prosecution. Market Surveillance uses surveillance technology and pattern recognition systems to detect and investigate activity that may violate NYSE rules or federal securities laws. These violations may include insider trading or frontrunning, manipulative trading activity, and NYSE rules and federal securities laws and rules governing members' trading procedures.

The Market Surveillance program uses a variety of automated surveillances to assist its analysts and investigators in identifying potential violations. For example, Market Surveillance has a surveillance that looks for potential instances of insider trading or manipulative behavior. This surveillance incorporates company or sector news and price movements to generate alerts on a

Municipal Securities Rulemaking Board’s Real-Time Transaction Reporting System. The NASDAQ MarketWatch Department also surveils its markets on a real-time basis for unusual price movements and monitors for compliance with NASDAQ rules and policies.

real-time basis. Other surveillances examine trading patterns to detect market manipulation such as abuse of odd lot orders, intraday price ramping, and marking the close. Still other surveillances can detect prohibited and/or unusual trading including front running and trading ahead of public customer orders; “spoofing” the market near the open or the close (in which orders are entered and then cancelled within seconds prior to the open or the close with the intent to manipulate the price or create artificial interest in a security); and Regulation NMS trade-through instances. Market Surveillance also has procedures for reviewing intrusions (in which an account is taken over and used to engage in fraudulent behavior) as well as monitoring corporate price manipulation (in which a company that is close to falling below listing standards manipulates its stock price to keep it above a certain level).

Market Surveillance runs most of its surveillances on a scheduled basis. In addition to automated surveillances, NYSE Regulation has retained FINRA to conduct routine examinations of member firms’ compliance with NYSE rules. Market Surveillance also conducts “for cause” examinations when new issues arise that may be outside the scope of an existing surveillance.¹⁷⁶ Additionally, the Exchange’s Market Operations division monitors the market for disruptions and coordinates with Market Surveillance where member conduct may be involved.

Market Surveillance staff reviews surveillance alerts and, to analyze the conduct, works closely with the member firm that is the subject of the alert to get a chronology of events, or other supporting documents. In addition, Market Surveillance staff may request information about the trading of the security (referred to as obtaining a “blue sheet”). Alerts may be resolved in several different ways, including referral to NYSE Regulation’s Division of Enforcement for informal or formal action, referral to another SRO such as FINRA for further investigation or prosecution, or referral to Enforcement. Market Surveillance may also impose informal disciplinary action through a letter of admonition and/or levy a summary fine against the member, member organization or employees of the member organization.

Surveillance of Options Markets

The SROs that oversee options exchanges similarly have automated systems that identify unusual transactions. CBOE, the largest options exchange in the U.S., is discussed below as an example.

CBOE’s Department of Market Regulation (DMR) is responsible for monitoring CBOE member compliance with trading rules and procedures designed to provide a fair and equitable marketplace. CBOE has more than 60 separate surveillance programs including programs to detect price and volume manipulations of the options markets, such as trading activity designed to unduly influence the closing market price of an option (“marking”), and trading activity designed to inappropriately benefit from non-public information or to inappropriately affect market volatility. CBOE also conducts surveillance to detect potential capping and supporting activity (manipulative trading intended to move the price of an option’s underlying stock to

¹⁷⁶ Through an agreement with FINRA, FINRA has primary examination authority over NYSE members. However, where appropriate, MKS conducts “for cause” exams and coordinates closely with FINRA in such instances.

trigger or prevent the exercise of an option), front running activity (trading on non-public information), and marking the open and close activity (trading intended to manipulate the price).

Surveillance patterns also include those designed to monitor for compliance with order-handling rules prohibiting a broker-dealer from backing away from its firm quotes, requiring the display of certain limit orders, and requiring broker-dealers to adhere to a specific priority when executing orders on the exchange. These reviews, and particularly those in index option classes, require in-depth study of volatile or expiring series and the underlying securities in connection with in-depth review of member options trades, futures trading activity and stock block or program trades. DMR also addresses certain control issues, such as investigating inappropriate use of market maker accounts by non-members and related abuses of the market maker exemption from the net capital rule.

DMR's surveillance and investigative work concerns trading conduct both on and off the trading floor, including activity in CBOE listed options, stock-like products and related marketplaces. The department investigations are initiated through complaints and specialized computer programs designed to highlight particular types of abusive activity from CBOE order routing, trade match and audit trail data, OCC trade clearance data, futures and underlying stock data, and other relevant market information. Standard investigative techniques include obtaining testimony and applying tested analytical techniques to interpret various trading and market data. If a DMR analyst finds evidence of a potential violation, then DMR will conduct a further investigation to try to build a case. Once the case is established by DMR or, in some situations during the investigative process, DMR will involve CBOE Enforcement staff to seek disciplinary action against the CBOE member who may have violated the rule. In cases involving non-CBOE members or in other special situations, matters investigation by CBOE staff may also be referred to Enforcement.

DMR is also responsible for reviewing floor broker practices to address the improper use of error accounts and abuses of the solicitation, crossing and facilitation provisions of CBOE rules. Reviews are also conducted to insure floor brokers comply with best execution and due diligence obligations, such as limit order display, systematizing orders and inter-positioning and trading ahead of agency orders. Some reviews are conducted through an audit process. Finally, DMR conducts surveillance and assists in the administration of the CBOE summary fine program for trade reporting, book priority, position limits, index and equity exercise advice and firm quote compliance. Surveillance is also conducted to monitor member compliance with linkage and quoting obligations and to detect activity in newly listed option classes that may have been affected to induce order flow or create a false or misleading appearance of volume, trading in restricted option classes, pre-arranged trading and improper position adjustments.

For information on requirements that markets have surveillance techniques in place to police their members, *see* responses to Questions 25.3, 26.1(a), and 28.2(a). *See* response to Question 18.1 for descriptions of some of the types of fraudulent or unusual trading activity discussed in this section.

10.3

Can the regulator demonstrate adequate mechanisms and procedures to detect and investigate:

- a) Market and/or price manipulation?***
- b) Insider trading?***
- c) Failure of compliance with other regulatory requirements, for example: conduct of business, capital adequacy, disclosure or segregation of client assets?***

While the SEC has adequate mechanisms and procedures to detect and investigate suspected breaches of the federal securities laws, no law enforcement program has the capacity to detect all misbehavior, much less prevent all misbehavior.

The SEC can at anytime request trading information, Market Maker price movement reports from the SROs, and Equity Clearing runs, which allows the SEC to identify clearing firms that traded in issuers of interest for specific days or time period.

Additionally, the SEC's electronic Bluesheet System, which is useful in insider trading and market manipulation matters, is the primary means in which trading data in a particular security is transmitted from a broker-dealer to the SEC.

Short interest reports are another useful tool used by the SEC to detect violations of the federal securities laws. Short interest reports are provided twice a month pursuant to SRO rules, including NYSE, AMEX, and FINRA, and provide the total number of shares of a security that investors have sold short, and that have not been repurchased to close out the short position. Usually investors sell short to profit from market declines and consequently, the short interest is an indicator of the amount of pessimism in the market about a particular stock. Shorting involves buying, at some point, however, so a high short ratio may be interpreted as an indicator that there will be some buying pressure on that security that would increase its price. Short interest may also be an indicator of hedging strategies for mergers and acquisitions, as well as certain derivative positions.

The SEC also engages in Market Surveillance activities to detect violations of the federal securities laws. The SEC, based on a mandate from Congress, operates under the SRO model of Market Surveillance. Both the SROs and the SEC have automatic systems that identify unusual transactions on authorized exchanges and regulated trading systems. SROs have congressionally mandated market surveillance responsibilities and have primary surveillance authority over their marketplaces. The SEC's Office of Market Surveillance (OMS) coordinates daily with the SROs to timely detect any anomalous market activity, including suspect trading by particular persons/entities. While the SROs focus surveillance on their respective marketplaces, the OMS surveillance program covers all domestic equity and options markets. Market Surveillance activity is essential in detecting possible market manipulation and insider trading activity.

Finally, OCIE examiners test SROs' surveillance programs as part of SRO inspections. If a surveillance pattern or surveillance program is determined to be ineffective, Staff will obtain authorization from the Commission to issue an inspection report to the SRO in which the Staff will cite the SRO for deficiencies and requests that the SRO improve the surveillance accordingly. If the examination team identifies a serious violation of the federal securities laws or of the SROs own procedures or if the SRO will not correct the deficiencies noted in the inspection report, the examination team may refer the matter to Enforcement.

Market and/or Price Manipulation

See response to Question 10.2. As discussed in our response to Question 9.1, the SEC has the power to investigate possible violations of the federal securities laws. These include laws against fraud and market manipulation. The federal securities laws broadly prohibit market participants from engaging in fraud. Rule 10b-5 under the Exchange Act makes it unlawful for any person, directly or indirectly, to use any device, scheme or artifice to defraud, to make any untrue statements of material fact or to omit to state a material fact necessary in order to make the statements made not misleading, and to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security. Rule 10b-5 implements Section 10(b) of the Exchange Act prohibiting any person, in connection with a purchase or sale of any security, from using or employing any manipulative device in violation of the SEC's rules and regulations. Section 17 of the Securities Act prohibits fraud, material misstatements and omissions of fact "in the offer or sale of any security."

The federal securities laws also broadly prohibit market manipulation, including engaging in wash sales or other attempts to create a false or misleading appearance of active trading in any security, as well as affecting a series of transactions to raise or depress the price of a security for the purpose of inducing transactions in the security by others. Section 10(b) of the Exchange Act empowers the SEC to promulgate rules barring manipulative and deceptive conduct, and Section 15(c) prohibits fraudulent and manipulative conduct by broker-dealers. Section 9 of the Exchange Act outlaws manipulative practices in connection with the trading of exchange-listed securities and also provides a private remedy for investors injured by the prohibited manipulative conduct. Section 9(a)(6) gives the SEC the authority to promulgate rules prohibiting "pegging, fixing or stabilizing" securities prices. Section 9 applies only to securities that are listed on a national exchange. Section 10(b) is broader and applies to all securities transactions utilizing an instrumentality of interstate commerce. Section 15(c) of the Exchange Act covers the over-the-counter markets and municipal securities. Several additional provisions of, and rules under, the Exchange Act govern specific manipulation activities.¹⁷⁷

¹⁷⁷ *See e.g.*, Sections 9(b) and (e), 13(e), 14(e), 10(a) and (b), and 15(c) of the Exchange Act; Rules 10b-1, 10b-3, 10b-5, 10b-9, 10b-10, 14e-3, 14e-4, 14e-5, 10b-16, 10b-17, 10b-18, 15c1-2, 15c1-3, 15c1-5, 15c1-6, 15c1-7, 15c1-8, 15c1-9, 15c2-1, 15c2-4, 15c2-5, 15c2-7, 15c2-8, and 15c2-11 thereunder; and Regulation M. These requirements and prohibitions against market manipulation are supplemented by rules of the SROs and the Municipal Securities Rulemaking Board.

The SROs use the alerts from their surveillance systems in part to select firms for investigation or examination. OCIE may obtain such surveillance reports both during the inspection process as well as on an *ad hoc* basis if necessary to assess an exchange's market activity on a specified date or in a particular security. Additionally, the Staff utilizes OEA's expertise and surveillance programming capabilities to assist with examination selection and with analyzing data for specific examinations.

In fiscal year 2008, the SEC brought 52 market manipulation cases, which constituted 8% of all cases brought that fiscal year; in 2007, the SEC brought 36 market manipulation cases, which constituted 5% of the total cases brought that year; and in 2006, the SEC brought 27 market manipulation cases, which constituted 5% of the total cases brought that fiscal year.

Enforcement Actions Regarding Insider Trading

In the federal securities laws, insider trading is generally described as trading on the basis of material non-public information that has been used or obtained in a breach of duty. The fundamental prohibition against insider trading under the federal securities laws is not based on an explicit statutory prohibition against insider trading. Instead, federal courts have interpreted the general anti-fraud provisions of the Exchange Act (primarily Section 10(b) and Rule 10b-5 thereunder) to prohibit insider trading.

Insider trading enforcement actions may be brought against the person who traded on the basis of material, nonpublic information, and against a "tipper" – a person who disclosed material nonpublic information, in violation of a duty, to another person who traded on the basis of that information – the "tippee." Actions also may be brought against the tippee, if he or she knew or should have known, that the information was provided in breach of a duty.

In addition, Section 16(b) of the Exchange Act imposes liability for short-swing profits in the issuer's stock upon all persons required to file reports under Section 16(a) of the Exchange Act (officers, directors and beneficial owners of more than ten percent of any class of equity security). These statutory insiders must disgorge to the issuer any profit realized as a result of a purchase and sale or sale and purchase of covered equity securities occurring within a six-month period.

Section 14(e) of the Exchange Act and Rule 14e-3 thereunder establish a specific insider trading prohibition in the context of tender offers. Together, these provisions prohibit trading while in possession of material nonpublic information if any person has taken substantial steps toward a tender offer, and the person knows or had reason to know that the information was nonpublic and came from a proscribed source such as the offeror.

In fiscal year 2008, the SEC brought 61 insider trading cases, which constituted 9% of all cases brought that fiscal year; in 2007, the SEC brought 47 insider trading cases, which constituted 7% of all cases brought; and in 2006, the SEC brought 46 insider trading cases, which constituted 8% of all cases brought.

SRO Surveillance and SEC Examination Program

To detect insider trading, SROs have established electronic surveillance systems that monitor their markets for aberrational movements in a stock's price or volume of shares traded, among other things, and generate alerts if a stock's price or volume of shares traded moves outside of set parameters. These systems link trade activity data to news and research about corporate transactions (such as mergers, acquisitions, or earnings announcements); public databases of listed company officers and directors; and other internal and external sources of information to detect possible insider trading. For example, FINRA's automated surveillance system combines trade activity from various markets with news stories and other external sources of information to detect potential instances of insider trading and other potential violations of federal securities laws or FINRA rules.

SRO staff reviews the thousands of alerts generated by the electronic surveillance systems annually to identify those that are most likely to involve insider trading or fraud and warrant further investigation. In conducting reviews of these alerts, SRO staff considers such factors as the materiality of news, the existence of any previous news announcements, and the profit potential. If, in reviewing the trading associated with the alert, SRO staff determines there is a strong likelihood of insider trading, they can expand this review to a full investigation. In the course of a full investigation, SROs gather information from their member broker-dealers and the issuer of the traded stock to determine whether there is any relationship between those individuals who traded the stock and those individuals who had advance knowledge of the transaction or event. For example, SRO staff will typically request from their member broker-dealers the names of individuals and organizations that traded in advance of a corporate transaction or event, a process known as Bluesheeting. These data are then cross-referenced with information the SRO staff obtains from the issuer of the stock, including a chronology of the events leading up to the corporate transaction or event and the names of individuals who had knowledge of inside information.

SROs have created technology-based tools to assist in the identification of potential repeat offenders. For example, SROs can compare their blue sheets to a database called the Unusual Activity File, which includes data on suspicious trading activity identified by all SROs that are part of the Intermarket Surveillance Group, to help identify persons or entities that have been flagged in prior referrals or cases related to insider trading, fraud, or market manipulation. Some SROs have also developed other databases for their internal use. For example, FINRA developed a database similar to the Unusual Activity File for suspicious trading activity it has identified. NYSE also has developed a database of individuals who are affiliated with entities that it considers at high risk for insider trading.

The options markets SROs and equity markets SROs submitted plans to the SEC to create a more uniform and coordinated method for surveillance and investigation of insider trading in the options and equities markets. These plans are briefly described below.

The plan for the options markets is known as the Options Regulatory Surveillance Authority (ORSA) Plan. In June 2006, the SEC approved the ORSA Plan. Pursuant to the plan, the options exchanges are acting jointly in the administration, operation, and maintenance of a regulatory system for surveillance, investigation, and detection of the unlawful use of

undisclosed, material information in trading on one or more of their markets. ORSA is governed by a Policy Committee made up of one member from each of the Exchanges. The operation of the surveillance and investigative facility has been delegated to CBOE. As such, CBOE performs certain regulatory and surveillance functions and uses its automated insider trading surveillance system to perform these functions on behalf of the Exchanges. However, each exchange remains responsible for the regulation of its market and for bringing its own enforcement proceedings. The ORSA surveillance is a detection and alert system that flags underlying securities for review based on price movement and news.

The equities markets submitted a plan known as Consolidated Insider Trading. Similar to ORSA, the equities exchanges established this process as a means to enhance insider trading surveillance and detection. Generally, regulatory responsibility is assigned to NYSE Regulation for surveillance, investigation, and enforcement of insider trading by broker-dealers, and their associated persons, with respect to NYSE-listed stocks and NYSE Arca-listed stocks, irrespective of the marketplace on which the relevant trading may occur. The Plan assigns regulatory responsibility to FINRA for surveillance, investigation, and enforcement of insider trading by broker-dealers, and their associated persons, with respect to NASDAQ-listed stocks and Amex-listed stocks, as well as any CHX solely-listed equity security, irrespective of the marketplace on which the relevant trading may occur. FINRA and NYSE Regulation are able to look at alerts on a case by case basis and can also find concealed insider trading rings through reviews of the consolidated data.

See response to Question 10.2 for additional details on insider trading surveillance.

Failure to Comply with Other Regulatory Requirements

As described above in response the Question 10.1, SEC examinations review a wide-range of risk-based topics, including, for example, conduct of business, capital adequacy, and disclosures or segregation of client assets. For example, broker-dealers are required to maintain a certain level of financial soundness. This is regulated through broker-dealer financial responsibility rules, which are designed to provide safeguards with respect to customer funds and securities held at registered broker-dealers; promote accountability of those funds and securities; require the maintenance of accurate books and records; and require the broker-dealer to maintain sufficient liquid assets so that it can, if necessary, be liquidated in an orderly manner without the need for a formal proceeding.

Rule 15c3-1 under the Exchange Act, the “net capital rule,” prescribes minimum liquidity standards for broker-dealers. Its purpose is to ensure that broker-dealers maintain sufficient liquid assets to satisfy promptly the claims of customers in the event the broker-dealer fails, plus a cushion of liquid assets in excess of liabilities to cover potential market and credit risks. Rule 15c3-3 under the Exchange Act, the “customer protection rule,” protects customer funds and securities held by the broker-dealer. It requires a broker-dealer to have possession or control of all fully paid and excess margin securities of customers, and to make a daily determination to ensure that it is complying with this aspect of the rule. Additionally, the rule requires a broker-dealer to segregate and make a periodic computation of credits in excess of debits.

SEC rules under the Exchange Act require a broker-dealer to file periodic reports containing financial and operational data with the SRO which is designated as its examining authority. Most broker-dealers must also file with the SEC and its designated examining authority an annual audited report containing a statement of financial condition, a statement of income or loss, a statement of changes in financial position, a statement of changes in shareholders' equity and a statement of changes in subordinated liabilities. The annual audited report is accompanied by a supplemental accountant's report setting forth any material inadequacies. Finally, the rules require broker-dealers carrying customer accounts to send their customers an audited balance sheet and other information.

Other regulatory requirements reviewed in broker-dealer examinations include, but are not limited to:

- Reserve formula computations;
- Proper accounting for, and safekeeping of, customer funds and securities;
- Internal controls issues, including trading risk management, credit risk management, operational and legal controls, and internal auditing;
- Supervision;
- Sales practice issues, including suitability, churning, misrepresentations, cold calling, and unauthorized trading;
- Underwriting and distribution issues; and
- Anti-money laundering.

The most common problems referred to Enforcement from broker-dealer examinations were those related to unsuitable transactions, misrepresentations and omissions, employment of manipulative and deceptive devices, inadequate supervisory practices, inadequate preservation of books and records, and inadequate net capital.

Additionally, Staff also meets regularly with broker-dealers, with an emphasis on six broker-dealers that use VaR to compute regulatory net capital, (ANC Broker-Dealers). Staff monitors ANC Broker-Dealers on a regular basis focusing on, among other things, market risk, credit risk liquidity risk, price verification, treasury, finance, and internal audit. Market events may cause the office to monitor the firms more closely, sometimes on a daily basis.

Regulatory requirements reviewed in investment company inspections included valuation procedures, suitability, disclosure, revenue sharing, performance representations, and misappropriation of fund assets. Topics covered in investment company inspections included, but were not limited to:

- Regular reconciliation of custodial records with fund and investment advisers'

- records that resolve all discrepancies;
- Ensuring that information that is created, recorded, maintained, and reported is protected from unauthorized alteration and destruction;
 - Fund/shareholder order processing and cash-book reconciliations;
 - Safety of clients' funds and assets;
 - Fund asset pricing and fund NAV calculations;
 - Personal trading of access persons;
 - Fair allocation of blocked and IPO trades;
 - Order placement practices consistent with seeking best execution and disclosures;
 - Accuracy and fairness of fund performance information;
 - Fund corporate governance; and
 - Independent, third-party control over periodic account statements to clients.

The matters referred to Enforcement from investment company inspections most commonly involved issues regarding business development companies, conflicts of interest, corporate governance, books and records, and pricing of fund assets

Regulatory requirements reviewed in investment adviser examinations included, but were not limited to:

- Blocked trades and IPOs are allocated fairly and are consistent with disclosures;
- Client assets are priced accurately;
- Clients receive periodic account statements from third parties;
- Information created, recorded, maintained, and reported is protected from unauthorized alteration and destruction;
- Portfolio management decisions are consistent with client mandates;
- Clients' funds and assets are safely maintained;
- The firm maintains a strong compliance culture;

- The firm's control systems are subject to override by control persons;
- Orders are placed in ways that result in best execution; and
- Performance information provided to clients is presented fairly.

The matters referred to Enforcement from investment adviser examinations most commonly involved conflicts of interest, misappropriation of client funds, brokerage and execution practices, personal securities transactions, material compliance program deficiencies, and books and records concerns.

SROs are responsible for establishing, reviewing, and enforcing standards of conduct for their members and, accordingly, make rules governing sales practices, trading and business practices, member financial responsibility and enforcement of those rules and the relevant SEC laws and rules. In addition, the SEC conducts inspections of the SROs' examination, regulatory and surveillance programs.

In addition to examinations, OCIE has a large firm compliance monitoring program in which examiners are assigned to monitor compliance issues of certain large broker-dealers and investment advisers. Each entity selected for monitoring has a significant amount of assets or customer accounts. As part of the monitoring program, the monitor keeps abreast of all significant issues affecting the organizations as identified in SEC examinations (broker-dealer, investment adviser, investment company, and transfer agent), SRO examinations, enforcement case updates, quarterly meetings with FINRA and the firms, and news and other resources. The monitor also maintains ongoing communications with other examiners nationwide, other SEC Divisions and offices, the SROs and other regulatory agencies to discuss with them significant issues that may impact their areas of responsibility. In addition, the monitor serves as the point of contact for the firm when compliance questions or issues arise. Based on the information compiled, monitors will notify OCIE senior management if any significant risk events arise.

10.4

Does the regulator have an adequate system to receive and respond to investor complaints?

Although the system is adequate, the SEC has identified areas for improvement. The financial scandals of 2008 convinced us that our systems to detect fraud via our handling of tips, complaints and referrals needed to be upgraded. The steps the SEC has taken to upgrade these systems are discussed in detail, below.

The SEC receives hundreds of thousands of investor complaints each year, including letters, calls and emails sent to Enforcement, OIEA and other offices. In fiscal year 2008, Enforcement received approximately 618,000 Complaints, Tips and Referrals (CTRs). Staff responds to complaints, and they are triaged for further appropriate disposition, including assigning to Enforcement Staff for follow up and if appropriate, further investigation. As of September 30, 2008, the SEC had 4080 investigations pending, which were the result of several sources, including investor complaints. While the current review, triage and assignment of CTRs has

resulted in a large number of solid leads for Enforcement Staff, the SEC wanted to ensure that its processes for handling CTRs kept the pace with the large number of CTRs received.

On March 5, 2009, the SEC Chairman announced that the SEC had retained the Mitre Group, a non-profit, federally funded research firm, to conduct a comprehensive review of the agency's systems and procedures for evaluating and tracking CTRs. Mitre's work is being conducted in three phases: Phase One, which involves a thorough examination of the agency's existing procedures for handling CTRs and recommendations as to how the CTR intake, triage and resolution process can be improved to ensure that enforcement leads and areas for high risk examinations are more effectively identified; Phase Two, which involves the drafting of new policies and procedures that each SEC Office and Division with significant CTR responsibilities will follow; and Phase Three, which will involve the procurement and implementation of a centralized information technology solution that will provide the agency with an automated mechanism for, among other things, tracking and reporting on CTR handling activities on an agency-wide basis.

Specifically, in Phase One, the Mitre Group assessed the current handling of CTRs by the SEC and will be making recommendations concerning CTR intake, triage, risk evaluation and ranking, distribution and assignment of CTRs for resolution, tracking of CTRs, monitoring progress and internal and external reporting concerning CTR handling throughout the agency.

Phase Two involves the Staff's drafting of rules, policies and procedures that will apply to the intake, triage and resolution tracking systems. Phase Three involves the implementation of the centralized IT systems for CTRs agency wide.

Parallel to the work being performed pursuant to the CTR initiative, Enforcement has formed a Risk Focus Group which is responsible for evaluating Enforcement's handling of CTRs, its risk assessment function and its strategic planning capability and how these functions can be integrated into one unit within the Division of Enforcement. The Risk Focus Group is currently assessing the resource and structural requirements that the Division will have in coordinating the Division's CTR intake, triage and resolution process as it relates to the centralized information technology solution that will likely be implemented pursuant to the recommendations made by the Mitre Group.

Additionally, the SEC's anti-spam initiative, spearheaded by Enforcement, has been a successful initiative. The goal of this initiative is to reduce the amount of financial-related spam received by investors. Continuing vigilance and publicity stemming from this initiative has helped to reduce the number of spam solicitations received by investors, and accordingly, the number of investor complaints regarding financial spam have decreased, as well.

Examination Program Complaint Handling

Enforcement and OIEA may refer to OCIE some complaints regarding broker-dealers, investment advisers, investment companies, SROs, transfer agents, and clearing firms, NRSROs, Alternative Trading Systems, Electronic Communication Networks, and their associated persons. At times, OCIE examiners will also receive complaints from other divisions or offices

within the SEC, other regulators, investors, concerned citizens, employees of entities allegedly engaged in fraud, and at times, anonymous sources. OCIE Staff reviews and evaluates the complaints for possible referral. Referred complaints are handled by the appropriate responsible staff or entity, including Staff within other OCIE examination groups, Staff in one of the SEC's 11 regional offices, other SEC divisions, or SROs, for further investigation or examination. OCIE Staff tracks complaints and associated referrals through a tracking spreadsheet.

10.5

Is there evidence, such as inspection reports and follow up action, which indicates that the regulator is competently discharging inspection responsibilities?

The SEC issues non-public reports summarizing findings of examinations and inspections of broker-dealers, investment advisers, investment companies, SROs, NRSROs, transfer agents, clearing agencies, and other registered entities. In addition, OCIE has implemented various programs designed to reach out to the compliance community and educate and encourage compliance with securities laws and rules.

Examination Reports and Follow-up Action

Generally, an examination may have one or a combination of the following six results: (a) the issuance of a letter to the firm indicating that no further action will be taken; (b) the issuance of a Deficiency Letter to the firm (or inspection report to an SRO); (c) referral of the matter to Enforcement for further investigation and possible enforcement action; (d) referral of the matter to another Division or Office when examinations identify recurring problems or gaps in regulatory coverage; and (e) referral of the matter to an SRO for possible further investigation; and (f) referral of the matter to other state and federal regulators and law enforcement.

When an examination ends with no findings of violations or other problems, the Staff will provide a letter confirming that the examination has been closed and that no deficiencies were identified during the examination.¹⁷⁸ When examiners identify compliance failures or internal control weaknesses, the registrant is generally provided with a deficiency letter identifying the deficiencies and requiring the registrant to take remedial steps and provide the staff with a written explanation of the remedial steps. Most examinations end with deficiency letters. When the registrant has potentially violated SRO rules, OCIE will note the potential violations in the deficiency letter and may, in some instances, refer the matter to the appropriate SRO. When the registrant's compliance or internal control failures are serious, OCIE may refer the matter to Enforcement for further investigation. When examination staff identifies recurring problems or gaps in regulatory coverage, they may refer such issues to another office or division at the SEC, such as TM and IM.

¹⁷⁸ The letter would also note that, even though no deficiencies or violations came to the Staff's attention during the review, it does not mean that all of the registrant's activities comply with the federal securities laws and other relevant rules and regulations.

Additionally, as discussed in response to Question 10.1, OCIE conducts oversight examinations and inspections of SROs to ensure that they are competently discharging their examination responsibilities.

In addition to examination reports and follow-up action, the SEC engages in a wide variety of activities that evidence its competent discharge of its inspection responsibilities. These activities include internal memoranda, public reports, public measures of accountability, and outreach to the compliance community.

First, OCIE prepares internal memoranda evidencing its work. These include an annual non-public memorandum describing the examination program and setting out its strategic goals for the year. This memorandum is presented to the SEC Chairman and Commissioners, and other divisions and offices for their input and comments. OCIE also presents information memoranda to the SEC Chairman and Commissioners and other divisions and offices summarizing findings from special examination and risk-focused examination sweeps. These information memoranda describe the results of the examinations and make recommendations for other possible regulatory action.

Second, OCIE occasionally issues public reports that evidence its work. OCIE conducts special examinations to gather information about areas of interest or concern to the Commission. Occasionally, the examination reports summarizing findings are released publicly. Recent reports include: *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies* (July 2008); *Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Services Firms in Serving Senior Investors* (September 2008); *Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free Lunch" Sales Seminars* (September 2007); *Report on Refunds, Sales Practices, and Revenues from Periodic Payment Plans* (March 2007); and *Report Concerning Examinations of Options Order Routing and Execution* (March 2007).

Third, from time-to-time, OCIE issues public notices called *ComplianceAlerts*. In July 2008, OCIE issued its second *ComplianceAlert* on its public website, which highlighted recent, significant examination findings. OCIE expects to issue similar alerts from time-to-time each year.

Fourth, OCIE conducts active outreach to the community through its *CCOutreach* program, which is designed to assist the chief compliance officers of broker-dealers, investment companies, and investment advisers in performing their important responsibilities and, ultimately, to help ensure strong compliance program for the protection of investors. This program includes national, regional, and interactive broadcast seminars that address current compliance risk areas and developments.

Fifth, OCIE is subject to public measures of accountability that set forth specific criteria by which to judge the SEC's discharge of its inspection responsibilities. For example, the SEC publishes an annual Performance and Accountability Report which includes examination program highlights and initiatives. These measures include the program's success in meetings its goal for visiting higher risk advisers (at least once every three years), the percentage of the

registered population examined, the percentage of examinations concluded in 120 days, the percentage of examinations with significant findings, and the percentage of firms receiving deficiency letters that took corrective action.

Sixth, OCIE is subject to oversight by the SEC's Office of the Inspector General (IG) and the GAO. The IG, an independent office with the SEC, conducts published audits of programs and operations of the SEC. The mission of this office is to, among other things, promote integrity, economy, efficiency and effectiveness in the SEC's programs and operations. Also, upon a request from Congress, the GAO¹⁷⁹ prepares publically available reports accessing the perceived strengths and weaknesses of the SEC's operations, including its examination and inspections program. Any recommendations for improvement included in its reports are subject to follow up by the GAO.

Finally, the SROs also issue documents relating to their examination authority which measure their competency in discharging inspection responsibilities. For example, FINRA, the largest SRO, issues Regulatory Notices to provide its members with information on issues such as approval by the SEC of new FINRA rules or rule amendments; FINRA rule interpretations; and notices of disciplinary actions against member firms and/or associated persons. Additionally, FINRA occasionally publishes reports and studies regarding examination findings. Examples include: *Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free Lunch" Sales Seminars* (September 2007)¹⁸⁰; and *Examination Findings Regarding Gifts and Gratuities* (December 2006).¹⁸¹

10.6

Is there evidence that the regulator is adequately addressing unusual market activity?

Yes, *see* responses to Questions 10.2, 10.3(a) and 10.3(b).

10.7

Does the regulator require regulated entities to have in place supervisory and compliance procedures reasonably designed to prevent securities laws violations?

The SEC and SROs require regulated entities to have in place supervisory and compliance procedures reasonably designed to prevent violations of the federal securities laws and the SRO

¹⁷⁹ The general mission of the GAO is to support the Congress in meeting its constitutional responsibilities and to help improve the performance and ensure the accountability of the federal government for the benefit of the American people.

¹⁸⁰ *Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free Lunch" Sales Seminars* (September 2007) was published by the NASD prior to its consolidation with the member regulation, enforcement and arbitration functions of NYSE into FINRA, which occurred in July 2007.

¹⁸¹ *Examination Findings Regarding Gifts and Gratuities* (December 2006) was jointly published by OCIE, North American Securities Administrators Association and FINRA.

rules. OCIE and the SROs test regulated entities' supervisory and compliance procedures through examinations as discussed in response to Question 10.1. As part of each examination, OCIE and the SROs generally review at least a portion of a firm's written supervisory procedures and policies and test to ensure that these policies and procedures are being followed. The SEC may bring enforcement actions against "regulated" persons or entities that also serve as intermediaries for violations of the federal securities laws. These intermediaries include broker-dealers and investment advisers. In addition, the SEC may sanction intermediaries and their associated persons for failure reasonably to supervise individuals subject to their supervision who commit violations of the federal securities laws.

For example, as to broker-dealers, under Section 15(b)(4)(E) of the Exchange Act, the SEC is authorized to bring an enforcement action against a broker-dealer for failures reasonably to supervise "with a view to preventing violations" of the federal securities laws. The SEC may also bring an action against individuals who fail reasonably to supervise others under Section 15(b)(6)(A)(i) of the Exchange Act.

Similarly, as to investment advisers, under Section 203(e)(6) of the Advisers Act, the SEC is authorized to bring an enforcement action against an investment adviser for failure reasonably to supervise, in the same terms as applied to broker-dealers.

SEC and SRO Rules Related to Supervision and Compliance

Investment Adviser and Investment Company Rules: Rule 206(4)-7 of the Investment Advisers Act, Compliance Procedures and Practices, makes it unlawful for registered investment advisers to provide investment advice unless they have adopted and implemented written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder. The rule also requires that the firm must do a review at least annually of the adequacy of the policies and procedures and the effectiveness of their implementation and must designate a chief compliance officer who is responsible for administering the policies and procedures.

Rule 204A-1, the Investment Adviser Code of Ethics, requires that registered investment advisers establish, maintain, and enforce a written code of ethics and states that firms must require supervised persons to acknowledge receipt of the code of ethics in writing.

Rule 38a-1 promulgated under the Investment Company Act, Compliance Procedures and Practices of Certain Investment Companies, requires that investment companies ("funds") adopt, implement, and review at least annually written policies and procedures reasonably designed to prevent violation of the federal securities laws by the fund, including policies and procedures that provide for the oversight of compliance by each adviser, principal underwriter, administrator and transfer agent of the fund. The fund board of directors must approve these procedures. The rule also requires that the fund designate a chief compliance officer responsible for administering the policies and procedures.

SRO Rules:¹⁸² FINRA rules related to supervision and compliance includes FINRA Rule 3130, Annual Certification of Compliance and Supervisory Procedures, that requires that each member firm designate a chief compliance officer. The rule also requires that the chief executive officer must certify annually that the member has in place processes to establish, maintain, review, test, and modify written compliance policies and written supervisor procedures reasonably designed to achieve compliance with FINRA and MSRB rules and the federal securities laws. This rule also requires a certification that the chief executive officer has conducted one or more meetings with the chief compliance officer in the preceding 12 months to discuss such processes.

NASD rules related to supervision and compliance include: (1) NASD Rule 3010(a), Supervision, which requires each member to have a supervisory system in place that is reasonably designed to achieve compliance with the federal securities laws and NASD rules. Each registered representative must be assigned a supervisor and must have an annual meeting with a firm designee regarding compliance matters relevant to the registered representative; (2) NASD Rule 3010(b), which requires its members to develop written procedures to supervise the types of business in which they engage and to supervise the activities of their employees and other associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations and NASD rules; (3) NASD Rule 3010(c), which sets forth the requirements for firms to conduct internal inspections of offices of supervisory jurisdiction and other branch and non-branch locations; and (4) NASD Rule 3010(d), which requires firms to have written procedures regarding the supervision transactions and for the review of correspondence by registered representatives. The NASD, prior to becoming FINRA, published several notices reminding members of their supervision responsibilities and providing guidance on supervision.

NYSE rules related to supervision and compliance include: (1) NYSE Rule 342.16, Offices – Approval, Supervision and Control, which states that supervision of registered representatives would ordinarily include at least approval of new accounts and reasonable procedures for review of registered representatives communications with the public; (2) NYSE Rule 342.19, which provides for the supervision of producing branch managers; and (3) NYSE Rule 342.24, which requires member firms to conduct annual branch inspections (with limited exceptions).

For additional information on supervisory and compliance procedures required for regulated entities, *see* responses to Questions 17.12, 17.13, 21.2(e), 23.1, 23.2, and 23.10.

¹⁸² Following the consolidation of NASD and the member regulation, enforcement and arbitration functions of NYSE Regulation into FINRA, FINRA began working to harmonize and streamline existing rules in order to develop a consolidated rulebook. The rulebook consolidation process is occurring in phases.

10.8

Does the regulator monitor how compliance procedures are executed and communicated to employees of such entities?

Through the annual CEO certification requirement and the investment adviser and company annual review requirements discussed in response to Question 10.7, firms are required to do annual monitoring of the adequacy of their written supervisory procedures as well as how the procedures are being carried out. FINRA staff review broker-dealer annual CEO certifications and utilize them to select potential examination candidates. OCIE staff review investment advisers and investment company annual compliance reviews as part of examinations of those entities. Additionally, OCIE examination staff and the SROs conduct reviews of the adequacy of firms' written supervisory procedures and test whether the procedures are being carried out. Areas reviewed include:

- Determining whether the firm has written supervisory procedures;
- Reviewing the written supervisory procedures to determine whether they are reasonably designed to achieve compliance with applicable securities laws and SRO rules and that they are updated as necessary;
- Ascertaining whether employees received the written supervisory procedures and any updates;
- Reviewing investment adviser employees' acknowledgements of receipt of the code of ethics; and
- Testing various provisions of firms' written supervisory procedures in order to determine whether they are carried out in practice.

Finally, during oversight inspections of SRO examination programs, OCIE examination staff works to ensure that the SROs' are adequately reviewing their respective member firm's written supervisory procedures.

10.9

Can the regulator take measures against or discipline or sanction intermediaries for failure to supervise reasonably subordinate personnel whose activities violate the securities laws?

The SEC can take measures against or discipline or sanction intermediaries for failure to supervise reasonably subordinate personnel whose activities violate the federal securities laws. In addition, the SEC delegates some supervisory and disciplinary responsibilities to the SROs. As discussed in response to Question 10.7, the SROs have detailed rules regarding the supervision of personnel. As discussed in response to Question 10.11, the SROs investigate and discipline firms that fail to abide by these rules, but in some cases may refer the firm to Enforcement for further investigation. As discussed in response to Question 10.1, OCIE conducts inspections of the SROs regulatory programs, including their investigative and

disciplinary processes. If examiners find deficiencies in an SRO's regulatory programs, the SRO would typically be sent a deficiency letter outlining the deficiencies and requesting that the SRO improve its examination program accordingly. If examiners find serious deficiencies, they may refer the SRO to Enforcement for further investigation.

SEC Disciplinary Actions

As noted in response to Question 10.7, the SEC may bring enforcement actions against "regulated" persons or entities that also serve as intermediaries for violations of the federal securities laws. These intermediaries include broker-dealers and investment advisers. In addition, the SEC may sanction intermediaries and their associated persons for failure reasonably to supervise individuals subject to their supervision who commit violations of the federal securities laws.

A broker-dealer or investment adviser can be charged with failure to supervise when it fails to have or to implement supervisory and compliance policies reasonable to detect and prevent violations of the federal securities laws by subordinate personnel. Moreover, a broker-dealer or investment adviser may be charged for failure to supervise if, for example, supervisors at the intermediary failed to investigate suspicious trading activity or other suspicious activity by subordinate personnel.

Allegations of failure to supervise under the Exchange Act and the Advisers Act may be adjudicated only in SEC administrative proceedings and are not actionable in civil actions in federal court. Under Section 15(b) of the Exchange Act, the SEC can censure, suspend or revoke the registration of a broker-dealer or place limitations on the activities of a person subject to its jurisdiction, with a view to detecting or preventing a violation of the law. The SEC may also impose suspensions or bars from particular activities, such as suspending a firm from opening new accounts or participating in underwritings. Similar sanctions are available against investment advisers for failure to supervise. These sanctions are also available only in administrative proceedings, under Section 203(e) of the Advisers Act.¹⁸³ Civil penalties may be ordered in administrative proceedings against broker-dealers and investment advisers for failure to supervise violations (pursuant to Exchange Act Section 21B(a)(4), and Advisers Act Section 203(i)(1)(D)).

Civil penalties (pursuant to Exchange Act Section 21B(a)(4)), may be ordered in administrative proceedings against broker-dealers and investment advisers for failure to supervise violations.

SEC and SRO Rules Related to Discipline or Sanctions for Failure to Supervise

Exchange Act Rules: Section 6(b) of the Exchange Act states that an exchange shall not be registered as a national securities exchange unless the SEC determines that the exchange is

¹⁸³ Recent matters involving failure to supervise include, *In the Matter of Royal Alliance Associates, Inc.*, Admin. Proc. File No. 3-13456 (Apr. 28, 2009); *In the Matter of Bradley E. Moyer*, Admin. Proc. File No. 3-13490 (May 27, 2009); *In the Matter of Pritchard Capital Partners, LLC, et al.*, Admin. Proc. File No. 3-12753 (Apr. 3, 2008); *In the Matter of SG Americas Securities LLC, et al.*, Admin. Proc. File No. 3-13372 (Feb. 13, 2009).

organized and has the capacity to be able to carry out the federal securities laws and to comply, and (subject to any rule or order of the SEC pursuant to section 17(d) or 19(g)(2)) of the Exchange Act to enforce compliance by its members and persons associated with its members, with the provisions the federal securities laws and the rules of the exchange.

Section 19(g)(1) of the Exchange Act requires SROs to comply with the federal securities laws and the SRO's own rules and absent reasonable justification or excuse to enforce compliance by its members with the federal securities laws and the SRO's rules.

See response to Question 6.1(c) for additional details on SEC disciplinary authority.

Advisers Act and Investment Company Act Rules: Section 203(e)(6) of the Advisers Act, Registration of Investment Advisers, allows the SEC to censure, put limitations, or suspend the activities of an investment adviser for a period not exceeding 12 months or revoke the registration of any investment adviser if it is in the public interest to do so and has failed to reasonably supervise persons under its control, with a view to preventing violations of the federal securities laws.

Section 42 of the Investment Company Act, Enforcement of Title, allows the SEC to make investigations as it deems necessary to determine whether any person has violated or is about to violate the federal securities laws. The SEC can ask a court to grant it a permanent or temporary injunction when it appears that an individual has or is about to violate the federal securities laws. The SEC can also seek monetary penalties in civil actions.

SRO Rules: FINRA Rule 8310, Sanctions for Violations of the Rules, describes the sanctions that FINRA can impose on member firms including censure, fine, suspension, expulsion, and a cease and desist order.

NYSE Rule 476 allows for disciplinary sanctions by the NYSE if a member firm violates the federal securities laws or NYSE rules. Possible sanctions include: expulsion; suspension; limitations as to activities, functions and operations, including the suspension or cancellation of a registration; and a bar from being associated with any member or member organization.

See response to Question 6.1(c) for additional details on SRO disciplinary authority.

10.10

Does the regulator require market surveillance mechanisms that permit an audit of the execution and trading of all transactions on authorized exchanges and regulated trading systems?

Section 19(g) of the Exchange Act requires each SRO to enforce compliance with its rules by its members. In furtherance of this requirement, the SROs surveil the trading activity of their members and the SEC examines the SROs to evaluate the adequacy of their surveillance efforts.

The SROs maintain audit trails and utilize them as part of their surveillance programs. Additionally, as part of the SEC's inspections of SROs and examinations of broker-dealers, examiners often review portions of the SROs' audit trails. If the audit trail is not kept in proper order, examiners will cite the SRO for the deficiency and could report the matter to Enforcement if the case of a serious violation. The SROs also have rules requiring their members to maintain certain order, execution, and quote information.

Each exchange maintains an audit trail of all orders received by its systems and trades executed on its systems. FINRA maintains an audit trail of all trades in exchange-listed stocks that are executed otherwise than on an exchange. In addition, FINRA maintains an audit trail of certain OTCBB, Pink Sheet, and corporate fixed-income trades and the life cycle of all of its members' customer orders in Nasdaq securities. The SROs have also worked together to create consolidated repositories of certain trade information in both equities and options.

For additional information on audit trails and the requirement that an exchange must have the capability to maintain an order audit trail, *see* responses to Questions 25.3(b), 25.6, 26.1(c), and 28.3.

10.11

Does the regulator or other competent authority have an effective enforcement program in place to enforce regulatory requirements?

Enforcement Program

The SEC has over 1100 attorneys in Enforcement who are charged with investigating and prosecuting violations of the federal securities laws. Currently, there are over 4000 active, pending investigations in Enforcement. Moreover, 92% of Enforcement cases were successfully resolved in fiscal year 2008.

Each year, the SEC brings between 500 and 600 enforcement actions. In fiscal year 2008, the SEC brought 671 enforcement cases, which was its second highest number in history. Additionally, in fiscal year 2008, the SEC obtained orders in judicial and administrative proceedings requiring securities violators to disgorge illegal profits of approximately \$774 million, and to pay penalties of approximately \$256 million.

Currently, the SEC is implementing systems to measure qualitative factors to determine the Enforcement program's effectiveness in enforcing regulatory requirements and in meeting programmatic objectives. Specifically, systems are being implemented to track whether Enforcement cases of the utmost importance are being brought, whether Enforcement cases are being brought in a timely manner, and whether Enforcement resources are being used effectively to meet our objectives. The SEC is also using metrics to measure the deterrent impact of the Enforcement cases brought.

New systems are being put in place and current systems are being enhanced which will track relief obtained in Enforcement cases, including monetary relief, officer and director bars, and

102(e) suspensions of accountants and attorneys from practicing in front of the Commission. Also tracked will be the number of emergency actions, such as TROs and asset freezes. Reports generated from this information will assist in assessing the effectiveness of the SEC's enforcement efforts.

Finally, the SEC is starting to develop systems that would measure changes in industry behavior as a result of the SEC's Enforcement actions.

For additional information, please *see* the response to Question 10.4.

The SROs' Programs to Enforce Regulatory Requirements

The SROs also have programs in place to enforce regulatory requirements. SROs evaluate and resolve disciplinary actions and enforce the SROs' own rules and the SEC's rules against the SRO's members and the members' associated persons. SROs investigate potential violations discovered through their examination programs, market surveillance, and/or through customer complaints or tips. Investigations can result in no action, informal disciplinary action or formal disciplinary action. Informal actions result in either a letter of caution or a compliance conference. Formal action cases are handled by enforcement departments who after their own assessment can settle or litigate actions. The largest SRO, FINRA, has an independent Office of Disciplinary Affairs that must authorize the initiation and/or settlement of all formal disciplinary actions. Litigated cases are heard by professional hearing officers. Formal disciplinary action cases can result in fines, restitution, suspensions and/or bars from the industry. Respondents can appeal the decisions to the SEC.

As discussed in response to Question 10.1, OCIE conducts inspections of the SROs' regulatory systems including the effectiveness of their enforcement programs. If the programs or certain aspects of the programs are deemed ineffective or violative of the federal securities laws in some way, OCIE takes one of the following actions: (a) send an inspection report to the SRO requesting that the SRO take corrective action; (b) if the matter is serious, refer the SRO to Enforcement; and (c) in instances where rule making by the SEC potentially needs to occur, OCIE would refer the matter to TM.

COOPERATION

Principles 11-13

Cooperation – Principle 11

The Regulator should have the authority to share both public and non-public information with domestic and foreign counterparts.

Assessment

Fully Implemented.

11.1

For each of the regulators identified, does the regulator have authority to share with other domestic regulators and authorities information on:

- a) Matters of investigation and enforcement?*
- b) Determinations in connection with authorization, licensing or approvals?*
- c) Surveillance?*
- d) Market conditions and events?*
- e) Client identification?*
- f) Regulated entities?*
- g) Listed companies and companies that go public?*

Non-public Information

The SEC may share non-public information in its possession with other domestic regulators and authorities pursuant to Section 24(c) of the Exchange Act and Rule 24c-1 promulgated thereunder. The SEC may, in its discretion and upon a showing that such information is needed, provide non-public information in its possession to any person foreign or domestic provided the SEC receives assurances of confidentiality from the person receiving such non-public information. Rule 24c-1 defines “person” to include, among other things, federal, state, local or foreign governments or any political subdivision, authority, agency or instrumentality of such government.

Rule 24c-1 broadly defines “non-public information” to mean records, as defined in Section 24(a) of the Exchange Act, and other information in the SEC’s possession which are not available for public inspection and copying. “Records” includes all applications, statements, reports, contracts, correspondence, notices and other documents filed with or otherwise obtained

by the SEC. “Non-public information,” as defined in Rule 24c-1, could cover the types of information identified in Question 11.3(a)-(g).

Public Information

Some of the information listed in Question 11.1(a)-(g) may be publicly available and can be obtained directly by domestic regulators and authorities without making a request to the SEC. A number of public resources, including websites, provide information for identifying the registration status and disciplinary history of persons, entities and companies in the United States, including broker-dealers, investment advisers, and issuers. These resources include, without limitation:

- FINRA’s website provides public information about member firms and their associated persons, including registration status, address information, types of business conducted, legal status, and disciplinary history. See <http://www.finra.org/>.
- IARD is an Internet-based system of electronic filing for investment advisers. See www.adviserinfo.sec.gov.
- The EDGAR database provides the registration status and SEC filings of public companies registered with the SEC. See <http://www.sec.gov/edgar/searchedgar/webusers.htm>.
- The SEC’s website contains information on SEC enforcement proceedings including descriptions of, among other things: civil suits filed in federal court, administrative proceedings filed before the SEC, and trading suspensions. See <http://www.sec.gov/divisions/enforce/enforceactions.shtml>.
- The SEC’s website contains information on proposed rule changes submitted by SROs and SEC orders granting approval of proposed rule changes. See <http://www.sec.gov/rules/sro.shtml>.

11.2

Can the regulator share the information described in Key Question 1 with other domestic authorities without the need for external approval such as from a relevant government minister or attorney?

The SEC may release information pursuant to Section 24(c) of the Exchange Act without the need for external approval. See response to Question 11.1.

11.3

Does the regulator have the authority to share information with foreign counterparts with respect to each of the matters listed in Key Question 1, specifically:

- a) Matters of investigation and enforcement?*
- b) Determinations in connection with authorization, licensing or approvals?*
- c) Surveillance?*
- d) Market conditions and events?*
- e) Client identification?*
- f) Regulated entities?*
- g) Listed companies and companies that go public?*

Non-public Information

The SEC may share non-public information in its possession with foreign counterparts pursuant to Section 24(c) of the Exchange Act and Rule 24c-1 promulgated thereunder. The SEC may, in its discretion and upon a showing that such information is needed, provide non-public information in its possession to any person foreign or domestic, provided the SEC receives assurances of confidentiality from the person receiving such non-public information. “Person” is defined to include, among other things, federal, state, local or foreign governments or any political subdivision, authority, agency or instrumentality of such government, and foreign financial regulatory authorities. The term “foreign financial regulatory authority” is broadly defined in Section 3(a)(52) of the Exchange Act and includes a foreign securities authority and other foreign governmental body or foreign equivalent of a self-regulatory organization empowered by a foreign government to administer or enforce its laws related to securities matters. As noted in the response to Question 11.1, “non-public information” is broadly defined and could cover the types of information identified in Question 11.3(a)-(g).

For information other than that the SEC already possesses, Section 21(a)(2) of the Exchange Act permits the SEC, on request from a foreign securities authority, to conduct an investigation as the SEC “deems necessary to collect information and evidence pertinent to the request for assistance.” This could include the types of information identified in Question 11.3(a)-(g). Under Section 21(a)(2) of the Exchange Act, the SEC has the authority to provide assistance to a foreign securities authority if the requesting authority states that it is conducting an investigation which it deems necessary to determine whether any person has violated or is violating or is about to violate any laws or rules relating to securities matters that the requesting authority enforces or administers. Notably, Section 21(a)(2) specifically states that the SEC may provide such without regard to whether the facts stated in the request would constitute a violation of U.S. laws. In exercising this authority, Section 21(a)(2) of the Exchange Act directs the SEC to consider: (1)

whether the requesting authority has agreed to provide reciprocal assistance to the SEC, and (2) whether compliance with the request would prejudice the public interest of the United States. While not a prerequisite for sharing information with a foreign counterpart, requests made pursuant to the terms of an MOU between the SEC and a foreign authority, including the IOSCO MMOU, generally would be deemed to satisfy both of these conditions.

The SEC may use its subpoena powers under Section 21(b) of the Exchange Act to compel the production of documents and testimony from any entity or individual in the United States. As part of providing assistance to a foreign securities authority under Section 21(a)(2), the SEC may conduct an investigation and use its compulsory powers under Section 21(b) of the Exchange Act as it would in its own investigations. This power includes requiring the production of documents held by regulated entities as well as the ability to use the SEC's subpoena powers to compel the production of documents or testimony from any person or entity anywhere within the United States.

As a practical matter, the SEC frequently provides enforcement assistance to its counterparts. In fiscal year 2008,¹⁸⁴ the SEC cooperated with 414 requests from foreign regulators for enforcement assistance.

No secrecy or blocking laws are imposed in the United States on information sharing with foreign securities authorities.

Public Information

As noted in the response to Question 11.1, some of the information listed in Question 11.1(a) - (g) may be publicly available. The SEC staff regularly provides public resources, including websites, to its foreign counterparts to assist them in identifying the registration status and disciplinary history of persons, entities and companies in the United States, including broker-dealers, investment advisers, and issuers. For a list of some those resources, *see* the response to Question 11.1.

11.4

Can the regulator share the information for enforcement and regulatory purposes with foreign counterparts without the need for external approval, such as from a relevant government minister or attorney?

The SEC may release information pursuant to Sections 24(c) of the Exchange Act without the need for external approval. *See* response to Question 11.3.

¹⁸⁴ *See* SEC 2008 Accountability and Performance Report, available at <http://www.sec.gov/about/secpar/secpar2008.pdf>.

11.5

Can the regulator provide information to other domestic and foreign authorities on an unsolicited basis?

Under Section 24(c) of the Exchange Act, the SEC could provide information to other domestic and foreign authorities on an unsolicited basis. The SEC may share such information upon a showing that it is needed and that the authority receiving the information provides assurances of confidentiality. In some instances, both of these requirements can be satisfied in advance by the terms and conditions set forth in MOUs to which SEC is a signatory.¹⁸⁵ For example:

- Some of the SEC’s supervisory MOUs with foreign authorities provide that the SEC may inform the other authority “in advance of pending regulatory changes that may have a significant impact on the operations, activities, or reputation of a Firm, in the other jurisdiction; and any material event that could adversely impact each other’s markets or the stability of a Firm, in the other jurisdiction. Such events include known changes in the operating environment, operations, management, or systems and controls” (emphasis added).¹⁸⁶
- Paragraph 16 of the SEC’s MOU with the College of Euronext Regulators provides that: “to the extent practicable and as appropriate in the particular circumstances, each Authority endeavors to inform the other Authority in advance of: regulatory changes or other material events that may have a significant impact on the operations or activities of NYSE Euronext; and enforcement actions or sanctions that could adversely impact NYSE Euronext or a Market in the other Authority’s jurisdiction” (emphasis added).
- Section 13 of the IOSCO MMOU, to which the SEC is a signatory, provides that “each authority will make all reasonable efforts to provide, without prior request, the other authorities with any information that it considers is likely to be of assistance to those other authorities in securing compliance with laws and regulations applicable in their jurisdiction” (emphasis added).
- Pursuant to Paragraph 9(a) of the MOU between the FRB, CFTC and SEC regarding Central Counterparties for Credit Default Swaps, the parties agree “to the extent practicable and as appropriate in the particular circumstances, to inform each other, in

¹⁸⁵ See http://www.sec.gov/about/offices/oia/oia_cooparrangements.htm for a complete list of the SEC’s MOUs with foreign authorities.

¹⁸⁶ See Paragraph 20 of the MOU Concerning Consultation, Cooperation and the Exchange of Information related to Market Oversight and the Supervision of Financial Services Firms between the SEC and the UK Financial Supervisory Authority (March 2006); Paragraph 21 of the MOU Concerning Consultation, Cooperation and the Exchange of Information related to Market Oversight and the Supervision of Financial Services Firms between the SEC and the German Federal Financial Supervisory Authority (April 2007); Paragraph 22 of the MOU Concerning Consultation, Cooperation and the Exchange of Information related to Market Oversight and the Supervision of Financial Services Firms between the SEC and the Australian Securities and Investments Commission (August 2008).

advance where feasible and otherwise as soon as practicable, of issues that may affect the respective regulatory or supervisory interests of the other Party or Parties with respect to CCPS and CDS” (emphasis added).

In addition, the SEC regularly makes enforcement referrals to other domestic authorities -- including DOJ, state securities regulators, SROs such as FINRA and NYSE – and to foreign securities authorities.

11.6

Can the regulator share information with foreign counterparts even if the alleged conduct is not such that it would constitute a breach of the laws of the regulator's jurisdiction if conducted within that jurisdiction?

Section 21(a)(2) of the Exchange Act authorizes the SEC to provide assistance to a foreign securities authority at its discretion, without regard to whether the facts as stated in the foreign securities authority’s request constitute a violation under U.S. laws.

In addition, Section 24(c) of the Exchange Act and Rule 24c-1 thereunder permit the SEC, at its discretion, to share non-public information in its possession with foreign government authorities, provided it receives assurances of confidentiality.

11.7

Where the regulator can obtain information and records identifying the person or persons beneficially owning or controlling bank accounts related to securities and derivatives transactions and brokerage accounts, can the regulator share that information with domestic and foreign counterparts?

See responses to Questions 11.1 and 11.3. The SEC may share non-public information in its possession with domestic and foreign counterparts pursuant to Section 24(c) of the Exchange Act and Rule 24c-1 promulgated thereunder. Such information could include information concerning the beneficial ownership or control of a bank or brokerage account, provided the requesting authority shows that such information is needed and provides the SEC with assurances of confidentiality.

Moreover, as noted in the response to Question 11.3, the SEC may use its subpoena powers under Section 21(b) of the Exchange Act to compel the production of documents and testimony from any entity or individual in the United States. As part of providing assistance to a foreign authority under Section 21(a)(2) of the Exchange Act, the SEC may conduct an investigation and use its compulsory powers under Section 21(b) under the Exchange Act as it would in its own investigations. This power includes requiring the production of documents held by regulated entities as well as the ability to use the SEC’s subpoena powers to compel the production of documents or testimony from any person or entity anywhere within the United States.

Consequently, insofar as information concerning the beneficial ownership or control of a bank or brokerage account is relevant to such an investigation, the SEC has the authority to use its subpoena powers to obtain this information regardless of where it is located in the United States.

See also response to Question 13.1.

Cooperation – Principle 12

Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.

Assessment

Fully Implemented.

12.1

Does the regulator have the power, by legislation, rules or as a matter of administrative practice, to enter into information-sharing agreements (whether formal or informal) with other domestic authorities?

As a matter of practice, the SEC can enter into information-sharing arrangements, generally known as MOUs, to facilitate consultation, cooperation and the exchange of information, public or non-public, with other domestic authorities. MOUs are statements of intent to consult, cooperate and exchange information, which are approved by the SEC and signed by the Chairman or his/her designee. MOUs facilitate cooperation by establishing clear mechanisms for the exchange of information, including setting forth the terms and conditions for sharing and protecting the confidentiality of non-public information.

It is important to note that such arrangements are not a prerequisite for the SEC to cooperate with domestic authorities. As discussed in the response to Question 11.1, the SEC can cooperate and share non-public information with domestic authorities, whether on an *ad hoc* basis or under an MOU, pursuant to Section 24(c) and Rule 24c-1 provided, among other things, that the SEC has received assurances of confidentiality regarding the use of non-public information. Assurances of confidentiality are typically incorporated in the terms of the SEC's MOUs.

12.2

Does the regulator have the power, by legislation, rules or as a matter of administrative practice, to enter into information-sharing agreements (whether formal or informal) with foreign counterparts?

As a matter of practice, the SEC can enter into information-sharing arrangements, generally known as MOUs, to facilitate consultation, cooperation and the exchange of information with foreign authorities. Indeed, the SEC has a long history of executing MOUs with foreign counterparts, both bilaterally and multilaterally, for enforcement and supervisory purposes. *See* Annex A for a list of the SEC's MOUs with foreign authorities.

MOUs are statements of intent to cooperate, which are approved by the SEC and signed by the Chairman or his/her designee. MOUs facilitate cooperation by establishing clear mechanisms for the exchange of information, including setting forth the terms and conditions for sharing and protecting the confidentiality of non-public information.

It is important to note that such arrangements are not a prerequisite for the SEC to cooperate with foreign authorities regarding enforcement or supervisory matters. As discussed in the response to Question 11.3, the SEC can cooperate and share non-public information with foreign counterparts, whether on an *ad hoc* basis or under an MOU, pursuant to Section 24(c) and Rule 24c-1 provided, among other things, that the SEC has received assurances of confidentiality regarding the use of non-public information. Assurances of confidentiality are typically incorporated in the terms of the SEC's MOUs.

12.3

Has the relevant regulator developed information-sharing mechanisms to:

- a) Facilitate the detection and deterrence of cross-border misconduct?***
- b) Assist in the discharge of licensing and surveillance responsibilities (when the person that is the subject of the inquiry is known to the requested authority)?***

The SEC has developed MOUs with foreign counterparts for purposes of cooperation in both enforcement and supervisory matters. *See* Annex A for a complete list of these MOUs.

Enforcement Cooperation

The SEC's MOUs for enforcement cooperation facilitate the ability of the SEC and its foreign counterparts to assist one another in investigations and prosecutions of cross-border securities fraud.

In 2002, IOSCO created the MMOU, the first global multilateral information-sharing arrangement among securities regulators. Pursuant to the MMOU, signatories, including the SEC, agree, among other things, to provide certain critical information, to permit use of that information in civil or administrative proceedings, to onward share information with self-regulatory organizations and criminal authorities, and to keep such information confidential. In particular, the MMOU provides for the following:

- sharing information and documents held in the regulators' files;
- obtaining information and documents regarding transactions in bank and brokerage accounts, and the beneficial owners of such accounts; and
- taking or compelling a person's statement or, where permissible, a person's testimony.

Before the establishment of the IOSCO MMOU, the SEC signed bilateral information sharing MOUs for enforcement cooperation with the securities authorities of 20 different countries.

Bilateral MOUs have proven crucial to investigations undertaken by the Commission's enforcement staff and, as such, the SEC considers these bilateral arrangements to be a useful supplement to the information sharing mechanism of the MMOU. In light of the MMOU, the SEC staff now generally recommends the negotiation of bilateral MOUs for enforcement cooperation only if a foreign securities authority is empowered to provide assistance beyond that required by the IOSCO MMOU such as the ability to compel testimony or the gathering of Internet service provider, phone and other records other than bank, broker, and beneficial owner information on behalf of the requesting authority.

Regulatory Cooperation

The SEC's MOUs for regulatory cooperation with foreign authorities establish clear mechanisms for consultation, cooperation and the exchange of supervisory information. Such mechanisms eliminate the need to address supervisory information-sharing issues on an *ad hoc* basis and address new information-sharing needs created by global financial conglomerates and cross-border affiliated markets.

The SEC's MOUs for regulatory cooperation can vary in scope and purpose and, to date, the SEC has entered into MOUs that cover information sharing and cooperation related to:

- affiliates within a financial group subject to consolidated supervision by the SEC and/or a foreign authority;
- firms registered with both the SEC and a foreign authority;
- the oversight of markets in the U.S. and a foreign jurisdiction affiliated through a common ownership structure; and/or
- the sharing of non-public issuer-specific information relating to the application of IFRS by dually-listed companies.

12.4

Where warranted by the scope of cross-border activity and the ability to provide reciprocal assistance, does the regulator actively try to establish information-sharing arrangements with foreign regulators?

Since the early 1990s, the SEC has actively worked to establish information-sharing arrangements with foreign regulators for enforcement cooperation where warranted, as evidenced by the number of MOUs for enforcement cooperation between the SEC and its foreign counterparts. More recently, the SEC increasingly has been exploring the use of MOUs to facilitate cooperation in the supervision of financial services and the oversight of markets. Since 2006, the SEC has entered into 11 MOUs for supervisory cooperation. *See* the response to Question 12.3 and Annex A.

In addition, the SEC has established a number of bilateral dialogues¹⁸⁷ with its foreign counterparts aimed at:

- identifying and discussing regulatory issues of common concern;
- improving cooperation and the exchange of information in cross-border securities enforcement matters; and/or
- continuing and expanding upon the existing program of training and technical assistance provided by the SEC to the foreign regulator.

These dialogues include both regular meetings and ad hoc information exchange at the staff level and between high-level representatives of the SEC and the foreign regulator. To date, the SEC has entered into bilateral dialogues with securities regulators in Korea, China and Japan as well as with the Committee of European Securities Regulators.

12.5

Are these arrangements documented in writing?

All of the SEC's MOUs are in writing. As noted in Questions 12.1 and 12.2, MOUs are approved by the SEC and signed by the Chairman or his/her designee. The SEC's arrangements with foreign authorities are available on the SEC's web site at:

http://www.sec.gov/about/offices/oia/oia_cooparrangements.htm. See also Annex A.

Many of the SEC's arrangements with domestic authorities are also available on the SEC's web site. See response to Question 12.7. In addition, the certain information-sharing procedures of SEC examination Staff are discussed in the responses to Questions 12.6 and 12.7 below.

12.6

Does the regulator take steps to assure safeguards are in place to protect the confidentiality of information transmitted consistent with its uses?

Confidentiality of SEC Files

Officers and employees of the SEC are prohibited from making confidential information or documents or any other non-public record of the SEC available to anyone other than a member, officer or employee of the Commission.¹⁸⁸ Upon joining the SEC, Commission members and employees must acknowledge in writing receipt of a memorandum entitled "Prohibitions Concerning Confidential/Non-Public Information" (SEC Employee Memorandum). Paragraph 3-7 of the SEC Employee Memorandum provides that, "[a] member or employee of the

¹⁸⁷ See http://www.sec.gov/about/offices/oia/oia_cooparrangements.htm.

¹⁸⁸ See Rule 24(c)(1) of the Exchange Act; See also 17 C.F.R. §§ 200.735-3(7), 203.2, 230.122,240.0-4 & 260.0-6.

Commission shall not divulge to any unauthorized person or release in advance of authorization for its release, any non-public Commission document or any information contained in any such document or any confidential information . . .”¹⁸⁹ That duty remains beyond a person's employment with the SEC. Upon leaving the SEC, each employee is required to sign a memorandum acknowledging that the employee is aware of these requirements. Under the Exchange Act, SEC officers or employees who fail to comply with SEC regulations may, upon conviction, be fined up to \$1,000,000 and/or imprisoned for a period not exceeding 10 years.¹⁹⁰

Disclosure under the FOIA

Under Section 24(d) of the Exchange Act, the SEC is able to protect from unnecessary public disclosure information regarding requests made by foreign securities authorities as well as information received from foreign securities authorities. With the exception of a formal request from the U.S. Congress or a court order in an action commenced by the SEC or the U.S. government, Section 24(d) states that the SEC shall not be compelled to disclose records obtained from a foreign securities authority if the foreign securities authority has stated that public disclosure of the records would violate its laws. This section explicitly exempts from disclosure under the FOIA any records obtained from a foreign securities authority. Under Section 24(a) of the Exchange Act, the term “records” is defined to include “applications, statements, reports, contracts, correspondence, notices and other documents,” and would cover correspondence from the foreign securities authority and notes from consultations between or among the authorities involved requesting assistance. Section 24(d) also permits the SEC to refuse third party discovery requests to access confidential information received from a foreign securities regulator.

Disclosure to Congress

Section 24(e) of the Exchange Act provides that: “nothing in this section shall. . . authorize the Commission to withhold information from the Congress or prevent the Commission from complying with an order of a court of the United States in an action commenced by the United States or the Commission.” The U.S. Congress has oversight responsibility for the SEC and is entitled to obtain information from the SEC’s files. Should the SEC Staff learn of an impending demand from Congress for production of non-public information provided by a foreign authority, the Staff would recommend to the Commission that the SEC inform Congress that: (i) the SEC had undertaken to keep the information non-public; and (ii) disclosure could harm the SEC’s relationship with the foreign authority and adversely impact the SEC’s ability to obtain information from its counterpart in the future. Requests for non-public information of this type from Congress are extremely infrequent and, historically, Congress has been very sensitive to the need to preserve the confidentiality of non-public information contained in the SEC’s files.

¹⁸⁹ The relevant provisions mandating the nonpublic nature of this information may be found at Subpart M of the SEC’s Rules on Organization, Conduct and Ethics; and Information and Requests, Rule 2 of the SEC’s Rules Relating to Investigations, Securities Act Rule 122, Exchange Act Rule 0-4, and Trust Indenture Act Rule 0-6. See also responses to Questions 11.1 and 11.3.

¹⁹⁰ Exchange Act, § 32. See also C.F.R. § 200.735-13.

Assurances of Confidentiality

The SEC requires assurances of confidentiality under Section 24(c) of the Exchange Act and Rule 24c-1 thereunder. These confidentiality assurances do not restrict the foreign authority's ability to use the information for the purposes of its investigation and/or proceeding or any resulting proceedings, or its ability to transfer the information to criminal law enforcement authorities and self-regulatory organizations. Typically the terms and conditions of the SEC's MOUs with domestic and/or foreign authorities will be deemed to satisfy the requirement for confidentiality assurances.

SEC Staff Procedures

OIA has implemented a process to help ensure that the confidentiality of information provided by foreign authorities, whether on an *ad hoc* basis or under an MOU, is maintained in accordance with Section 24(d). Non-public documents provided by a foreign authority to the SEC in response to a request for enforcement assistance are circulated internally for use by staff only after: (1) a cover memorandum is attached noting that the information has been provided by a foreign authority along with any applicable restrictions on its use, and (2) each page of the document is identified with an individual number and the applicable restrictions.

In order to share non-public information with other authorities on an *ad hoc basis* (*i.e.*, absent an MOU that includes confidentiality safeguards), the SEC has established a process that requires all access requests to SEC files to be in writing and signed by a senior SEC official. An access request must, among other things, stipulate the reason why the information is being requested (*i.e.*, demonstrate the regulator's "need to know") and provide assurances regarding the security and confidentiality of the information to be shared.

In addition, OCIE has implemented formal procedures that must be followed by the examination staff when sharing examination-related information with other regulatory authorities (both foreign and domestic). The procedures are designed to assist examination staff in complying with Section 24(c) of the Exchange Act and Rule 24c-1. Specifically, they are designed to, among other things, enable the Staff to obtain appropriate assurances of confidentiality from the regulator prior to the release of the non-public information, and to ensure that Staff appropriately documents the request and the information shared. When a foreign regulator requests examination information, Staff follows the same process as when the request is by a domestic regulator, the only difference being that OCIE Staff coordinates with Staff in OIA to prepare the access request letter.

12.7

Can the regulator demonstrate that it shares information, where appropriate safeguards are in place, when it is requested by another domestic authority or foreign counterpart?

See responses to Questions 12.3 and 12.4. The SEC routinely consults, cooperates and shares information, in accordance with statutory requirements, with domestic and foreign authorities for both enforcement and supervisory purposes.

Foreign

In fiscal year 2008, the SEC handled 414 requests for enforcement assistance from foreign authorities and made 594 requests to foreign authorities.¹⁹¹ Requests for assistance for enforcement cooperation from foreign authorities (or to foreign authorities) are centrally handled by OIA, in close coordination with Enforcement.

With respect to regulatory cooperation with foreign counterparts, in recent years the SEC has taken steps to increase its consultation and cooperation with foreign authorities on supervisory issues. Since 2006, the SEC has entered into 11 MOUs for supervisory cooperation, which cover cooperation with respect to a range of entities including:

- affiliates within a financial group subject to consolidated supervision by the SEC and/or a foreign authority;
- firms registered with both the SEC and a foreign authority;
- the oversight of markets in the U.S. and a foreign jurisdiction affiliated through a common ownership structure; and/or
- the sharing of non-public issuer-specific information relating to the application of IFRS by dually-listed companies.

For example, in 2007 the SEC entered into an MOU with the College of Euronext Regulators to consult, cooperate and share information in the oversight of NYSE Euronext. Pursuant to this arrangement, staff of the SEC and the Euronext College generally meet twice a year to discuss issues of common regulatory concern. Also, pursuant to a number of regulatory dialogues, Staff meets with foreign counterparts regularly on a bilateral and multilateral basis to discuss regulatory and other issues of shared concern. See response to Question 12.4.

Domestic

Domestically, the Staff coordinates and meets with domestic regulators to share information: (a) when necessary to perform the SEC's regulatory functions; (b) when authority requests the SEC do so; and (c) on an as-need basis. In recent years, the SEC has taken steps to increase its use of MOUs to facilitate supervisory cooperation. For example, in 2008, the SEC entered into four

¹⁹¹ See SEC 2008 Accountability and Performance Report, available at <http://www.sec.gov/about/secpar/secpar2008.pdf>.

regulatory MOU with other domestic regulatory agencies under which terms the SEC is actively sharing regulatory and supervisory information. These include:

- In November 2008, the SEC, the Federal Reserve and the CFTC entered into an MOU that establishes a framework for consultation and information sharing on issues related to CDS central counterparties.¹⁹²
- In July 2008, the SEC and the Federal Reserve signed an MOU to share information and cooperate across a number of important areas of common interest.¹⁹³
- In July 2008, the SEC and Department of Labor signed an MOU that establishes a process for the department's Employee Benefits Security Administration and SEC staff to share information on retirement and investments and meet regularly to discuss matters of mutual interest.¹⁹⁴
- In March 2008, the SEC and CFTC signed an MOU that establishes a permanent regulatory liaison between the agencies and provides for enhanced information sharing, and sets forth several key principles guiding their consideration of novel financial products that may reflect elements of both securities and commodity futures or options.¹⁹⁵

Staff routinely shares non-public examination and other information with the Board of Governors of the Federal Reserve System and the Financial Crimes Enforcement Network pursuant to the SEC's MOUs with these agencies. Staff also shares examination and other information pursuant to MOUs with other regulators upon their request for information. *See* response to Question 12.6.

As noted in response to Question 12.6 above, OCIE has established formal procedures for sharing information that include appropriate documentation of the requests made and the information shared.

¹⁹² *See* <http://www.sec.gov/news/press/2008/2008-269.htm>.

¹⁹³ *See* <http://www.sec.gov/news/press/2008/2008-134.htm>.

¹⁹⁴ *See* <http://www.sec.gov/news/press/2008/2008-154.htm>.

¹⁹⁵ *See* <http://www.sec.gov/news/press/2008/2008-40.htm>.

Cooperation – Principle 13

The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.

Assessment

Fully Implemented.

13.1

Is the domestic regulator able to offer effective and timely assistance to foreign regulators in obtaining:

- a) *Contemporaneous records sufficient to reconstruct all securities and derivatives transactions, including records of all funds and assets transferred into and out of bank and brokerage accounts relating to those transactions?*
- b) *Records for securities and derivatives transactions that identify:*
 - i) *The client:*
 - (1) *Name of the account holder?*
 - (2) *Person authorized to transact business?*
 - ii) *The amount purchased or sold?*
 - iii) *The time of the transaction?*
 - iv) *The price of the transaction?*
 - v) *The individual and the bank or broker and brokerage house that handled the transaction?*
- c) *Information located in its jurisdiction identifying persons who beneficially own or control non-natural persons organized in its jurisdiction?*

See response to Question 11.3 for a description of the SEC's legal authority to share non-public information with a foreign authority under Section 24(c) of the Exchange Act and to conduct an investigation on behalf of a foreign authority under Section 21(a)(2) of the Exchange, including use of compulsory powers.

As discussed in the response to Questions 11.1 and 11.3, Rule 24c-1 promulgated under the Exchange Act broadly defines “non-public information” to mean records, as defined in Section 24(a) of the Exchange Act, and other information in the SEC’s possession which are not available for public inspection and copying. “Records” includes all applications, statements, reports, contracts, correspondence, notices and other documents filed with or otherwise obtained by the SEC. “Non-public information,” as defined in Rule 24c-1, could cover the types of information identified in Question 13.1(a)-(c).

Each year, the SEC receives hundreds of requests from foreign securities authorities for assistance with cross-border investigations, including requests for the types of information described under Question 13.1(a)-(c). Many of these requests come from jurisdictions with whom the SEC interacts frequently and with whom the SEC has an MOU; however, the SEC can also assist jurisdictions that satisfy the requirements of Section 21(a)(2) stated above even absent the existence of an MOU.

OIA is the office within the SEC delegated to receive all requests for assistance in securities enforcement matters from foreign regulators and it has established an intake procedure to receive and answer requests from foreign authorities. OIA works closely other Staff, including Enforcement Staff and the foreign regulators to provide the information requested in a timely fashion. Pursuant to statutory authority, the SEC frequently provides foreign regulators with non-public information in the SEC’s files, information obtained from regulated entities under Section 17(a) of the Exchange Act, and/or information obtained pursuant to an SEC investigation conducted on behalf of the foreign authority. As a practical matter, requests requiring that the SEC open an investigation on behalf of a foreign regulator and use its compulsory powers to provide assistance may take longer to complete than requests for information maintained by regulated entities or in the SEC’s files. In fiscal year 2008, the SEC provided assistance in 414 requests from foreign regulators.¹⁹⁶

The following paragraphs describe the ability of the SEC to obtain and share the types of information set forth in Question 13.1(a)-(c) with foreign counterparts.

Brokerage records

Entities regulated by the SEC, which includes, *inter alia*, national securities exchanges, members thereof, brokers or dealers who transact business in securities, registered clearing agencies and registered transfer agents, are required to maintain the records they keep for prescribed periods of time. Section 17(a) of the Exchange Act and rules promulgated thereunder require exchanges and broker-dealers to maintain records as determined by the SEC. Given that the SEC can obtain records from regulated entities pursuant to its supervisory powers, as discussed in response to Questions 8.1 and 8.2 above, the SEC can obtain these records for a foreign authority in a relatively short period of time.

¹⁹⁶ SEC 2008 Accountability and Performance Report, available at <http://www.sec.gov/about/secpar/secpar2008.pdf>.

Exchanges maintain records of the audit trail of a transaction (including the amount of the security purchased or sold, the time and price of the transactions and the individual or entity that handled the transaction) under SRO rules that must be approved by the SEC. Exchange Act Rule 17a-1 requires securities exchanges to maintain their records and files for not less than five years. Exchange Act Rule 17a-3 requires broker-dealers to maintain records identifying the name of the account holder and person authorized to transact business, the amount of the security purchased or sold, the time and price of the transactions and the individual or entity that handled the transaction. These records include trading blotters, ledgers, account statements, records regarding stock borrowing and short/long selling, share purchase and repurchase agreements, memoranda recording all purchase and sale orders, sale and purchase confirmations, and information concerning the owner and address of the account holder and detailed personal information about this individual or entity.

Exchange Act Rule 17a-4 requires broker-dealers to retain the records listed in Rule 17a-3 for various periods: trading blotters, certain ledgers, and records reflecting security clearance dates must be kept for not less than six years, while other records must be preserved for not less than three years. In addition, customer identification information required under the Patriot Act (which is also required under Rule 17a-3) must be retained for not less than five years after the customer's account has been closed under the SEC's rules implementing these Patriot Act provisions.¹⁹⁷

Section 31(a) of the Investment Company Act and Rule 31a-1 thereunder require investment companies to maintain records identifying the account holder and any persons authorized to transact business, daily records of purchases and sales and transaction times, ledgers, and the individual or entity that handled the transaction. Under Investment Company Act Rule 31a-2, investment companies must preserve permanently certain ledger and account holder records, while other information must be retained for not less than six years. In addition, for open-end investment companies, customer identification information required under the Patriot Act must be retained for not less than five years after the customer's account has been closed.¹⁹⁸

Section 204 of the Investment Advisers Act and Rule 204-2 thereunder require investment advisers to maintain journal records of all transactions, ledgers, internal audit papers, powers of attorney and other information about persons authorized to transact business, and records of transactions of securities transactions (among other information). Under Investment Advisers Act Rule 204-2, investment advisers must maintain their records for not less than five years.

The CFTC also has independent authority to compel records from regulated entities and subpoena records from any person or entity, including all CFTC registrants and non-registrants in the United States. Please *see* the CFTC self assessment for more information.

¹⁹⁷ SEC Release No. 34-46192 "Customer Identification Programs for Broker-Dealers.

¹⁹⁸ SEC Release No. IC-25657 "Customer Identification Programs for Mutual Funds.

Bank records

As discussed in Question 11.3, under Section 21(a)(2) of the Exchange Act, the SEC may conduct an investigation on behalf of a foreign authority and use its compulsory powers under Section 21(b) of the Exchange Act as it would in its own investigations. This power includes use of the SEC's subpoena powers to compel the production of documents or testimony from any person or entity anywhere within the United States, including banking entities.

The SEC can obtain bank records through its subpoena authority; however if the SEC is seeking financial records of a customer, defined as an individual or a small partnership of five or fewer individuals, from a financial institution the SEC must follow procedures set forth in the RFPA. The RFPA provides that a government authority may have access to or obtain copies of bank records of customers fitting the above description if certain steps are taken by the SEC: the financial records are reasonably described and where either the customer has authorized such disclosure or the financial records are disclosed in response to an investigative subpoena or summons that meets certain requirements.¹⁹⁹ The SEC typically does not seek authorization by the customer, but instead issues an investigative subpoena that sets forth a reason to believe that the bank records are relevant to a legitimate law enforcement inquiry. The SEC must also ensure that a copy of the subpoena has been served upon the customer or mailed to the last known address, and ten days have expired from the date of service or fourteen days have expired from the time of mailing and the customer has not challenged the inquiry. The SEC may also obtain bank records for a customer without first notifying the customer through a delayed notice provision. The SEC may appeal to an appropriate court in order to delay notice to the customer if:

- (1) a delay in obtaining access to bank records would result in a flight from prosecution, destruction or tampering with evidence, transfer of assets or records outside the United States, improper conversion of investor assets or impeding the ability to identify or trace the source or disposition of funds;
- (2) a delay is necessary to identify or trace the record or beneficial ownership interest in any security;
- (3) the acts or practices under investigation involve the dissemination of materially false or misleading information concerning any security, issuer or market or failure to make disclosures required under the securities laws, or a financial loss to investors or other persons which remains substantially uncompensated;
- (4) the acts or practices under investigation involve significant financial speculation in securities, or endanger the stability of any financial or investment intermediary.

Under Section 21(b), the SEC may use its compulsory powers to issue an administrative subpoena to a bank for bank records on behalf of a foreign authority as it would in its own investigations. The SEC may subpoena records of a customer, as defined under the RFPA, in

¹⁹⁹ See 12 U.S.C. § 3402.

accordance with the notice provisions of the RFPA or in accordance with the delayed notice provisions as described above. Finally, OCIE may seek information from banks on a voluntary basis to confirm account balances and other information related to accounts managed by registered securities firms.

Beneficial owner information or control by non-natural persons organized in the U.S.

Incorporation laws in the United States are at the state, rather than the federal, level. Generally, states maintain registries of the companies incorporated in their jurisdiction, including the names and addresses of the individuals or entities serving as agents for service of process for these companies. State laws also generally require that companies maintain an updated list of shareholders.

In regards to public companies, Section 13(d) of the Exchange Act in addition requires public disclosure of the controlling ownership (defined as any ownership of more than five percent of a company's equity stock) of all U.S. companies whose shares are publicly traded.

Furthermore, Section 16(a) of the Exchange Act requires any person who is the beneficial owner of more than ten percent of any class of equity security that is registered under the Exchange Act, as well as the officers and directors of such company, to file a report with the SEC indicating the amount of all equity securities of that company owned by such person. Amendments to Section 16(a) under the Sarbanes-Oxley Act require that any changes in that ownership be reported to the SEC within two days of the transaction.²⁰⁰

Section 17A of the Exchange Act and Exchange Act Rule 17Ad-6 requires transfer agents to keep records relating to the transfer of securities. Exchange Act Rule 17Ad-7 requires these records to be maintained for a period of not less than two years.

13.2

Is the domestic regulator able to offer effective and timely assistance to foreign regulators in securing compliance with laws and regulations related to:

- a) Insider dealing, market manipulation, misrepresentation of material information and other fraudulent or manipulative practices relating to securities and derivatives, including solicitation practices, handling of investor funds and customer orders?***
- b) The registration, issuance, offer, or sale of securities and derivatives, and reporting requirements related thereto?***
- c) Market intermediaries, including investment and trading advisers who are required to be licensed or registered, collective investment schemes, brokers, dealers and transfer agents?***

²⁰⁰ SEC Release No. 34-46313: Ownership Reports and Trading by Officers, Directors and Principal Security Holders.

d) Markets, exchanges and clearing and settlement entities?

See response to Question 11.3 for a description of the SEC's legal authority to share non-public information with a foreign authority under Section 24(c) of the Exchange Act and to conduct an investigation on behalf of a foreign authority under Section 21(a)(2) of the Exchange, including use of compulsory powers. Notably, Section 21(a)(2) specifically states that the SEC may provide assistance where a foreign authority, among other things, can state that it is conducting an investigation which it deems necessary to determine whether any person has violated, is violating or is about to violate any laws or rules relating to securities matters in its jurisdiction and without regard to whether the facts stated in the request would constitute a violation of U.S. laws. The types of information the SEC possesses, can obtain and share with a foreign authority could include information described in Question 13.2(a)-(d) provided that the SEC receives assurances of confidentiality regarding the information's use and other prerequisites set forth in the law are met.

Moreover, the SEC has entered into numerous bilateral MOUs with foreign counterparts for purposes of cooperation in enforcement matters, as well as the IOSCO MMOU, which is a multilateral information-sharing arrangement among securities regulators concerning enforcement cooperation. See Annex A for a complete list of these MOUs.

These MOUs specifically contemplate assistance among regulators regarding violations of laws and regulations including those described in Question 13.2(a)-(d).²⁰¹ Further, these MOUs reiterate the principles that a foreign authority should be able to provide assistance regardless of whether the requested authority has an independent interest in the matter, which is consistent with Section 21(a)(2).

13.3

Is the domestic regulator able, according to its domestic laws and regulations, to provide effective and timely assistance to foreign regulators regardless of whether the domestic regulator has an independent interest in the matter?

As discussed in Question 11.6, Section 21(a)(2) of the Exchange Act authorizes the SEC to provide assistance to a foreign securities authority at its discretion, without regard to whether the facts as stated in the foreign securities authority's request constitute a violation under U.S. laws. The SEC has the authority to provide assistance to a foreign securities authority if the requesting authority states that it is conducting an investigation which it deems necessary to determine whether any person has violated or is violating or is about to violate any laws or rules relating to securities matters that the requesting authority enforces or administers. In exercising this authority, Section 21(a)(2) of the Exchange Act directs the SEC to consider (1) whether the requesting authority has agreed to provide reciprocal assistance to the SEC, and (2) whether compliance with the request would prejudice the public interest of the United States.

²⁰¹ See the IOSCO MMOU, Articles 6(a) and 4.

In addition, Section 24(c) of the Exchange Act and Rule 24c-1 thereunder permit the SEC, at its discretion, to share non-public information in its possession with foreign authorities, provided the SEC receives assurances of confidentiality regarding the material's use.

13.4

Is the domestic regulator able to offer effective and timely assistance to foreign regulators in obtaining information on the regulatory processes in its jurisdiction?

As discussed in the response to Question 11.3, Section 24(c) of the Exchange Act and Rule 24c-1 thereunder permit the SEC, at its discretion, to share non-public information with other domestic and foreign governmental authorities, provided the SEC receives assurances of confidentiality regarding the material's use. The response to Question 11.3 also discusses the wide availability of information through publicly available sources in the United States.

With respect to information on regulatory processes in particular, the SEC conducts training and technical assistance programs both in the United States and abroad for foreign securities authorities. These programs -- which are led by experienced SEC staff and can also include academia and industry -- cover a wide variety of regulatory and enforcement issues, including regulatory processes; enforcement investigations including insider trading, market manipulation, pyramid schemes, financial accounting fraud; inspections and compliance of industry participants; and other market development issues. The cornerstone of the SEC's technical assistance program is the International Institute for Securities Market Development, an annual two-week, management level training program covering the development and oversight of securities markets. The 2008 Market Development Institute took place from April 7 to April 17 and was attended by 192 senior securities officials from 77 foreign jurisdictions. In addition, the SEC conducts an annual Institute for Securities Enforcement and Market Oversight. The 2008 program was held from November 3-7, 2008 and was attended by 167 securities regulators from 58 jurisdictions. The SEC also meets with numerous foreign regulators on a one-on-one basis to discuss a variety of regulatory and enforcement related topics. Additionally, the SEC is available to address specific inquiries from foreign counterparts on a variety of questions. In fiscal year 2008, the SEC answered 374 requests from foreign regulators for technical assistance.²⁰²

The SEC also has entered into several MOUs for regulatory cooperation, which facilitate consultation and cooperation on issues of regulatory concern and may include a discussion of regulatory processes. In addition, the SEC has established a number of bilateral dialogues²⁰³ with its foreign counterparts aimed at:

- identifying and discussing regulatory issues of common concern;

²⁰² SEC 2008 Accountability and Performance Report, available at <http://www.sec.gov/about/secpar/secpar2008.pdf>.

²⁰³ See http://www.sec.gov/about/offices/oia/oia_cooparrangements.htm.

- improving cooperation and the exchange of information in cross-border securities enforcement matters; and/or
- continuing and expanding upon the existing program of training and technical assistance provided by the SEC to the foreign regulator.

These dialogues include both regular meetings and ad hoc information exchange at the staff level and between high-level representatives of the SEC and the foreign regulator. To date, the SEC has entered into bilateral dialogues with securities regulators in Korea, China and Japan as well as with the Committee of European Securities Regulators. *See* responses to Questions 12.3 and 12.4. Also *see* Annex A for a list of the SEC's MOUs with foreign counterparts, including MOUs for regulatory cooperation.

13.5

Is the domestic regulator able to offer effective and timely assistance to foreign regulators in requiring or requesting:

a) The production of documents?

b) Taking a person's statement or, where permissible, testimony under oath?

As discussed in the response to Question 11.3, under Section 21(a)(2) of the Exchange Act, the SEC has the authority to provide assistance to a foreign securities authority if the requesting authority states that it is conducting an investigation which it deems necessary to determine whether any person has violated or is violating or is about to violate any laws or rules relating to securities matters that the requesting authority enforces or administers. As part of providing assistance to a foreign securities authority, the SEC may conduct an investigation and use its compulsory powers under Section 21(b) of the Exchange Act as it would in its own investigations. This power includes requiring the production of documents held by regulated entities as well as the ability to use the SEC's subpoena powers to compel the production of documents or testimony from any person or entity anywhere within the United States.

Under Section 21(b) of the Exchange Act, the SEC has the power to compel testimony under oath from anyone within the United States in connection with any investigation or proceeding under the U.S. federal securities laws.

13.6

Is the domestic regulator able to offer effective and timely assistance to foreign regulators in obtaining court orders, if permitted, for example, urgent injunctions?

Where it does not have an independent interest in a matter, the SEC does not currently have the power to use its statutory authority to seek court orders, such as urgent injunctions and asset freezes, on behalf of foreign authorities. However, the SEC does assist in advising a foreign authority on how to initiate a proceeding in civil court or request the assistance of the DOJ.

For example, a final judgment issued by a foreign court may be enforced by a plaintiff (e.g., a foreign authority) in a private civil action against a judgment debtor in the United States. State law applies to such actions. Judgments issued by foreign courts generally are recognized by state law if they are issued by foreign courts of competent jurisdiction that have afforded the defendant appropriate notice, if the judgment was not obtained by fraud, if enforcement would not offend the public policy of the state in which enforcement is sought, and if the judgment complies with U.S. notions of due process of law.

In addition, many states of the United States have either adopted or follow the Uniform Foreign Money Judgments Recognition Act, whereby a foreign judgment is enforceable so long as the foreign court had jurisdiction over the matter, the proceedings were fair and the judgment was not obtained by fraud. "Foreign judgment" is defined under the Act as "Any judgment of a foreign state granting or denying recovery of a sum of money, other than a judgment for taxes, a fine or other penalty, or a judgment for support in matrimonial or family matters."

Alternatively, a plaintiff that seeks a U.S. court judgment may initiate a civil proceeding in U.S. court against a party in interest and proceed on the merits of the matter. To preserve the property at issue, the plaintiff may make a motion for pre-judgment relief as part of the proceeding on the merits. A pre-judgment attachment freezes the asset attached and places it in the custody of a marshal or other official.

Another option for foreign regulators is to pursue assistance in obtaining court orders through a Mutual Legal Assistance Treaty (MLAT) with DOJ. DOJ has the ability to assist foreign regulators or foreign criminal authorities in obtaining court orders to issue search warrants, obtain asset freezes, summon witnesses, and compel the production of documents and other real evidence. The ability of a foreign regulator depends on the specific language of the MLAT between the U.S. and the foreign country and typically the remedies offered are only available to prosecutors and for violations with a criminal nexus.

There are two provisions of the United States Code that may provide other U.S. authorities with the ability to assist a foreign authority in obtaining court ordered asset freezes:

(1) 28 USC Section 2467 (the Enforcement of Foreign Judgment Statute). Section 2467 provides that "A foreign nation seeking to have a forfeiture or confiscation judgment registered and enforced by a district court of the United States ... shall ... submit a request to the Attorney General ...which request shall include - a summary of the facts of the case and a description of the proceedings that resulted in the forfeiture or confiscation judgment; a certified copy of the forfeiture or confiscation judgment; an affidavit or sworn declaration establishing that the foreign nation took steps, in accordance with the principles of due process, to give notice of the proceedings to all persons with an interest in the property in sufficient time to enable such persons to defend against the charges and that the judgment rendered is in force and is not subject to appeal; and such additional information and evidence as may be required by the Attorney General...."

Section 2467 also includes provisions designed to preserve property which may be subject to a foreign forfeiture or confiscation judgment. While there is no requirement

that the foreign offense needs to be a criminal violation, there is a requirement that there be a treaty or other formal agreement in effect between the United States and the foreign State providing for mutual forfeiture assistance.

(2) 18 USC Section 981 (the Civil Forfeiture Statute). Section 981 may be used by DOJ to initiate civil forfeiture proceedings in response to a request for a freeze of assets by a foreign authority, but only where the proceeds in the United States are traceable to the fraud at issue. A civil forfeiture action is an original action by DOJ to forfeit the property at issue and render it the property of the U.S. Government. Civil forfeiture actions under Section 981 for violations of foreign law usually come to DOJ pursuant to a Mutual Legal Assistance Treaty or letter rogatory request, but may also be initiated based upon sufficient evidence provided by a foreign authority informally.

Section 981 includes provisions permitting DOJ to seek an ex parte temporary restraining order (for thirty days, and which may be extended for good cause) based on the fact that the foreign authority has an arrest warrant or charged a suspect an offense that would give rise to forfeiture of property in the United States. To extend the temporary order, DOJ would need to gather evidence and initiate a civil action in federal district court, as described above. Following the filing of the complaint in a civil forfeiture proceeding under Section 981, interested parties are provided notice and the opportunity to file a claim in the civil action. DOJ would need to prove its case by a preponderance of the evidence in order for the court to issue an order forfeiting the property. Once the property is forfeited to the U.S. Government under Section 981, DOJ could return proceeds to the foreign authority through a “Sharing Back” agreement, under which the U.S. Government would be reimbursed for all expenses incurred. To date, the U.S. Government has “shared” over a \$230 million forfeited proceeds of crime with 34 different foreign governments.

13.7

Is the domestic regulator able to provide effective and timely assistance to foreign regulators regarding information about financial conglomerates subject to its supervision and more precisely assistance in relation, for example, to:

- a) The structure of financial conglomerates?*
- b) The capital requirements in conglomerate groups?*
- c) Investments in companies within the same group?*
- d) Intra-group exposures and group-wide exposures?*
- e) Relationships with shareholders?*
- f) Management responsibility and the control of regulated entities?*

See response to Question 11.3 for a description of the SEC's legal authority to share non-public information with a foreign authority under Section 24(c) of the Exchange Act and to conduct an investigation on behalf of a foreign authority under Section 21(a)(2) of the Exchange, including use of compulsory powers. The types of information the SEC possesses, can obtain and share with a foreign authority could include the information described in Question 13.7(a)-(f) provided that the SEC receives assurances of confidentiality regarding the information's use and other prerequisites set forth in the law are met.

Moreover, since 2006, the SEC has begun entering into MOUs for regulatory cooperation. These MOUs establish clear mechanisms for consultation, cooperation and the exchange of supervisory information. These mechanisms eliminate the need to address supervisory information-sharing issues on an *ad hoc* basis and address new information-sharing needs created by global financial conglomerates and cross-border affiliated markets.

The SEC's MOUs for regulatory cooperation can vary in scope and purpose and, to date, the SEC has entered into MOUs that cover information sharing and cooperation related to:

- affiliates within a financial group subject to consolidated supervision by the SEC and/or a foreign authority;
- firms registered with both the SEC and a foreign authority;
- the oversight of markets in the U.S. and a foreign jurisdiction affiliated through a common ownership structure; and/or
- the sharing of non-public issuer-specific information relating to the application of IFRS by dually-listed companies.

See Annex A for a list of the SEC's MOUs, including MOUs for regulatory cooperation.

ISSUERS

Principles 14-16

Issuers – Principle 14

There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions.

Assessment

Fully Implemented.

14.1

Does the regulatory framework have clear, reasonably timely, comprehensive and specific disclosure requirements that apply to:

- a) *Public offerings, including the conditions applicable to an offering of securities or public sale, the content and distribution of prospectuses and other offering documents (and, where relevant, short form profile or introductory documents) and supplementary documents prepared in the offering?*

General Conditions Applicable to an Offering of Securities

The U.S. federal securities regulatory system is based on the principle of full and fair disclosure to investors. Under the Securities Act, every offer or sale of a security must be registered with the SEC unless an exemption is available.²⁰⁴ The registration statement used to register an offering includes a prospectus containing material information about the issuer and the offering which is delivered or made available to investors.

Exemptions are available to permit issuers to sell securities on a limited, non-public basis without Securities Act registration. The Securities Act provides exemptions from registration for specific types of securities or transactions. Examples of Securities Act exemptions relating to types of securities are: offerings of any security issued or guaranteed by a bank (but not bank holding company); offerings of short-term commercial paper; and offerings in connection with court-overseen bankruptcies.

The principal Securities Act exemptions for transactions are:

- Section 4(1) – transactions by persons other than issuers, underwriters or dealers. It is this exemption under which ordinary secondary market transactions are effected, because

²⁰⁴ Securities Act §§ 3-5.

most investors do not fall within the specified categories of “underwriters” or “dealers”;²⁰⁵

- Section 4(2) – transactions by an issuer not involving a public offering. This is the “private placement” exemption under which issuers may sell securities in limited, non-public offerings without registration under the Securities Act. The securities that are sold under this exemption may not generally be freely resold until at least six months (or sometimes one year) after the initial sale. This restriction is intended to ensure that an unregistered private placement does not result in a public offering of securities which should have been registered under the Securities Act;
- Section 4(3)(A) – transactions by a dealer taking place after forty days from the date that a security was first offered to the public by an issuer or an underwriter. This exemption is similar to Section 4(1) but is applicable to dealers in securities. It effectively establishes a forty-day period for unregistered offerings of securities during which dealers may not effect transactions in the subject securities; and
- Regulation S²⁰⁶ – provides a safe harbor from registration under the Securities Act for offers and sales of securities occurring outside the U.S. The safe harbor outlines various procedures for different types of securities from different types of issuers, depending in part on the likelihood of “flow-back” of the offered securities into the U.S.

In general, there are no exemptions available for public offerings in the U.S. of securities issued by domestic or foreign issuers. Issuers offering and selling any security (equity, debt, warrants, or other type) in a public offering, whether in an IPO or subsequent offering, must register the offering with the SEC under the Securities Act.²⁰⁷

The remainder of this section discusses the disclosure requirements applicable to public offerings of securities registered with the SEC under the Securities Act.

Content and Distribution of Prospectuses

To register securities under the Securities Act, an issuer must file a registration statement with the SEC. The registration statement includes a prospectus that contains a description of the issuer and its business, information about the issuer’s directors and senior management, executive compensation, audited financial statements, and management’s discussion and analysis (MD&A) of the issuer’s financial condition and results of operations, presenting a view of the

²⁰⁵ Persons who are deemed to control an issuer (such as directors, executive officers, and large security holders) are generally restricted in their ability to freely resell their securities holdings.

²⁰⁶ 17 C.F.R. §§ 230.901 – 230.905.

²⁰⁷ For certain purposes, persons and entities in a control relationship with the issuer (often referred to as “affiliates”) are treated in the same manner as the issuer. This treatment is intended to deter issuers from effecting an unregistered public offering of securities through their affiliates.

issuer through the eyes of management and explaining material trends and commitments. MD&A addresses liquidity and capital resources issues as well as events and uncertainties known to the issuer's management that may cause the reported results not to be indicative of future financial performance. A registration statement also includes certain other information that is not required to be included in a prospectus, as well as exhibits. Registration statements, including any amendments, are publicly available through the EDGAR system as soon as they are filed with the SEC, as discussed in this section, below.

In addition to the specific line item disclosure requirements described below, the prospectus and registration statement must include "such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading."²⁰⁸ To help assure that issuers disclose all material information to investors in connection with a registered public offering of securities, the federal securities laws provide for the liability of certain parties to the extent a prospectus or registration statement "includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading."²⁰⁹

In general, a prospectus includes disclosure of the following items:

- information with respect to the issuer, including:
 - a description of the business;
 - material legal proceedings;
 - a description of property, including reserve disclosure to the extent applicable;
 - identification of directors and executive officers;
 - financial statements meeting the requirements of Regulation S-X;²¹⁰
 - supplementary financial information;
 - selected financial data (five years of sales, income, dividends and other data);

²⁰⁸ Rule 408 of Regulation C.

²⁰⁹ Section 12(a)(2) of the Securities Act *cf.* Section 11(a).

²¹⁰ Regulation S-X contains, among other things, the form and content requirements for financial statements included in filings made with the SEC. It also includes many provisions on matters in addition to compliance with U.S. GAAP, for example, requirements for auditor qualifications and reports. *See* 17 C.F.R. §§ 210.1-01 – 210.12-29.

- management’s discussion and analysis of financial condition and results of operations;
 - quantitative and qualitative disclosures about market risk;
 - changes in and disagreements with accountants on accounting and financial disclosure;
 - executive compensation and corporate governance;
 - security ownership of certain beneficial owners and management; and
 - transactions with related persons, promoters, and certain control persons.
- a description of the securities to be registered;
 - risk factors relating to the issuer and the offering;
 - dilution;
 - use of proceeds;
 - a plan of distribution;
 - the manner of determining the offering price; and
 - the interests of named experts and counsel.

A registration statement also will include certain information that is not required to be contained in a prospectus, such as detailed expenses of the offering and information about the issuer’s indemnification policies and disclosure regarding recent sales of unregistered securities. An issuer must also file as exhibits to a registration statement various documents such as the underwriting agreement, the issuer’s certificate of incorporation and bylaws, legal opinions, material contracts, and indentures or other agreements detailing the rights of holders of the securities being registered. A registration statement must be signed by the issuer’s principal executive, financial, and accounting officers, and by at least a majority of the board of directors.

With respect to the distribution of prospectuses, the Securities Act requires delivery of a prospectus meeting specified requirements under the Securities Act, known as a “final prospectus,” to each investor in a registered offering. The SEC has noted that an investor’s purchase commitment generally occurs before the final prospectus is required to be delivered under the Securities Act. In 2005, the SEC adopted revisions to the prospectus delivery requirements.²¹¹ The new rules are intended to facilitate effective access to information, while

²¹¹ SEC Release 33-8591 (July 19, 2005).

taking into account advancements in technology and the practicalities of the offering process. The new rules are based on an “access equals delivery” model, under which investors are presumed to have access to the Internet, and issuers and intermediaries can satisfy their delivery requirements if the documents are posted to a website. These new rules have been well accepted by market participants, streamlining the offering process while maintaining essential investor protections.

Pursuant to Rule 460 of the Securities Act, the persons making the offering should take reasonable steps to make the information contained in the registration statement conveniently available to underwriters and dealers who are reasonably anticipated to participate in the distribution of the security to be offered or sold. At a minimum, reasonable steps involve the distribution of as many copies of the proposed form of preliminary prospectus as would appear to be reasonable to secure adequate distribution to each underwriter and dealer, a reasonable time in advance of the anticipated effective date of the registration statement. In practice, the lead representative of the underwriters often will inform the Staff in writing of the number of preliminary prospectuses distributed to investors.

Availability of Information – The EDGAR System

The SEC’s website provides public access to the EDGAR system. EDGAR provides investors free electronic access to the information that companies registered with the SEC file in disclosure documents. The EDGAR system performs automated collection, validation, indexing, acceptance, and forwarding of submissions by issuers and others who are required by law to file forms with the SEC. Its primary purpose is to increase the efficiency and fairness of the securities market for the benefit of investors and corporations by accelerating the receipt, acceptance, dissemination, and analysis of time-sensitive corporate information filed with the agency.

Interactive Disclosure through XBRL

In 2009, the SEC adopted rules to phase-in mandated interactive disclosure using XBRL technology, effective April 13, 2009.²¹² The SEC’s rules establish guidelines for the content and format of XBRL information including which data may be provided in XBRL and the relationship of the XBRL data to the original official filing. Such disclosure will be required to accompany the issuer’s official filing on the EDGAR system, and also be posted on the issuer’s website. Interactive data can be downloaded directly into spreadsheets, analyzed in various ways using commercial off-the-shelf software and used within investment models through other software formats.

Certain large domestic and foreign large accelerated filers that use generally accepted accounting principles as used in the U.S, U.S. GAAP, and have a worldwide public common equity float above \$5 billion as of the end of the second fiscal quarter of their most recently completed fiscal year will be required to supply financial statements and any applicable financial statement

²¹² SEC Release 33-9002 (January 30, 2009).

schedules in interactive data format beginning with disclosure documents that contain revised or updated financial statements for a fiscal period ending on or after June 15, 2009. All other domestic and foreign large accelerated filers²¹³ using U.S. GAAP will be required to follow the same interactive data reporting requirements for financial statements relating to a fiscal period ending on or after June 15, 2010, and all remaining U.S. GAAP filers for financial statements relating to a fiscal period ending on or after June 15, 2011.

Incorporation by Reference

Disclosure under the federal securities laws operates under an “Integrated Disclosure System,” which is based on the premise that certain information need not be repeated in a prospectus if the information has previously been disclosed in an annual, quarterly, or current report filed under the Exchange Act.

Because of the statutory framework in the U.S., under which the Securities Act focuses on prospectus disclosure in connection with offerings and the Exchange Act focuses on ongoing disclosure, at one time an issuer’s disclosure filings under each Act were considered separate and distinct. “Integrated Disclosure” recognizes that the disclosure regime under the two standards should operate together to provide investors with access to information whether they are purchasing securities from the issuer in an offering registered under the Securities Act or in an ordinary secondary market transaction on a stock exchange.

The SEC’s rules under the Securities Act allow for different manners of presenting information in the prospectus, depending on the characteristics of the issuer and the offering transaction. In most IPOs, all information must be directly presented in the prospectus. For other types of transactions, an issuer may be permitted to use “incorporation by reference,” under which a prospectus refers to past or future reports that are filed under the Exchange Act. By using incorporation by reference, an issuer is able to avoid repeating disclosure in a prospectus if that disclosure has already been included in an Exchange Act report. Incorporation by reference, which has been allowed for over thirty years, reduces burdens on issuers by allowing them to prepare streamlined prospectuses and provides parallel information to investors in both the primary and secondary markets.

Incorporation by reference does not change the liabilities associated with a registration statement or prospectus. The SEC has stated that “information presented in the registration statement, whether or not incorporated by reference, must be true and complete in all material respects and verified where appropriate. Likewise, nothing in the SEC’s integrated disclosure system precludes conducting adequate due diligence.”²¹⁴

²¹³ A large accelerated filer is an issuer that has a worldwide market value of at least \$700 million for its common equity held by non-affiliates, has been subject to reporting requirements for at least 12 months, and has filed at least one annual report. See Rule 12b-2 under the Exchange Act.

²¹⁴ SEC Release 33-6335 (August 6, 1981), 46 FR 42015, at 42020.

Staff Review of Prospectuses

The Securities Act does not specifically call for the Staff to review or clear prospectuses in connection with public offerings of securities. However, the Staff has assumed a review function for registration statements and prospectuses under the Securities Act as a result of the statutory framework under the Securities Act:

- Under Section 5 of the Securities Act, a registration statement must be “in effect” for securities to be sold under that registration statement.
- Under Section 8 of the Securities Act, while a registration statement becomes “effective” automatically twenty days after filing, the SEC has the authority to accelerate the effective date (the SEC has delegated this authority to the Staff).
- Also under Section 8 of the Securities Act, the SEC has the power to issue a “stop order” to suspend the effectiveness of a registration if it appears that a registration statement includes an untrue statement of material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading.

As a result, it is a long-standing practice for issuers to request the Staff to accelerate effectiveness of registration statements under the Securities Act. This practice reduces the possibility that the SEC would take action to stop an offering once it had started. It also allows issuers and underwriters to sell securities shortly after pricing, thus avoiding the significant market risk that would exist if the issuer and the underwriters had to wait twenty days after pricing for automatic effectiveness. The Staff will accelerate effectiveness when it has had the opportunity to consider, among other things, the adequacy of the disclosures in the registration statement, the public interest and the protection of investors.

The Staff’s review and the acceleration of effectiveness do not constitute an assessment by the SEC of the adequacy or accuracy of the information contained in the registration statement. *See* the response to Question 14.6 below for a more detailed description of the review process undertaken by the Staff of issuer disclosure documents.

Shelf Registration of Securities

The SEC has implemented a securities registration process under the Securities Act under which issuers may register securities up to three years in advance of publicly offering those securities. These sales may occur all at once, in several transactions over a period of time, or on a continual basis. This process, known as “shelf registration,” allows issuers to offer and sell securities in registered offerings without the delay that would be involved with filing a new registration statement for each offering. Once a shelf registration statement has become effective under the Securities Act, issuers may “take securities off the shelf” by means of filing a prospectus with the SEC, with no action required by the SEC to permit the offering to go forward.

Over time, the SEC has expanded the shelf registration process to provide issuers with additional flexibility. Under the current process, issuers can register a dollar amount of securities without

allocating how much would be sold of any particular type of security (common equity, preferred equity, senior or subordinated debt, warrants, or other). Generally, prospectuses under shelf registration statements are updated through incorporation by reference to subsequently filed annual reports.

In practice, under shelf registration, an issuer would file a “short-form” registration statement and prospectus that incorporate by reference virtually all information about the issuer from its Exchange Act reports and that include a generic description of the various types of securities that may be offered. After any review by the Staff, this registration statement is made effective by the SEC. The information in the registration statement and prospectus is deemed automatically updated with each filing of an annual report on Form 10-K, a quarterly report on Form 10-Q, or a Current Report on Form 8-K regarding certain enumerated events. From time to time, the issuer and one or more underwriters may identify windows of opportunity to sell securities “off the shelf.” The issuer and the underwriters prepare a short supplement to the prospectus that describes the pricing terms of the offering and the specific description of securities. The shelf registration process has been in place for nearly 30 years and provides issuers with great flexibility in raising capital. From time to time, the SEC has revised its rules to modify the availability of the shelf registration process.

Exchange Requirements

Issuers whose securities are listed on a U.S. stock exchange also are subject to the listing rules of that exchange. As described in response to Question 14.2(a) below, those rules generally provide that a listed issuer is expected to release “quickly” to the public any news or information that might reasonably be expected to materially affect the market for its securities. Under these rules, a listed issuer is also expected to act promptly to dispel rumors that result in unusual market activity or price variations. These disclosure obligations under exchange listing rules are separate from the SEC’s reporting requirements under the Exchange Act.

The listing requirements also require issuers to meet corporate governance requirements. For example, the NYSE, the NASDAQ, and the American Stock Exchange all require listed issuers to have, among other things, a majority of independent directors and independent audit, nominating, and compensation committees, or directors performing similar functions.

14.1

b) Annual reports?

Issuers are subject to the periodic reporting requirements of the Exchange Act under the following circumstances:

Listed Issuers: Before an issuer may list a class of securities (equity, debt, or other) on a national securities exchange, such as the NYSE or NASDAQ, it must register those securities under Section 12(b) of the Exchange Act. Registration generally takes place concurrently with an issuer’s IPO registered under the Securities Act. In this situation, registration under the Exchange Act is effected through a short-form registration statement, because an issuer would have prepared a prospectus for its IPO. Companies with a class of securities registered under

Section 12(b) are subject to the reporting requirements under Section 13(a) of the Exchange Act, which requires the filing of such information and documents as the SEC requires to keep reasonably current the information contained in the issuer's registration statement.

Non-Listed Companies: A U.S. issuer which, on the last day of its fiscal year, has more than \$10 million in total assets and a class of equity securities held by 500 or more record holders, must register that class of securities under Section 12(g) of the Exchange Act. These issuers are generally smaller issuers whose securities trade in the over-the-counter market. Registration of the class of securities is required even though the issuer is not raising capital. In this situation, the registration statement filed with the SEC must contain substantially all of the information contained in a prospectus and registration statement under the Securities Act other than offering-specific information.

Voluntary Filers: Additionally, an issuer may voluntarily register its securities under Section 12(g) of the Exchange Act. Once a company registers under Section 12(g), even if registration is voluntary, the Exchange Act requires it to file periodic reports. However, an issuer may not voluntarily file periodic reports under the Exchange Act without registering its securities.

Issuers with Recent Offerings: For previously non-reporting issuers, a reporting obligation arises under Section 15(d) of the Exchange Act upon the effectiveness of a Securities Act registration statement. Pursuant to Section 15(d), such issuers must comply with the reporting requirements of Section 13(a), in the same way as listed companies.

Section 13(a) of the Exchange Act requires issuers to file an annual report each year that contains extensive and comprehensive information about an issuer.²¹⁵ Generally, the annual report requires disclosure in all of the same areas, and addressing the same topics, as is required in a prospectus for an IPO under the Securities Act. The annual report must be signed by the issuer's principal executive, financial and accounting officers, and at least a majority of the board of directors. The annual report is required to disclose:

- Information about the company's business;²¹⁶
- Risk factors;²¹⁷

²¹⁵ The reports are filed within sixty days of fiscal year-end with respect to large accelerated filers, within seventy-five days of fiscal year-end with respect to accelerated filers, and within ninety days of fiscal year-end with respect to all other U.S. filers. Foreign private issuers file their annual reports within four months of fiscal year-end, beginning with fiscal years after December 15, 2011.

²¹⁶ The section on business includes the issuer's current and planned business operations, principal products and services, principal markets and distribution methods, source and availability of raw materials, dependence on customers and inventory practices. The section also requires the issuer to disclose whether it makes its SEC filings available for free on its corporate website or, if not, why.

²¹⁷ The issuer needs to present in a concise and logically organized manner the most significant factors that affect its business.

- Unresolved material comments from Staff filing reviews;
- Information about the company's properties;²¹⁸
- Legal proceedings;
- Any matters submitted to a vote of security holders;
- A description of the market for the issuer's equity, any related stockholder matters, and any of the issuer's purchases of equity securities;
- Selected financial data (five years of sales, income, dividends and other data);
- Management's discussion and analysis of financial condition and results of operation (MD&A);
- Quantitative and qualitative disclosures about market risk;
- Financial statements (audited consolidated financial statements) and supplementary data;²¹⁹
- Changes in and disagreements with accountants on accounting and financial disclosure;
- Information regarding the effectiveness of the issuer's disclosure controls and procedures;
- A management assessment and auditor report on whether the issuer's internal control over financial reporting is effective, and if not, the material weaknesses in such controls;²²⁰
- Current reporting information for the fourth quarter not previously disclosed in a Form 8-K report;
- Information about the company's directors, executive officers,²²¹ and corporate governance;²²²

²¹⁸ This disclosure also includes oil and gas reserve disclosures, if applicable.

²¹⁹ Depending on the business of the issuer, Item 802 of Regulation S-K requires certain industry-specific information for issuers, such as bank holding companies, interests in real estate limited partnerships, insurance companies and other specialized industries.

²²⁰ This disclosure also includes disclosure of any material changes in internal control over financial reporting during the issuer's last fiscal quarter.

- Executive officer and director compensation information, including a compensation discussion and analysis and a compensation committee report;
- Security ownership of certain beneficial owners and management;
- Certain relationships, related transactions, and director independence;
- Principal accountant fees and services, including the audit committee’s pre-approval policies for auditor services; and
- Exhibits²²³ and financial statement schedules, including certifications by the issuer’s principal executive and financial officer.

The financial statements required include three years of statements of income, cash flow, and changes in shareholders’ equity, two years of balance sheets, and a discussion of subsequent events.²²⁴ The issuer must present the information on a consolidated basis and provide comprehensive footnote disclosure. The financial statements must be audited by an independent public accountant registered with the PCAOB. Please *see* responses to Question 16 for more detail relating to financial statement and auditor qualification requirements.

Although MD&A is not a part of the financial statements, it must accompany financial statements. The MD&A presents a view of the issuer through the eyes of management and explains material trends and commitments. As required by Regulation S-K, MD&A addresses liquidity and capital resources issues as well as events and uncertainties known to the issuer’s management that may cause the reported results not to be indicative of future financial performance.²²⁵ This disclosure also includes off-balance sheet disclosures and contractual obligations.

²²¹ Required disclosure requires a description of the business experience and background of management, their compensation, stock ownership information and any of their transactions with related parties.

²²² The corporate governance disclosures include identification of the issuer’s audit committee and whether the issuer has an audit committee financial expert and code of ethics and, if not, why.

²²³ Principal exhibits include material contracts, charter documents and by-laws, instruments defining the rights of security holders, and code of ethics from Item 601 of Regulation S-K.

²²⁴ Regulation S-X may require additional financial statements in certain instances, such as financial statements of acquired businesses and real estate operations, financial statements of subsidiaries not consolidated and 50% or less owned persons; and financial statements of guarantors. In addition, in the event of certain transactions, such as a merger or an acquisition, the issuer must provide pro forma financial information about the effect of the transaction by showing how it might have affected historical financial statements if the transaction had been consummated at an earlier time.

²²⁵ 17 C.F.R. § 229.303.

14.1

c) *Other periodic reports?*

The SEC has a framework for periodic reporting that is clear, reasonably timed, comprehensive and specific. Issuers must file quarterly reports on Form 10-Q, along with current reports on Form 8-K upon the occurrence of certain enumerated events. In addition, should an issuer decide to selectively disclose information to certain individuals, it must also disseminate the same information through a means designed to distribute the information to the public on a non-exclusionary basis.

Quarterly Reports

Pursuant to Section 13(a) of the Exchange Act, issuers that are subject to the periodic reporting requirements under the Exchange Act must also file quarterly reports for the first three fiscal quarters on Form 10-Q.²²⁶ Issuers must describe their financial condition and results of operations for the preceding fiscal quarter and the corresponding period from the prior fiscal year and also include condensed financial statements. Foreign private issuers²²⁷ are not subject to quarterly reporting requirements.

The financial statements in quarterly reports include balance sheets as of the close of the quarter and the comparable quarter of the preceding year, comparative statements of operations for the quarter and for the beginning of the year through quarter-end and comparative statements of cash flow from the beginning of the year through quarter-end. These financial statements are not required to be audited; however, they are required to be reviewed by an independent public accountant pursuant to Rule 10-01(d) of Regulation S-X. If, in any filing, the company states that interim financial statements have been reviewed by an independent public accountant, a report of the reviewing accountant must be filed with the interim financial statements. However, usually quarterly reports do not mention a review, so review reports usually are not included.

Financial statements in quarterly reports also are required to be accompanied by MD&A which, as described above, presents a view of the issuer through the eyes of management to explain material trends and commitments, and addresses liquidity and capital resources of the issuer, as well as events and uncertainties known to the issuer's management that may cause the reported results not to be indicative of future financial performance. The quarterly financial statement requirements and MD&A are intended to provide interim updates of the financial statement and related information included in an issuer's annual report.

Other significant information required to be disclosed in quarterly reports includes:

- Quantitative and qualitative disclosures about market risk;

²²⁶ The reports are generally required to be filed within forty days of quarter-end. *See* response to Question 14.4(a).

²²⁷ Defined below in response to Question 14.10.

- Controls and procedures disclosures;
- Legal proceedings;
- Any material changes from risk factors as previously disclosed;
- Risk factors;
- Unregistered sales of equity securities and use of proceeds;
- Defaults on senior securities;
- Current reporting information for the quarter not previously disclosed in a Form 8-K report;
- Changes in director nomination procedures;
- The submission of matters to a vote of security holders; and
- Exhibits required by Item 601 of Regulation S-K.

The requirements for quarterly reports with respect to non-financial statement and related information are not as comprehensive and do not require updating of all information required in the annual report. For example, an issuer is not required to completely update its business description, disclosure relating to directors and executive officers, or disclosure relating to the security ownership of certain beneficial owners and management. Some of these matters may be required to be disclosed in a Current Report on Form 8-K.

Current Reports

Domestic issuers subject to the periodic reporting requirements under the Exchange Act must also must file Current Reports on Form 8-K upon the occurrence of enumerated events. In 2004, the SEC expanded the number of events that are reportable on Form 8-K, consistent with the “real-time issuer disclosure” mandate in Section 409 of the Sarbanes-Oxley Act. This section requires issuers to disclose “on a rapid and current basis” material information regarding changes in an issuer’s financial condition or operations as the SEC by rule determines to be necessary or useful. The primary subject headings under Form 8-K are:

- Section 1 – Registrant’s Business and Operations
 - Item 1.01 – Entry into a Material Definitive Agreement
 - Item 1.02 – Termination of a Material Definitive Agreement
 - Item 1.03 – Bankruptcy or Receivership
- Section 2 – Financial Information
 - Item 2.01 – Completion of Acquisition or Disposition of Assets

- Item 2.02 – Results of Operations and Financial Condition
- Item 2.03 – Creation of a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement of a Registrant
- Item 2.04 – Triggering Events that Accelerate or Increase a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement
- Item 2.05 – Costs Associated with Exit or Disposal Activities
- Item 2.06 – Material Impairments
- Section 3 – Securities and Trading Markets
 - Item 3.01 – Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing
 - Item 3.02 – Unregistered Sales of Equity Securities
 - Item 3.03 – Material Modifications to Rights of Security Holders
- Section 4 – Matters Related to Accountants and Financial Statements
 - Item 4.01 – Changes in Registrant’s Certifying Accountant
 - Item 4.02 – Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review
- Section 5 – Corporate Governance and Management
 - Item 5.01 – Changes in Control of Registrant
 - Item 5.02 – Departure of Directors or Principal Officers; Election of Directors; Appointment of Principal Officers; Compensatory Arrangements of Certain Officers
 - Item 5.03 – Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year
 - Item 5.04 – Temporary Suspension of Trading under Registrant’s Employee Benefit Plans
 - Item 5.05 – Amendments to the Registrant’s Code of Ethics, or Waiver of a Provision of the Code of Ethics
 - Item 5.06 – Change in Shell Company Status
- Section 6 – Asset Backed Securities
 - Item 6.01 – ABS Informational and Computational Material
 - Item 6.02 – Change of Servicer or Trustee
 - Item 6.03 – Change in Credit Enhancement or Other External Support
 - Item 6.04 – Failure to Make a Required Distribution
 - Item 6.05 – Securities Act Updating Disclosure
- Section 7 – Regulation FD
 - Item 7.01 – Regulation FD Disclosure
- Section 8 – Other Events
 - Item 8.01 – Other Events

Typically, a Form 8-K report providing appropriate disclosure is required to be filed within four days of the subject event.

Selective Disclosure – Regulation FD

As part of the current reporting requirements, reporting issuers are subject to Regulation FD, which addresses the selective disclosure of information by reporting issuers. This regulation is designed to promote full and fair disclosure among all classes of investors in reporting issuers. It requires a reporting issuer to make simultaneous or prompt public disclosure, depending on whether the disclosure was intentional, when it discloses material nonpublic information to certain individuals or entities (generally, securities market professionals, such as stock analysts or holders of the issuer’s securities who may trade on the basis of the information). Regulation FD defines “Public Disclosure” as furnishing or filing a Form 8-K, or disseminating the information through another method that is reasonably designed to provide broad, non-exclusionary distribution of information to the public.²²⁸

14.1

d) Shareholder voting decisions?

Any solicitation of a proxy with respect to an equity security registered under Section 12 of the Exchange Act must comply with the proxy rules under Regulation 14A under the Exchange Act. Generally, these rules require that a proxy statement contain specific disclosures, including material information about the matters that will be voted on, and that the proxy statement be delivered to shareholders that are being asked to vote on those matters. When the proxy statement relates to an annual meeting of an issuer at which directors are to be elected, the proxy rules are designed to provide shareholders with sufficient information about directors, corporate governance, executive compensation, and the independent auditors, as well as certain proposals by security holders.

When the proxy statement relates to a merger or acquisition, the proxy rules provide that certain material information about the terms of the transaction be disclosed to shareholders. When the merger or acquisition involves the issuance of shares or other securities by the acquiring company to shareholders of the public target company, the transaction is generally deemed to be a public offering of securities by the acquiror, which is required to be registered under the Securities Act. In this case, the proxy statement for the vote by shareholders of the target company is also a prospectus of the acquiring company, and the document is required to contain extensive financial and non-financial disclosure about the acquiring company, the target company, and the transaction, including pro-forma financial statements. If the merger or acquisition involves solely cash consideration payable by the acquiring company to target shareholders, more limited information is required.

²²⁸ 17 C.F.R. § 243.101.

In general, a proxy statement filed on Schedule 14A requires disclosure regarding the following items, where applicable:

- date, time and place of the meeting;
- revocability of the proxy;
- dissenters' right of appraisal;
- persons making the solicitation;
- interest of certain persons in matters to be acted upon;
- voting securities and principal holders thereof;
- directors and executive officers;
- compensation of directors and executive officers;
- independent public accountants;
- compensation plans;
- authorization or issuance of securities otherwise than for exchange;
- modification or exchange of securities;
- financial and other information;
- mergers, consolidations, acquisitions and similar matters;
- acquisition or disposition of property;
- restatement of accounts;
- action with respect to reports;
- matters not required to be submitted;²²⁹
- amendment of charter, bylaws or other documents;

²²⁹ If action is to be taken with respect to any matter not required to be submitted to a vote of security holders, for reasons of state corporate law or otherwise.

- other proposed action;²³⁰
- voting procedures; and
- delivery of documents to security holders sharing an address.

In 2006, the SEC substantially revised the disclosure requirements for executive compensation and several other related matters, which for most U.S. companies is included in the proxy statement for the annual shareholders' meeting and incorporated by reference into the annual report of the company.²³¹ With respect to disclosure of executive and director compensation, such revisions refined the required tabular disclosure and combined it with improved narrative disclosure, a "Compensation Discussion & Analysis", in order to obtain more clear and complete disclosure relating to the compensation for the principal executive officer, the principal financial officer, the three other highest paid executive officers, and the directors. Additionally, the Compensation Discussion and Analysis elicits disclosure relating to the objectives and implementation of executive compensation programs, focusing on the most important factors underlying each company's compensation policies and decisions.

With respect to the other areas addressed by the SEC in 2006 (*i.e.*, related person transactions, director independence and other corporate governance matters), the disclosure requirements were revised to require a company to address:

- its policies and procedures for the review, approval, or ratification of related person transactions;
- whether each director and director nominee is independent;
- any transactions, relationships, or arrangements not disclosed as a related person transaction that were considered by the board of directors when determining if applicable independence standards were satisfied;
- any audit, nominating, and compensation committee members who are not independent; and
- the compensation committee's processes and procedures for the consideration of executive and director compensation.

²³⁰ If action is to be taken on any matter not specifically referred to in Schedule 14A.

²³¹ SEC Release 33-8732A (August 29, 2006).

14.2

Does the regulatory framework have sufficiently clear, comprehensive and specific requirements that apply to:

a) Timely disclosure of events that are material to the price or value of listed securities?

As noted above, Forms 10-Q and 8-K require issuers to disclose on a regular and current basis material financial and non-financial information. All of this information is available on-line to investors immediately upon filing through the EDGAR system and, as also noted above, may be in XBRL format.

In addition, each registered securities exchange generally requires its listed companies to:

- timely disclose information that may affect security values or influence investment decisions; and
- timely provide the exchange with other information in order to maintain an orderly market in the company's securities.

As an example from the largest securities exchange, Section 202.05 of the Listed Company Manual for the NYSE states that a listed company is expected to release quickly to the public any news or information that might reasonably be expected to materially affect the market for its securities. Additionally, it states that a listed company should also act promptly to dispel unfounded rumors that result in unusual market activity or price valuations.

As described in the response to Question 7, all rules and rule amendments of a registered securities exchange are subject to the regulatory oversight of the SEC and must be submitted to the SEC for review pursuant to Exchange Act Section 19(b). Additionally, the exchanges' enforcement of their own rules is subject to the SEC's oversight and inspection. These exchange rules therefore supplement the SEC's rules and are a key part of the regulatory framework of issuer disclosure in the U.S.

14.2

b) Listing of securities?

Pursuant to Section 12(a) of the Exchange Act, securities listed on a U.S. national securities exchange must be registered under Section 12(b) of the Exchange Act. Companies with a class of securities registered under Section 12(b) are subject to the reporting requirements under Section 13(a) of the Exchange Act. That section requires the filing of specified information and documents, as the SEC requires, to keep the information contained in the issuer's registration statement reasonably current.

All of the registered securities exchanges have quantitative and qualitative listing standards, which are set out in their rules and posted on their websites. As an example from the largest

securities exchange, pursuant to Section 102.00 of the NYSE Listed Company Manual, an issuer is required to meet certain criteria before obtaining a listing on the NYSE. First, it must have at least 400 U.S. holders and at least 1,100,000 public shares outstanding, with a market value of such public shares being greater than \$60 million in the case of an IPO, spin-off, or carve out, and \$100 million for all other transactions. Second, an issuer also must satisfy any one of several alternative financial assessments based on various combinations of valuation, earnings, cash flow, revenue, assets, or capitalization of an affiliated company.

The NYSE explicitly notes that, pursuant to its rules, it has broad discretion with respect to listings and may either deny a listing or apply additional or more stringent criteria based on any event, condition, or circumstance that the NYSE deems to make the listing inadvisable or unwarranted. NYSE rules permit such determination to be made even if the company meets the standards set forth above.

For example, Section 804.00 of the listed company manual for the NYSE sets forth the procedures to be followed for delisting a security. If the NYSE staff determines that a security should be delisted, it sends written notification to the issuer, describing the basis for such decision, and the specific policy or criterion under which it proposes to delist the security. Additionally, the notice will advise the issuer of the issuer's right to a review of the determination to delist. If the issuer does not request such a review, or is unsuccessful upon the outcome of such review, the NYSE will suspend trading in the security and file a Form 25 with the SEC to strike the listing. The NYSE will then supply a copy of the filed Form 25 to the issuer in accordance with Section 12 of the Exchange Act. Prior to filing the Form 25 with the SEC, the NYSE will give public notice of its final determination by both issuing a press release and posting a notice on the NYSE's website, which will remain posted until the delisting is effective under Section 12 of the Exchange Act.

The NYSE's Enforcement Division investigates and prosecutes potential violations of NYSE rules as well as any other applicable federal laws or regulations. Action is pursued through an independent division of the NYSE – its Office of Hearing Board. An appeal of the decision of the Hearing Board may be made to the NYSE Regulation Board of Directors, and thereafter to the SEC and the U.S. federal court system. Enforcement issues that are entirely outside of the NYSE's jurisdiction may be referred directly to the SEC or other agencies.

OTCBB

The OTCBB is an electronic quotation system that displays real-time quotes, last-sale prices, and volume information for many OTC securities that are not listed on a national securities exchange. Brokers who subscribe to the system can use the OTCBB to look up prices or enter quotes for OTC securities. FINRA oversees the OTCBB.

Except in limited circumstances, the OTCBB requires that securities quoted on it also be registered under the Exchange Act and file reports under Section 13 or 15(d) of the Exchange Act. In order to meet this requirement, some companies voluntarily register a class of equity securities under Section 12(g). Section 13(a) states that any company that has a class of securities registered under Section 12 must file such information as the SEC requires, including

periodic and current reports, to keep reasonably current the information contained in the issuer's registration statement.

14.2

c) Advertising of public offerings outside of the prospectus?

In 2005, the SEC adopted a series of new rules and rule amendments that has resulted in issuers and other offering participants having the ability to communicate more openly and freely with investors and the marketplace.²³² Under this wide-ranging initiative:

- the largest publicly traded companies (*e.g.*, those with a public float in excess of \$700 million, among other criteria) are permitted to engage at any time in oral and written offering communications, subject to enumerated conditions (including, in specified cases, filing the communications with the SEC);
- all reporting issuers are permitted, at any time, to continue to publish regularly released factual business information and forward-looking information;
- non-reporting issuers are permitted, at any time, to continue to publish regularly released factual business information that is intended for use by persons other than in their capacity as investors or potential investors;
- communications by issuers more than thirty days before filing a registration statement are not prohibited offers so long as they do not reference a securities offering that is or will be the subject of a registration statement;
- all issuers and offering participants are permitted to use “free writing prospectuses” (written offering materials that do not contain or incorporate by reference all of the information required in a prospectus, as described in response to Question 14.1(a) after the filing of the registration statement, subject to enumerated conditions (including, in specified cases, filing with the SEC);
- a broader category of routine communications regarding issuers, offerings, and procedural matters, such as communications about the schedule for an offering or about account-opening procedures, are excluded from the definition of “prospectus”; and
- the exemptions for research reports were expanded.

Most of the new and amended rules are not available to blank check companies, penny stock issuers, or shell companies.

²³² SEC Release 33-8591 (July 19, 2005).

Several factors, combined with advances in technology, led the SEC to believe that investors and the market would benefit from greater access to permissible communications where protection for investors is maintained through the appropriate Securities Act liability standards for materially deficient disclosures in prospectuses and oral communications.

Prior to the adoption of the SEC's regulatory initiative in 2005, the Securities Act and the SEC's rules thereunder provided for extensive restrictions on the types of offering communications that issuers or other parties subject to the Securities Act's provisions, such as underwriters, could use during a registered public offering. The nature of the restrictions depended on the time period during which the communications were to occur (and were separate from those restrictions that depend on the accuracy of the information contained in the communication).

Before the registration statement was filed with the SEC, all offers, in whatever form, were prohibited. Between the filing of the registration statement and its effectiveness, offers made in writing (including by e-mail or Internet), by radio, or by television were limited to a "statutory prospectus" that conforms to certain information requirements of Securities Act. As a result, the only written material that was permitted in connection with the offering of the securities during the period between filing and effectiveness of a registration statement was a preliminary prospectus meeting the requirements of Securities Act Section 10, which had to have been filed with the SEC. Even after the registration statement was declared effective, offering participants could still make written offers only through a statutory prospectus (however they could use additional written offering materials if a final prospectus meeting the requirements of the Securities Act Section 10 was sent or given prior to or with those materials). Violations of these restrictions generally were referred to as "gun jumping."

The SEC has recognized that the gun-jumping provisions of the Securities Act were enacted at a time when the means of communications were limited and restricting communications (without regard to accuracy) to the statutory prospectus appropriately balanced available communications and investor protection. The gun-jumping provisions were designed to make the statutorily mandated prospectus the primary means for investors to obtain information regarding a registered securities offering.

The capital markets, in the U.S. and around the world, have changed significantly since those limitations were enacted. Today, issuers engage in all types of communications on an ongoing basis, including, importantly, communications mandated or encouraged by our rules under the Exchange Act, rules or listing standards of national securities exchanges, and comparable requirements in foreign jurisdictions. Modern communications technology, including the Internet, provides a powerful, versatile, and cost-effective medium to communicate quickly and broadly. The changes in the Exchange Act disclosure regime and the tremendous growth in communications technology are resulting in more information being provided to the market on a more non-discriminatory, current, and ongoing basis. The SEC recognized that the gun-jumping provisions of the Securities Act imposed substantial and increasingly unworkable restrictions on many communications that would be beneficial to investors and markets and would be consistent with investor protection.

Issuers, underwriters, and other offering participants have made extensive use of the new regulatory framework relating to offering communications. This initiative has greatly reduced the compliance burden associated with offering communications while maintaining and promoting investor protections.

14.3

If there are derivative markets, is there disclosure of the terms of the contracts traded, the mechanics of trading and the risks related to gearing or leverage by market operators or intermediaries?

In many cases, securities derivatives are privately negotiated over-the-counter between bilateral counterparties and are not traded on a registered exchange. In addition, the SEC's authority over certain derivative instruments is limited by Section 3A of the Exchange Act which excludes both a non-security-based and a security-based swap agreement from the definition of "security." However, the SEC requires detailed disclosure with respect to standardized options, which are traded on registered exchanges and are cleared at a registered clearing agency.

Investors are informed about the general characteristics of standardized options and the rules of options trading through an "options disclosure document" (ODD). The ODD, *Characteristics and Risks of Standardized Options*, provides information relevant to standardized options trading generally as well as of information about the issuing clearing agency. Rule 9b-1 under the Exchange Act requires that an ODD contain the following information with respect to the options classes covered by the document: 1) a glossary of terms; 2) a discussion of the mechanics of exercising the options; 3) a discussion of the risks of being a holder or writer of the options; 4) the identification of the market or markets in which the options are traded; 5) a brief reference to the transaction costs, margin requirements and tax consequences of options trading; 6) the identification of the issuer of the options; 7) a general identification of the type of instrument or instruments underlying the options class or classes covered by the document; 8) if the options are not exempt from registration under the Securities Act of 1933, the registration of the options on form S-20 and the availability of the prospectus and the information in part II of the registration statement; and 9) such other information as the Commission may specify. The ODD is the primary disclosure document with respect to trading in standardized options.²³³

In addition to setting forth the information that must be disclosed in the ODD, Rule 9b-1 requires brokers and dealers to furnish a copy of the ODD to a customer before or at the time they approve that customer's account or accept the customer's order to trade options covered by the ODD. The exchanges on which the registered options trade work closely with the clearing corporation to prepare and update the ODD. Broker-dealers are precluded from accepting orders to purchase or sell standardized options from a customer or from approving a customer's account for trading in these options unless the broker-dealer has furnished the customer with the ODD. Furthermore, before extending credit to a customer, a broker-dealer generally must provide a

²³³ A similar disclosure document is required with respect to security futures products (the Security Futures Risk Disclosure Statement), which are jointly regulated by the SEC and the CFTC.

written statement to the customer describing the terms of the credit arrangement and must provide the customer with quarterly account statements.

14.4

Does the regulatory framework require:

- a) *Financial information and other required disclosure in prospectuses, listing documents, annual and other periodic reports, and, where applicable, in connection with shareholder voting decisions, to be of sufficient timeliness to be useful to investors?*

Prospectuses and Listing Documents

The SEC's rules relating to the age of financial statements are designed so that financial information in prospectuses and listing documents is sufficiently up-to-date to be useful to investors.

Financial Information: Until forty-five days following the issuer's fiscal year end, a prospectus may include audited annual financial statements covering the prior fiscal year and unaudited interim period financial statements covering the first three fiscal quarters of the most recent fiscal year.²³⁴ After forty-five days following the issuer's fiscal year end, a prospectus for an IPO must include audited annual financial statements covering the most recent fiscal year. Until 135 days following the end of the issuer's interim period fiscal quarter, a prospectus for an IPO is not required to include financial statements covering that fiscal quarter.²³⁵ After such 135-day period, an IPO prospectus must contain interim period financial statements covering the most recently ended fiscal quarter.

For prospectuses relating to offerings by issuers that are subject to the periodic reporting requirements under the Exchange Act, the age of financial statement requirements are generally consistent with the filing requirements applicable to annual reports, described below. However, if such an issuer has not filed all reports required to be filed under the Exchange Act, the same timing rules that apply to an IPO would apply.

Non-Financial Information: There is no specific regulatory requirement relating to the timeliness of non-financial information in a prospectus. However, the regulatory framework under the Securities Act is designed so that information contained in a prospectus and registration statement is current. For example, the liability provisions under Section 11 of the Securities Act are based on the date the registration statement becomes effective.

²³⁴ Rule 3-01 of Regulation S-X.

²³⁵ *Id.*

Additionally, other liability provisions also help ensure that information in a prospectus used for the offer and sale of a security is sufficiently timely to be useful to investors. For example, under Section 12(a)(2) of the Securities Act, sellers of securities have liability to purchasers for offers and sales by means of a prospectus or oral communication that includes an untrue statement of material fact or omits to state a material fact that makes the statements made, based on the circumstances under which they were made, not misleading. Also, Section 17(a) of the Securities Act (a general anti-fraud provision) provides, among other things, that it shall be unlawful for any person in the offer and sale of a security to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. Liability under Sections 12(a)(2) and 17(a)(2) attaches when an investor has committed to purchase the securities.

As noted previously, the principal disclosure documents prepared by issuers under the federal securities laws are prospectuses for the offering of securities and annual and other reports under the Exchange Act. Listing documents do not play a significant role in the disclosure framework in the U.S. See the discussion under in response to Question 14.1(a) above.

Annual Reports

Large accelerated filers must file annual reports within sixty days of the fiscal year-end covered by the report, accelerated filers must file annual reports within seventy-five days of the fiscal year-end covered by the report, and all other U.S. filers must file annual reports within ninety days of the fiscal year-end covered by the report. Additionally, but for information required to be provided for the fiscal year or as of a specified date, disclosure is to be given as of the latest practicable date prior to filing.

Quarterly Reports

Large accelerated filers and accelerated filers must file a quarterly report within forty days after the end of the fiscal quarter covered by the report. All other filers must file within forty-five days after the end of the fiscal quarter covered by the report.

Current Reports

Unless otherwise specified, a current report must be filed or furnished within four business days after occurrence of the reportable event. When the current requirements were adopted in 2004, the SEC stated that, by moving its rules towards a system emphasizing current reporting, markets might become more effective as price discovery mechanisms during periods between periodic reports and enhance investor confidence in the financial markets.²³⁶ In turn, confidence in receiving enhanced disclosure should provide greater certainty to investors that they are making investment decisions in a more transparent market, which should reduce market volatility

²³⁶ SEC Release 33-8400 (March 16, 2004), 58 FR 15594, at 15611.

resulting from uncertainty about the availability of accurate timely information about public companies.

Voting Decisions

In 2007, the SEC adopted amendments to its proxy rules that require issuers to offer Internet delivery of proxy materials to their shareholders.²³⁷ Under these rules, issuers are required to post their proxy materials (the notice of a shareholders' meeting, the proxy statement prepared in accordance with Schedule 14A or information statement prepared in accordance with Schedule 14C under the Exchange Act, the form of proxy, and the annual report of shareholders) on an Internet website and send a Notice of Internet Availability of Proxy Materials to their shareholders. Issuers have the choice of (1) providing all shareholders with a full set of paper copies of the proxy materials (as has traditionally been done) with a copy of the Notice of Internet Availability, (2) ceasing to mail paper copies and instead implementing a "notice-and-access" model, or (3) combining the two options, one for some shareholders and the other for the remainder.

Under the "notice-and-access" model, the issuer must mail the Notice of Internet Availability of Proxy Materials at least forty days prior to the shareholders' meeting, informing shareholders of the Internet availability of proxy materials. The forty-calendar day time frame does not apply to the option to deliver paper copies.

Exchange Rules

Exchange rules also promote the timely disclosure of financial and other required information. For example, the NYSE has an "immediate release" policy which, as set forth in Section 202.05 of the Listed Company Manual, requires a listed company to release quickly to the public any news or information that might reasonably be expected to materially affect the market for its securities.

In accordance with recently adopted changes to the NYSE's Procedures for Public Release of Information, Section 202.06 of the Listed Company Manual, the quick release of information required by the Exchange's policy should be effected by any Regulation FD-compliant method. As discussed above, in response to Question 14.1(c), Regulation FD requires a company to make public disclosure *simultaneously* with any other disclosure if such other disclosure is intentional, and *promptly* if such other disclosure is not-intentional ("promptly" is interpreted to be "as soon as practicable" after a senior official of the issuer learns that there has been a non-intentional disclosure, but in no event after the later of 24 hours or the commencement of next day's trading on the NYSE). "Public Disclosure" under Regulation FD is defined as disclosure made by furnishing or filing a Form 8-K, or disseminating the information through another method that is reasonably designed to provide broad, non-exclusionary distribution of information to the public.

²³⁷ SEC Release 34-55146 (January 22, 2007).

14.4

- b) Periodic information about financial position and results of operations (which may be in summary form) to be made publicly available to investors?***

As noted in the responses to Questions 14.1(b), (c), and 14.2(a), above, periodic reports must contain MD&A, which addresses liquidity and capital resources issues as well as events and uncertainties known to the issuer's management that may cause the reported results not to be indicative of future financial performance. Such disclosure also includes off-balance sheet disclosures and contractual obligations. The financial statements in quarterly reports include balance sheets as of the close of the quarter and the comparable quarter of the preceding year, comparative statements of operations for the quarter and for the beginning of the year through quarter-end, and comparative statements of cash flow from the beginning of the year through quarter-end.

14.4

- c) Appropriate measures to be taken (for example, provision of more recent unaudited financial information) when the audited financial statements included in a prospectus for public offerings are stale?***

As noted above in the responses to Question 14.4(a), above, financial statements contained in a prospectus must be periodically updated so as to keep the financial information presented in such prospectus useful to investors.

14.5

In addition to specific disclosure requirements, is there a general requirement to disclose either all material information or all information necessary to keep the disclosures made from being misleading?

The framework for the issuer disclosure requirements under the U.S. federal securities laws includes both principles-based standards for issuer disclosure and specific "line-item" disclosures that are required in various disclosure documents. This combination of principles-based standards and specific line-item requirements is designed to provide investors and the market at large with full and fair information about reporting issuers.

Materiality

Materiality is an important standard in determining what must be disclosed under the U.S. federal securities laws. As discussed more fully below, the U.S. Supreme Court has stated that information is material if a reasonable investor would consider it important in making an investment decision. Because line-item disclosure requirements may not capture all the material information that should be disclosed in specific circumstances, the U.S. federal securities laws

require issuers to add such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading.²³⁸

SEC Rules

The SEC has adopted rules under the Securities Act and the Exchange Act that contain a general disclosure requirement based on a materiality standard. Securities Act Rule 408 provides that, in addition to the information expressly required to be included in a registration statement, such further material information, if any, shall be added as may be necessary in order to make the required statements, in the light of the circumstances under which they are made, not misleading. Similarly, Exchange Act Rule 12b-20 requires, in addition to the information expressly required to be included in a statement or report, there be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading.

In connection with the SEC's disclosure requirements relating to financial statements, Rule 3-13 of Regulation S-X provides that the SEC also may require the filing of other financial statements in addition to, or in substitution for, the statements specifically required in any case where such statements are necessary or appropriate for an adequate presentation of the financial condition of any person whose financial statements are required, or whose statements are otherwise necessary for the protection of investors.

General Disclosure Principles

The laws and rules that govern publicly held companies in the U.S. derive from the principle that all investors in securities, whether large institutions or private individuals, should have access to full and fair disclosure about an investment prior to making it and so long as they hold it. In pursuit of this aim, the U.S. federal securities laws, and the rules and regulations of the SEC, require issuers to disclose material financial and non-financial information when publicly offering securities and on an ongoing basis. The concept of materiality is important to understanding the approach to disclosure under the U.S. federal securities laws. There is no statutory or regulatory definition of "material" and there is no "bright-line" test for materiality, such as a certain percentage of an issuer's revenues or assets. The U.S. Supreme Court has stated that information is material if a reasonable investor would consider it important in making an investment decision²³⁹ and that the determination of what constitutes material information is a mixed question of law and fact.

²³⁸ See Rule 12b-20 under the Exchange Act.

²³⁹ The U.S. Supreme Court cases of *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) and *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) provide the strongest authorities on materiality. Expressly adopting the standard of materiality set forth in *TSC Industries*, in *Basic* the Supreme Court defined materiality in the following manner:

there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

Under the federal securities laws, issuers must provide a steady flow of timely, comprehensive, and accurate information in order to assist investors in making informed investment and voting decisions – a common pool of knowledge for all investors to use in judging for themselves whether to buy, sell, or hold a particular security and how to vote that security. The U.S. judicial system does not evaluate the merits of any transaction or make any determination as to whether an investment is appropriate for any investor. In addition, responsibility for complete and accurate disclosure lies with the company and others involved in the preparation of a company's filings.

The framework for issuer disclosure requirements under the U.S. federal securities laws is based on a comprehensive approach, which includes both principles-based standards and specific line-item disclosure requirements. Disclosure principles, based on the broad anti-fraud prohibitions under the U.S. federal securities laws, as discussed below, provide an overall context through which the specific line-item requirements should be applied. In turn, line-item requirements provide issuers and their advisers specific matters that must be addressed in a particular disclosure document, and help to ensure comparability of information among issuers. This combination of principles-based standards and specific line-item requirements is designed to provide investors with full and fair information about reporting issuers.

Approximately 12,000 issuers are registered and reporting to the SEC under the Exchange Act. For certain purposes, as described below, the SEC has established various classes of issuers such as large accelerated filers, accelerated filers, smaller reporting companies, and foreign private issuers. The discussion set forth below principally addresses the disclosure requirements of large accelerated filers and accelerated filers.²⁴⁰ Of these, approximately 4,200 issuers are large accelerated filers or accelerated filers, constituting approximately 93% of the market capitalization of all issuers registered and reporting under the Exchange Act.

SEC rules relating to issuer disclosure requirements address in detail the content, accuracy, and timing of disclosure documents. Issuers are required to accurately disclose and report various categories of information, including financial statements that have been prepared using a comparable basis of accounting and audited by an independent public accountant. Disclosure documents from companies registered with the SEC are filed electronically on EDGAR and are publicly available on the Internet at no cost.

In addition to requiring disclosures, the U.S. federal securities laws impose on issuers requirements relating to the maintenance of books and records, internal controls over financial reporting, and disclosure controls and procedures. Depending on whether the issuer's securities are listed on an exchange, an issuer may be subject to varying levels of corporate governance requirements, such as oversight of financial reporting by an independent audit committee of the issuer.

²⁴⁰ The disclosure requirements for foreign private issuers and smaller reporting companies are not specifically addressed. Foreign private issuers are discussed in more detail below in response to Question 14.10. The SEC recently adopted scaled disclosure requirements for smaller reporting companies, and revised its disclosure requirements for foreign private issuers. See SEC Release Nos. 33-8876 (December 19, 2007) and 33-8959 (September 23, 2008), respectively.

As described in more detail below, the SEC has adopted rules under the Securities Act and the Exchange Act that contain a general requirement relating to the disclosure of material information. In addition, a key component of the statutory liability structure of the federal securities laws is a materiality standard for the disclosure of information.

Statutory Liability for Issuer Disclosures

The federal securities laws contain strong liability provisions to protect investors from false and misleading information and to provide issuers with incentives to provide full disclosure. These liability provisions are based on a general standard of materiality.

The federal securities laws prohibit market participants from making fraudulent disclosure. Pursuant to Rule 10b-5 of the Exchange Act, it is unlawful to employ any device, scheme, or artifice to defraud; to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. This definition forms the foundation for third party private actions, SEC civil actions and both criminal and civil actions by the U.S. Attorney.²⁴¹

Securities Act Liability

Remedies available under the Securities Act include damages, the right to rescind the sale of the securities at issue, and injunctive relief.

- **Section 11 Liability.** Under Section 11 of the Securities Act, the issuer, the principal executive, financial and accounting officers, signing members of the board of directors, the underwriters, and certain other parties involved with the preparation of the registration statement may be liable to purchasers of securities if any part of the registration statement, when it became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading. Section 11 is enforceable by private litigants rather than the SEC.
- **Section 12 Liability.** Under Section 12 of the Securities Act, any person who offers or sells a security by means of a prospectus or oral communication which includes an untrue

²⁴¹ In addition, issuers are liable under Section 13 of the Exchange Act if they fail to file a required report or file a report that is not true, accurate and complete. Unlike Section 10 and Rule 10b-5, Section 13 liability does not require scienter. The Sarbanes-Oxley Act also added several additional liability provisions related to issuer disclosures, such as the certification requirements discussed in Section I.A.1.j. The Sarbanes-Oxley Act also increased focus on criminal fraud. In particular, the Sarbanes-Oxley Act established a new fraud provision under Section 1348 of Title 18 of the U.S. Code. In addition, the Sarbanes-Oxley Act added Section 1350 of Title 18 of the U.S. Code, requiring Chief Executive Officers and Chief Financial Officers to certify periodic financial reports. The U.S. DOJ has the authority to bring criminal charges for violations.

statement of material fact or omits to state a material fact necessary in order to make the statement, in the light of the circumstances under which they were made not misleading may be liable to the person purchasing the security. Section 12 is enforceable by private litigants rather than the SEC.

- **Section 17 Liability.** Under Section 17 of the Securities Act, it is unlawful for any person in the offer or sale of any security to obtain money or property by means of an untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. Section 17 is enforceable by the SEC.

Exchange Act Liability

Remedies available under the Exchange Act include damages and injunctive relief.

- **Section 10(b) and Rule 10b-5.** Section 10(b) of the Exchange Act and one of its implementing regulation, Rule 10b-5, are the most commonly used provisions against securities fraud under the Exchange Act. Section 10(b) states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

- **Section 18 Liability.** Section 18 of the Exchange Act provides an express private cause of action for a “statement [that] was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact.” This applies to investors who can demonstrate that they relied on such statements contained in a document filed with the SEC under the Exchange Act when they purchased or sold the securities and the false or misleading statements caused their damages.

Practical Application of the General Requirement

Much of the SEC’s work relating to issuer disclosure involves the application of the general disclosure requirements discussed above. While the Staff’s review process, discussed under response to Question 14.6, may point out disclosure deficiencies based on line-item requirements, much of the review work and requests for further information and disclosure are not based on the SEC’s specific requirements but rather are based on the Staff’s view that additional information is appropriate to enable the issuer to better fulfill its general disclosure obligations under the federal securities laws.

14.6

Are there measures available to the regulator (e.g., review, certification, supporting documentation, sanctions) to help assure the sufficiency, accuracy and timeliness of the required disclosures?

There are several measures available to the SEC that support and promote robust issuer disclosure, including:

- the Staff's filing review process;
- various required certifications relating to the content of disclosure and eligibility to use scaled disclosure;
- the loss of certain benefits if disclosure obligations are not met in a consistent and timely manner; and
- investigation and possible enforcement actions concerning violations of the disclosure requirements.

Filing Review Process

Staff in CF selectively reviews filings made under the Securities Act and the Exchange Act to monitor and enhance compliance with the applicable disclosure and accounting requirements. The Staff may comment on an issuer's legal and/or financial disclosure to identify deficiencies and promote full and fair disclosure.

The work of CF focuses on issuer disclosure. CF does not evaluate the merits of any transaction or make any determination as to whether an investment is appropriate for any investor. CF's review process is not a guarantee that the disclosure is complete and accurate – responsibility for complete and accurate disclosure lies with the company and others involved in the preparation of a company's filings.

CF performs its primary review responsibilities through eleven offices staffed with approximately 80 percent of CF's employees. The members of these eleven offices have specialized industry, accounting, and disclosure expertise.²⁴² CF assigns filings by companies in a particular industry to one of the eleven review offices. CF has staffed each office with 25 to 35 professionals, primarily accountants and lawyers. Each company's office assignment is shown in EDGAR following the basic company information that precedes the company's filing history.

²⁴² The eleven review offices are organized by industry and include: health care and insurance; consumer products and utilities; computers and online services; natural resources and food; structured finance; transportation and leisure; manufacturing and construction; financial services; real estate and business services; beverages, apparel, and health care services; electronics and machinery; and telecommunications.

Required and Selective Review: As required by Section 408 of the Sarbanes-Oxley Act, CF reviews the periodic reports made under Section 13(a) of the Exchange Act of each reporting company at least once every three years. CF reviews a significant number of companies more frequently. In addition, CF selectively reviews transactional filings – documents companies file when they engage in public offerings, business combination transactions, and proxy solicitations.

In deciding how to allocate Staff resources among filings, CF undertakes a substantive evaluation of each company’s disclosure in what it calls a preliminary review. To preserve the integrity of the selective review process, CF does not publicly disclose its preliminary review criteria. Based on its preliminary review, CF decides whether to undertake any further review of the company’s filings or whether the company’s disclosure appears to be substantially in compliance with the applicable accounting principles and the federal securities laws and regulations.

Levels of Review: If CF selects a filing for further review, the extent of that further review will depend on many factors, including the results of the preliminary review. The level of further review may be:

- a full cover-to-cover review in which the Staff will examine the entire filing for compliance with the applicable requirements of the federal securities laws and regulations;
- a financial statement review in which the Staff will examine the financial statements and related disclosure, such as MD&A of Financial Condition and Results of Operations, for compliance with the applicable accounting standards and the disclosure requirements of the federal securities laws and regulations; or
- a targeted issue review in which the Staff will examine the filing for one or more specific items of disclosure for compliance with the applicable accounting standards and/or the disclosure requirements of the federal securities laws and regulations.

CF’s review involves examining the disclosure from a potential investor’s perspective and asking questions that an investor might ask when reading the document. When the Staff notes instances where it believes a company can enhance its disclosure or improve its compliance with the applicable disclosure requirements, it provides the company with written or verbal comments. In addition to a first level examiner, in nearly all cases a second person reviews a filing and the draft comments to help achieve consistency in comments across filing reviews. The range of possible comments is broad and depends on the issues that arise in a particular filing review. The Staff completes many filing reviews without issuing any comments.

Staff Comments: CF views the comment process as a dialogue with a company about its disclosure. CF’s comments are based on a company’s disclosure and other public information and made in the context of the Staff’s understanding of that company’s facts and circumstances. In issuing comments to an issuer, the Staff may request additional supplemental information so the Staff can better understand the company’s disclosure. The Staff may also request that the

issuer revise disclosure in a document on file with the SEC, provide additional disclosure in a document on file with the SEC, or provide additional or different disclosure in a future filing with the SEC. For Securities Act transactional filings, the Staff seeks to provide initial comments on filings selected for review within thirty days of the filing date. The target of thirty days or less has become a de facto industry expectation for the maximum time to receive initial comments from CF on Securities Act transactional filings. There is no comparable target for Exchange Act filings. In the following fiscal years, CF issued initial comments on Securities Act filings selected for review on average in the following number of days:

FY 2005	26.1 days
FY 2006	26.2 days
FY 2007	25.5 days
FY 2008	25.2 days

Issuer Responses to Comments: A company generally responds to each comment in a letter to the Staff and, if appropriate, by amending its filings. Depending on the nature of the issue, the Staff's concern, and the company's response, the Staff may issue additional comments following its review of the company's response to its prior comments. This comment and response process continues until CF and the issuer resolve the comments.

Closing a Filing Review: Under current practice, when a company has resolved all of CF's comments on a Securities Act registration statement, the company may request that the SEC declare the registration statement effective so that it can proceed with the transaction. When taking that action, CF, through authority delegated from the SEC, gives public notice on the SEC's EDGAR system that the registration statement is effective.

When a company has resolved all comments from CF on an Exchange Act registration statement, a periodic or current report, or a preliminary proxy statement, CF provides the company with a "no further comment" letter to confirm that its review of the filing is complete. However, Exchange Act registration statements may go effective by operation of law whether or not all comments have been resolved and a company's Exchange Act reporting obligations will begin.²⁴³ In such cases, the Staff will not issue a "no further comment" letter and, if comments remain outstanding at the time of filing the company's Form 10-K, the substance of any material unresolved comments must be disclosed.

To increase the transparency of the review process, when CF completes a filing review it makes its comment letters and company responses to those comment letters public on the SEC's EDGAR system. CF makes this correspondence public no earlier than forty-five days after it has completed its review of a periodic or current report or declared a registration statement effective. CF includes the "no further comment" letter in this public posting of correspondence. The Sarbanes-Oxley Act requires that the SEC review the disclosures of all companies reporting under the Exchange Act at least once every three years. In the following fiscal years, CF reviewed the following percentage of companies:

²⁴³ Please *see* the response to Question 14.1, above, for a discussion of the Staff review process.

FY 2005	50%
FY 2006	33%
FY 2007	36%
FY 2008	38%

Certification and Supporting Documentation

Sarbanes-Oxley Section 302 Certifications: Pursuant to Section 302 of the Sarbanes-Oxley Act, the SEC adopted rules,²⁴⁴ as amended,²⁴⁵ which require an issuer's principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, each to certify in each quarterly and annual report, including transition reports, filed or submitted by the issuer under Section 13(a) or 15(d) of the Exchange Act that:

- I have reviewed this [quarterly or annual] report of the registrant;
- Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
- Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
- The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the

²⁴⁴ SEC Release 33-8124 (August 29, 2002).

²⁴⁵ SEC Release 33-8238 (June 5, 2003).

preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

- Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
- Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
- The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Sarbanes-Oxley Section 906 Certifications: Section 906 of the Sarbanes-Oxley Act added a new section to the United States Criminal Code which contains a certification requirement separate and distinct from the certification requirement mandated by Section 302 and subject to specific federal criminal provisions.

Section 906 requires each periodic report containing financial statements filed by an issuer to be accompanied by a written statement by the chief executive officer and chief financial officer (or equivalent thereof) certifying that:

- the periodic report containing the financial statements fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.

Issuer Categories: The sufficiency, accuracy, and timeliness of required disclosure is also addressed through the potential loss of benefits associated with specific classifications of issuers created under the federal securities laws. As indicated above in response to Question 14.5, there

are a number of different issuer categories. Certain rules and benefits may apply to each category, relating to such issues as form eligibility, filing deadlines, and required disclosure. Some Securities Act and Exchange Act filings require that an issuer identify itself as belonging to a certain category of issuer, such as a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or shell company by checking the box pertaining to such classification.

These categories are important because, as described in Section 14.2(c), above, the relaxation of certain communications restrictions, including the use of a “free-writing prospectus,” is available only to certain classes of larger issuer. Additionally, Forms S-3 and F-3, which are the “short forms” used by issuers to register securities offerings under the Securities Act, are available only to those issuers that meet its eligibility requirements.²⁴⁶ These forms allow such companies to rely on their reports filed under the Exchange Act to satisfy the form’s disclosure requirements and enables companies to conduct primary offerings “off the shelf” under Rule 415 of the Securities Act. Rule 415 provides considerable flexibility in accessing the public securities markets from time to time in response to changes in the markets and other factors. The shelf eligibility resulting from Form S-3 eligibility and the ability to forward incorporate information on Form S-3, therefore, allow companies to avoid additional delays and interruptions in the offering process and can reduce or even eliminate the costs associated with preparing and filing post-effective amendments to the registration statement. Form S-8, which provides for the automatic registration of an issuer’s securities pursuant to employee benefit plans, is not available to a shell company or former shell company (unless at least sixty calendar days has passed since it filed current information equivalent to that contained in a registration statement reflecting its non-shell status and is available only to reporting companies that are current in their Exchange Act reporting obligations.

Conversely, smaller reporting companies are required to indicate they qualify as such so that investors may be alerted that the issuer is eligible to use the scaled disclosure requirements available to smaller reporting companies, and thus permitted to disclose less information, both non-financial and financial in nature.

Delinquent Filings Program and other Enforcement Efforts: One important means by which the Staff helps to ensure the sufficiency, adequacy, and timeliness of required disclosure is through its Delinquent Filings Program. Under its Delinquent Filings Program, CF issues delinquency notice letters to issuers that have failed to make required filings and requests that such issuers promptly come into compliance with their reporting obligations. These letters state that if an issuer fails to comply with its reporting obligations, or otherwise fails to respond appropriately to the delinquency notice letter, then it risks suspension or revocation of the registration of its securities, and possibly a trading suspension of up to ten business days. The

²⁴⁶ Such requirements include having a class of securities registered pursuant to Sections 12(b) or 12(g) of the Exchange Act or required to file reports pursuant to Section 15(d) of the Exchange Act; and being subject to such requirements and filing in a timely manner all the material required to be filed pursuant to Sections 13, 14 or 15(d) for a period of at least twelve calendar months immediately preceding the filing of the Form S-3 registration statement.

SEC only takes such actions if the SEC determines that such actions are authorized and appropriate under the law.

In an effort to assure that investors have access to up-to-date financial and other information about the issuers of securities, Enforcement conducts investigations into possible violations of the federal securities laws, such as failure to make required filings with the SEC, or failure of corporate insiders to file the appropriate forms with the SEC regarding their personal securities trades, and files civil actions and administrative proceedings in this area. As discussed throughout this assessment, referrals to the Division of Enforcement may come from a variety of sources.

Pursuant to Section 12(j) of the Exchange Act, the SEC is authorized to deny, to suspend the effective date of, to suspend for a period not exceeding twelve months, or to revoke the registration of a security, if the SEC finds, on the record after notice and opportunity for hearing, that the issuer of such security has failed to comply with any provision of the Exchange Act or the rules and regulations thereunder. As a result, no member of a national securities exchange, broker, or dealer may effect any transaction in, or induce the purchase or sale of, any security where the registration of that security has been and is suspended or revoked pursuant to Section 12(j).

14.7

Does regulation ensure that proper responsibility is taken for the content of information in disclosure documents and the timeliness of disclosure by providing for sanctions or liability of the issuer and those responsible persons who fail to exercise due diligence in the gathering and provision of information? (Depending upon the circumstances, these persons may include the issuer, underwriters, directors, authorizing officers, promoters, and experts and advisers consenting to be named as such.)

The Securities Act contains several provisions providing for rights of action against persons who sold or are involved in the sale of securities in an offering.²⁴⁷

Under Section 11 of the Securities Act, purchasers may sue the following people for material misstatements or omissions in a registration statement (which includes the prospectus or offering document):

- the issuer;
- each of its directors;
- each underwriter;

²⁴⁷ See Sections 11, 12(a), and 17(a) of the Securities Act. Sections 11 and 12(a) of the Securities Act are described below. Section 17(a) of the Securities Act is a general anti-fraud provision that imposes liability upon any person who commits fraud in connection with the offer or sale of securities.

- each person signing the registration statement, which includes the issuer's principal executive officer, its principal financial officer, and its principal accounting officer (comptroller);
- the independent accountant with respect to audited financial statements included in the registration statement upon which the accountant renders an audit report; and
- each expert with respect to information included in the registration statement in reliance upon the expert (*e.g.*, an appraiser, mining engineer, or petroleum consultant).

Issuers are subject to strict liability. All persons other than the issuer are entitled to certain due diligence defenses which generally require them to demonstrate that, after reasonable investigation, they had reasonable ground to believe that the matters in question were true.

Pursuant to Section 8 of the Securities Act, the SEC may at any time issue an order preventing or suspending the effectiveness of a registration statement if it has reason to believe that such registration statement includes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein, in the light of the circumstances under which such prospectus is or is to be used, not misleading.

Pursuant to Section 12 of the Securities Act, any person who offers or sells a security by means of a prospectus or oral communication which includes an untrue statement of material fact or omits to state a material fact necessary in order to make the statement, in the light of the circumstances under which they were made, not misleading, may be liable to the person purchasing the security for an amount equal to the consideration paid for such security with interest thereon, less the amount of any income received thereon, or for damages if such person no longer owns the security.

Under Section 12 of the Securities Act however, an ordinary negligence standard applies and the seller is also entitled to assert a due diligence defense in order to demonstrate that, after reasonable investigation, it had reasonable grounds to believe that the matters in question were true.

14.8

Are the circumstances where disclosures may be omitted or delayed limited to trade secrets, similar proprietary information or other valid business purposes, such as incomplete negotiations?

Generally speaking, the disclosure obligations under the federal securities laws do not allow for derogations. However, in limited circumstances, the SEC's rules permit certain limited information not to be publicly disclosed.

Confidential Treatment of Certain Information Contained in Filed Exhibits

As discussed throughout this assessment, the federal securities laws generally require any company that is publicly held or that is registering its securities for public sale to disclose a broad range of financial and non-financial information in registration statements, annual reports and other filings made with the SEC.

Significantly, a registrant must file publicly all contracts material to its business other than those it enters into in the ordinary course of business.²⁴⁸ However, disclosure of information required by the regulations can sometimes raise concern among issuers that such disclosure may adversely affect a company's business and financial condition due to competitive harm. Typical examples of such concern include pricing terms, technical specifications and milestone payments. To address the potential disclosure hardship, the SEC allows companies to request confidential treatment of certain information filed under the Securities Act and the Exchange Act.

The SEC may grant an issuer's request for confidential treatment, provided the subject information is filed with the SEC for review on a non-public basis and the information meets the legal test for exclusion provided by FOIA. Specifically, Rules 406 and 24b-2 set forth the primary means for obtaining confidential treatment of information contained in a document required to be filed under the Securities Act and under the Exchange Act, respectively.

FOIA requires all federal agencies to make specified information available to the public, including the information required to be filed publicly by SEC rules. FOIA contains nine specific exemptions from this requirement. The SEC's confidential treatment rules require that requests for confidential treatment contain an analysis of the applicable FOIA exemption. Often, registrants applying for confidential treatment in connection with filings rely on the exemption that covers "trade secrets and commercial or financial information obtained from a person and [that is] privileged or confidential" which is commonly referred to as "the (b)(4) exemption."²⁴⁹

In practice, these requests usually relate to information in the material contracts that the issuer must file as exhibits to its filings or for portions of a written response to a Staff comment letter. The Staff reviews applications for confidential treatment, and may grant them if the information to be kept confidential is very limited. For example, the Staff might permit an issuer to omit the specific pricing terms in a supply contract, but not the entire contract or even an entire section of the contract.

Incomplete Negotiations

Disclosure is required only for agreements which provide for obligations that are material to and enforceable against a company, or rights that are material to a company and enforceable by the

²⁴⁸ Item 601(b)(10) of Regulation S-K.

²⁴⁹ 5 U.S.C. 552(b)(4); 17 CFR 200.80(b)(4).

company against one or more other parties to the agreement.²⁵⁰ In adopting its rules, while noting that there may be instances in which a company is required to provide disclosure (*e.g.*, in order to avoid an omission of material fact that would otherwise make a statement misleading), the SEC recognized the view of some that the disclosure of non-binding agreements may cause significant competitive harm to a company and create excessive speculation in the market in certain cases.²⁵¹

Such circumstances would not include a material definitive agreement that is subject to customary closing conditions, such as the delivery of legal opinions or comfort letters, completion of due diligence or regulatory approval when such agreement is enforceable against or by the company despite the fact that such conditions have not yet been satisfied. On the other hand, if a company enters into a non-binding letter of intent or memorandum of understanding that also contains some binding, but non-material elements, such as a confidentiality agreement or a no-shop agreement, the letter or memorandum does not need to be filed because the binding provisions are not material.²⁵²

14.9

Where there are derogations from the objective of full and timely disclosure, is regulation sufficient to provide for:

a) Temporary suspensions of trading?

When issuers deviate from the objective of full and timely disclosure, the SEC has measures available to provide for the temporary suspension of trading. *See* response to Question 9.2 discussing the SEC's authority to issue an order under Section 12(k) of the Exchange Act temporarily suspending trading in an issuer's security for a period of up to ten business days.

The exchanges in the U.S. have adopted rules relating to the temporary suspension of trading of listed securities in certain circumstances relating to the pending announcement of material information. For example, Rule 202.06(B) of the NYSE Listed Company Manual provides that a listed company must notify their exchange representatives by telephone at least ten minutes prior to a news announcement of a material event or a statement addressing a rumor. At that time, the NYSE will be in a position to consider whether, in its opinion, trading in the security should be temporarily halted. A delay in trading provides a period of calm for public evaluation of the announcement. The halt also allows customers to revise the terms of limit orders. Rule 202.07 of the NYSE Listed Company Manual notes that the NYSE will monitor the situation closely, noting that if an announcement is not made by the issuer, the exchange may open or re-open trading. If the announcement is not made within approximately 30 minutes after the delay or halt is implemented, the exchange may commence the opening or re-opening of trading, though the

²⁵⁰ SEC Release 33-8400 (March 16, 2004), 58 FR 15594, at 15596.

²⁵¹ *Id.*

²⁵² *Id.*

time period would vary depending on the circumstances. The Nasdaq Stock Market has similar procedures.

14.9

b) Restrictions on, or sanctions regarding, the trading activities of persons with superior information?

See response to Question 14.1(c) above, for a discussion of Regulation FD.

See response to Question 10.3 above for a discussion relating to prohibitions on insider trading.

14.10

If public offerings or listings by foreign issuers are significant within the jurisdiction, are the jurisdiction's disclosure requirements for such offerings or listings of equity securities by foreign issuers consistent with IOSCO's International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers?

There are over 1,000 foreign private issuers²⁵³ that are registered and file reports with the SEC under the Exchange Act. For over 30 years, the SEC has had in place a separate disclosure regime specifically tailored to foreign private issuers. While this regime largely elicits equivalent disclosures in connection with public offerings of securities and annual reports as for U.S. companies, the SEC's disclosure system for foreign private issuers contains targeted disclosure modifications that promote participation by foreign private issuers in the U.S. public capital markets in a manner consistent with investor protection.

In September 1999, the SEC substantially revised its disclosure requirements for foreign private issuers to fully incorporate the IOSCO International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers.²⁵⁴ In adopting these revisions, the SEC stated: "We believe IOSCO's disclosure standards represent a strong international consensus on fundamental disclosure topics, and that they can be used to produce offering and listing documents that will contain the same high level of information we traditionally have required...The international disclosure standards replace most, but not all, of the previous

²⁵³ An issuer is defined as a foreign private issuer if:

- more than 50% of its outstanding voting securities are held of record (directly or indirectly) by residents of the U.S.; and
- any one of the following is true:
 - o the majority of its executive officers or directors are U.S. citizens or residents;
 - o more than 50% of the issuer's assets are located in the U.S.; or
 - o the issuer's business is administered principally in the U.S.

²⁵⁴ SEC Release 34-41936 (September 28, 1999) 64 FR 53900.

requirements of Form 20-F, the combined registration and annual report form for foreign private issuers under the Exchange Act.”²⁵⁵

The SEC has not taken specific actions to incorporate the IOSCO International Disclosure Principles for Cross-Border Offerings and Listings of Debt Securities by Foreign Issuers into its disclosure requirements for filings with the SEC by foreign private issuers. The SEC’s current disclosure standards for foreign private issuers relating to debt securities are substantially the same as those relating to equity securities. The SEC’s debt disclosure standards for foreign private issuers are consistent with the IOSCO debt disclosure standards.

In general, foreign private issuers must provide financial statements prepared in accordance with U.S. GAAP or which contain a reconciliation to U.S. GAAP. However, in December 2007, the SEC revised its financial statement requirements that are applicable to foreign private issuers to accept from such issuers in their filings with the SEC financial statements prepared in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board without a reconciliation to U.S. GAAP.²⁵⁶ In adopting this revision, the SEC stated that the revision was part of an effort to foster the use of a single set of high quality globally accepted accounting standards.

²⁵⁵ *Id.*, at 53901.

²⁵⁶ SEC Release 33-8879 (December 21, 2007).

Issuers – Principle 15

Holders of securities in a company should be treated in a fair and equitable manner.

Assessment

Fully Implemented.

General Overview

In the U.S., there are four primary sources of law, regulation and entitlements relating to corporate governance and the rights of shareholders: state corporate law; a company's articles of incorporation and by-laws; the federal securities laws; and the listing rules of U.S. exchanges. These sources operate in an inter-relationship that supports shareholders as the owners of corporate entities in an environment characterized by thousands of publicly traded companies ranging from many of the largest companies in the world to micro-cap companies. Shareholder bases for these companies range from a few hundred to millions of shareholders, and shareholder populations range from individuals with modest shareholdings to institutions with billions of dollars under management to invest in equity securities. Furthermore, technology permits corporate communications to be increasingly electronic and Internet-based, and a litigation environment allows shareholders frequently to bring claims against companies, directors and corporate management to enforce their rights.

State corporate laws: There is no federal corporation law in the U.S. Instead, corporate entities are created under state law. The corporation laws of the 50 states of the U.S. (and the District of Columbia) are enabling statutes that provide for the formation of corporate entities and the terms of governance among shareholders, the board of directors and management. State corporate law is embodied in both the enacted statutory provisions and judicial decisions interpreting those provisions. In fact, several key facets of the corporate governance framework in the U.S., such as directors' duties of loyalty and fairness, are derived from judicial decisions. This survey focuses on the Delaware General Corporation Law (DGCL) as the reference point for its state law discussions.²⁵⁷

Corporate chartering documents: In many areas, state corporate laws often provide for flexibility in order to permit companies to structure their governance as shareholders, directors and management see appropriate. State corporate law permits the basic chartering documents of a corporation – the certificate or articles of incorporation that are filed with the corporate office of the state of incorporation and the by-laws of the company – to provide for different rights than

²⁵⁷ More than one-half of the Fortune 500 companies are incorporated in Delaware and Delaware corporate law statutes and related jurisprudence are well-developed. See *Why Corporations Choose Delaware*, Lewis Black, Jr. (Delaware Department of State 2007). Because it does not administer state corporate law, the SEC relies on underlying reported sources for this survey and its summary or explanation is not authentication.

as may be set out under the statutory provisions. For example, as discussed below, DGCL Section 212(a) provides that each stockholder is entitled to one vote for each share of capital stock held by such stockholder, unless otherwise provided in the company's certificate of incorporation.

Federal securities laws: As discussed above in the response to Question 14, the Securities Act and the Exchange Act regulate offerings and sales of securities and on-going disclosure by issuers. The Exchange Act also regulates the process by which public companies solicit proxies in connection with shareholder meetings. Regulation of the proxy process and disclosure is a core function of the SEC, stemming from a Congressional belief that "fair corporate suffrage is an important right that should attach to every equity security bought on a public exchange."²⁵⁸ The SEC's rules relating to proxies seek to improve the corporate proxy process so that it functions, as nearly as possible, as a replacement for an actual in-person meeting of shareholders.

Exchange rules: The rules adopted by the various stock exchanges that apply to listed companies provide an additional source of corporate governance requirements. In order to maintain a listing of a security on one of the stock exchanges in the U.S., a company must comply with various corporate governance requirements, as well as other requirements. The corporate governance listing requirements of the several stock exchanges, including the NYSE and Nasdaq, the principle markets in the U.S., are broadly similar, but they do vary in some respects. As noted in response to Question 14.2(a), all rules of the exchanges are subject to approval by the SEC. When referencing the exchange corporate governance requirements, this assessment cites the Listed Company Manual of the NYSE.

15.1

Does the regulatory framework and legal infrastructure address the rights and equitable treatment of shareholders in connection with the following:

a) Voting?

State Corporate Laws

Pursuant to DGCL Section 211(a), shareholder meetings may be held at any place either within or outside of Delaware, as either determined by the board of directors or in the manner provided in the certificate of incorporation or bylaws. The board may, in its sole discretion, determine that a meeting shall not be held at any place but, rather, may instead be held solely by means of remote communication. Additionally, shareholders not physically present at a meeting may participate, and be deemed present for voting purposes, by means of remote communication.

Pursuant to DGCL Section 212(b), each stockholder entitled to vote at a meeting of stockholders, or to express consent or dissent to corporate action in writing without a meeting, may authorize another person or persons to act for such stockholder by proxy.

²⁵⁸ H.R. Rep. No. 1383, 73d Cong., 2d Sess., at 13, as quoted in SEC Release 33-9046 (June 10, 2009).

Pursuant to DGCL Section 222, written notice of any meeting must be given not less than ten days and not more than sixty days before the date of the meeting, and shall set forth the place (if not held solely by means of remote communication), the date, and the hour of the meeting.

Pursuant to DGCL Section 212(a), each stockholder is entitled to one vote for each share of capital stock held by such stockholder, unless otherwise provided in the certificate of incorporation. DGCL Section 213 requires that the record date for determining stockholders eligible to vote shall be fixed by the board and may not precede the date upon which the board adopts a resolution to such effect. Further, the record date shall not be more than sixty or less than ten days before the date of the meeting. If the meeting is adjourned, the board may fix a new record date as long as the same sixty day/ten day notice provisions required for an initial meeting date are observed.

Pursuant to DGCL Section 151, a corporation may provide for different voting rights to be conferred on stockholders by issuing more than one class or series of stock with voting powers as stated either in the certificate of incorporation or of any amendment thereto, or in the resolution or resolutions providing for the issue of such stock.

Federal Securities Laws

The federal securities laws provide a framework that supports compliance with the state law requirements set forth above. For example, the federal securities laws require disclosure of matters to be voted upon in the form of a proxy statement for a stockholders' meeting pursuant to Schedule 14A under the Exchange Act or an information statement relating to action taken in lieu of a stockholders' meeting pursuant to Schedule 14C under the Exchange Act.

Pursuant to Schedule 14A, a proxy statement must set forth the date, time, and place of the stockholders meeting as well as the record date for determining eligibility to vote. Schedule 14A requires disclosure of the manner by which stockholders may exercise their votes, the voting powers designated to each class or series of stock, and the availability and effect of cumulative voting (if any). In the case of Schedule 14C, if matters are to be acted upon in lieu of a stockholders' meeting, information must be furnished with respect to all of the items contained in Schedule 14A that would be applicable to any matter to be acted upon at the meeting if proxies were to be solicited in connection with the meeting.

As further described below in response to Question 15.1(c), the federal securities laws also contain other requirements relating to the efficient distribution of proxies and information statements to beneficial owners.

Exchange Rules

Stock exchange rules also address the rights and equitable treatment of shareholders in the context of voting decisions. Section 401.01 of the Listed Company Manual of the NYSE requires a company to provide immediate publicity for a shareholders' meeting where any matter

affecting the rights or privileges of shareholders or any other matter not of a routine nature is to be considered. Such publicity should adequately describe the matter(s) to be considered.

Section 402.04 of the Listed Company Manual of the NYSE requires actively operating companies to solicit proxies for all meetings of shareholders so as to provide shareholders with a convenient method of voting with adequate disclosure on the matters to be presented. Such proxy materials must be in the format and distributed by such means as permitted or required by applicable law or regulation, including those of the SEC.

Section 313.00 of the Listed Company Manual of the NYSE states that the voting rights of existing shareholders of publicly traded common stock registered under Section 12 of the Exchange Act cannot be disparately reduced or restricted through any corporate action or issuance. Examples of such corporate action or issuance include, but are not limited to, the adoption of time phased voting plans, the adoption of capped voting rights plans, the issuance of super voting stock, or the issuance of stock with voting rights less than the per share voting rights of the existing common stock through an exchange offer.

Although there is no exchange rule addressing the interval between record and meeting dates, the NYSE recommends that a minimum of 30 days be allowed so as to provide ample time for the solicitation of proxies, as explicitly stated in Section 401.03 of its Listed Company Manual.

15.1(a)

i) For election of directors?

In addition to the corporate law, federal securities law, and exchange requirements relating to notice and dissemination of material information noted above, an annual meeting of stockholders must be held for the election of directors on a date and at a time designated by or in the manner provided in a company's bylaws pursuant to DGCL Section 211(b). In the alternative, stockholders may act by written consent to elect directors unless the certificate of incorporation provides otherwise. However, written consent may be less than unanimous only if all of the directorships to which directors could be elected are vacant and are filled by such action. If not, an annual meeting must be held.

Pursuant to DGCL Section 214, cumulative voting is possible if provided for in a company's certificate of incorporation. Under cumulative voting, each holder of stock is entitled to the number of votes attached to the number of shares they hold multiplied by the number of directors to be elected by the holder. The stockholder may cast all of such votes for a single director or may distribute them among any two or more candidates as such holder may see fit.

15.1(a)

ii) On corporate changes affecting the terms and conditions of their securities?

The rights, preferences, restrictions and conditions of shareholders are set forth in a company's certificate of incorporation. In addition to the corporate law, federal securities law, and

exchange requirements relating to notice and dissemination of material information noted above, there are specific state law requirements relating to corporate changes affecting the terms and conditions of securities.

Pursuant to DGCL Section 242(a), a corporation may amend its certificate of incorporation in order to take the following actions:

- To increase or decrease its authorized capital stock or to reclassify the same (including, but not limited to, changes in the number, par value, designations, preferences, or other special rights of the shares, or by subdividing or combining the outstanding shares of any class or series of a class of shares into a greater or lesser number of outstanding shares);
- To cancel or otherwise affect the right of the holders of the shares of any class to receive dividends which have accrued but have not been declared; or
- To create new classes of stock having rights and preferences either prior and superior or subordinate and inferior to the stock of any class then authorized, whether issued or unissued.

Such amendment(s) must be made in the manner set forth in DGCL Section 242(b), which requires the company's board to either call a special meeting or direct that the amendment proposed be considered at the next annual meeting. A special or annual meeting must be called and held upon the notice provisions of DGCL Section 222, discussed above. The notice must set forth the proposed amendment(s) in full or provide a brief summary of the proposed amendments as the directors deem advisable. The proposed amendment(s) become effective only if a majority of the outstanding stock entitled to vote thereon, and a majority of the outstanding stock of each class entitled to vote thereon as a class, vote in favor of the amendment(s).

If the proposed amendment(s) would:

- increase or decrease the aggregate number of authorized shares of such class;
- increase or decrease the par value of the shares of such class; or
- alter or change the powers, preferences, or special rights of the shares of such class so as to affect them adversely,

then the holders of the outstanding shares of a class are entitled to vote as a class regardless of whether specifically set forth in the certificate of incorporation. If the proposed amendment(s) would not affect the entire class, but would adversely affect the powers, preferences, or special rights of one or more series of any class, then the shares of the series potentially affected are considered a separate class for voting eligibility purposes.

Exchange rules also impose requirements relating to voting decisions affecting the terms and conditions of securities. For example, Section 204.13 of the Listed Company Manual of the NYSE requires a company to give at least twenty days' advance notice with respect to any

proposed changes in the form or nature of listed securities or in the rights or privileges attached to such securities.

Section 312.03 of the Listed Company Manual of the NYSE requires shareholder approval under the following three circumstances:

- a) the issuance of common stock, or of securities convertible into or exercisable for common stock, in any transaction or series of related transactions if:
 - o the common stock has, or will have upon issuance, voting power equal to or in excess of twenty percent of the voting power outstanding before the issuance of such stock or of securities convertible into or exercisable for common stock; or
 - o the number of shares of common stock to be issued is, or will be upon issuance, equal to or in excess of twenty percent of the number of shares of common stock outstanding before the issuance of the common stock or of securities convertible into or exercisable for common stock;

Though shareholder approval will not be required for any such issuance involving any public offering for cash or any bona fide private financing involving a sale of common stock (or securities convertible into or exercisable for common stock) for cash at a price at least as great as each of the book and market value of the issuer's common stock;

- b) an issuance that will result in a change of control of the issuer; or
- c) the issuance of common stock, or of securities convertible into or exercisable for common stock, in any transaction or series of related transactions, to:
 - o a director, officer or substantial security holder of the company (each a "Related Party");
 - o a subsidiary, affiliate or other closely-related person of a Related Party; or
 - o any company or entity in which a Related Party has a substantial direct or indirect interest;

if the number of shares of common stock to be issued, or if the number of shares of common stock into which the securities may be convertible or exercisable, exceeds either one percent of the number of shares of common stock or one percent of the voting power outstanding before the issuance.

However, if the Related Party involved in the transaction is classified as such solely because such person is a substantial security holder, and if the issuance relates to a sale of stock for cash at a price at least as great as each of the book and market value of the issuer's common stock, then shareholder approval will not be required unless the number of shares of common stock to be issued, or unless the number of shares of common stock

into which the securities may be convertible or exercisable, exceeds either five percent of the number of shares of common stock or five percent of the voting power outstanding before the issuance.

15.1(a)

iii) On other fundamental corporate changes?

In addition to changes affecting the terms and conditions of a security, the regulatory framework and legal infrastructure also addresses the rights and equitable treatment of shareholders in connection with votes relating to mergers and consolidations of companies.

Under DGCL Section 251, any two or more corporations may merge into a single corporation, which may be either one of the constituent corporations or a new corporation formed by the consolidation, pursuant to an agreement of merger or consolidation. The company's board of directors must adopt a resolution declaring the advisability of the proposed merger, and then either call a special meeting of the stockholders entitled to vote on such amendment or directing that the amendment proposed be considered at the next annual meeting of the stockholders, either at least twenty days prior to the date of the meeting. The notice must contain a copy of the agreement or a brief summary thereof, as the directors deem advisable. Adoption of the merger or consolidation requires the approval of a majority of the outstanding stock of the corporation entitled to vote upon such matters.

Pursuant to DGCL Section 262(c), any corporation may provide for appraisal rights in its certificate of incorporation for any class or series of its stock as a result of an amendment to its certificate of incorporation, any merger or consolidation, or the sale of all or substantially all of the assets of the corporation. Pursuant to DGCL Section 262(d), the corporation must notify shareholders of the shares for which appraisal rights are available no less than twenty days prior to the meeting at which the proposed merger or consolidation is to be submitted.

As noted above, if a merger or consolidation would entail the issuance of common stock (or of securities convertible into or exercisable for common stock), exchange rules also impose shareholder voting requirements when such issuances would amount to more than twenty percent of the voting power or number of common shares outstanding before the issuance.

Pursuant to DGCL Section 271(a), a corporation may sell, lease or exchange all or substantially all of its property and assets. Such action may be taken only if a majority of its board of directors deems it to be expedient and for the best interests of the corporation, a majority of the outstanding stock of the corporation entitled to vote thereon adopt a resolution to such effect at a meeting called upon at least twenty days' notice, and the notice of such meeting states that such a resolution will be considered.

Pursuant to DGCL Section 275(a), a corporation may dissolve if it is deemed advisable in the judgment of the board and a majority of the outstanding stock of the corporation entitled to vote thereon adopts a resolution to such effect at a meeting called for that purpose. Alternatively,

pursuant to DGCL Section 275(c), dissolution may also be authorized without action of the directors if all the stockholders entitled to vote thereon consent in writing.

15.1

b) With the timely notice of shareholder meetings?

DGCL Section 222 requires written notice of any shareholders meeting to be provided not less than ten days and not more than sixty days before the date of the meeting. This notice must set forth the place, if any, the date and the hour of the meeting. Section 401.02 of the NYSE Listed Company Manual requires a company to notify the Exchange a minimum of ten days prior to the record date of any shareholders meeting called.

As noted above, these advance notice requirements are in addition to the federal securities law requirement that a form of proxy or information statement be mailed to record holders sufficiently in advance of the meeting date to allow five business days for processing by the banks and brokers for delivery to beneficial holders and an additional period to provide ample time for delivery of the materials, consideration of the materials by the beneficial owners, return of their voting instructions, and transmittal of the vote from the bank or broker to the tabulator.

15.1

c) Procedures that enable beneficial owners to give proxies or voting instructions efficiently?

As described in response to Question 15.1(a), above, each stockholder entitled to vote at a meeting of stockholders, or to express consent or dissent to corporate action in writing without a meeting, may authorize another person or persons to act for such stockholder by proxy pursuant to DGCL Section 212(b).

In recognition of the fact that most beneficial holders of securities are not also necessarily the record holders, registrants have an obligation under the proxy rules to distribute proxy and other soliciting material to banks and brokers on a timely basis in order to forward them to beneficial owners. Pursuant to Rule 14a-13(a) of the Exchange Act, registrants subject to the proxy rules are required, among other things: (1) to inquire of each bank and broker of the number of copies of proxy soliciting materials necessary to furnish to beneficial owners at least twenty business days prior to the record date absent certain circumstances; and (2) to supply, in a timely manner, copies of the proxy and other proxy soliciting material in such quantities as reasonably requested by the bank or broker in order to send such material to each beneficial owner of securities. This notice also applies to the obligation of registrants to distribute information statements (and, if directors are to be elected, annual reports to shareholders) to banks and brokers pursuant to Rule 14c-7(a)(4) under the Exchange Act.

Although the rules do not specify the number of days before the meeting by which registrants must make their proxy materials available for distribution to their beneficial owners, in order to comply with the timeliness requirement, the materials must be mailed sufficiently in advance of

the meeting date to allow five business days for processing by the banks and brokers pursuant to Rules 14b-1(b)(2) and 14b-2(b)(2) and an additional period to provide ample time for delivery of the material, consideration of the material by the beneficial owners, return of their voting instructions, and transmittal of the vote from the bank or broker to the tabulator.²⁵⁹

NYSE Rules 450-455 contain requirements intended to facilitate the solicitation of proxies held in the names of brokers or their nominees, while safeguarding the rights of beneficial holders. Their purpose is to aid companies in meeting quorum requirements and obtaining a representative vote of shareholders.

Section 402.05 of the Listed Company Manual of the NYSE requires companies or others soliciting proxy material through brokers to make inquiry of such brokers at least ten days in advance of the record date in order to determine the number of sets of proxy soliciting materials necessary to enable brokers to supply each beneficial owner with a set. This period of time matches the minimum ten days prior notice to the Exchange required by Section 401.02.

15.1

d) Ownership registration (in the case of registered shares) and transfer of their shares?

Requirements relating to ownership registration and transfer are addressed by state corporate laws and the listing requirements of exchanges.

Under the DGCL, the officer who has charge of the stock ledger of a corporation is required to prepare and make, at least ten days before every meeting of stockholders, a complete list of the stockholders entitled to vote at the meeting, arranged in alphabetical order, and showing the address of each stockholder and the number of shares registered in the name of each stockholder.²⁶⁰ The stockholder list is required to remain accessible to any stockholder during the time of the meeting. That shareholder list is the only evidence of stockholders that are eligible to examine the list or to vote at any stockholders meeting, either in person or by proxy,²⁶¹ thereby providing the means through which shareholders can address their rights through voting. The accessibility of the list to all shareholders appearing on it provides for the equitable treatment of all shareholders, regardless of the number of shares they hold.

Exchange rules also may require that an issuer of listed securities maintain a qualified registrar where all of its listed stock may be registered.²⁶² Transfer agents serve as the custodians of security holder records for issuers. In this capacity, transfer agents frequently are responsible for

²⁵⁹ SEC Release 33-33768 (March 16, 1994).

²⁶⁰ § 211(a).

²⁶¹ § 211(C).

²⁶² See, for example, NYSE Listed Company Manual § 601.01.

disseminating shareholder communications and dividend and interest payments. The transfer agent is primarily a record keeper. They keep track of shareholders and their stock positions. By transferring stock, they provide a variety of reports on shareholders and stock activity, facilitate mailings to the shareholders, provide a variety of annual meeting services and perform any of a number of other related services, including paying dividends and assisting shareholders with their needs. Transfer agents are regulated by the SEC pursuant to Section 17A of the Exchange Act.

15.1

e) Receipt of dividends and other distributions, when, as and if declared?

State corporate laws provide the primary source of substantive regulation with regard to the payment of dividends. As a general matter, state corporate laws require that a corporation that declares a cash dividend on common stock pay that dividend to shareowners of record on the declared record date. Dividends on shares directly registered on the books of the corporation are paid directly to shareholders while dividends on shares held through a broker or other intermediary are paid by the corporation to the broker or other intermediary.

Under the DGCL,²⁶³ the directors of every corporation, subject to any restrictions contained in its certificate of incorporation, may declare and pay dividends upon the shares of its capital stock either (1) out of its surplus, or (2) in case there shall be no such surplus, out of its net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year. If the capital of the corporation is diminished by depreciation in the value of its property, or by losses, or otherwise, to an amount less than the aggregate amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets, the DGCL does not permit the directors of a corporation to declare and pay out of such net profits any dividends upon any shares of any classes of its capital stock until the deficiency in the amount of capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets shall have been repaired.

Under the DGCL,²⁶⁴ dividends may be paid in cash, in property, or in shares of the corporation's capital stock. If the dividend is to be paid in shares of the corporation's previously unissued capital stock the board of directors shall, by resolution, direct that there be designated as capital in respect of such shares an amount which is not less than the aggregate par value of par value being declared as a dividend and, in the case of shares without par value being declared as a dividend, such amount as shall be determined by the board of directors.

The federal securities laws require disclosure relating to dividends in an issuer's registration statements and annual reports.²⁶⁵ Under those requirements, an issuer must disclose, among

²⁶³ § 170.

²⁶⁴ § 173.

²⁶⁵ Regulation S-K, Item 201(c).

other information, the frequency and amount of any cash dividends declared on each class of common equity declared over the last two fiscal years for which financial statements are provided, and any interim periods. An issuer must also disclose information regarding any material limitations on its ability to pay dividends currently or in the future. If an issuer has not paid a cash dividend but has the ability to do so, the federal securities laws encourage disclosure about the issuer's intention to pay dividends. Additionally, Exchange Act Rule 10b-17 prohibits a dividend to be paid without ten days notice prior to the record date for determining holders entitled to receive the dividend, including the amount to be paid per share and the date of payment.

Exchanges also have provisions relating to the payment of dividends as part of their listing standards. For example, the NYSE requires notice to the exchange of any dividend or distribution related to a listed stock, including the postponement or omission of a dividend. This information includes the record and payment dates for the dividend, as well as any conditions that must be satisfied for the distribution to be made. Although there is no restriction on the interval between the record and the payment date under NYSE rules, the NYSE advises that it is desirable that the interval should be as short as possible.

15.1

f) Transactions involving:

i) A takeover bid?

The term "takeover bid" is not defined under the U.S. federal securities laws. Takeover bids are commonly referred to in the U.S. as "tender offers." The term "tender offer" is not defined under the federal securities laws or the SEC's rules. Judicial decisions have enumerated various characteristics of tender offers, essentially defining a tender offer as any public offer to purchase securities from security holders. The determination of whether a particular course of conduct is a tender offer for an issuer's securities is an important one: transactions that are tender offers are subject to the federal securities laws and the SEC's rules relating to tender offers, discussed below; transactions that are not tender offers are not subject to those laws and rules. Given that the manner in which securities are sought to be acquired may vary, and may become more innovative and complex over time, the absence of a definition for the term "tender offer" provides flexibility in determining whether present or future attempts to acquire shares should be subject to our comprehensive federal tender offer regulatory framework.

The consideration used to effectuate tender offers may be cash, stock, debt securities or some combination thereof. A tender offer is not always for all of the outstanding securities of a class; it may be for only a specified amount. Tender offers made by persons other than the issuer are often undertaken to acquire control or outright ownership of an issuer.

The underlying purpose of U.S. federal tender offer regulation is to provide disclosure and certain procedural safeguards to shareholders who hold securities that are subject to a tender

offer. Federal tender offer regulation is based on SEC rules and regulations, in combination with Section 13(e); Section 14(d); and Section 14(e) of the Exchange Act. The applicability of each section and its underlying regulations depends on: (i) the party conducting the offers; (ii) the nature of the subject security; (iii) whether the security is registered under Section 12 of the Exchange Act; and (iv) whether the bidder would own more than five percent of a class of equity securities after the tender offer. A tender offer is distinguishable from a merger that is subject to security holder vote. In a merger, security holders act collectively to decide whether to sell their shares; the minority, subject to appraisal rights, is bound by the decision of the majority. In a tender offer, conversely, security holders act individually in determining whether to sell their securities to a bidder. No statutory voting requirements exist in connection with a tender offer.

Although applicable state corporate laws and exchange rules may apply, the conduct of tender offers and the disclosure provided to security holders are principally governed by the SEC's rules, which include both principles-based standards and specific line-item disclosures. These requirements provide security holders with information about the proposed offer so that they are able to make informed decisions about whether to tender their securities to the bidder. These disclosure requirements also operate to impose liability on the bidder for material misstatements or omissions.

Third Party (Non-Issuer) Tender Offers

The statutory provisions that apply to tender offers made by parties other than the issuer include Exchange Act Sections 14(d) and (e) and Regulations 14D and 14E under the Exchange Act. Section 14(d) and Regulation 14D apply to all tender offers for Exchange Act registered equity securities made by parties other than the issuer so long as upon consummation of the tender offer the bidder would beneficially own more than five percent of the class of equity securities subject to the offer. A bidder must include any shares it owns before the commencement of the tender offer in calculating the five percent amount.

Section 14(d) of the Exchange Act requires any person or group intending to make a tender offer meeting the requirements noted in the preceding paragraph to file with the SEC a disclosure document on Schedule TO outlining the terms of the offer. This disclosure document must be filed electronically and is immediately available through the SEC's EDGAR system. Section 14(d) and the rules thereunder also require compliance with certain procedural safeguards that include dissemination of the Schedule TO to security holders. Regulations 14D and 14E prescribe detailed disclosure and procedural requirements with respect to third party tender offers, including withdrawal rights, proration, and protection to ensure the equal treatment of all security holders. These provisions were designed to require disclosure of material information to security holders and the marketplace and provide procedural protections that preserve the ability of security holders to act on that information without coercion. Tender offers featuring an offer to exchange securities are further subject to having the securities offering aspect of the transaction registered under the Securities Act. *See* the response to Question 14.1(a).

Exchange Act Section 14(d)(5) provides that persons who have deposited their securities pursuant to a tender offer may withdraw them at any time within seven calendar days after the time definitive copies of the offer are first published, sent or given to security holders or at any

time after sixty calendar days from the date of the original offer. The SEC, by Rule 14d-7, has substantially expanded these withdrawal rights. Rule 14d-7(a) grants each security holder the right to withdraw, at any time during the offering period, any securities it has tendered. If the offering period is extended for any reason, withdrawal rights are automatically extended for the duration of the offering period. Under Rule 14d-7(a), an offeror may not purchase securities during a time in which a security holder maintains the right to withdraw the securities. Accordingly, a bidder is effectively prohibited from purchasing any securities that have been tendered until the offering period has expired. This rule-based withdrawal right supplements the statutory right of withdrawal under Section 14(d)(5).

When the tender offer is for less than 100% of the outstanding class of equity securities, a so-called “partial tender offer”, a statutory safeguard becomes available in order to give all security holders an equal opportunity to participate in a partial tender offer and to protect security holders against pressure to make an early tender, Exchange Act Section 14(d)(6) provides that where more shares are tendered in a partial tender offer within the first ten calendar days of an offer than the bidder is bound or willing to take up, the securities must be taken up pro-rata, disregarding fractions, according to the number of securities deposited by each tendering security holder.

The SEC has expanded the protections introduced by this statutory provision through rulemaking. If the aggregate number of shares tendered in an offer for less than all of the outstanding securities of a class exceeds the maximum number of shares that the purchaser has offered to buy at the end of an offering period, Rule 14d-8 requires the purchaser to purchase tendered securities on a pro rata basis.

Section 14(d)(7) of the Exchange Act requires that if the purchaser increases the consideration offered, it must pay the highest amount for all securities purchased regardless of whether securities were tendered before or after the change in consideration. In practice, Section 14(d)(7) has become known as the “Best Price” provision. The express purpose of Section 14(d)(7), as specified in the U.S. Congressional legislative history, is to “assure fair treatment of those persons who tender their shares at the beginning of the tender period, and to assure equality of treatment among all shareholders who tender their shares.”²⁶⁶ Rule 14d-10, adopted in furtherance of this goal, provides that the offer must be open to all shareholders and that each tendering security holder must receive the highest consideration paid to any security holder during the period of the tender offer.

Regulation 14D requires the bidder to make specific disclosures to security holders and mandates certain other procedural protections. The disclosure focuses on the terms of the offer and information about the bidder. Rules 14d-4(c) and 14d-6(d) require a bidder to disclose promptly, in an amendment to its tender offer materials, any material change in information previously disseminated to target security holders in a manner reasonably designed to inform them of this change. This requirement necessarily includes a requirement that security holders be given adequate time to consider the new information. The procedural protections include the right to withdraw tendered securities while the offer remains open and the right to have tendered

²⁶⁶ H.R. Rep. No. 1711, 90th Cong. 2d Sess. at 11 (1968).

securities accepted on a pro-rata basis throughout the term of a partial tender offer. Also, Regulation 14D requires the bidder to file its offering documents and other information with the SEC and deliver a copy to the target issuer and any competing bidders. Rule 14d-9 further requires the target of the tender offer to send to security holders specific disclosure about its recommendation, file a Schedule 14D-9 containing that disclosure, and send the Schedule 14D-9 to the bidder.

Section 14(e) of the Exchange Act is an antifraud provision and prohibits a bidder from making material misstatements, or omitting to state any material fact necessary in order to make a statement made not misleading. Section 14(e) further prohibits any fraudulent, deceptive or manipulative acts in connection with any tender offer. Section 14(e) and Regulation 14E adopted thereunder apply to tender offers for any type of security (including most debt). These provisions apply both to registered and unregistered securities (including securities issued by a private company). Section 14(e) and Regulation 14E apply irrespective of the amount sought or the amount that would be owned after the consummation of the offer. Section 14(e) and Regulation 14E apply to tender offers made under Regulation 14D, as well as those made under Rule 13e-4 (issuer tender offers), discussed below. Section 14(e) and the rules promulgated thereunder apply to tender offers for securities regardless of whether the class is registered under Section 12 of the Exchange Act.

Rule 14e-1(a) of Regulation 14E requires that an offer remain open for a minimum offering period of twenty business days from the date the offer commences. Rule 14e-1(b) of Regulation 14E requires that the offer remain open for ten business days following a change in the offering price or the percentage of securities being sought. Rule 14e-1(c) of Regulation 14E requires that the bidder promptly pay for or return securities when the tender offer expires. If a bidder voluntarily or involuntarily extends the offering period, it must provide notice of such an extension pursuant to Rule 14e-1(d) of Regulation 14E. Such notice must be given by press release or other public announcement prior to 9:00 a.m. Eastern time and identify the number of securities tendered. Rule 14e-2 of Regulation 14E also requires the target company to state its position about the offer within ten business days after the offer begins. The target must state either that it recommends that its security holders accept or reject the offer; that it expresses no opinion and remains neutral toward the offer; or that it is unable to take a position on the offer. There are no filing requirements with the SEC in connection with tender offers that are only subject to Section 14(e).

Issuer Tender Offers

Section 13(e) of the Exchange Act authorizes the SEC to prescribe rules governing repurchases of equity securities by an issuer that is obligated to file reports under Section 12 of the Exchange Act. Rule 13e-4, promulgated under Section 13(e) of the Exchange Act, applies to all tender offers by an issuer for its equity securities when the issuer has a class of equity securities registered under Section 12 or when the issuer files periodic reports under Section 15(d) of the Exchange Act. Pursuant to Section 13(e), Rule 13e-4 regulates cash tender offers and exchange offers by issuers for their equity securities. Rule 13e-4 also applies to a tender offer by an affiliate of the issuer for the issuer's securities where the tender offer is not subject to Section 14(d). Rule 13e-4 is different from Regulation 14D because it applies even if the class of

securities sought in the offer is not registered under Section 12. Rule 13e-4 also applies regardless of the amount of securities sought in the offer. Rule 13e-4 provides for disclosure, filing and procedural safeguards that generally mirror those provided under Section 14(d) and Regulation 14D. The rule defines certain fraudulent, deceptive, or manipulative acts or practices in connection with issuer cash tender or exchange offers, and prescribes the disclosure and dissemination of certain information, among other requirements, as measures reasonably designed to prevent such acts or practices. The rule also requires that an issuer making a cash tender offer or exchange offer for its equity securities allow tendering security holders be given the opportunity to withdraw their tendered securities. Also, Rule 13e-4(f)(8), commonly viewed as the “equal treatment provision,” provides that the offer must be open to all security holders and that each tendering security holder must receive the highest consideration paid to any security holder during the period of the tender offer.

15.1(f)

ii) Other change of control transactions?

The federal securities laws would not apply to a change of control transaction if the transaction did not involve a tender offer, an offer of securities, or a shareholders’ vote. State corporate law generally would not apply to a change of control transaction if the transaction did not involve a business combination or a shareholders’ vote on a matter. Parties involved in a change of control transaction may be required to disclose the transaction afterward (for example, under Exchange Act Section 16, *see* response to Question 15.5). In addition, an issuer must disclose a change in control in a Current Report on Form 8-K within four business days after occurrence of the event, including: the identity of the person(s) who acquired control; the date and a description of the transaction(s) which resulted in the change in control; the basis of the control, including the percentage of voting securities of the registrant beneficially owned directly or indirectly by the person(s) who acquired control; the amount of the consideration used by such person(s); the source(s) of funds used by the person(s); the identity of the person(s) from whom control was assumed; and any arrangements or understandings among members of both the former and new control groups and their associates with respect to election of directors or other matters.

When two companies combine by means of a statutory merger or consolidation, state corporation law generally requires that the transaction be approved by security holders of one or both of the companies. The federal securities laws do not require the solicitation of proxies. However, if one of the companies is a publicly held company with a class of securities registered under Section 12 of the Exchange Act, if it solicits proxies, the solicitation must be in accordance with the SEC’s proxy rules adopted under Exchange Act Section 14(a).

Under Regulation 14A, persons soliciting proxies must file a proxy statement prepared in accordance with Schedule 14A that contains comprehensive disclosures about the proposals being introduced, the interests of the parties in the solicitation and other important information. Unlike the federal securities laws that regulate tender offers, no “equal treatment” provision exists under the federal proxy rules which govern change of control transactions that guarantees all security holders in the class will be invited to participate or that they have an equal opportunity to be paid the highest form of consideration available, although such transactions

may also be governed by state law. Moreover, “change of control” transactions may be deemed to occur without any consideration being offered to security holders where the solicitation of proxies relates only to the replacement of a majority of the board directors.

Section 14(c) of the Exchange Act requires issuers that are not soliciting proxies or consents from each holder entitled to vote or take action by written consent to distribute to such holders an information statement describing the corporate action to be taken. Section 14(c) imposes disclosure obligations for those situations where the issuer chooses not to or has no opportunity to solicit proxies from some or all of its security holders. Instances where Section 14(c) may become operative include those where management may control sufficient shares to assure a quorum and a favorable vote (*e.g.*, majority owned subsidiary), where a solicitation of proxies is made of only certain security holders, or in instances where security holders unilaterally act to take action. Regulation 14C, promulgated under Section 14(c), applies to the issuer only and governs the disclosure and mechanics of distributing an information statement containing the disclosure specified by Schedule 14C.

15.1

g) Holding the company, its directors and senior management accountable for their involvement or oversight in violations of law?

Under Section 11 of the Securities Act, purchasers of a security may sue the issuer, its directors, and each person who signs the registration statement, which includes the issuer’s principal executive officer, its principal financial officer, and its principal accounting officer, for material misstatements or omissions in a registration statement.²⁶⁷

In addition, under Section 12 of the Securities Act, any person selling a security in a public offering may be held liable to the purchaser for material misstatements or omissions determined as of the date of sale. This may include directors and officers, including those who are not signatories of the registration statement, among other persons.

An issuer and its directors and officers may also face liability under Section 17(a) of the Securities Act for misstatements and misleading statements in a registration statement if they commit fraud in connection with the offer or sale of a security, or obtain money or property in connection with the offer and sale of a security by means of any untrue statement or material fact or omission to state a material fact necessary to make the statements in the registration statement not misleading. Section 17 does not provide for a private right of action, and is enforceable only by the SEC.

²⁶⁷ Section 11 liability also extends to each underwriter, the independent accountant (with respect to audited financial statements upon which the accountant renders an audit report) and each expert (with respect to information included in reliance upon the expert).

Under the Exchange Act, Section 18 imposes liability for false and misleading statements in documents filed with the SEC, including annual reports and proxy statements. Under Section 18, any person who makes or causes a false and misleading statement to be made in a filing with the SEC filing may be held liable. Rule 10b-5 under the Exchange Act prohibits fraudulent and deceptive practices and untrue statements or omissions in connection with the sale of any security. This anti-fraud provision applies not only to filings made with the SEC but also to any information released to the public by an issuer.

Under SEC rules adopted pursuant to Section 404 of the Sarbanes-Oxley Act, companies are required to include in their annual reports a report of management, and an accompanying auditor's attestation report, on the effectiveness of the company's internal control over financial reporting, and to evaluate, as of the end of each fiscal quarter, any change in the company's internal control over financial reporting that occurred during the period that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.²⁶⁸

Under Section 302 of the Sarbanes Oxley Act, the SEC has also adopted rules under which the principal executive and principal financial officers, or persons performing similar functions, of a company filing periodic reports under Section 13(a) or 15(d) of the Exchange Act, must provide a certification of the disclosure contained in each quarterly and annual report filed with the SEC.²⁶⁹ Section 906 of the Sarbanes-Oxley Act also contains a certification requirement for periodic reports that is subject to specific federal criminal provisions and that is separate and distinct from the certification requirement mandated by Section 302.

Certain corporate law remedies are available to shareholders in order to hold the company, its directors and senior management accountable for their involvement or oversight in violations of law. For example, pursuant to DGCL Section 102(b), a company's certificate of incorporation may not contain any provision eliminating or limiting the personal liability of a director under the following circumstances:

- For any breach of the director's duty of loyalty to the corporation or its stockholders;
- For acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;
- For any unlawful payment of dividend or unlawful stock purchase or redemption; or
- For any transaction from which the director derived an improper personal benefit.

Under the DGCL, shareholder derivative suits provide additional means for holding directors and senior managers accountable for their oversight of a company's affairs. A shareholder derivative

²⁶⁸ SEC Release 33-8238 (June 5, 2003).

²⁶⁹ SEC Release 33-8124 (August 29, 2002).

suit enables a stockholder to bring suit on behalf of the corporation for harm done to the corporation. Because a derivative suit is being brought on behalf of the corporation, the recovery, if any, must go to the corporation. A stockholder who is directly injured, however, does retain the right to bring an individual action for injuries affecting his or her legal rights as a stockholder. Such a claim is distinct from an injury caused to the corporation alone. In such individual suits, the recovery or other relief flows directly to the stockholders, not to the corporation.

15.1

h) Bankruptcy or insolvency of the company?

Federal bankruptcy laws govern how companies go out of business or reorganize their debt obligations, including the resolution of competing creditor claims. Federal securities laws, on the other hand, aim to protect investors and foster capital formation through disclosure.

There are two primary routes through business bankruptcy in the U.S. Under Chapter 11 of the Bankruptcy Code, a company usually attempts to reorganize its business and become profitable again. Management usually continues to run day-to-day business operations, but all significant business decisions must be approved by a bankruptcy court. Under Chapter 7, the company stops all operations and goes out of business. A trustee is appointed to liquidate the company's assets and the money is used to pay off creditors and investors.

A company's securities may continue to trade even after the company has filed for reorganization under Chapter 11. Since its securities are still trading, a company must continue to file SEC reports and disclose material information to shareholders. In most instances, companies that file under Chapter 11 are generally unable to meet the listing standards to continue to trade on NASDAQ or the New York Stock Exchange. However, even when a company is delisted from one of these major stock exchanges, its shares may continue to trade on either the OTCBB or the Pink Sheets. There is no federal law that prohibits trading of securities of companies in bankruptcy.

Public companies generally file under Chapter 11 rather than Chapter 7 because they can continue to run their business and control the bankruptcy process. In a Chapter 11 bankruptcy, although a company may emerge from the process as a viable entity, the creditors and the bondholders generally become the new owners of the shares. In most instances, the company's plan of reorganization will cancel the existing equity shares. This happens in bankruptcy cases because secured and unsecured creditors are paid from the company's assets before common stockholders. In situations where shareholders do participate in the plan, their shares are usually subject to substantial dilution.

The SEC has statutory authority to participate in all Chapter 11 cases, but generally limits its activity to large public company cases. The SEC focuses its activity in four principal areas: (1) ensuring that plans and disclosure statements contain adequate information; (2) ensuring that public investors are adequately represented by an official committee, if appropriate; (3) ensuring that Bankruptcy Code exemptions from Securities Act registration are not misused; and (4) participating on legal issues that affect the rights of public investors (such as improper efforts

by debtors to shield officers and directors from lawsuits for securities fraud). Although the SEC reviews disclosure of reorganization plans, the SEC does not get involved in the economic terms of plans.

15.2

Is full disclosure of all information material to an investment or voting decision required in connection with shareholder voting decisions generally and the transactions referred to in Questions 1(f)(i) and 1(f)(ii) specifically?

Under the federal securities laws, full disclosure of information material to an investment or voting decision is required in connection with security holder voting decisions generally and takeover bids and change of control transactions specifically. For transactions involving an offer and sale of securities that must be registered under the Securities Act, a registration statement must be filed that contains specific line item disclosures and information required by applicable regulations. The response to Question 14 discusses the full disclosure requirements for offerings that are registered under the Securities Act.

Take-Over Bids (Tender Offers)

Tender offers filed on Schedule TO must comply with specific line item disclosure requirements and provide comprehensive information about the offer terms, the bidder(s) and other important information pursuant to Regulation M-A. In addition, for tender offers filed on Schedule TO, Item 11 of that schedule requires the bidder(s) to disclose “other material information...as may be necessary to make the required statements, in light of the circumstances under which they are made, not materially misleading.” For tender offers made by an issuer, Rule 13e-4(j)(1)(ii) similarly requires the issuer not to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

In addition to the foregoing, Section 14(e) of the Exchange Act makes it unlawful for any person in any tender offer to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading. Exchange Act Rule 12b-20 also may require additional information as to make any required statements made in a tender offer not misleading. For example, in tender offers for cash consideration subject to only Section 14(e) and Regulation 14E in which no filing requirement exists with the SEC, Section 14(e) would require that the price be disclosed.

Other Change of Control Transactions

Proxy statements containing the disclosures specified by Schedule 14A and information statements containing the disclosures specified by Schedule 14C must comply with line item disclosure and other substantive disclosure requirements governed by Exchange Act Regulations. Rules 12b-20, 10b-5 and 14a-9 or 14c-6 under the Exchange Act are designed so that proxy and information statements contain all material information as each rule requires that a person not

make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

15.3

With respect to transactions referred to in Question 1(f)(i) and 1(f)(ii), are shareholders of the class or classes of securities affected by the proposal:

a) Given a reasonable time in which to consider the proposal?

Take-Over Bids (Tender Offers)

With respect to take-over bids, security holders are given twenty business days under Rule 14e-1(a) of Regulation 14E to consider a third party tender offer proposal. Issuers also must comply with Rule 14e-1(a) and, to the extent an issuer conducts an issuer tender offer subject to Rule 13e-4, the issuer also is required to keep the offer open for at least twenty business days from its commencement under Rule 13e-4(f)(1)(i).

Other Change of Control Transactions

With respect to other change of control transactions other than business combinations, an issuer or third party may satisfy its disclosure obligations under the SEC's proxy rules to furnish proxy materials to shareholders in connection with a proxy solicitation by posting its proxy materials on a publicly-accessible Internet Web site (other than the SEC's EDGAR Web site) and sending a Notice of Internet Availability of Proxy Materials to security holders at least forty calendar days before the security holder meeting date.

To the extent an issuer or third party chooses to mail the proxy statement to security holders, the proxy rules do not specify the number of days before the meeting by which registrants must make their proxy materials available for distribution to their beneficial owners. In the absence of an express requirement regarding the timeliness of the distribution, the SEC has interpreted its existing proxy rules as requiring a proxy statement to be mailed sufficiently in advance of the meeting date to allow five business days for processing by banks and brokers (acting on behalf of beneficial owners) and an additional period to provide ample time for delivery of the material, consideration of the material by the beneficial owners, return of their voting instructions, and transmittal of the vote from the bank or broker to the tabulator.²⁷⁰ To the extent that financial information is incorporated by reference to satisfy line item disclosure requirements in the proxy statement instead of being disclosed directly in the document, Note D to Schedule 14A requires the proxy statement to be sent to security holders no later than twenty business days prior to the date on which the meeting of security holders is held. The same timeliness standard is applicable in cases where an information statement on Schedule 14C incorporates information by reference. Rule 14c-2(b) of Regulation 14C otherwise requires that the information statement filed on

²⁷⁰ SEC Release 34-33768 (March 16, 1994).

Schedule 14C must be disseminated to security holders twenty calendar days before the corporate action is taken.

15.3

b) Supplied with adequate information to enable them to assess the merits of the proposal?

As described in the response to Principle 14, security holders receive comprehensive disclosure documents upon which they may rely in order to make an informed voting or investment decision when the transaction involves an offering of securities that is registered under the Exchange Act.

Take-Over Bids (Tender Offers)

In the context of tender offers, security holders will receive a Schedule TO as described in response to Question 15.1(f)(ii). To the extent that non-cash consideration is offered, the bidder will need to register the offer and sale of such consideration on a registration statement under the Securities Act or claim an exemption.

Other Change of Control Transactions

In the context of other change of control transactions that involve approval by security holders pursuant to a vote, security holders will receive a proxy statement that complies with Schedule 14A. In the event a change of control may be effectuated without a security holder vote by way of consent executed by a majority of the securities in the class outstanding, security holders will receive an information statement that complies with Schedule 14C. To the extent that non-cash consideration is offered, the offeror(s) will need to register the offer and sale of such consideration on a registration statement under the Securities Act or claim an exemption.

15.3

c) As far as practicable, given reasonable and equal opportunities to participate in any benefits accruing to the shareholders under the proposal?

Take-Over Bids (Tender Offers)

As discussed in the responses to Questions 15.1(f)(i) and (ii), Section 14(d)(7) of the Exchange Act and corresponding Exchange Act Rule 14d-10 are designed to ensure that target security holders receive fair and equal treatment. In the context of tender offers made by issuers subject to Rule 13e-4, Rule 13e-4(f)(8) similarly requires that the offer be made to all holders in the subject class and that each security holder is eligible to receive the highest form of consideration.

Other Change of Control Transactions

The proxy rules under the federal securities laws do not require that security holders be given reasonable and equitable opportunities to participate in a transaction or receive an equal amount of consideration. Notwithstanding the absence of an express requirement to guarantee equal treatment, change of control transactions ordinarily provide members of the class an equal opportunity to vote. In order to achieve the desired result in a transaction subject to security holder vote, a natural incentive exists to ensure that adoption of the proposal would result in a fair distribution of the benefits among security holders.

In change of control transactions in which an ownership or management transition may be effectuated without a security holder vote of a class of securities registered under Section 12 of the Exchange Act, the issuer may be required to disseminate an information statement complying with Schedule 14C. Instances in which Section 14(c) may require the dissemination of an information statement are those where management may control sufficient shares to assure a quorum and a favorable vote (*e.g.*, majority owned subsidiary), or where a solicitation of proxies is made of only certain security holders or certain security holders act unilaterally by written consent. While no provision exists in Section 14(c) or corresponding Regulation 14C to offer a reasonable and equal opportunity to participate in any benefits accruing to participants in the transaction or certain security holders, the requirement under Rule 14c-2(b) of Regulation 14C that the information statement complying with Schedule 14C be disseminated at least twenty calendar days before the corporate action is to be taken provides security holders with an opportunity to legally challenge the transaction in a court of competent jurisdiction.

In certain acquisitions of securities registered under Section 12 that are subject to the tender offer or beneficial ownership reporting requirements under the federal securities laws, agreements may exist as part of those acquisitions that result in the replacement of a majority of the board of directors. Such transactions may be classified as a change of control transaction. Section 14(f) of the Exchange Act and Rule 14f-1 thereunder require the issuer to disseminate an information statement that contains information that is the substantial equivalent of information contained in the proxy statement with respect to solicitations involving the election of directors. This information statement must be transmitted to security holders at least ten calendar days before the designated officers take office.

15.3

- d) Given fair and equal treatment (in particular, minority security holders) in relation to the proposal?***

Please *see* the responses to Questions 15.1 (f)(i) and (ii).

15.3

- e) Not unfairly disadvantaged by the treatment and conduct of directors of any party to the transaction or by the failure of the directors to act in good faith in responding to or making recommendations with respect to the proposal?***

This area of the regulatory framework is addressed principally under state corporate law. DGCL 141(a) provides that the business and affairs of a corporation are to be managed or under the control of its board of directors. Delaware common law provides that directors owe fiduciary duties to the corporation and its stockholders. While DGCL contains statutory provisions that address the rights and equal treatment of stockholders, as discussed in the response to Question 15.1, above, the outlines of management's fiduciary duties towards the corporation and its stockholders have been developed through common law jurisprudence. Most states possess similar judicial precedent.

Two general fiduciary duties imposed on directors are the duty of care and the duty of loyalty. In furtherance of the basic concept contained in DGCL 141(a), the duty of care is aimed at a director's responsibility to exercise an appropriate degree of diligence when managing the corporation's business or affairs and requires that a director remain fully informed about the corporation's activities. This can mean that the director should commit time to and regularly attend meetings, pay attention and ask questions at these meetings, stay adequately informed about the corporation, and bring relevant information to the attention of other directors. It is expected that directors will exercise their duty of care in a manner that a person in a like position would reasonably believe appropriate given the circumstances.

The duty of loyalty requires that the best interests of the corporation and its stockholders take precedence over any direct or indirect personal interest not shared by stockholders generally. Directors should watch for and be aware of any interests that could potentially be considered to conflict with the corporation's interests.

Delaware courts have also developed jurisprudence relating to subsets of the duty of loyalty, reflecting the related concepts of good faith and candor. The duty of good faith requires that directors act in the best interests of the corporation and its stockholders, as with the duty of loyalty, but court review centers on the motivations behind board actions and considers the process by which the board considered a matter (similar to the duty of care). The duty of candor may be breached when a board issues deceptive or incomplete communications to shareholders. Closely following the standard of materiality discussed above in the introduction to Question 14, Delaware courts have stated that directors have a duty to disclose all material information that a reasonable stockholder would consider important in deciding how to vote on a corporate action and, in order to be considered material, such information must significantly alter the "total mix" of information made available.

The business judgment rule is an established judicial standard of review ordinarily used by the judiciary if a director's satisfaction of the duty of care is challenged in court. It allows courts to analyze a director's behavior and determine whether a board decision can be successfully challenged or whether a director should be personally liable.

As discussed under the response to Question 15.1(a)(iii), DGCL also provides for the availability of appraisal rights to stockholders as a result of an amendment to a corporation's certificate of incorporation, any merger or consolidation, or the sale of all or substantially all of the assets of the corporation. Additionally, as discussed under the response to Question 15.1(g), shareholder

derivative suits provide additional means for holding directors accountable for their oversight of a company's affairs.

The federal securities laws also contain requirements designed to address the concern that stockholders not be unfairly disadvantaged by the treatment and conduct of directors or by the failure of the directors to act in good faith in responding to or making recommendations with respect to a proposal. For example, Rule 13e-3 under the Exchange Act relates to transactions: (1) designed or reasonably likely to eliminate or substantially reduce the public equity interest in an issuer, and (2) in which an affiliate of the target company is the acquiror. Because the issuer, control person(s) and management have vested interests in the outcome of these types of transactions that may not be shared on a pro rata basis with other security holders, they potentially may overreach and treat unaffiliated security holders unfairly or otherwise place them at a disadvantage. Rule 13e-3 is intended to minimize the potential for unfair treatment by imposing procedural and disclosure obligations upon issuers and their affiliates engaged in these types of transactions. Among these are requirements to disclose whether the issuer believes the transaction is fair to all unaffiliated stockholders, the factors considered in support of such fairness determination, and whether stockholders possess any rights to seek appraisal of their shares outside of the transaction proposed by management or an affiliate of the issuer.

15.4

With respect to substantial holdings of voting securities:

a) Is information about the identity and holdings of persons who hold a substantial (well below controlling) beneficial ownership interest in a company required to be timely disclosed:

i) In public offering and listing particulars documents?

Generally, beneficial ownership is defined under Exchange Act Rule 13d-3(a) as persons who may, directly or indirectly, vote or dispose or direct the voting and disposition of a voting class of equity securities registered under Section 12 of the Exchange Act. Beneficial ownership of directors and executive officers of the registrant as a group and any person who is known to the registrant to be the beneficial owner of more than five percent of any class of the registrant's voting securities must be disclosed in registration statements under the Securities Act pursuant to Item 403 of Regulation S-K.

15.4(a)

ii) Once the ownership threshold requiring disclosure has been reached?

The beneficial ownership reporting requirements under the federal securities laws provide investors and the issuer with information about accumulations of voting classes of equity securities that may have the potential to change or influence control of the issuer. The statutory and regulatory framework establishes a comprehensive reporting system for gathering and disseminating information about the ownership of publicly held equity securities. This framework is established under Sections 13(d) and 13(g) of the Exchange Act.

Section 13(d) of the Exchange Act requires a person who beneficially owns more than 5% of a class of equity security registered under the Exchange Act to provide certain information to the issuer of the subject equity security, to the SEC (and consequently to the public), and to each exchange on which the security is traded. The information must be provided within ten days after the acquisition of securities that triggered the obligation under Section 13(d).

Section 13(d) specifies the information required to be disclosed and gives the SEC the authority to adopt rules and regulations that vary those requirements. Under this authority, the SEC has adopted Regulation 13D-G and Schedule 13D under the Exchange Act, which provide the specific disclosure requirements to be satisfied.

Under Section 13(d) and Schedule 13D, a beneficial owner who is required to report must disclose the background and identity, residence, and citizenship of, and the nature of the beneficial ownership by, such person and all other persons by whom or on whose behalf the purchases have been or are to be effected. The disclosure must also cover the number of shares beneficially owned, the source of funds used to purchase the shares, and if the purpose of the purchase is to acquire control of the issuer, then any plans of the reporting person to liquidate the issuer, to sell its assets, to engage it in a merger, or other specified transactions.

When two or more individuals or entities come together for the purpose of acquiring, holding or disposing of a target company's securities, the group is deemed to be a single "person" for purposes of the filing requirement under Section 13(d). As a result, a Schedule 13D must be filed by the members of the "group" when they collectively beneficially own more than 5% of the class of target company securities. Application of this "group" notion is based on the facts and circumstances of any particular situation.

Exchange Act Section 13(g) and Regulation 13D-G provide that certain investors may file a Schedule 13G, "short-form" disclosure document, to disclose their ownership interest in equity securities. These Schedule 13G filers include specified institutional investors holding securities in the ordinary course of business and not with a control purpose. The types of institutional investors that may file on Schedule 13G include registered broker-dealers, banks, insurance companies, registered investment companies, registered investment advisers and employee benefit plans and pension funds subject to the Employee Retirement Income Security Act, and related holding companies and groups. Schedule 13G must be filed by these investors within forty-five days after December 31 of the year in which the 5% threshold was exceeded.

In addition, Regulation 13D-G permits another class of investors to file a Schedule 13G. A person is permitted to disclose its ownership on a Schedule 13G if it: (1) has not acquired the securities with any purpose, or with the effect of changing or influencing control of the issuer or in connection with or as a participant in any transaction having that purpose or effect; (2) is not a type of institution described in the preceding paragraph; and (3) is not the beneficial owner of 20% or more of the class of securities. In this circumstance, the due date for filing is ten days after the acquisition.

15.4(a)

iii) At least annually (e.g., in the issuer's annual report)?

Consistent with the disclosure required in registration statements filed under the Securities Act and Exchange Act, as outlined in the response to Question 15.4(a)(i), above, beneficial ownership of directors and executive officers of the registrant as a group and any person who is known to the registrant to be the beneficial owner of more than 5% of any class of the registrant's voting securities must be disclosed in annual reports pursuant to Item 403 of Regulation S-K. As discussed more fully below in the response to Question 15.5, officers and directors of an issuer with a class of equity securities registered under Section 12 of the Exchange Act, and every person who is the beneficial owner of more than 10% of the class of such securities must file with the SEC an initial ownership report and subsequent ownership reports noting any changes in ownership, and these reports are publicly available upon filing.

15.4

b) Are material changes in such ownership and other required information required to be timely disclosed?

Sections 13(d)(2) and 13(g)(2) of the Exchange Act, in combination with Exchange Act Rule 13d-2, require that material changes to the information disclosed in the various Schedules be disclosed in an amended filing. Under that rule, the acquisition or disposition of beneficial ownership of securities in an amount equal to 1% or more of the class of securities shall be deemed material, although acquisitions or dispositions of less than those amounts may be material, depending on the facts and circumstances. Other material changes in the facts disclosed must likewise be disclosed. An amendment to a Schedule 13D must be filed promptly. Amendments to Schedule 13G are due on a more relaxed timeframe.

15.4

c) Are these disclosure requirements applicable to two or more persons acting in concert even though their individual beneficial ownership might not have to be disclosed?

Section 13(d)(3) of the Exchange Act provides that when two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a "person." Application of this statutory provision therefore results in an aggregation of the ownership interests between two or more persons acting in concert. Related Exchange Act Rule 13d-5(b)(1) operates to help determine when two or more persons should be deemed to be a "group." Rule 13d-5(b)(1) sets forth the test for whether two or more persons constitute a group. The test is twofold. First, there must be an agreement. The agreement need not be in written form. In determining whether persons agreed to act together, the SEC and the courts look to circumstances such as contacts between persons, parallel action by persons and whether persons had similar goals. To be deemed to have formed a group, persons must agree to act together for purposes of acquiring, holding, voting or disposing of the subject securities.

15.4

- d) Is the legal infrastructure sufficient to assure enforcement of, and compliance with, the applicable requirements?***

As discussed in the response to Question 14.6, Staff in CF selectively review filings made under the Securities Act and the Exchange Act to monitor and enhance compliance with the applicable disclosure and accounting requirements. The Staff may comment on an issuer's legal and/or financial disclosure to identify deficiencies and promote full and fair disclosure. CF may make referrals for non-compliance to Enforcement.

Additionally, Enforcement may itself initiate and conduct investigations into possible violations of the federal securities laws, such as failure to make required filings with the SEC, or failure of corporate insiders to file the appropriate forms with the SEC regarding their personal securities trades, and files civil actions and administrative proceedings in this area.

15.5

With respect to holdings of voting securities by directors and senior management:

- a) Is information about the beneficial ownership interest and material changes in beneficial ownership in a company required to be timely disclosed?***
- b) Is such information available:***
- i) In public offering and listing particulars documents?***
- ii) At least annually (e.g., in the issuer's annual report)?***
- c) Is the legal infrastructure sufficient to ensure enforcement of and compliance with these requirements?***

Disclosure about the beneficial ownership interest of directors and executive officers in a company, and material changes in those interests, is required pursuant to two distinct reporting regimes under the federal securities laws: one regime relates to disclosure provided by the issuer on a periodic basis under the issuer's disclosure obligations under the federal securities laws; and the second regime relates to disclosure provided by "insiders" (described below) under Section 16 of the Exchange Act.

Issuer Disclosure

In various disclosure documents described below, issuers are required to disclose, as of the most recent practicable date, in a specified tabular format, as to each class of equity securities of the issuer or any of its subsidiaries or parent companies, the beneficial ownership of securities of all directors and nominees (naming them), each of the five mostly highly compensated executive

officers (naming them), and all directors and executive officers as a group (without naming them). The information disclosed must include the title of the class of securities, the name of the beneficial owner, the amount and nature of beneficial ownership, and the percent of the class. This disclosure must specify the amount of shares that are pledged as security and the amount of shares with respect to which the named persons have the right to acquire beneficial ownership.²⁷¹

For purposes of this disclosure, an executive officer broadly includes any officer who performs a policy making function for an issuer, which could include officers of subsidiaries if they perform policy making functions for the issuer. Beneficial ownership is broadly defined as discussed in response to Question 15.4.

This disclosure must be made in a prospectus relating to an offering of the issuer's shares under the Securities Act²⁷² and in a registration statement under the Exchange Act.²⁷³ In addition, the disclosure must be updated at least yearly, either in the issuer's annual report filed under the Exchange Act or in the issuer's proxy or information statement delivered to shareholders in connection with the election of directors.²⁷⁴

As noted elsewhere in this assessment, issuers are subject to SEC enforcement actions and other sanctions with respect to incomplete or misleading disclosures.

Section 16 Reporting Regime

Section 16 of the Exchange Act provides for a stand-alone reporting regime with respect to ownership of an issuer's securities. Section 16 applies to every officer and director of an issuer with a class of equity securities registered under Section 12 of the Exchange Act.²⁷⁵ Upon becoming a reporting person or upon the Section 12 registration of that security, Section 16(a) requires a reporting person to file an initial ownership report with the SEC disclosing his or her beneficial ownership of all equity securities of the issuer. The insider must report the number of securities in which he or she has a direct or indirect opportunity to profit. To keep this information current, Section 16(a) also requires reporting persons to report changes in such ownership, or the purchase or sale of a security-based swap agreement involving such equity security, before the end of the second business day following the day on which the subject transaction was executed.

²⁷¹ Item 403(b) of Regulation S-K.

²⁷² Form S-1, Item 11(m).

²⁷³ Form 10, Item 4.

²⁷⁴ Form 10-K Item 12 and Schedule 14A Item 6(d).

²⁷⁵ Section 16 also applies to every person who is the beneficial owner (as defined under Exchange Act Rule 13d-3(a)) of more than 10% of the class of securities registered under Section 12. This assessment refers to all persons to whom Section 16 applies as "reporting persons" or "insiders." See also the response to Question 15.4.

The SEC has adopted various forms and rules to implement this reporting requirement. Insiders are required to report their initial ownership and all changes in ownership on the required forms. The SEC has adopted rules that exempt insiders from reporting some changes in security ownership on a current basis, such as routine acquisitions pursuant to broad-based, non-discriminatory employee benefit plans. Insiders who are delinquent in their current transaction reporting, or who engage in transactions for which deferred reporting is permitted (*e.g.*, bona fide gifts) must file an annual statement to report those previously unreported transactions.

All filings under Section 16 (*i.e.*, the initial statement of ownership, the statement of changes in ownership, and the annual statement, if required) must be filed electronically through the SEC's EDGAR system. These filings are immediately publicly available on filing.

The SEC's Delinquent Filers Program, described in the response to Question 14.6, applies similarly to filings under Section 16. The SEC has brought enforcement actions against insiders who have not complied with their Section 16 filing obligations.²⁷⁶

15.6

If public offerings or listings by foreign issuers are significant within the jurisdiction, does the jurisdiction require disclosure in foreign issuers' offering and listing particulars documents of any governance provisions or information relating to the foreign issuer's jurisdiction that may materially affect the fair and equitable treatment of shareholders?

There are over 1,000 foreign private issuers that are registered and filing reports with the SEC under the Exchange Act. Please refer to the response to Question 14.10 for a discussion of the SEC's disclosure regime applicable to foreign private issuers. As noted in that discussion, in September 1999, the SEC substantially revised its disclosure requirements for foreign private issuers to fully incorporate the IOSCO International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers.²⁷⁷ As a result, in prospectuses under the Securities Act and registration statements under the Exchange Act, foreign private issuers are required to disclose material information relating to shareholder rights as required under those IOSCO standards.

In addition, in prospectuses under the Securities Act and annual reports under the Exchange Act, all issuers, including foreign private issuers, are required to disclose material "risk factors," *i.e.*, those factors that are specific to the company that make an investment speculative or one of high risk. In practice, in providing "risk factor" disclosure, a foreign private issuer may frequently disclose differences in shareholder rights between the foreign jurisdiction and the U.S., or note the existence of provisions of foreign corporate law or of the issuer's chartering document that have a material effect on shareholders' ability to pursue certain remedies or other matters affecting shareholder rights.

²⁷⁶ SEC Release 34-41428 (May 20, 1999).

²⁷⁷ SEC Release 34-41936 (September 28, 1999).

Further, in September 2008, the SEC adopted a new disclosure requirement applicable to the annual reports of foreign private issuers.²⁷⁸ Under this new requirement, all foreign private issuers that are listed on a U.S. exchange must provide a concise summary of the significant ways in which the issuer's corporate governance practices differ from the corporate governance practices followed by U.S. companies under the relevant exchange's listing standards.

²⁷⁸ SEC Release 33-8959 (September 23, 2008).

Issuers – Principle 16

Accounting and auditing standards should be of a high and internationally acceptable quality.

Assessment

Fully Implemented

16.1

Are public companies required to include audited financial statements in:

a) Public offering and listing particulars documents?

In responding to this Principle the term “public companies” is considered to refer to the offerings and listings of corporate registrants. The SEC has separate requirements for more specialized offerings and listings; for example, for those of investment funds (mutual funds); asset-backed securities trusts, royalty trusts and mutual life insurance companies.

The SEC requires that the content of issuer registration statements for public offerings of securities under the Securities Act and public listings of securities under the Exchange Act include audited financial statements. These requirements are put into effect via SEC Regulation S-X,²⁷⁹ which calls for provision of the balance sheet and profit and loss statement as well as a statement of comprehensive income, a statement of cash flows and a statement of changes in equity. Regulation S-X also requires that the financial statements be audited.

16.1

b) Publicly available annual reports?

Under the Exchange Act, issuers of a class of securities that is registered under that Act must file annual reports. Regulation S-X calls for and describes the audited financial statements that must appear in such annual reports. These requirements are the same as noted above in response to Question 16.1 (a).

Companies file their annual reports with the SEC through the EDGAR system. These annual reports are publicly available, free of charge, electronically from the SEC’s web site. The SEC also provides an ordering service for older documents not available on the web site and maintains a Public Reference Room at the SEC’s Headquarters.

²⁷⁹ See 17 C.F.R. §§ 210 *et seq.*

16.2

Do the required audited financial statements include:

- a) A balance sheet or statement of financial position?*
- b) A statement of the results of operations?*
- c) A statement of cash flow?*
- d) A statement of changes in ownership equity or comparable information included elsewhere in the audited financial statements or footnotes?*

Yes. The information in 16.2 (a)-(d) is required in audited financial statements, as specified in Regulation S-X.

16.3

With respect to the financial statements required in public offering and listing particulars documents and publicly available annual reports:

- a) Are these required to be prepared and presented in accordance with a comprehensive body of accounting standards?*

The financial statements of U.S. public companies are required to be prepared and presented in accordance with U.S. GAAP. U.S. GAAP is a comprehensive body of accounting standards that has evolved and developed since the first Accounting Research Bulletins were issued by the AICPA in the late 1930's. It is comprised of standards and interpretations established by the FASB and its predecessors, as modified or supplemented in a few places by rules and guidance from the SEC and its staff. It has been established and continuously improved by a full-time standard setting organization, the FASB, since 1973.

16.3

- b) Are these accounting standards of a high and internationally acceptable quality?*

U.S. GAAP is a long-established and continually-improving high quality and comprehensive body of accounting standards and related guidance that has long been accepted in capital markets throughout the world for the preparation of financial statements.

The Exchange Act gives the SEC statutory authority to establish financial accounting and reporting standards for publicly held companies. Throughout its history, however, the SEC's practice has been to look to the private sector for this function to the extent that the private sector demonstrates the ability to fulfill the responsibility in the public interest.

Since 1973, the FASB has been the full-time U.S. organization in the private sector for establishing standards of financial accounting. The FASB's standard setting process allows for

due process that includes broad public exposure, consultation from various advisory groups, task forces and working groups of constituents, as well as input from the SEC staff.

Pursuant to its authority under Section 108 of the Sarbanes-Oxley Act, the SEC has recognized the standards of the FASB as “generally accepted” for the purpose of the U.S. federal securities laws.²⁸⁰

16.4

Are the financial statements presented under circumstances so that they:

a) Are comprehensive?

The financial statements prepared under U.S. GAAP are comprehensive. U.S. GAAP is widely recognized globally as comprehensive and has evolved from decades of development of the requirements of the standards. These requirements are modified or supplemented in a few places by rules and guidance from the SEC and its Staff.

16.4

b) Are understandable by investors?

In addition to the requirements of the accounting standards and the SEC’s guidance, the Staff regularly performs selective reviews of the accounting and disclosure included in the financial reporting of public companies to monitor if necessary information is included and presented in a clear and understandable manner in order to be understandable by investors, and advises the company via comment letter if improvement is needed. The Staff also issues guidance to promote clear, complete and understandable reports and disclosures for investors.

16.4

c) Reflect consistent application of accounting standards?

U.S. GAAP and related Staff guidance relating to changes in accounting standards direct that information is to be presented on a consistent basis and prescribe special procedures and disclosures if reclassifications and/or changes in accounting occur.

²⁸⁰ See the April 25, 2003 SEC policy statement recognizing the FASB as satisfying the criteria in Section 19(b) of the Securities Act, as added by Section 108 of the Sarbanes-Oxley Act of 2002.

16.4

d) Are comparable if more than one accounting period is presented?

U.S. GAAP and related Staff guidance promote consistency and comparability in period to period reporting. Specific guidance is included for presentation and disclosure associated with reclassifications and changes in accounting policies, changes in estimates, changes in reporting entity and other conditions which affect comparability. The PCAOB's auditing standards require an auditor to recognize material changes in accounting in the auditor's report by making an explanatory paragraph.

16.5

With respect to the audited financial statements included in public offering and listing particulars documents and publicly available annual reports:

a) Are these required to be audited in accordance with a comprehensive body of auditing standards?

The auditing standards used by auditors of public companies in the U.S. are the standards of the PCAOB, as modified or supplemented by the SEC. These standards are comprehensive. Regulation S-X requires that financial statements be audited and Section 103 of the Sarbanes-Oxley Act requires that audits of public companies be conducted in accordance with standards established by the PCAOB as described above.

16.5

b) Are these auditing standards of a high and internationally acceptable quality?

The auditing standards and requirements of the U.S. have long been accepted throughout the world's capital markets and are widely recognized as being of high quality. Before the enactment of the Sarbanes-Oxley Act and the establishment of the PCAOB in 2002, auditing standards for registered public companies were established by the AICPA. The AICPA's Auditing Standards Board had developed a number of Statements of Auditing Standards through a process that included deliberations in public meetings and public exposure of draft statements.

The Sarbanes-Oxley Act gave the PCAOB authority to establish auditing, ethics, independence and quality control standards for registered public accounting firms and specified that the PCAOB may establish standards through its own development and/or through the adoption of standards proposed by other professional groups of accountants, all pursuant to SEC oversight.²⁸¹ The SEC has authority under the U.S. federal securities laws to set auditing standards for audits

²⁸¹ Sarbanes-Oxley Act Section 103.

of reporting issuers.²⁸² The PCAOB adopted the auditing and related professional practice standards of the ASB as they existed in April 2003 as interim professional standards. Subsequently, the PCAOB is reviewing these standards to determine whether they need to be modified, superseded or adopted as a permanent standard. The PCAOB's standard setting process allows for due process that includes broad public exposure, consultation from its Standing Advisory Group, *ad hoc* task forces, as well as a review and approval by the SEC of its standards.²⁸³

16.6

Are there standards or requirements sufficient to ensure that the external auditor is independent?

Independence of the external auditor is required under the U.S. system. It is comprehensively addressed by the SEC's auditor independence rules adopted in 2000.²⁸⁴ These rules were amended and strengthened in 2003 following the passage of the Sarbanes-Oxley Act that amended Exchange Act Section 10A.²⁸⁵ Some of the major areas covered include, for example, general independence standards, financial interests, employment relationships, business relationships, non-audit services, contingent fees, partner rotation, audit committees, administration of the audit engagement, quality controls, definitions and other matters.

16.7

Where unaudited financial statements are used, for example, in interim reports, and interim period financial statements in public offering and listing particulars documents, in full or summary format, is the financial information presented in accordance with accounting standards that are of a high and internationally acceptable quality?

Financial statements in interim reports and offering and listing documents are required to be prepared and presented in accordance with Regulation S-X and U.S. GAAP, whether audited or unaudited. In addition, unaudited interim financial statements are required to be reviewed by an independent public accountant registered with the PCAOB.

If a registrant publicly discloses material information that includes non-GAAP financial measures as discussed in Regulation G,²⁸⁶ the information must be presented with the

²⁸² Section 10A of the Exchange Act requires that auditors of financial statements of issuers within the SEC's jurisdiction perform audit procedures "in accordance with generally accepted auditing standards as may be modified or supplemented from time to time by the Commission."

²⁸³ Sarbanes-Oxley Act Section 107.

²⁸⁴ SEC Release No. 33-7919 codified in Rule 2-01 of Regulation S-X (17 C.F.R. §210.2-01).

²⁸⁵ SEC Releases Nos. 33-8183 and 33-8183A.

²⁸⁶ Rule 100 of the Exchange Act.

comparable GAAP measures, reconciled to GAAP and presented in ways that are not misleading to investors.

The PCAOB’s interim auditing standards also require the auditor to read other information provided with interim financial information and to consider whether such information or the manner of presentation is materially inconsistent with the interim financial information.²⁸⁷

16.8

In regard to oversight, interpretation and independence:

a) With respect to accounting standards:

i) Does the regulatory framework provide for an organization responsible for the establishment and timely interpretation of accounting standards?

The U.S. federal securities laws authorize the SEC to set standards of accounting and financial reporting for companies that file information and reports with the SEC. The SEC historically has looked to private-sector standard-setting bodies to develop accounting principles and standards for public companies. Pursuant to its authority under Section 108 of the Sarbanes-Oxley Act,²⁸⁸ the SEC has recognized the standards of the FASB as “generally accepted” for the purpose of the U.S. federal securities laws.²⁸⁹

Section 108 of the Sarbanes-Oxley Act establishes criteria that must be met in order for the work product of an accounting standard-setting body to be recognized by the SEC as “generally accepted.” Section 108 requires that the SEC determine whether the standard-setting body has the capacity to assist the SEC in fulfilling the requirements of the securities laws. In addition, the standard setting body must have adopted procedures to ensure prompt issuance, by a majority vote of its members, of changes to accounting principles necessary to reflect emerging accounting issues and changes in business practices.²⁹⁰

The FASB’s mission is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors and users of financial information. The FASB follows certain precepts in the conduct of its activities. These precepts are: to be objective in its decision-making; to weigh carefully the views of its constituents; to promulgate standards only when the expected benefits exceed the perceived costs; to bring about needed changes in ways that minimize disruption to the continuity of reporting practice; and to review the effects of past decisions and interpret, amend, or replace standards in a timely fashion

²⁸⁷ See AU 722.18(f).

²⁸⁸ Securities Act § 19(b).

²⁸⁹ See the April 25, 2003 SEC policy statement recognizing the FASB as satisfying the criteria in Section 19(b) of the Securities Act, as added by Section 108 of the Sarbanes-Oxley Act of 2002.

²⁹⁰ Securities Act § 19(b)(1)(A)(iv).

when such action is indicated. The FASB describes itself as “committed to following an open, orderly process for standard setting that precludes placing any particular interest above the interests of the many who rely on financial information.”²⁹¹

The FASB is part of a structure that is independent of all other business and professional organizations. Funding is received through an annual accounting support fee assessed against issuers as provided for under Section 109 of the Sarbanes-Oxley Act. The FASB is overseen by the Financial Accounting Foundation (FAF) which is responsible for selecting the five full-time FASB members, selecting members of its advisory council, and ensuring adequate funding of its activities. The FAF is an independent, non-profit organization that is run by a Board of Trustees of between 14 and 18 members. The FASB is supported by the Financial Accounting Standards Advisory Council which is responsible for consulting with the FASB as to technical issues on the FASB’s agenda and project priorities. The FASB both establishes standards and related guidance, and interprets its standards through approving positions of the FASB staff and of its own Emerging Issues Task Force.

16.8(a)

- ii) If yes, are the organization's processes open and transparent, and, if the organization is independent, is the interpretation process undertaken in cooperation with, or subject to oversight by, the regulator or another body that acts in the public interest?***

The FASB’s standard setting meetings (including those of the Emerging Issues Task Force) are open to the public and information about the status of all projects is available on its website. Proposed standards may be developed with input from task forces, working groups and public roundtables. The FASB exposes its proposed standards and interpretations for public comment for a reasonable period of time. The comments received are discussed in public meetings as the proposed standard is redeliberated by the Board in light of the public input received. The SEC Staff closely monitors the standards development work of the FASB as described above. The Staff also monitors and participates in meetings of the Emerging Issues Task Force.

16.8

b) With respect to auditing standards:

- i) Does the regulatory framework provide for an organization responsible for the establishment and timely interpretation of auditing standards?***

Section 101 of the Sarbanes-Oxley Act established the PCAOB as an independent, nonprofit, nongovernmental organization “to oversee the audit of public companies that are subject to the [U.S.] securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors.”

²⁹¹ See www.fasb.org, Facts about FASB.

Section 103 of the Sarbanes-Oxley Act gave the PCAOB the authority to establish auditing, ethics, independence and quality control standards for registered public accounting firms, including through the adoption of standards proposed by other professional groups of accountants, pursuant to SEC oversight. The SEC also has authority under the U.S. federal securities laws to set auditing standards for the audits of the financial statements of reporting issuers. Section 10A of the Exchange Act requires that auditors of financial statements of issuers within the SEC's jurisdiction perform audit procedures "in accordance with generally accepted auditing standards as may be modified or supplemented from time to time by the Commission."

The SEC selects the five Board members of the PCAOB. The Staff oversees the operation of the PCAOB and also closely monitors its standard setting work as part of the SEC review and approval process for its standards and interpretive guidance. Both the FASB and the PCAOB receive funding through an annual accounting support fee, as provided for under Section 109 of the Sarbanes-Oxley Act.

16.8(b)

- ii) If yes, are the organization's processes open and transparent, and, if the organization is independent, is the interpretation process undertaken in cooperation with, or subject to oversight by, the regulator or another body that acts in the public interest?***

The PCAOB recognizes that the development of standards should be an open, public process in which investors, the accounting profession, the preparers of financial statements and others have the opportunity to participate.

PCAOB staff is actively involved in drafting proposed standards and in advising the PCAOB in its standard-setting. The PCAOB also encourages comments on proposed standards and recommendations regarding its standard-setting agenda from the public. Exposure drafts of proposed standards are issued for public comment. In addition, Section 103(a)(4) of the Sarbanes-Oxley Act authorizes the PCAOB to convene expert advisory groups as may be appropriate to aid in standard-setting. The PCAOB has convened a Standing Advisory Group to advise it on the establishment of auditing and related professional practice standards.

After completing the development process, which ordinarily includes consultation with the Standing Advisory Group and may include discussion in other public forums such as roundtable discussions, the PCAOB's staff recommends a proposed standard to the PCAOB in an open public meeting. Proposed standards approved by the PCAOB in an open meeting will be published for public consideration and comment. After the PCAOB and its staff evaluate the comments received, the PCAOB's staff recommends to the PCAOB in an open meeting a final standard, revised as necessary based on the evaluation of the comments received. Final standards adopted by the PCAOB are submitted to the SEC for approval and do not become effective unless approved by the SEC.

The SEC reviews the rules, issues them for public comments, considers the comments received and then determines whether to approve the standards.

16.8

c) With respect to the external auditor, in the case of listed companies:

i) Is the external auditor required to be independent in both fact and appearance of the company being audited?

The Sarbanes-Oxley Act and Regulation S-X (Article 2, Rule 2-01) contain rigorous independence requirements. The Preliminary Note to Rule 2-01 expressly provides that the rule is designed to ensure that auditors are independent both in fact and in appearance. Audit firms need to be registered with the PCAOB to conduct audits of listed companies and are required to comply with both SEC and PCAOB independence requirements. Rule 2-01—which is invoked by both offering and class registration statements as well as for periodic filings—contains general restrictions on financial and business relationships, employment with the audit client, and restrictions on providing certain non-audit services to ensure auditor independence and is designed to ensure that auditors are independent in both fact and in appearance.

16.8(c)

ii) Is there a governance body independent in both fact and appearance of the management of the company (e.g., shareholders or a statutory or corporate audit oversight body) that oversees the process of selection and appointment of the external auditor?

Listing standards mandated by the Sarbanes-Oxley Act require that the Audit Committee of the Board of Directors is the one that oversees the process of selection and appointment of the external auditor of a public company. Each national securities exchange has requirements that issuers have audit committees composed of independent directors. These requirements also include certain composition, charter and responsibility requirements for audit committees. Pursuant to Rule 10A-3 under the Exchange Act national securities exchanges are prohibited from listing any security of an issuer that is not in compliance with the following standards:

- each member of the audit committee of the issuer must be independent according to specified criteria above and beyond the general director independence requirement in the listing standards;
- the audit committee of each issuer must be directly responsible for the appointment, compensation, retention, and oversight of the work of any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review, or attest services for the issuer, and each such registered public accounting firm must report directly to the audit committee;
- each audit committee must establish procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, or auditing matters, including procedures for the confidential, anonymous

submission by employees of the issuer of concerns regarding questionable accounting or auditing matters;

- each audit committee must have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties; and
- each issuer must provide appropriate funding for the audit committee.

Also, the U.S. regulatory framework has a number of specific audit committee requirements for listed issuers. The SEC's rules implementing Sections 10A(h) and 10A(i) of the Exchange Act, as added by Sections 201 and 202 of the Sarbanes-Oxley Act, require that all auditing and non-audit services to be provided by the independent accountant must be pre-approved by the issuer's audit committee, subject to a *de minimis* exception. Information regarding the audit committee's pre-approval responsibilities is required to be disclosed in the issuer's annual report.²⁹² The auditor is also required by the PCAOB standards to communicate information to the audit committee regarding the auditor's independence.²⁹³

16.8(c)

iii) Is prompt disclosure of information about the resignation, removal or replacement of an external auditor required?

When the auditor has resigned during a current audit or declined to stand for re-election after the completion of the audit, or was dismissed by the company being audited, public disclosure of these facts is required. For U.S. companies, this occurs by the issuer filing a Form 8-K within four business days of the termination date. Item 304 of Regulation S-K specifies the information required to be disclosed in the Form 8-K and encompasses such matters as whether there were any disagreements with the former auditor on accounting matters, whether the former auditor's report for the last two years involved an adverse opinion or disclaimer of opinion or other qualifications to the opinion, whether the change was recommended or approved by the Board of Directors or the Audit Committee, and other matters relating to the change in auditors. There is a formal procedure by which the former auditor can express its views on the company's disclosure. Additionally, under rules of the AICPA's SEC Practice Section incorporated into PCAOB requirements, the predecessor auditor must communicate in writing to notify OCA that the auditor-client relationship has ceased.

²⁹² The term audit committee is defined as “a committee (or equivalent body) established by and among the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer and, if no such committee exists with respect to an issuer, the entire board of directors of the issuer.”

²⁹³ See PCAOB Rule 3526 – “Communicating with Audit Committee Concerning Independence.”

16.9

Is there an adequate mechanism in place for:

- a) Enforcing compliance with accounting standards such as requiring restatements of financial statements that deviate from accepted standards?*

The SEC can use both formal and informal mechanisms to enforce compliance with accounting standards.

Formal mechanisms include:

- Seek injunctions against future violations of the reporting provisions;
- Seek an administrative cease and desist order against future violations;
- Deregister an issuer's securities;
- Suspend trading in the issuer's securities;
- Restrict a company's ability to complete a public offering of its securities;
- Seek monetary fines against the issuer and culpable individuals;
- Bar officers and directors from future work in those capacities; and
- Refer matters to DOJ for possible criminal prosecution.

Informal mechanisms include:

- Seek supplemental or amended disclosures;
- Seek correction in future filings; and
- Seek restatements.

The Staff selectively reviews the financial information contained in prospectuses, listing documents, registration statements, periodic reports and ongoing material disclosure reports. In addition to these documents, the Staff also selectively reviews the financial information contained in proxy statements that are filed by companies. The financial information contained in prospectuses, registration statements and listing documents is reviewed for compliance with accounting standards and reporting requirements, compliance with auditing standards and reporting requirements, accuracy and completeness of disclosure, timeliness and other qualities. Additional information about these selective reviews is provided in the response to Question 14.

If the Staff notes a perceived accounting or disclosure deficiency during the review of a company's filing, the staff will send a comment letter to the company or its counsel that sets forth the specific concerns that the staff has with the filing. The company has an opportunity to address the Staff's comments by amending the disclosure contained in the filing or by explaining in a response letter to the staff why no amendment to the filing is required.

16.9

b) Enforcing compliance with auditing and auditor independence standards, such as refusal to accept, or requiring revision of, audit reports that deviate from required standards as to the opinion expressed or scope of the audit, or for lack of independence?

The SEC can use both formal and informal mechanisms to enforce compliance with auditing and independence standards.

Formal mechanisms include:

- Seek injunction from future violations;
- Seek cease and desist order;
- Censure and/or bar individual auditors from auditing listed and/or reporting companies;
- Restrict a company's ability to complete a public offering of its securities;
- Refer matters to DOJ for possible criminal prosecution;
- Censure and/or bar the audit firm from conducting audits of listed and/or reporting companies; and
- Fine the auditor.

Informal mechanisms include:

- Referral of the matter to the PCAOB or state licensing authority;
- Seek disclosure of additional facts; and
- Seek auditor quality assurance.

Pursuant to its selective review of filings described in response to Question 16.9(a), above, the Staff also considers the appropriateness of the form of the auditors' report on the financial statements. The Staff's process for addressing any concerns is similar to that described for concerns about the content of the financial statements and associated disclosures themselves.

In addition, the PCAOB, in carrying out its auditor oversight responsibilities, has the responsibility to inspect audit firms. Specifically, its responsibilities are to:

- register and inspect public accounting firms that prepare audit reports for reporting issuers;
- enforce compliance with the Sarbanes-Oxley Act, the rules of the PCAOB, professional standards, and the securities laws;
- investigate registered firms for violations of the rules applicable to audits;
- impose sanctions for violations; and
- perform other duties as the PCAOB or SEC deem necessary.

16.10

If public offerings or listings by foreign issuers are significant within the jurisdiction, does the regulator permit the use of high quality, internationally acceptable accounting standards by foreign companies that wish to list or offer securities in the country?

The financial statements of non-U.S. public companies that are foreign private issuers as defined in Rule 405 under the Securities Act or Rule 3b-4 under the Exchange Act may be presented in accordance with (i) U.S. GAAP, (ii) another comprehensive body of accounting standards reconciled to U.S. GAAP, or (iii) IFRS as issued by the IASB. Each company may elect the basis of presentation.

COLLECTIVE INVESTMENT SCHEMES

Principles 17-20

Forward

Principles for Collective Investment Schemes

For purposes of this self assessment, a CIS includes:

- open-end investment companies (open-end CIS)²⁹⁴ as defined in section 5(a)(1) of the Investment Company Act;
- closed-end investment companies (closed-end CIS) as defined in section 5(a)(2) of the Investment Company Act; and
- unit investment trusts (UIT) as defined in section 4(2) of the Investment Company Act.

SEC notes that numerous questions in this self assessment request information about the regulation of CIS operators and CIS boards of directors, and other matters that are not applicable to UITs because of their unique structure.

In particular, a UIT does not have an operator (or a board of directors) because its investment portfolio is not subject to active management. A UIT is organized under a trust indenture, contract of custodianship or similar instrument. In contrast, open-end and closed-end CIS have investment portfolios that are subject to active management by investment advisers (“operators”) and are overseen by a board of directors or trustees.²⁹⁵

As further background, open-end CIS issue redeemable shares, while the shares of closed-end CIS generally trade on the secondary market and are not redeemable. In contrast, a UIT issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities. Most UITs do not actively redeem their units -- instead, sponsors maintain a secondary market in the units to provide liquidity and to minimize the depletion of the UIT’s assets.

For purposes of SEC responses to the self assessment, a CIS does not include private pools of capital. Private pools of capital that are not offered to the public typically rely on one of two statutory exclusions to avoid the regulatory requirements of the Investment Company Act.²⁹⁶

²⁹⁴ In other parts of this self assessment, the term “mutual fund” may be used instead of “open-end CIS.” The two terms, as used in this self assessment, are interchangeable.

²⁹⁵ The board of directors of an open-end or closed-end CIS has overall legal responsibility for the management and performance functions of the CIS. SEC staff views the investment adviser of such a CIS as the CIS’s operator for purposes of this response because, as a practical matter, the adviser manages, and generally assumes responsibility for the conduct of, the CIS on a day-to-day basis. For more information on the CIS’s board of directors, please refer to response to Question 17.6 below.

²⁹⁶ Section 3(c)(1) of the Investment Company Act excludes any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred investors and who does not make a public offering of such securities. This exclusion reflects the view that privately placed CIS owned by a limited number of investors do not rise to the level of federal interest under the Investment Company Act. Section 3(c)(7)

Additionally, these private pools of capital tend to rely on an exemption from the registration and prospectus delivery obligations of the Securities Act.²⁹⁷ Operators of private pools of capital also may rely on an exemption from the Advisers Act to refrain from registering with the SEC as an investment adviser.²⁹⁸ Many private pool operators, however, otherwise voluntarily register with the SEC and are therefore subject to the same regulatory requirements as operators of registered CIS.²⁹⁹ Private pools of capital and their operators that are exempt from registration nevertheless are subject to the antifraud provisions of the U.S. federal securities laws.³⁰⁰

of the Investment Company Act excludes any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are “qualified purchasers” and who does not make a public offering of such securities. This exclusion reflects the view that certain highly sophisticated investors do not need the protections of the Investment Company Act because they are in a position to appreciate the risks associated with pooled investment vehicles.

²⁹⁷ The exclusions from the Securities Act also reflect Congress’s view that certain highly sophisticated investors do not need the protections of the Securities Act because investors in the private CIS relying on the exclusions are in a position to appreciate the risks associated with an investment.

²⁹⁸ See Section 203 (b)(3) of the Advisers Act. For a more detailed discussion of the regulation of private pool operators, please see the response to Question 21.2.

²⁹⁹ As of May 2009, the SEC estimates that 1,637 private pool operators were registered with the SEC with approximately \$11 trillion in assets under management.

³⁰⁰ From December 2008 to May 2009, the SEC has filed approximately 32 enforcement cases against private pools and/or their operators.

Collective Investment Schemes - Principle 17

The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.

Assessment

Fully Implemented.

17.1

Does the regulatory framework set standards for the eligibility and the regulation for those who wish to:

- a) Market a CIS; or*
- b) Operate a CIS?*

Section 203 of the Advisers Act requires a CIS operator to register with the SEC. Generally, the shares of any CIS may be marketed by the CIS itself, its operator (if any), or a broker-dealer. Each of these entities is required to be registered with the SEC.

The U.S. federal securities laws impose certain standards for eligibility on persons who market or operate a CIS.

The criteria for eligibility to serve as an operator to a CIS were set forth by Congress in the Advisers Act and the Investment Company Act. The criteria for eligibility to market CIS shares were set forth by (a) Congress in the Exchange Act and the Investment Company Act, (b) the SEC in the rules adopted under the Exchange Act and the Investment Company Act, and (c) the FINRA in its rules.³⁰¹

For further information, please *see* response to Question 21.2 below.

17.2

Do the eligibility criteria for CIS include the following:

- a) Honesty and integrity of the operator?*

³⁰¹ FINRA is the primary self-regulatory organization for broker-dealers.

Because the questions in this self assessment focus on the role of the CIS operator rather than the CIS marketing agent, SEC has focused responses on the regulatory provisions governing operators. For more information on the role of the CIS marketing agent, please *see* responses to the Principles 21 - 24.

- b) Competence to carry out the functions and duties of the operator (i.e., human and technical resources)?***
- c) Financial capacity?***
- d) Operator specific powers and duties?***
- e) Adequacy of internal management procedures?***

The applicable criteria for eligibility to operate a CIS include several of these factors. Other provisions of the Investment Company Act and Advisers Act also address several of these factors.

Section 9(a) of the Investment Company Act provides that the following persons and companies are automatically ineligible to operate a CIS:

- Any person who, within ten years, has been convicted of any felony or misdemeanor involving the purchase or sale of any security or arising out of such person's conduct as an underwriter, broker, dealer, CIS operator, municipal securities dealer, government securities broker, government securities dealer, bank, transfer agent, credit rating agency, or entity or person required to be registered under the Commodity Exchange Act, or as an affiliated person, salesman, or employee of any CIS, bank, insurance company, or entity or person required to be registered under the Commodity Exchange Act;
- Any person who, by reason of any misconduct, is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an underwriter, broker, dealer, CIS operator, municipal securities dealer, government securities broker, government securities dealer, bank, transfer agent, credit rating agency or entity or person required to be registered under the Commodity Exchange Act, or as an affiliated person, salesman, or employee of any CIS, bank, insurance company, or entity or person required to be registered under the Commodity Exchange Act, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of any security; or
- A company any affiliated person of which is ineligible, by reason of either of the above two paragraphs, to serve or act in the foregoing capacities.

Section 9(b) of the Investment Company Act also provides that the SEC may prohibit any person or company from operating a CIS if the person or company:

- Has willfully made or caused to be made in any registration statement, application or report filed with the SEC under the Investment Company Act any false or misleading statement with regard to a material fact or has omitted to state any material fact required;

- Has willfully violated, or has willfully aided, abetted, counseled, commanded, induced or procured the violation by any other person, of the U.S. federal securities laws or the Commodity Exchange Act;
- Has been found by a foreign regulatory authority to have: (a) made or caused to be made in any application for registration or report filed with the foreign securities authority, or in any proceeding before it, any false or misleading statement with regard to a material fact or has omitted to state any material fact required; (b) violated any foreign securities or commodity futures laws; or (c) aided, abetted, counseled, commanded, induced or procured the violation by any other person, of the foreign federal securities laws or commodity futures laws;
- Within ten years has been convicted by a foreign court of a crime that is substantially equivalent to a felony or misdemeanor as described in bullet 1 of the previous paragraph regarding automatic ineligibility to operate a CIS; or
- Has been temporarily or permanently enjoined by reason of any misconduct by a foreign court from acting in any of the capacities described in bullet 2 of the previous paragraph regarding automatic ineligibility to operate a CIS or a substantially equivalent foreign capacity, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of any security.

Section 203(e) of the Advisers Act provides that the SEC may prohibit any person or company from operating a CIS if the person or company:

- Has willfully made or caused to be made in any application for registration or report required to be filed with the SEC under the Advisers Act, or in any proceeding before the SEC with respect to registration, any false or misleading statement with regard to a material fact or has omitted to state any material fact required;
- Has within ten years been convicted by a foreign court of a crime involving the purchase or sale of any security, or other crimes involving dishonesty or arising out of the conduct of a securities business or any crime punishable by imprisonment for one or more years;
- Is permanently or temporarily enjoined by any court, including a foreign court, from acting as a CIS operator, investment adviser, underwriter, broker, dealer, municipal securities dealer, government securities broker, government securities dealer, transfer agent, credit rating agency, or foreign person performing substantially the same function as any of the above, or entity or person required to be registered under the Commodity Exchange Act or equivalent statute, or is unable to comply with any such provision;
- Has willfully violated any provision of the U.S. federal securities laws or the Commodity Exchange Act or any rule of the Municipal Securities Rulemaking Board;

- Has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person, of the U.S. federal securities laws or the Commodity Exchange Act or any rule of the Municipal Securities Rulemaking Board or has failed to reasonably supervise another person who commits such a violation, if such other person is subject to his supervision;
- Has been found by a foreign financial regulatory authority to have: (a) made or caused to be made in any application for registration or report filed with a foreign securities authority, or in any proceeding before it with respect to registration, any false or misleading statement with regard to a material fact or has omitted to state any material fact required; (b) violated any foreign securities or commodity futures laws; or (c) aided, abetted, counseled, commanded, induced or procured the violation by any other person, of the foreign federal securities or commodity futures laws or has failed to supervise another person who commits such a violation, if such other person is subject to his supervision; or
- Is subject to any final order of a state securities commission, state banking authority, state insurance commission, a federal banking agency or the National Credit Union Administration that: (a) bars them from association with an entity regulated by the state or federal agency or from engaging in the business of securities, insurance, banking, savings association activities or credit union activities; or (b) constitutes a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative or deceptive conduct.

Section 203(f) of the Advisers Act also provides that the SEC may prohibit any person from association with a CIS operator if the person has committed or omitted any act enumerated in bullets 1, 4, 5, 6, or 7 above or has been convicted of any offense specified in bullet 2 above or is enjoined from any action as described in bullet 3 above. Under this provision, the SEC may, but is not required to, prohibit such persons or companies from operating a CIS. Whether the SEC does so depends on the facts and circumstances of each case.

As noted above, other provisions of the Investment Company Act and Advisers Act address criteria for eligibility to operate a CIS. As described below, these provisions generally relate to approval of the contract between the CIS and the CIS operator by shareholders and directors of the CIS, as well as disclosure of the relevant information to the SEC and to directors and shareholders of the CIS.

The responsibility for assessing the fitness and competence of a CIS's operator is placed primarily upon the CIS's board of directors. That is, under section 15(c) of the Investment Company Act, the terms of a CIS operator's contract, and any renewal thereof, must be approved by a vote of a majority of the CIS's independent directors; the CIS operator's contract also must be approved by shareholders in the CIS, by a vote of a majority of the holders of the CIS's outstanding voting securities. Section 15(c) requires CIS directors to request and evaluate such information as may be reasonably necessary to evaluate the terms of the advisory contract. Additionally, section 15(c) requires CIS operators to furnish this information to CIS directors. When shareholder approval of the CIS operator's contract is sought under section 15, certain

information regarding the CIS operator and the contract, including the compensation to be paid under the contract, must be provided in the shareholder proxy statement provided to shareholders.

As noted above, CIS operators must register with the SEC. The Advisers Act requires operators that seek to become registered with the SEC to make certain public disclosures. For example, an operator must disclose in Part II of its Form ADV (the SEC's registration form for operators) the educational and business background of its employees who provide investment advice. In the case of a CIS, an operator generally provides the CIS's board of directors with a copy of the operator's Form ADV. A CIS also must disclose in its registration statement certain information regarding the operator, including the operator's experience as an operator, the operator services that it provides to the CIS and a description of the compensation that the CIS operator receives.

Under the Investment Company Act and the Advisers Act, the SEC does not assess the qualifications of persons or firms seeking to become CIS operators, except as noted above. The fact that an entity is registered with the SEC as an operator does not represent a determination by the SEC as to the criteria for eligibility to operate CIS that are listed above. The SEC does not make registration determinations based on those factors, except to the extent noted above. The SEC uses a disclosure-based approach to investment adviser regulation. A primarily disclosure-based approach is similar to the approach in other U.S. federal securities laws (*e.g.*, the Securities Act). This approach provides prospective clients with information to assess the adequacy of an adviser's background and experience.

The lack of U.S. federal educational requirements for CIS operators and their employees does not prohibit states from imposing certain educational and professional training requirements upon investment adviser representatives (as defined under the Advisers Act) that have a place of business in that state.³⁰² Many states also require the registration of the individual persons who are associated with state-registered investment advisers. The states may also impose certain educational and professional training requirements upon the representatives of SEC-registered CIS operators who have a place of business in that state. Under section 203A(b)(1)(A) of the Advisers Act, a state may not compel the registration of an employee of an SEC registered operator of a CIS unless the employee is an investment adviser representative as defined under the Advisers Act who has a place of business in the state.

CIS and their operators also must have written compliance policies and procedures in place that are reasonable designed to prevent violations of the U.S. federal securities laws including, among other things, policies and procedures designed to ensure that the CIS's board is composed of the appropriate number of independent directors. For more information on these policies and procedures, see response to Question 17.6 below.

³⁰² An investment adviser representative is defined in rule 203A-3(a) under the Advisers Act as a supervised person of an investment adviser (i) who has more than five clients who are natural persons and (ii) more than ten percent of whose clients are natural persons. Certain "qualified clients" are excluded from the thresholds for counting natural persons. An investment adviser representative does not include supervised persons who do not regularly solicit, meet or otherwise communicate with clients, or who provide only impersonal investment advice.

17.3

Does the approval of schemes take into account the possible need for international cooperation in the case of CIS marketed across jurisdictions or where promoters, managers or custodians are located in several different jurisdictions?

Please *see* responses to Questions 11 and 12, which address cooperation with foreign and domestic authorities.

17.4

Are there:

- a) Effective, proportionate and dissuasive sanctions for unlicensed operation of a CIS and/or for violation of CIS operator obligations? and***
- b) Are these sanctions consistently applied?***

Section 7(a) of the Investment Company Act makes it unlawful for a CIS, among other things, to engage in any business in interstate commerce unless the CIS is registered with the SEC. In addition, section 203 of the Advisers Act makes it unlawful for a CIS operator to make use of the mails or any means or instrumentality of interstate commerce in connection with his or its business as an operator, unless the operator is registered with the SEC.

Additionally, section 47(a) of the Investment Company Act makes any provision requiring a person to waive compliance with the Investment Company Act or the rules or regulations thereunder void. Similarly, section 47(b) of the Investment Company Act makes a contract unenforceable by either party if it violates the Investment Company Act or the rules or regulations thereunder unless a court finds that such a result would be inequitable.

SEC enforcement authority generally is discussed in response to Question 9. In addition, sanctions are consistently applied. Every SEC enforcement action undergoes a vigorous review process prior to filing. Although sanctions for each case are tailored to the facts and circumstances of each case, the review process promotes fair and consistent application of sanctions.

For example, with respect to the imposition of a civil money penalty, the purpose of which is deterrence from future misconduct, a three-tier system of penalties is available by statute as a civil remedy, as follows:

- First tier penalties can be assessed for any violation.
- Second tier penalties can be assessed if the violation “involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement.”
- Third tier penalties can be assessed if the violation “involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement” and “such violation

directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons.”

The tier system permits appropriate flexibility in setting penalty amounts while, at the same time, establishing an important foundational guideline.

17.5

Is the regulator responsible for ensuring compliance with the eligibility standard? In particular, does the regulatory framework provide for attribution to the regulatory authority of responsibilities and clear powers with respect to:

a) Registration or authorization of a CIS?

CIS generally must be registered with the SEC in order to operate in the United States.³⁰³ In order to sell its shares to the public, a CIS must register itself under the Investment Company Act and register the offering of its securities under the Securities Act. A CIS initiates the registration process by filing a “Notification of Registration” with the SEC on Form N-8A. In addition, a CIS must file a registration statement within three months of filing its Form N-8A.

An open-end CIS files its registration on Form N-1A, and a closed-end CIS files its registration on Form N-2. The filing of Form N-1A and Form N-2 registers an open-end and closed-end CIS, respectively, under the Investment Company Act and registers the offering of the open-end and closed-end CIS’ shares under the Securities Act. A UIT files its registration as a UIT under the Investment Company Act on Form N-8B-2 and registers its securities under the Securities Act on Form S-6. All of these registration statements are public documents.

Form N-1A and Form N-2 consist of three parts: a prospectus, a statement of additional information (SAI) and a section containing other information (Part C).³⁰⁴ The prospectus contains the most essential information for investors to make an informed decision about investing in an open-end or closed-end CIS. The SAI contains information that, while important, is not considered as essential to the investor’s investment decision as the information contained in the prospectus. Part C contains exhibits to the registration statement that include the CIS’s

³⁰³ See section 8(a) of the Investment Company Act.

³⁰⁴ A UIT’s registration statement under the Investment Company Act consists of nine parts and requires a detailed description of the trust, including: (a) the name (including a complete history of any name changes), address and jurisdiction of organization; (b) significant aspects of the trust indenture and any contracts into which the trust has entered; (c) description of the securities being offered; (d) description of all sales loads, fees, charges and expenses; (e) information regarding the sponsor/depositor, including its history and operations and its officers, directors and employees and their compensation; (f) distribution and redemption arrangements, including information regarding the principal underwriter(s); (g) information regarding the trustee, custodian and any other service providers; (h) information regarding portfolio insurance, if applicable; (i) significant tax consequences of investment in the trust; (j) audited financial statements in accordance with Regulation S-X under the Securities Act; and (k) exhibits, including, but not limited to, the trust indenture and all material contracts.

articles of incorporation and/or bylaws, as well as all material contracts, such as the advisory contract and any distribution contracts.

The SEC's staff conducts selective reviews of CIS registration statements to assess the eligibility of the CIS and its operator. No sales of a CIS's shares may be made before its registration statement is "effective."

17.5

b) Inspections to ensure compliance by CIS operators?

As described in the response to Question 17.6 below, the OCIE conducts and coordinates the nationwide inspections and examination program for entities that are registered with the SEC. Additionally, OCIE conducts exams in foreign jurisdictions in coordination with OIA and the regulator in the other jurisdiction. In conducting its inspections and examination program, OCIE reviews CIS operators to ensure compliance by CIS operators with the U.S. federal securities laws. For additional detail regarding OCIE examinations of CIS operators, *see* responses to Questions 8.1, 10.1 and 17.8.

17.5

c) Investigation of suspected breaches?

The SEC's staff may conduct investigations of CIS and their operators to determine whether a violation of the U.S. federal securities laws is about to occur or has already occurred, including suspected violations of the eligibility standards by the CIS or its operator. Because these investigations involve suspected misconduct, they are conducted by Enforcement.

Section 42 of the Investment Company Act gives the SEC broad authority to enforce the Investment Company Act. Section 42(a) authorizes the SEC and its staff to conduct investigations to determine whether any person (including a CIS operator) has violated or is about to violate the Investment Company Act and to determine whether any administrative or judicial action should be instituted against any person or with respect to a particular transaction. For purposes of any investigation or other proceeding under the Investment Company Act, members of the SEC and designated officers are empowered to administer oaths, subpoena witnesses, take evidence, and require production of books and records relevant to the inquiry. When a person refuses to obey a subpoena, section 42(c) authorizes the SEC to invoke the aid of a court to order compliance. Any person who without cause fails or refuses to answer or produce documents under any legitimate SEC inquiry may be found guilty of a misdemeanor and, upon conviction, may be fined not more than \$1,000 or imprisoned for up to one year, or both. The SEC has similar investigative authority and power with regard to CIS operators under sections 209(a), (b) and (c) of the Advisers Act.

17.5

d) Remedial action in the event of breach or default?

For information regarding the powers of the regulator with respect to actions available (statutory or otherwise) in the event of breaches or default by those permitted to market a CIS, please *see* response to Question 21.3 below. The remainder of this response addresses the powers of the regulator with respect to actions available (statutory or otherwise) in the event of breaches or default by CIS operators.

Actions Available under the Advisers Act

The Advisers Act and Investment Company Act authorize the SEC, in its discretion, to institute administrative proceedings against CIS operators and their associated persons³⁰⁵ or to sue any person in federal court for violations of those acts.

Administrative Proceedings: Sections 203(e) and (f) of the Advisers Act authorize the SEC to sanction an operator, or a person associated with an operator, if the SEC finds (after notice and an opportunity for a hearing) that the operator or an associated person has engaged in certain willful misconduct and if the sanctions are in the public interest. Specifically, the SEC may “censure, place limitations on the activities, functions, or operations of [an operator or associated person of an operator]” and may suspend the registration of the operator, or prohibit the associated person from acting as such, for a period of not more than twelve months. Additionally, the SEC may revoke the registration of an operator, or bar a person from being associated with any operator. Sections 203(e) and (f) of the Advisers Act list the types of misconduct for which the SEC may sanction operators and their associated persons. Under section 203(i), the SEC may, upon a proper showing and when in the public interest, impose civil money penalties in proceedings instituted pursuant to sections 203(e) or (f).³⁰⁶ Administrative proceedings also may be based on prior injunctions issued by, and/or findings of violations made by, a federal court. Under section 203(k) of the Advisers Act, the SEC may issue a cease-and-

³⁰⁵ An “associated person” is defined in section 202(a)(17) of the Advisers Act, which reads, in part, that a “person associated with an investment adviser” includes “any partner, officer, or director of [an investment adviser], or any person directly or indirectly controlling or controlled by such investment adviser, including any employee of such investment adviser.” A “person” is defined as a natural person or a company under section 202(a)(16) of the Advisers Act.

³⁰⁶ Under section 203(i) of the Advisers Act, the SEC may impose civil penalties for each violation according to a three-part scale: (a) if the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and resulted in or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the wrongdoer, a maximum of \$100,000 for a natural person or \$500,000 for any other person; (b) if fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement is involved, a maximum of \$50,000 for a natural person or \$250,000 for any other person; and (c) in other cases, a maximum of \$5,000 for a natural person or \$50,000 for any other person. Under section 203(j) of the Advisers Act, in any proceeding in which the SEC may impose a penalty under section 203 of the Advisers Act, the SEC may enter an order requiring an accounting and disgorgement (that is, the payment of any unjust enrichment as a result of the violation), including reasonable interest.

desist order³⁰⁷ requiring a person to cease violating or causing the violation of the Advisers Act or the rules or regulations thereunder.

Civil Federal Court Actions: The SEC is authorized to institute an action seeking an injunction and other equitable relief in federal court under section 209(d) of the Advisers Act against any person who has violated, is violating, or is about to violate, the Advisers Act or the rules or regulations thereunder. The SEC similarly may seek an injunction against any person for aiding and abetting a violation of the Advisers Act. Under section 209(e) of the Advisers Act, the SEC may seek monetary penalties in federal court from any person who has violated the Advisers Act, the rules or regulations thereunder, or a cease-and-desist order previously entered by the SEC pursuant to section 203(k) of the Advisers Act. Upon a proper showing, a court may impose monetary penalties of varying amounts, depending upon the nature of the violation, as described in section 209(e)(2) of the Advisers Act.³⁰⁸

Actions Available Under the Investment Company Act

The U.S. federal securities laws also authorize the SEC to institute administrative proceedings against any person or to sue any person in federal court for violations of the Investment Company Act.

Administrative Proceedings: The Investment Company Act generally authorizes the SEC to temporarily or permanently bar any person from the CIS industry if it finds that the person engaged in the conduct listed in section 9(b) (including a violation of the U.S. federal securities laws, being convicted of certain types of crimes, being subject to foreign regulatory or court action or having been convicted by a foreign court of a financial crime) and if the sanctions are in the public interest. Under section 9(d) of the Investment Company Act, the SEC may, upon a proper showing and when in the public interest, impose civil money penalties in proceedings instituted pursuant to section 9(b).³⁰⁹ Under section 9(f) of the Investment Company Act, the

³⁰⁷ A “cease-and-desist” order under either section 9(f) of the Investment Company Act or section 203(k) of the Advisers Act is an administrative order that the SEC may issue when it finds that a person has violated, is violating or is about to violate a provision of the Investment Company Act or the Advisers Act or the rules or regulations thereunder. In any cease-and-desist proceeding under either section 9(f) of the Investment Company Act or section 203(k) of the Advisers Act, the SEC may enter an order requiring an accounting and disgorgement, including reasonable interest.

³⁰⁸ Under section 209(e)(2) of the Advisers Act, a court may assess civil penalties for each violation according to a three-part scale: (a) if the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and resulted in or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the wrongdoer, a maximum of \$100,000 for a natural person or \$500,000 for any other person or the pecuniary gain to the defendant as a result of the violation; (b) if fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement is involved, a maximum of \$50,000 for a natural person or \$250,000 for any other person or the pecuniary gain to the defendant as a result of the violation; and (c) in other cases, a maximum of \$5,000 for a natural person or \$50,000 for any other person or the pecuniary gain to the defendant as a result of the violation. The federal courts also possess the power to grant other equitable relief, such as disgorgement, including reasonable interest.

³⁰⁹ Under section 9(d) of the Investment Company Act, the SEC may impose civil penalties for each violation according to a three-part scale: (a) if the act or omission involved fraud, deceit, manipulation, or deliberate or

SEC may order a person to cease and desist from committing or causing a violation of the Investment Company Act or the rules thereunder if the SEC finds, after notice and opportunity for a hearing, that the person has violated or is about to violate a provision of the Investment Company Act or the rules thereunder.

Civil Federal Court Actions: Section 42(d) of the Investment Company Act authorizes the SEC to institute an action for an injunction and other equitable relief in federal court against any person who has violated, is violating, or is about to violate, the Investment Company Act or the rules or regulations thereunder. Section 42(e) of the Investment Company Act authorizes the SEC to seek monetary penalties in federal court from any person for violating a cease-and-desist order previously issued by the SEC under section 9(f) of the Investment Company Act. Upon a proper showing, the court may impose monetary penalties in civil actions according to the three-part scale described in section 42(e)(2) of the Investment Company Act.³¹⁰

In addition, section 36(a) of the Investment Company Act authorizes the SEC to seek injunctive or other relief against, among others, officers, directors and operators of a CIS, in a federal court with respect to acts “constituting a breach of fiduciary duty involving personal misconduct in respect” of the CIS for which such persons serve.³¹¹ If the allegations are established, the court may temporarily or permanently enjoin these persons from acting as, among others, officers, directors and operators of a CIS and award injunctive or other relief as may be reasonable and appropriate.

Finally, under section 36(b) of the Investment Company Act, the SEC may institute an action in a federal court against, among others, a CIS operator for a breach of fiduciary duty with respect to the receipt of compensation from the CIS.

reckless disregard of a regulatory requirement and resulted in or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the wrongdoer, a maximum of \$100,000 for a natural person or \$500,000 for any other person; (b) if fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement is involved, a maximum of \$50,000 for a natural person or \$250,000 for any other person; and (c) in other cases, a maximum of \$5,000 for a natural person or \$50,000 for any other person. Under section 9(e) of the Investment Company Act, in any proceeding in which the SEC may impose a penalty under section 9 of the Investment Company Act, the SEC may enter an order requiring an accounting and disgorgement, including reasonable interest.

³¹⁰ Under section 42(e) of the Investment Company Act, a court may assess civil penalties for each violation according to a three-part scale: (a) if the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and resulted in or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the wrongdoer, a maximum of \$100,000 for a natural person or \$500,000 for any other person or the pecuniary gain to the defendant as a result of the violation; (b) if fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement is involved, a maximum of \$50,000 for a natural person or \$250,000 for any other person or the pecuniary gain to the defendant as a result of the violation; and (c) in other cases, a maximum of \$5,000 for a natural person or \$50,000 for any other person or the pecuniary gain to the defendant as a result of the violation. The federal courts also possess the power to grant other equitable relief, such as disgorgement, including reasonable interest.

³¹¹ Section 36(a) also prohibits a breach of fiduciary duty involving personal misconduct by a UIT’s principal underwriter.

Automatic Bar: Under section 9(a) of the Investment Company Act, the following persons are automatically barred from serving or acting as, among others, an employee, officer, director, member of an advisory board, principal underwriter or operator for a CIS: (a) any person who within 10 years has been convicted of certain securities-related crimes (felonies or misdemeanors); (b) any person who, by reason of any misconduct, is permanently or temporarily enjoined from acting in certain securities-related capacities; and (c) a company any affiliated person of which is ineligible to serve or act as, among other things, a director by reason of (a) or (b). If a person serves in such capacity in violation of section 9(a) of the Investment Company Act, the SEC may institute an administrative proceeding or an action in federal court against the person.

Criminal Actions

Any person who willfully violates any provision of the Advisers Act, or any rule, regulation or order promulgated by the SEC thereunder, is subject to criminal penalties under the Advisers Act. Section 217 of the Advisers Act provides for criminal sanctions, upon conviction, not to exceed \$10,000 and/or imprisonment for no more than five years. Section 49 of the Investment Company Act contains similar provisions. The SEC does not have authority to prosecute criminal actions. Rather, matters that may be appropriate for criminal investigation or action are referred to, and may be prosecuted by, the U.S. Department of Justice.

17.6

Is there ongoing monitoring of the conduct of CIS operators throughout the life of a scheme, including continued compliance with eligibility, licensing, registration, or authorization requirements?

As discussed below, the SEC monitors CIS operators throughout the life of a scheme.

Regulatory Supervision

As discussed in response to Question 17.11 below, the Investment Company Act, the Advisers Act and the rules thereunder require CIS and CIS operators to maintain and preserve certain books and records. All books and records required to be maintained and preserved are subject at any time, or from time to time, to such reasonable periodic, special, and other examinations as the SEC may prescribe. In addition, all records maintained by a CIS operator (whether or not required to be maintained) are similarly subject to such examinations.

OCIE administers an examination program that covers both CIS and their operators. Examinations are conducted primarily to determine whether CIS and their operators meet eligibility standards and conduct their practices and procedures in compliance with the U.S. federal securities laws and regulations, as well as to keep the SEC and its staff informed of developments in the industry. OCIE coordinates its examinations with state regulators and federal banking regulators (as well as with other offices and Divisions of the SEC). OCIE conducts routine or cycle examinations, in which the staff periodically evaluates a registrant's compliance with the U.S. federal securities laws. OCIE also conducts cause examinations, based

on complaints, tips, press reports or other information that suggests violations may have occurred, and focuses on the transactions or events giving rise to its concern. As part of its compliance oversight, OCIE may also conduct risk-targeted sweep examinations, in which OCIE typically focuses on a particular compliance risks (*e.g.*, soft dollar practices) among a number of operators.

During inspections and examinations, OCIE staff generally visits the offices of registrants, interviews management, reviews documents and analyzes the registrant's operations. SEC examiners usually pay particular attention to the internal controls and compliance program of the CIS and its operator both to better understand their operations and to determine whether significant problems exist.³¹² For more information regarding follow-up action after an inspection or examination, please see response to Question 10.5 above. If a SEC examination uncovers material deficiencies or material compliance problems, the independent directors of a CIS may have an obligation to determine the cause thereof, the adequacy of any proposed solutions, whether shareholders have been harmed, and the adequacy of existing procedures to prevent recurring problems.

Additionally, as discussed further in response to Question 17.7 below, SEC Staff reviews the adequacy of disclosures in CIS registration statements and periodic reports.

For further information regarding topics covered in OCIE examinations, *see* response to Question 10.1 above.

Independent Accountants

Section 30 of the Investment Company Act requires a CIS to have an independent public accountant to certify the CIS's financial statements that are filed with the CIS's registration statement and sent to shareholders with annual reports. An accountant who certifies financial statements for a CIS must meet certain standards of independence. In addition, Rule 30a-2 under the Investment Company Act requires a CIS's principal executive officer and financial officer to certify the information contained in that company's shareholder reports.

Independent accountants conduct a required annual audit of a CIS's financial statements. During the audit, the independent accountant is required to perform a review of the CIS's internal control procedures and render a report to the CIS's board of directors on its findings, including any weakness in controls.³¹³ The CIS is required to file the independent accountant's report on internal accounting controls as an exhibit to the CIS's Form N-SAR (the semi-annual report required to be filed with the SEC).³¹⁴ Although not required to do so, a CIS's independent accountant typically reviews certain items in the CIS's Form N-SAR.

³¹² Section 31(b)(3) of the Investment Company Act states that the SEC shall exercise its examination authority with due regard for the benefits of internal compliance policies and procedures and the effective implementation and operation thereof.

³¹³ Sub-Item 77 of Form N-SAR.

³¹⁴ A UIT is required to file Form N-SAR only annually.

In general, a CIS's independent directors select the CIS's independent public accountant. Many CIS boards of directors establish an audit committee -- usually comprised solely of independent directors³¹⁵ -- which evaluates and recommends the CIS's independent accountant for approval by the board of directors. The audit committee also meets with the independent accountant to review the scope and anticipated cost of the CIS's audit. Upon completion of the CIS's audit, the audit committee usually has primary responsibility for studying the accountant's report, discussing particular items with the accountant, and reporting to the CIS's board of directors. A CIS must disclose annually on Form N-CSR that its board of directors has determined that the CIS either: (i) has at least one audit committee financial expert serving on its audit committee, and if so, the name of the expert and whether the expert is independent; or (ii) does not have an audit committee financial expert serving on its audit committee. A CIS disclosing that it does not have an audit committee financial expert must explain why it does not have such an expert.³¹⁶

Internal Supervision

Although CIS and CIS operators are not required to employ internal auditors, rule 38a-1 under the Investment Company Act requires open-end and closed-end CIS to have written policies and procedures, approved by the board of the CIS, reasonably designed to prevent violations of the U.S. federal securities laws and a chief compliance officer to administer and oversee the compliance policies and procedures. CIS chief compliance officers must annually conduct a review of the CIS's compliance policies and procedures and furnish the board with a written report on the operation of the CIS's policies and procedures and those of its service providers. The report must address, at a minimum: (i) the operation of the policies and procedures of the CIS and each service provider since the last report; (ii) any material changes to the policies and procedures since the last report; (iii) any recommendations for material changes to the policies and procedures as a result of the annual review; and (iv) any material compliance matters since the date of the last report. Additionally, the chief compliance officer must meet annually with the independent directors of the CIS without the CIS operator present.

CIS operators also establish and comply with procedures, and systems for applying such procedures, to prevent and detect any violations of the U.S. federal securities laws by persons under their supervision. Rule 206(4)-7 under the Advisers Act requires CIS operators to designate a chief compliance officer to administer its compliance policies and procedures. If the U.S. federal securities laws are violated by employees who are subject to the supervision of the operator, section 203(f) of the Advisers Act authorizes the SEC to institute administrative proceedings against the operator for failing to reasonably supervise the employees. Section 203(e)(6) of the Advisers Act provides, however, that the operator will not be deemed to have

³¹⁵ Rule 32a-4 under the Investment Company Act provides that if the audit committee is composed wholly of independent directors, and the CIS meets other requirements, then the CIS is not required to hold a shareholder vote on the selection of the independent public accountant.

³¹⁶ Item 3 of Form N-CSR.

failed to reasonably supervise the employee if (a) it established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect a violation of the U.S. federal securities laws by the employee and (b) it complied with the procedures without reasonable cause to believe that the procedures and system were not being complied with. Section 203(i) authorizes the SEC to sanction and to impose a civil penalty on any operator that fails reasonably to supervise any employee who commits a violation of the U.S. federal securities laws. Please *see* response to Question 17.5(d) above.

The Board

The board of directors of a CIS has overall responsibility for the management of the CIS. The board of directors' oversight responsibility encompasses a number of specific duties including: (a) approving the CIS's investment advisory and principal underwriting contracts;³¹⁷ (b) appointing the CIS's custodian and approving the custodian agreement;³¹⁸ (c) approving the CIS's code of ethics relating to personal trading (please refer to response to Question 17.12 below, "Employees Transacting for their Own Accounts"); (d) approving the independent accountant (please refer to "Independent Accountants" above (discussing the formation of audit committees) and response to Question 17.7 below (discussing the obligation of the board of directors regarding auditors' discovery of illegal acts)); and (e) approving the designation and compensation of the chief compliance officer.³¹⁹ Certain of these matters also must be approved by a majority of the board's independent directors and/or by CIS shareholders. In addition, the CIS board of directors should assess the implementation and effectiveness of risk controls of the operator when approving or reviewing the advisory contract between the CIS and the operator.

Section 10(a) of the Investment Company Act requires that an open-end or closed-end CIS's board of directors consist of no more than 60% "interested" directors. An "interested" director is one who, among other things: (1) is affiliated with the CIS; (2) has an immediate family member who is affiliated with the CIS; (3) is an interested person of any operator of or principal underwriter to such CIS; or (4) is a person or partner or employee of such a person who has served as legal counsel to the CIS in the past two fiscal years.

Under the Investment Company Act, independent directors play a major role in the resolution of the conflicts that may arise between a CIS and its operator, or other affiliated persons of the CIS. The Investment Company Act requires independent directors of CIS to approve various actions and to monitor certain arrangements on an ongoing basis.³²⁰

³¹⁷ Section 15 of the Investment Company Act.

³¹⁸ Rule 17f-1 under the Investment Company Act.

³¹⁹ Rule 38a-1 under the Investment Company Act.

³²⁰ For example, section 15 of the Investment Company Act, among other things, requires that a CIS operator's contract with the CIS be reviewed and approved by the majority of the CIS's independent directors. Rule 32a-4 under the Investment Company Act provides that an audit committee may select a CIS's independent public accountant, without submitting the choice to shareholders, if, among other things, independent directors comprise the entire committee. In addition, rule 17a-8 under the Investment Company Act requires that directors, including a

The Trustee

The trustee of a UIT generally has certain ongoing responsibilities with regard to the trust, including: (a) maintaining the assets of the trust; and (b) ensuring that trust expenses are paid.³²¹ A trustee is prohibited from resigning until the UIT has been liquidated or a successor trustee has been installed.³²²

17.7

Does the ongoing monitoring involve review of reports to the regulator submitted by CIS (CIS operators, custodians, etc.) on a routine basis?

To assure the prompt and orderly processing of CIS filings, the staff of the SEC conducts a selective review of registration statements, post-effective amendments, proxy statements and other periodic reports. The staff reviews these registration statements and other reports to assess, among other things, the continued eligibility of the CIS and its operator. This practice permits the staff to use its limited resources more efficiently by eliminating, or at least reducing, staff review of routine filings by CIS.

Additionally, as noted in response to Question 17.6 above, a CIS must have an independent public accountant, among other things, certify the CIS's financial statements that are filed with the CIS's registration statement and sent to shareholders with annual reports. Among its other audit functions, a CIS's independent accountant is required, in its audit, to include procedures designed to detect illegal acts, identify related party transactions, and evaluate the CIS's ability to continue as a going concern. Under section 10A of the Exchange Act and rule 10A-1 thereunder, if the CIS's independent accountant detects or becomes aware that an illegal act has occurred, the accountant must promptly notify the CIS's operator and ensure that the CIS's audit committee or directors are also informed. If the accountant determines that the illegal act has a material effect on the CIS's financial statements, that the operator has not taken timely and appropriate remedial action, and that the absence of remedial action is expected to lead to a departure from the standard audit opinion (or resignation from the engagement), the accountant must report its conclusions directly to the CIS's directors. Once the CIS's board of directors has received this report from the independent accountant, the board of directors has one business day to notify the SEC's Office of the Chief Accountant that it has received the report (and to provide that office with either a copy of the report or a summary) and to furnish the independent public accountant making the report with a copy of such notice. If the accountant does not receive a

majority of independent directors, approve mergers between CIS. Section 10(f) of the Investment Company Act and rule 10f-3 thereunder permit certain purchases during an underwriting syndicate involving a principal underwriter that has a close relationship to the CIS and that otherwise would not be permitted if, among other things, the board of directors, including a majority of the independent directors, takes steps to ensure that such purchases are consistent with the protection of investors.

³²¹ Section 26(a)(1) and 26(a)(2) of the Investment Company Act.

³²² Section 26(a)(3) of the Investment Company Act.

copy of this notice within that one-day period, the accountant is required to provide its report directly to the SEC's Office of the Chief Accountant.

Furthermore, section 24(b) of the Investment Company Act and the rules thereunder require CIS and their underwriters to file copies of all of their advertisements and sales literature with the SEC or with FINRA. A CIS must have its advertisements and sales literature filed with FINRA if its shares are sold by a FINRA member. If a CIS's shares are not sold by a FINRA member, the CIS must file its advertisements and sales literature directly with the SEC. There is no requirement that advertisements and sales literature of CIS operators be filed with the SEC.

CIS advertisements and sales literature are reviewed by FINRA, if filed with FINRA. CIS and CIS operator advertisements and sales literature may be reviewed by the SEC Staff as part of an inspection of the CIS or its operator by the staff. When reviewed by the SEC Staff, CIS and CIS operator advertisements and sales literature are reviewed to assess if the material is false or misleading. A review does not constitute an approval or authorization of the advertisement or sales literature.

17.8

Does the ongoing monitoring normally involve performance of on-site inspections of entities involved in operating CIS (CIS operators, custodians, etc.)?

OCIE examines entities involved in operating CIS by performing on-site examinations or inspections of CIS and their operators. In many cases, examinations are conducted in conjunction with an examination of the CIS's operator, because CIS operators often perform recordkeeping and operational duties, and may perform custodial services for the CIS. The scope of examinations of CIS is tailored to the activities of the CIS and its compliance risks. In formulating the findings of the examination, the examiners may consult with other SEC staff, including supervisory staff and staff in relevant offices and divisions, to ensure that the findings are consistent with SEC rules, regulations, and interpretations. For more information regarding OCIE's inspections and examinations program, please see response to Question 8.2 above.

17.9

Do the regulatory authorities proactively perform investigative activities in order to identify suspected breaches with respect to entities involved in the operation of a CIS?

As discussed in response to Question 17.5 above, the SEC's staff conducts investigations of CIS, their operators and other entities involved in the operation of a CIS when it has reason to believe that a violation of the U.S. federal securities laws is about to occur or has already occurred.

17.10

Is the operator of a CIS subject to a general and continuing obligation to report to the regulatory authority or investors, either prior to or after the event, any information relating to material changes in its management, organization or by-laws?

CIS Operator

In general, a CIS operator has a general and continuing obligation to report to the SEC, either prior to or after the events, information relating to material changes in its management or organization because (a) that information generally must be described in the operator's Form ADV, and (b) an operator must keep current the relevant responses on its Form ADV by promptly amending its Form ADV to correct any responses that become materially inaccurate.³²³

CIS

In addition, CIS have a general and continuing obligation to report to the SEC, either prior to or after the events, information relating to material changes in their management or organization because (a) that information generally must be described in the CIS's prospectus, and (b) a CIS generally must amend its registration statement to correct any disclosure that becomes materially inaccurate.³²⁴

17.11

Does the regulatory system assign clear responsibilities for maintaining records of the operations of the scheme?

The Investment Company Act, the Advisers Act and the rules thereunder require CIS and CIS operators to maintain and preserve certain books and records.³²⁵ All books and records required to be maintained and preserved are subject at any time, or from time to time, to such reasonable periodic, special, and other examinations as the SEC may prescribe. In addition, all records

³²³ See Form ADV General Instructions at instruction 4.

³²⁴ The Securities Act requires a CIS that is making a continuous offering of its securities to maintain a "current" statutory prospectus. Specifically, section 10(a)(3) of the Securities Act requires that any prospectus used more than nine months after the registration statement's effective date must contain financial and other information as of a date not more than sixteen months prior to such use. A CIS making a continuous offering of its securities can update its prospectus by filing a post-effective amendment to its registration statement that contains updated financial statements and other information. In addition, CIS must amend the registration statement to avoid potential liability. In particular, section 11 of the Securities Act provides that the CIS itself, its directors (including persons named in the CIS's registration statement as about to become directors of the CIS), all of the persons who sign the CIS's registration statement, any expert who is named as having certified or prepared information in the registration statement, and the underwriter may be liable for any materially false statement or omission in a CIS's registration statement.

³²⁵ See Section 31 of the Investment Company Act and Section 204 of the Advisers Act and the respective rules thereunder.

maintained by an operator (whether or not required to be maintained) are similarly subject to such examinations. For further information please *see* responses to Questions 8.2 and 8.4 above and Question 23.11 below.

17.12

Are there provisions to prohibit, restrict or disclose certain conduct likely to give rise to conflicts of interests between a CIS and its operators or their associates or connected parties?

The answer below delineates the various conflicts of interest addressed by the regulatory system.

Principal Transactions between a CIS and its Affiliates

Section 17(a) of the Investment Company Act addresses conflicts of interests that arise from principal transactions between a CIS and its affiliates by prohibiting these transactions. Section 17(a) generally prohibits any affiliated person of a CIS (or any affiliated person of an affiliated person³²⁶ of a CIS), acting as principal, from knowingly buying securities or other property from, or selling securities or other property to, the CIS.³²⁷

Section 17(b) of the Investment Company Act authorizes the SEC to grant orders exempting affiliated principal transactions from the prohibitions of section 17(a) on a case-by-case basis if:

- the terms of the proposed transaction are reasonable and fair and do not involve overreaching by any of the parties to the transaction;
- the proposed transaction is consistent with the policy of each CIS that is a party to the transaction; and

³²⁶ As used herein, the term “affiliate” includes both an affiliated person of a CIS and an affiliated person of an affiliated person of a CIS. The Investment Company Act defines an “affiliated person” of another person as: (a) any person directly or indirectly owning, controlling, or holding with power to vote, 5% or more of the outstanding voting securities of such other person; (b) any person 5% or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (c) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (d) any officer, director, partner, copartner, or employee of such other person; (e) if such other person is a CIS, any operator thereof or any member of an advisory board thereof; and (f) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

³²⁷ A UIT is created by a sponsor, which is usually a broker-dealer that is registered with the SEC. Prior to the actual sale of UIT units to investors, the sponsor may assemble a securities portfolio and, on a certain date, deposit this portfolio with the UIT’s trustee under the terms of a trust indenture. In return, the sponsor receives units of the UIT. Section 17(a)(1) exempts from the prohibitions of section 17(a) the sponsor's deposit of securities with the trustee and receipt of units from the UIT.

- the proposed transaction is consistent with the general purposes of the Investment Company Act.

In addition, the SEC has adopted several rules that exempt certain types of affiliated principal transactions from these prohibitions. The rules are intended to provide that the terms of a transaction are fair and, in some cases, require that an independent party (such as a CIS's board of directors) approve the transaction. Entities that are entitled to rely on those rules are not required to obtain exemptive orders from the SEC.

Transactions in which a CIS and its Affiliates Jointly Participate

Section 17(d) of the Investment Company Act and rule 17d-1 thereunder together prohibit a CIS's affiliate, acting as principal, from participating in or effecting any transaction in connection with a "joint enterprise or other joint arrangement or profit-sharing plan" in which the CIS is a participant unless the SEC grants an order exempting the transaction before it is effected.³²⁸ In determining whether to grant an exemptive order under these provisions, rule 17d-1 states that the SEC will consider:

- whether the CIS's participation in the transaction is consistent with the provisions, policies and purposes of the Investment Company Act; and
- whether the CIS is participating on a basis that is different or less advantageous than that of the other participants.

Soft Dollars

As a fiduciary, a CIS operator has an obligation to seek to obtain "best execution" of a CIS's transactions. Under section 28(e) of the Exchange Act, an operator may, consistent with that duty, cause a CIS to pay more than the lowest available commission for executing a securities trade in return for research services and products. To do so, an operator must make a good faith determination that the amount of commission paid is reasonable in relation to the value of the brokerage and research services provided by the broker-dealer, viewed in terms of the particular transaction or the operator's overall responsibilities to its clients. In making this determination, an operator may consider not only the benefit to be derived by the CIS that pays the commissions, but also the benefits derived by the operator's other accounts. A CIS operator's burden for substantiating its good faith determination is greater when the operator enters into a soft dollar arrangement with an affiliated broker-dealer, as opposed to an unaffiliated broker or dealer. Not any type of transaction, however, can be used to generate soft dollar benefits. For instance, soft dollar benefits may not be generated by certain types of principal transactions, such

³²⁸ The terms "joint enterprise or other joint arrangement or profit-sharing plan" include any written or oral plan, contract, authorization or arrangement, or any practice or understanding concerning an enterprise or undertaking in which a CIS or a company controlled by it and an affiliate have a joint or a joint and several participation or share in the profits of such enterprise or undertaking.

as those that occur in the markets for fixed-income securities.³²⁹ Furthermore, soft dollars may not be used for all brokerage and research services. For instance, soft dollars may not be used for hardware, such as telephones or computer terminals, overhead or products to help the operator meet compliance responsibilities.³³⁰ A CIS must adequately disclose any soft dollar arrangements in its registration statement and an operator must adequately disclose any soft dollar arrangements in its Form ADV.

In addition, section 17(e)(1) of the Investment Company Act makes it unlawful for any affiliated person of a CIS (such as its operator), acting as agent, to accept any compensation (other than a regular salary or wages from the CIS) for the purchase or sale of property to or for the CIS (except when acting as a broker or an underwriter as discussed below with respect to the “Use of Affiliated Brokers”). Section 17(e)(1) limits the types of soft dollar benefits that a CIS operator may receive in connection with CIS brokerage transactions to only the research-related benefits that are permitted under section 28(e) of the Exchange Act. The receipt of research services in connection with the CIS’s payment of commissions is considered to be compensation within the meaning of section 17(e)(1) because the CIS operator is thereby relieved of the necessity to produce the research itself or to purchase the research with its own money.

Directed Brokerage

In a directed brokerage arrangement, a CIS -- rather than the operator -- instructs its operator to direct transactions to a particular broker and the CIS receives products and services from the broker directly. Rule 12b-1(h)(1) prohibits CIS from compensating a broker-dealer for promoting or selling CIS shares by directing brokerage transactions to that broker. The prohibition applies both to directing transactions to selling brokers, and to indirectly compensating selling brokers by participation in step-out and similar arrangements in which the selling broker receives a portion of the commission. The ban extends to any payment, including any commission, mark-up, mark-down, or other fee (or portion of another fee) received or to be received from the CIS's portfolio transactions effected through any broker or dealer.

Lending and Borrowing to or from Affiliates

Section 17(a) of the Investment Company Act generally prohibits any affiliate of a CIS from borrowing money or other property from the CIS, and section 21(b) of the Investment Company Act generally prohibits a CIS from lending money or other property to any person that controls or is under common control with the CIS. A CIS, however, is not prohibited from borrowing from an affiliate. Nonetheless, in order to protect a CIS from large, leveraged losses, section 18 of the Investment Company Act generally restricts the ability of a CIS to borrow.

³²⁹ Soft dollar benefits may be generated by certain riskless principal transactions so long as the transaction meets certain transparency, disclosure and oversight conditions. *See SEC Guidance on the Scope of Section 28(e) of the Exchange Act*, Securities Exchange Act Rel. No. 45194 (Dec. 27, 2001), available at <http://www.sec.gov/rules/interp/34-45194.htm>.

³³⁰ *See Commission Guidance Regarding Client Commission Practices under Section 28(e) of the Securities Exchange Act of 1934*, Securities Exchange Act Rel. No. 54165 (July 18, 2006), available at <http://www.sec.gov/rules/interp/34-54165.htm>.

Purchase of an Affiliate’s Securities or Securities Underwritten by an Affiliate

Section 10(f) of the Investment Company Act generally prohibits a CIS from purchasing, during an underwriting, any security when a principal underwriter of the security has certain affiliated relationships with the CIS. The SEC, however, has adopted a rule that exempts certain purchases from that prohibition. Rule 10f-3 permits a CIS that is affiliated with a member of an underwriting syndicate to purchase certain securities underwritten by the syndicate provided that certain conditions that are designed to protect investors have been met (*e.g.*, the CIS’s board of directors adopts procedures for purchases made in reliance on the rule and regularly reviews the terms of purchases effected in reliance on the rule to determine whether they comply with the procedures). As discussed above, section 17(d) of the Investment Company Act and rule 17d-1 thereunder prohibit affiliated joint transactions. Under certain circumstances, a CIS that purchases securities that an affiliated person is selling may be engaged in such a prohibited joint transaction.

In addition, section 12(d)(3) of the Investment Company Act and rule 12d-3 thereunder generally prohibit a CIS from purchasing securities issued by its operator and its principal underwriter, *i.e.*, the broker-dealer that is primarily responsible for selling the CIS’s shares (CIS principal underwriter).

Use of Affiliated Brokers

Section 17(e)(2) of the Investment Company Act limits the compensation that an affiliate may receive (from any source) when acting as broker for a CIS. When acting as a broker in connection with the sale of securities to or by the CIS, which is effected on an exchange, an affiliate may not receive compensation in excess of the “usual and customary broker’s commission.”³³¹ If the sale is effected in connection with a secondary distribution of securities, the compensation cannot exceed 2% of the sales price. For sales effected through other means, the compensation cannot exceed 1% of the sales price.

Employees Transacting for their Own Accounts

Rule 17j-1 under the Investment Company Act generally requires a CIS, its operator and principal underwriter each to adopt a code of ethics governing the personal securities transactions of its employees. In general, the codes of ethics are designed to ensure that people who have access to information regarding purchases and sales of securities by the CIS (“access persons”) do not use that information, or their ability to influence the CIS’s transactions, for their own personal gain. Rule 17j-1 requires that a CIS’s board of directors, including a majority of the independent directors, approve the CIS’s code and the code of any operator or CIS principal

³³¹ Under rule 17e-1 under the Investment Company Act, a commission will not exceed “usual and customary broker’s commission” if the commission is fair compared to the commission received by other brokers in connection with comparable transactions involving similar securities being purchased or sold on an exchange during a comparable period of time and if the CIS’s board of directors has certain procedures in place designed to monitor the fairness of the commissions.

underwriter, as well as any material changes to the codes. The management of the operator, CIS principal underwriter or CIS must, at least once a year, provide the CIS's board of directors with a written report that describes any issues that arose during the previous year under the code, including but not limited to material violations. The management must certify to the CIS's board of directors that reasonably necessary procedures have been adopted to prevent access persons from violating the code of ethics.

Rule 17j-1 also requires access persons to report personal securities transactions quarterly and to provide initial and annual securities holdings reports to his or her organization. Appropriate management or compliance personnel of the access persons' organizations are required to review the reports. In addition, the CIS or its operator must review and pre-approve any investment in an initial public offering or private placement by certain investment personnel of the CIS or CIS operator.

Rule 17j-1 also prohibits an operator, a CIS principal underwriter and their affiliated persons from engaging in certain fraudulent activities in relation to a CIS. The rule prohibits such persons, in connection with their purchase or sale of securities that are held or are to be acquired by the CIS, from engaging in any act, practice or course of business that would operate as a fraud or deceit on the CIS or from engaging in any manipulative practice with respect to the CIS. In addition, section 10(b) of the Exchange Act and rule 10b-5 thereunder contain a broad prohibition against any fraudulent activity in connection with the purchase or sale of any security by any person.

In addition, section 204A of the Advisers Act requires CIS operators to establish, maintain, and enforce written procedures designed to prevent the misuse of material non-public information. Rule 204A-1 under the Advisers Act requires CIS operators to adopt codes of ethics. The rule requires an operator's code of ethics to set forth standards of conduct and require compliance with U.S. federal securities laws. Codes of ethics must also address personal trading: they must require operators' personnel to report their personal securities holdings and transactions, including those in affiliated CIS, and must require personnel to obtain pre-approval of certain investments. CIS operators are required to keep copies of their codes of ethics and records relating to the code and to describe their codes of ethics to clients.

Affiliate's Receipt of Compensation for CIS Transactions

As discussed above, section 17(e)(1) of the Investment Company Act makes it unlawful for any affiliated person of a CIS (such as its operator) to receive any compensation (other than a regular salary or wages from the CIS) for the purchase or sale of property to or for the CIS when acting as an agent (except when acting as a broker or underwriter). For example, please refer to response above with respect to "Soft Dollars" discussing the limitations of section 17(e)(1) with regard to an operator's receipt of non-research related soft-dollar benefits.

Advisory Fees

Conflicts of interest may arise when operators set the fees that they charge to a CIS for the services that they provide because an operator has an incentive to charge the highest possible fee.

The SEC does not directly limit or regulate the amount of fees that an operator, or any other entity, can charge to a CIS. Section 36(b) of the Investment Company Act, however, deems an operator to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature by the CIS or its shareholders to the operator and its affiliates. Section 36(b) permits the SEC and CIS shareholders to sue the operator for breach of this fiduciary duty. In addition, section 15 of the Investment Company Act requires a majority of the independent directors of a CIS's board of directors to annually approve the advisory contract. In doing so, the directors generally must evaluate the terms of the contract, including the fees charged by the operator and the relationship between the nature and quality of the services provided under the contract and the fees charged, consistent with section 36(b) of the Investment Company Act.³³²

In addition, if an operator charges a fee based on the performance of a CIS, the operator might be encouraged to take undue risks with the assets of the CIS to increase the amount of the fee that it will receive. Section 205 of the Advisers Act provides that a CIS operator may charge a performance fee only if the fee also penalizes the operator for poor performance. In particular, a CIS operator may charge a "fulcrum fee," *i.e.*, a fee that increases or decreases proportionately with the investment performance of the CIS over a specified period of time as compared to an appropriate index of securities or other measure of performance specified by the SEC.

CIS Distribution

Conflicts of interest also may arise when an open-end CIS pays for the marketing of its own shares. A CIS operator that receives an asset-based management fee may have an incentive to spend excessive amounts of the open-end CIS's assets on the marketing efforts because the operator may receive an increased amount of advisory fees due to any increase in open-end CIS assets caused by the sale of additional open-end CIS shares.

Under section 12(b) of the Investment Company Act and rule 12b-1 thereunder, an open-end CIS may only pay for the marketing or distribution of its shares if it complies with certain conditions. For instance, an open-end CIS must adopt a written plan describing all material aspects of the proposed distribution financing. The plan generally must be approved by the open-end CIS's shareholders, a majority of the open-end CIS's board of directors, and a majority of the independent directors who have no direct or indirect financial interest in the operation of the plan or in any agreement related to the plan. In addition, an open-end CIS's board of directors, including a majority of its independent directors, must annually approve the plan.

Shareholder approval is required for any amendment to increase materially the amount spent for marketing or distribution under the plan, and all other material amendments to the written plan must be approved by the open-end CIS's board of directors and a majority of the independent directors who have no direct or indirect financial interest in the operation of the plan or in any agreement related to the plan. The board of directors must review, at least quarterly, a written report of the amounts spent under the plan and the reasons for these expenditures. An open-end

³³² *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923 (2d Cir. 1982).

CIS may adopt a plan only if the selection and nomination of independent directors of the open-end CIS is committed to the discretion of the independent directors.

UIT Expenses

Under section 26(a)(2)(C) of the Investment Company Act, the UIT's trust indenture must provide that no payment may be made to the UIT's depositor or principal or affiliate thereof or underwriter except for certain administrative services as prescribed by the SEC. Rule 26a-1 generally limits the amount of any administrative fee paid to the UIT's depositor or principal or affiliate to the costs of the services provided, without profit.

17.13

Are there regulatory provisions aiming at minimizing conflict of interest situations, to ensure that any conflicts that do arise do not adversely affect the interests of investors?

The answer below breaks out the various regulatory provisions and discusses them separately. For general information about disclosure of CIS operator conflicts, *see* response to Question 23-13(a).

Direct Prohibition of Particular Transactions under the Law

As discussed above, section 17 of the Investment Company Act prohibits affiliated transactions including: (a) principal transactions involving purchases and sales of securities or other property; (b) borrowing from the CIS and CIS lending; (c) joint transactions in which a CIS's affiliate acts as principal; (d) transactions in which a CIS's affiliate acts as agent and receives compensation for the purchase or sale of property for the CIS; and (e) transactions in which a CIS's affiliate acts as broker to the CIS and receives compensation over a specified amount for the purchase or sale of securities for the CIS.

Furthermore, section 206(3) of the Advisers Act prohibits a CIS operator from acting as principal for its own account without disclosing to its client in writing before the completion of the transaction the capacity in which it is acting and obtaining the consent of the client to the transaction.

Code of Ethics

As discussed above in response to Question 17.12 above, rule 17j-1 under the Investment Company Act also requires the CIS, its operator and principal underwriter to adopt codes of ethics governing the personal securities transactions of their employees. A CIS must disclose annually whether it has adopted a code of ethics that applies to the CIS's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, regardless of whether these individuals are employed by the CIS or a third party. If the CIS has not adopted a code of ethics, it must explain why it has not done so. This rule addresses the conflicts of interest that arise when CIS insiders have access to information about the CIS's portfolio transactions. Section 204A of the Advisers Act requires

CIS operators to establish, maintain and enforce written policies and procedures reasonably designed, taking into consideration the nature of the CIS operator's business, to prevent the misuse of insider information. Additionally, rule 204A-1 under the Advisers Act requires the CIS operator to adopt codes of ethics similar to those required by rule 17j-1.

Review and/or Approval of Certain Transactions and Activities by the Regulatory Authority

The SEC reviews certain filings, including registration and proxy statements, and certain transactions, including affiliated mergers and certain other transactions that involve potential conflicts of interest.

Section 6(c) of the Investment Company Act and section 206A of the Advisers Act authorize the SEC by rule, or by order upon application, to exempt, conditionally or unconditionally, any person, security, or transaction from one or more provisions of such acts or SEC rules. To grant an exemption, the SEC generally must find that the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policies and provisions of the Acts. The exemption process includes notice to the public and an opportunity to request a hearing. Exemptive orders issued by the SEC are publicly disclosed.

As described in response to Question 17.6 above, OCIE conducts and coordinates the nationwide examination program for entities that are registered with the SEC, including CIS operators. If serious violations are found, OCIE staff may refer the matter to the SEC's Division of Enforcement to consider whether an investigation and possible enforcement action are appropriate.

Disclosure by the Operator

The prohibited affiliated transactions described above are not permitted even if the CIS or its operator (or other affiliated persons of the CIS) discloses the conflicts presented by the transactions. The form used to register CIS shares with the SEC requires disclosure regarding the operator's use of affiliated broker-dealers, or any affiliated service provider, and any affiliated transactions that are material to the discussion of the CIS's investment strategies.

An operator must disclose all material facts regarding potential conflicts of interest between the CIS and its operator, even if the operator believes that a conflict has not affected and will not affect the operator's recommendations to the CIS. This obligation to disclose conflicts of interest includes the obligation to disclose any benefits that the operator may receive from third parties as a result of its recommendations to the CIS.³³³ The operator often provides the disclosure to the board of directors of the CIS in connection with the board's approval of the advisory contract. In addition, the CIS may disclose information about certain conflicts between

³³³ See, e.g., *In the Matter of Dawson-Samberg Capital Mgmt., Inc., et al.*, Investment Advisers Act Rel. No. 1889 (Aug. 3, 2000).

the CIS and its operator to CIS shareholders.³³⁴ Rule 206(4)-6 under the Advisers Act also requires CIS operators to adopt proxy voting policies and procedures, which must include how the CIS operator proposes to address conflicts. CIS operators are required to disclose to CIS those policies and procedures and how CIS can obtain information about how the CIS operator has voted CIS proxies, and require the CIS operator to keep records of how it votes CIS proxies.

Prior Approval or Ratification of Certain Transactions by the Investors

In general, the prohibited affiliated transactions described in the response to Question 17.12 above generally are not permitted even with prior approval or ratification by investors. Note, however, that the Investment Company Act addresses some potential conflict of interest situations by requiring prior approval by open-end and closed-end CIS shareholders. For example, section 15 of the Investment Company Act provides that open-end and closed-end CIS shareholders must approve any increase in the operator's fees. In addition, section 12(b) of the Investment Company Act and rule 12b-1 thereunder provide that an open-end CIS may pay for the marketing or distribution of its shares only if, among other conditions, a written plan describing all material aspects of the proposed distribution financing is approved by the open-end CIS's shareholders.

Record Keeping by the Operator

A CIS must keep extensive books and records available for inspection by the Staff. Rule 31a-1 under the Investment Company Act requires a CIS to maintain and keep current the accounts, books, and other documents relating to its business that form the basis for the CIS's financial statements that are required to be filed with the SEC. Rule 31a-2(a)(2) requires the preservation of those records for a period of six years from the end of the fiscal year in which the transaction occurred, the first two years in an easily accessible place. Section 204 of the Advisers Act and rule 204-2 thereunder require a CIS operator to maintain and preserve specified books and records and make them available to Staff for inspection.

The record keeping requirements are designed, in part, to assist the Staff in assessing whether conflicts exist and adversely affect the CIS. For example, rule 17j-1 under the Investment Company Act and rule 204-2 under the Advisers Act require certain CIS personnel and CIS operators and their advisory representatives to keep records of their personal securities transactions. The record keeping requirements also assist the SEC in assessing whether a CIS operator is favoring one CIS over another.

As noted above, the SEC has provided, in the form of rules of general application and individual exemptions, limited relief from the affiliated transaction prohibitions. Certain of those rules and orders require the CIS or its operator to maintain certain records for SEC inspection. For example, rule 17a-7 under the Investment Company Act requires that for every transaction conducted pursuant to the rule, the CIS must preserve written records that describe the transaction and its terms.

³³⁴ See Form N-1A.

Independent Review by a Third Party

The Board: The CIS's board of directors, including the independent directors, is expected to provide general oversight and independent checks on the CIS operator and other service providers to the CIS. In general, this duty requires the board of directors to monitor the conflict of interest transactions involving the CIS. For example, rule 17a-7 under the Investment Company Act exempts certain affiliated purchase and sale transactions from the prohibition in section 17(a) (discussed in response to Question 17.12 above), provided that the board, including a majority of the independent directors, adopts procedures to ensure that the purchase and sale transactions comply with the conditions of the rule and, each quarter, determines that the transactions during the preceding quarter complied with the rule. Please also refer to response to Question 17.6 above with respect to "The Board," and Question 17.12 above with respect to "Principal Transactions between a CIS and its Affiliates."

Independent Accountants: The annual financial statements of a CIS must be audited by an independent accountant. Please refer to response to Question 17.6 above with respect to "Independent Accountants." If an open-end or closed-end CIS maintains custody of its own assets, an independent accountant must also verify the assets by actual examination at least three times a year, at least two of which must be chosen by the accountant without prior notice to the operator or CIS.³³⁵

17.14

Is the CIS required to comply with rules related to:

a) Best execution?

As a fiduciary, an operator has an obligation to seek to obtain "best execution" of a CIS's transactions. Please also refer to response to Question 17.12 above with respect to "Soft Dollars."

17.14

b) Appropriate trading and timely allocation of transactions?

In examinations of CIS and their operators, the SEC gives particular scrutiny to allocation procedures to ensure that they are fair and equitable. Although no special method of allocation is required, the method employed must be fair and reasonable and consistently applied on a timely basis. The SEC has brought several enforcement proceedings against CIS operators for allegedly failing to disclose adequately that allocation policies favored certain clients.

³³⁵ Rule 17f-2 under the Investment Company Act. Section 26(a) of the Investment Company Act provides that a UIT may not maintain custody of its own assets; rather, it must designate one or more bank custodians.

17.14

c) *Churning?*

CIS operators are subject to the antifraud provisions of the Advisers Act with respect to churning.³³⁶

Additionally, broker-dealers that market CIS shares are subject to rules related to churning. Churning refers to the excessive buying and selling of securities in an account by a broker, for the purpose of generating commissions and without regard to the customer's investment objectives. For churning to occur, a broker must exercise control over the investment decisions in an account, either through a formal written discretionary agreement or otherwise. Churning can be a violation of rule 15c1-7 under the Exchange Act and other U.S. federal securities laws.

The major securities industry self-regulatory organizations have rules prohibiting churning and excessive trading. Excessive trading is the same as churning, but without the requirement that the person engaging in the trading does so for the purpose of generating commissions. Churning and excessive trading can violate NASD Rule 2310, NASD Rule 2310-2(b)(2), NYSE Rule 408(c), and NYSE Rule 476(a)(6).

17.14

d) *Related party transactions?*

The prohibited affiliated transactions described in the response to Question 17.13 above are not permitted even if the CIS or operator (or other affiliated person of the CIS) discloses the conflicts presented by the transactions. Other conflicts between an operator and a CIS that are not specifically prohibited by the Investment Company Act must be disclosed to the board of directors, and often are disclosed to investors, as well. For example, the form used to register CIS shares with the SEC requires disclosure regarding the operator's use of affiliated broker-dealers, or any affiliated service provider, and any affiliated transactions that are material to the discussion of the CIS's investment strategies. In addition, a CIS is required to disclose information about the nature and extent of all relationships with its affiliates in the CIS's financial statements, which must be filed with the SEC, sent to its investors semi-annually and audited annually.

17.14

e) *Underwriting arrangements?*

Section 22(d) of the Investment Company Act and rule 22d-1 thereunder generally prohibit a CIS and its principal underwriter or a dealer in its shares from selling its securities at other than the current public offering price described in the CIS's prospectus unless a scheduled variation in

³³⁶ See, e.g., *SEC v. Galleon Capital Management*, Litigation Rel. No. 14315 (Nov. 1, 1994), and *First Multifund Advisory Corp. et. al.*, Rel. No. 34-11064 (Mar. 4, 1980).

sales loads is established, uniformly applied, and disclosed. Furthermore, FINRA generally limits sales loads on CIS shares to a maximum of 8.5%.

Additionally, the Investment Company Act imposes requirements on principal underwriting contracts with CIS that are similar to, but less stringent than, those imposed on advisory contracts. Section 15(b) of the Investment Company Act requires any principal underwriter for an open-end CIS to sell the CIS's securities only pursuant to a written contract. This contract, in turn, must provide that it may continue in effect for more than two years from execution only if continuance is approved annually by: (1) the board or by shareholders; and (2) by the independent directors of the board. The contract also must automatically terminate on its assignment.

17.15

Does the regulatory system provide for clear indication of circumstances under which delegation is allowed and is there prohibition of systematic and complete delegation of core functions of the CIS operator to the extent that there is a transformation, gradual or otherwise, into an empty box?

There is no statutory prohibition on delegation of CIS operator functions to other persons if the contract between the CIS operator and the CIS (the "advisory contract") permits the delegation.

As noted above, delegation is allowed if the advisory contract permits such delegation. If the contract permits delegation and advisory responsibilities are delegated, the delegate would be considered to be an operator to the CIS, and may perform services for the CIS only pursuant to a written contract ("subadvisory contract") that is approved in the same manner as the advisory contract, *i.e.*, by a majority of the CIS's shareholders and a majority of the CIS's independent directors. In addition, the delegate must be registered with the SEC as an operator under the Advisers Act. As an investment adviser, the delegate would have a fiduciary duty to the CIS and, as discussed below, in the event that the delegate fails to perform its duties satisfactorily, the CIS operator and the delegate may both be accountable. There is no statutory prohibition against the systematic and complete delegation of core functions (*i.e.*, the advisory responsibilities) of the CIS operator.

In some instances, a CIS advisory contract may obligate the CIS operator to provide non-advisory services. If the contract provides for delegation, the CIS operator also may delegate the non-advisory services to another person, such as an administrator.

17.16

If delegation is permitted, is the delegation done in such a way so as not to deprive the investor of the means of identifying the company legally responsible for the delegated functions? In particular:

- a) Is the CIS operator responsible for the actions or omissions, as though they were its own, of any party to whom it delegates a function?***

Whether the CIS operator is responsible for the actions of the delegate depends on the advisory and subadvisory contracts. Usually, the advisory contract will provide that the CIS operator is responsible for all aspects of the advisory relationship, and the subadvisory contract will provide that the CIS operator is responsible for supervising the delegate. In that case, if the delegate fails to perform its duties satisfactorily, the CIS operator and the delegate both may be accountable to the CIS and its shareholders.

If an advisory contract with a CIS provides (a) for the use of a second CIS operator that would not be supervised by the first CIS operator, and (b) that the first CIS operator would not be considered accountable for the actions of the second CIS operator, the first CIS operator would not be accountable to the CIS and its shareholders for the actions of the second CIS operator. The second CIS operator would be accountable for its actions.

The same principals apply to delegations of administrative functions from CIS operators to administrators.

17.16

- b) Does the regulatory system require the CIS operator to retain adequate capacity and resources and have in place suitable processes to monitor the activity of the delegate and evaluate the performance of the delegate?***

While there are no direct requirements requiring the CIS operator to supervise a sub-adviser (see response to sub-section (a) above), the SEC can bring an enforcement action against a CIS operator for failure to supervise a delegate if the delegate violates the U.S. federal securities laws and is subject to the CIS operator's supervision. Furthermore, the board of directors, when annually renewing the advisory contract with the delegate, generally examines the effectiveness of the delegate's internal controls.

17.16

- c) Can the CIS operator terminate the delegation and make alternative arrangements for the performance of the delegated function where appropriate?***

If the delegate is a sub-adviser, section 15 of the Investment Company Act provides that the CIS operator cannot terminate the contract without approval by either a majority of the CIS directors; or a majority of its shareholders. Please see response to Question 17.16(d) below. If the delegate is another service provider, this is a matter of private contract law between the CIS operator and the service provider. Such contracts typically contain a termination clause that requires advance notice of termination.

17.16

d) Are there requirements for disclosure to investors in relation to the delegation arrangements and the identity of the delegates?

As noted above, if advisory responsibilities are delegated, the delegate would be considered to be an adviser to the CIS, and may perform services for the CIS only pursuant to a subadvisory contract that is approved in the same manner as the advisory contract, *i.e.*, by a majority of the CIS's shareholders or a majority of the CIS directors. Disclosure to investors in relation to the delegation arrangements and the identity of the delegates would be made in connection with the shareholder vote approving the subadvisory contract.

In addition, a CIS generally must disclose information about the delegate in its registration statement (including its prospectus) to the same extent that it discloses information about its operator.³³⁷

17.16

e) Does the regulatory system address delegations which may give rise to a conflict of interest between the delegate and the investors?

The same provisions to prohibit, restrict or disclose certain conduct likely to give rise to conflicts of interest discussed above in response to Questions 17.12 and 17.13 above apply equally to delegates of a CIS.

³³⁷ See, *e.g.*, item 5 of Form N-1A.

Collective Investment Schemes - Principle 18

The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.

Assessment

Fully Implemented.

18.1

Does the regulatory framework provide for requirements as to the legal form and structure of CIS that delineate the interests of participants and their related rights?

Open-end CIS must offer redeemable securities which entitle a CIS investor to redeem the CIS shares for a proportionate cash equivalent of the CIS's net asset value (NAV) upon presentation to the CIS. Closed-end CIS, on the other hand, do not issue redeemable securities. Additionally, CIS are required to have directors or a functional equivalent thereof.

The Investment Company Act imposes certain capital structure requirements on CIS. For example, section 18 of the Investment Company Act requires that all common stock issued by a CIS be voting stock and have equal voting rights. With respect to closed-end CIS, section 18 of the Investment Company Act provides that such CIS are permitted to have only one class of debt and one class of preferred stock in addition to one class of common stock.

There are no specific requirements as to the legal form of an open-end or closed-end CIS in the Investment Company Act. Under sections 7(a), (b) and (d) and 8(a) of the Investment Company Act, a CIS must be organized or created either under the laws of the U.S. or a state or under the laws of a foreign country. An open-end or closed-end CIS generally may be organized as a corporation, a partnership, an association, a joint-stock company, a trust, or any organized group of persons, and most open-end and closed-end CIS are structured as business trusts or as corporations. Under section 4(2) of the Investment Company Act, a UIT must be organized under a trust indenture, contract of custodianship or agency, or similar instrument.

18.2

Does the regulatory framework provide that the legal form and structure of a CIS, as well as the implications thereof for the nature of risks associated with the scheme, be disclosed to investors in such a way that they are not dependent upon the discretion of the CIS operator?

Section 8(b) of the Investment Company Act requires an open-end or closed-end CIS to state in its registration statement its classification under sections 4 and 5 (*i.e.*, whether it is an open-end or closed-end CIS or UIT). All CIS are required to disclose in their registration statements information about the redeemability of their shares, as well as the name of the state or other

jurisdiction in which they are organized. In addition, as discussed in response to Question 19.3(b), a CIS's registration statement contains exhibits, including copies of its organizational documents, such as the articles of incorporation, by-laws, or trust agreement which could include information about legal form and structure. Please also *see* response to Question 18.3 below.

18.3

Is there a regulatory authority responsible for ensuring that the form and structure requirements are observed and evidence that the above requirements are enforced in the assessed jurisdiction?

The responsibility for ensuring that the requirements are observed rests primarily with the CIS and with those who signed its registration statement. The SEC's staff generally reviews CIS registration statements, but does not approve or disapprove a CIS registration statement based upon the merits of an investment in the CIS, the qualifications of a CIS operator, or the legal structure and form of the CIS. Please see response to Question 17.5 above. In addition, as described in responses to Questions 17.6 and 17.13 above, OCIE conducts and coordinates the nationwide examination program for entities that are registered with the SEC. If serious violations are found, OCIE staff may refer the matter to the SEC's Division of Enforcement to consider whether an investigation and possible enforcement action are appropriate.

18.4

Does the regulatory framework provide that where changes are made to investor rights that do not require prior approval from investors, notice is given to them before the changes take effect?

While a CIS generally is not required to give its existing shareholders prior notice of non-material changes that do not require shareholder approval³³⁸ open-end CIS and UITs must update

³³⁸ Note that the Investment Company Act and the rules thereunder provide shareholders with certain specific rights. Under section 13 of the Investment Company Act, no CIS may, unless authorized by the vote of a majority of its outstanding voting securities: (1) change from being an open-end CIS to a closed-end CIS or from being a diversified to a nondiversified company; (2) borrow money, issue senior securities, underwrite securities issued by other persons, purchase or sell real estate or commodities, or make loans to other persons, except in accordance with the recitals of policies contained in the CIS's registration statement; (3) deviate from any investment policy that is changeable only by shareholder vote; or (4) change the nature of its business so as to cease to be an investment company. Section 15 of the Investment Company Act generally prohibits any person from acting as an investment adviser (CIS operator) to a CIS except pursuant to a written contract that has been approved by the vote of "a majority of the outstanding voting securities" of the CIS that is cast at the annual meeting or at a special meeting of security holders. Section 16(a) of the Investment Company Act prohibits any person from acting as a director of a CIS unless elected to that office by the holders of the outstanding voting securities of such company, at an annual or a special meeting duly called for that purpose (except that vacancies occurring between such meetings may be filled in any otherwise legal manner if immediately after filling any such vacancy, at least two-thirds of the directors then holding office shall have been elected to such office by the holders of the outstanding voting securities of the company at such an annual or special meeting). Section 22 of the Investment Company Act and rule 22c-1 thereunder generally prohibit purchases and sales of the securities of an open-end CIS or in the units of a UIT except at a price based on the current NAV of the CIS's or UIT's shares, which is next computed after receipt of an order to

their registration statements, including prospectuses, to reflect any material changes that have been made to investor rights so that new shareholders, or existing shareholders making a new investment, are informed of the change.³³⁹ All CIS registration statements, including prospectuses, are available on the SEC's website and many open-end CIS provide updated prospectuses on their websites. CIS using a summary prospectus must provide updated prospectuses on their websites.³⁴⁰ As a practical matter, open-end CIS generally provide updated prospectuses annually to all existing shareholders.

In certain circumstances, a CIS must provide shareholders with at least sixty days notice prior to changing an investment policy of investing at least 80% of the CIS's assets in the type of investments that are suggested by the CIS's name.³⁴¹

18.5

Does the regulatory framework provide that where changes are made to investor rights, notice is given to the relevant regulatory authority?

A CIS that is making a continuous offering of its securities must maintain a current registration statement, including its prospectus. Any material change to the prospectus must be filed with the SEC.³⁴² Material changes include, among other things, changes in the CIS's investment objectives or fundamental policies, suspension of sales or redemption of shares, termination of an advisory contract, and, in some cases, the resignation of the CIS's independent public accountant.

purchase or redeem the security. Section 22 also prohibits CIS from suspending a shareholder's right to redeem their securities for more than seven days after the tender of a security except in certain exceptional circumstances.

³³⁹ See response to Question 17.10 above. Rule 8b-16 under the Investment Company Act provides that a closed-end CIS need not update its registration statement annually if it provides certain important information to shareholders in the closed-end CIS's annual report to shareholders.

³⁴⁰ Rule 498(e)(1) under the Securities Act.

³⁴¹ Rule 35d-1 under the Investment Company Act provides that if a CIS has a name that suggests that it focuses its investments in a particular investment or investments in an industry or group of industries, then the CIS must invest at least 80% in the particular type of investments suggested by the name. The rule requires that the CIS either: (1) adopt the 80% investment standard as a policy that cannot be changed without prior shareholder approval; or (2) adopt a policy to provide shareholders with at least sixty days notice prior to any change in its 80% investment policy.

³⁴² See response to Question 17.10 above.

18.6

Does the regulatory framework require the separation and segregation of CIS assets from the assets of the CIS operator and its managers?

To preserve the assets of CIS and protect them from abuses, pursuant to rule 17f-1 under the Investment Company Act, CIS may place their securities and similar investments in the custody of certain eligible custodians (“eligible custodians”). For open-end and closed-end CIS, eligible custodians include: (a) banks subject to federal or state regulation and that generally have capital of at least \$500,000; (b) members of a national securities exchange (*i.e.*, certain broker-dealers); (c) securities depositories; (d) futures commission merchants and commodity clearing organizations; and (e) certain foreign entities subject to certain conditions. In certain circumstances, an eligible custodian may deposit CIS assets with another eligible custodian, such as a registered clearing agency acting as a securities depository. Because a UIT has no board of directors to monitor custody arrangements, section 26(a) of the Investment Company Act provides that a UIT may not maintain custody of its own assets, but, instead, must designate one or more banks (that have an aggregate capital of not less than \$500,000) as trustees or custodians.

There is no requirement that a CIS’s custodian be legally or functionally independent from the CIS’s operator. If a CIS operator or its affiliate acts as a CIS’s custodian, however, the CIS is deemed to have “self custody” of its assets. If a CIS is deemed to have self custody, rule 17f-2 under the Investment Company Act requires, among other things, that: (a) the CIS must deposit the securities and similar investments in the safekeeping of, or in a vault or other depository maintained by, a bank or other company whose functions and physical facilities are supervised by federal or state authorities; (b) the securities and similar investments generally must be physically segregated from those of any other person to the extent that this is feasible; (c) the board of directors of the CIS must designate which employees (not more than five persons) are authorized to have access to the assets; and (d) written notations must document each deposit or withdrawal of securities. In addition, the CIS must employ an independent public accountant to verify by actual examination the CIS’s assets at least three times during the year (twice without prior notice). A certificate of such accountant, stating that the examination has been made, and describing the nature and extent of the examination, must be sent to the SEC after each examination.

For further information, please *see* response to Question 21.8 below.

18.7

Does the regulatory framework provide for requirements governing the safekeeping of CIS assets such as: a) the obligation to entrust the assets to an independent third party; or b) special legal or regulatory safeguards in cases where custodial functions are performed by the same legal entity responsible for investment functions (or related entities)?

The SEC has adopted a number of rules that govern the custody of open-end and closed-end CIS assets. One general objective of the rules is to separate the assets of a CIS from the assets of any

other person, including its operator. For more information on the requirements applicable to self-custody arrangements, please refer to response to Question 18.6 above. The requirements that apply to specific eligible custodians are discussed below.

Bank

A CIS may place its securities and similar investments in the custody of a bank that is subject to federal or state regulation and that generally has capital of at least \$500,000.³⁴³ If a CIS uses a bank as the eligible custodian of its securities and similar investments, then the cash proceeds from the sale of securities and other cash assets also generally must be kept in the custody of an eligible bank.³⁴⁴ A CIS that uses a bank custodian may, upon resolution of the CIS's board of directors, maintain limited cash to meet current expenses in another bank and up to \$500 in cash in a petty cash account, subject to certain conditions.³⁴⁵ The custodial activities of banks are regulated primarily by the appropriate federal or state banking regulator, rather than by the SEC.

Broker-dealer

A CIS also may use a member of a national securities exchange (*i.e.*, certain broker-dealers) as its custodian subject to the conditions of rule 17f-1 under the Investment Company Act. Rule 17f-1 requires, among other things, that the CIS's securities and investments be individually segregated from the securities and investments of any other person and marked to clearly identify them as the property of the CIS to the extent that this is feasible. Rule 17f-1 also requires that the securities and investments be verified by actual examination by an independent public accountant at the end of each annual and semi-annual fiscal period, and at least one other time chosen by the accountant during the fiscal year. Such securities and investments also must at all times be subject to inspection by the SEC. Broker-dealers are subject to regulation by FINRA as well as the SEC.

Securities Depository

Rule 17f-4 under the Investment Company Act permits a CIS or any eligible custodian to deposit all or any part of the securities owned by the CIS with a securities depository, which is a system for the central handling of securities where all securities of any particular class or series of an issuer deposited within the system are treated as fungible and may be transferred or pledged by bookkeeping entry without physical delivery of the securities. A securities depository includes a clearing agency that must be registered with the SEC that acts as a securities depository and certain federal agencies that act as depositories for government securities (the Federal Book-Entry System). Rule 17f-4(d) under the Investment Company Act requires that a CIS's custodian must, at a minimum, exercise due care in accordance with reasonable commercial standards in discharging its duty as a securities intermediary to obtain and thereafter maintain

³⁴³ Section 17(f)(1)(A) of the Investment Company Act.

³⁴⁴ Section 17(f)(5) of the Investment Company Act.

³⁴⁵ Rule 17f-3 under the Investment Company Act.

financial assets. If the CIS deals directly with a depository, the depository's contract or rules for participants must provide that the depository will meet similar obligations. The custodian also must provide, promptly upon request by the CIS, such reports as are available about the internal accounting controls and financial strength of the custodian. If the fund deals directly with a depository, the depository's contract or written rules for its participants must provide that the depository will provide similar financial reports.

Foreign Entities

Rule 17f-5 under the Investment Company Act provides that a CIS may maintain its foreign assets with an eligible foreign custodian that is a foreign bank, including a banking institution or trust company that is incorporated or organized under the laws of a non-U.S. country and is regulated by the country's government or an agency of the country's government, or with a majority-owned subsidiary of a U.S. bank or bank holding company. Rule 17f-5 requires, among other things, that a foreign custody manager determine that CIS assets will be subject to reasonable care if maintained with a particular foreign bank.³⁴⁶ The foreign custody manager must consider all factors relevant to the safekeeping of such assets, including the foreign bank's internal controls, financial strength, and general reputation. In addition, the foreign custody manager must determine that the written custody contract with the foreign bank will provide reasonable care for CIS assets. The rule also states that the contract must contain certain provisions listed in the rule, or that the foreign custody manager must determine that the contract contains other provisions that provide equivalent protection to the provisions listed in the rule.

Rule 17f-7 under the Investment Company Act provides that foreign assets of a CIS may be maintained with an eligible foreign securities depository, which generally includes a securities depository that acts or operates as a system for the central handling of securities or equivalent book-entries in the country where incorporated, or a transnational system for the central handling of securities or equivalent book-entries, if the depository or transnational system is regulated by a foreign financial regulatory authority. Rule 17f-7 requires, among other things, that the depository custody arrangement obligate the primary custodian, generally a U.S. bank or certain foreign banks that contract directly with a CIS to provide custody services for the CIS's foreign assets, to analyze and monitor the custody risks of using the depository, and provide information about the risks and any material changes in the risks to the CIS or its operator. The rule also requires that the eligible foreign securities depository maintain records identifying participants' assets and keeping the depository's own assets separate.

Futures Commission Merchants

Rule 17f-6 under the Investment Company Act permits a CIS to maintain assets with a futures commission merchant in amounts necessary to effect the CIS's transactions in exchange-traded futures contracts and commodity options. Rule 17f-6 requires, among other things, that the futures commission merchant be registered with the appropriate government agency under the

³⁴⁶ A "foreign custody manager" is defined as the CIS's board of directors or any person serving as the board's delegate in accordance with certain conditions imposed by rule 17f-5 under the Investment Company Act.

Commodity Exchange Act and be unaffiliated with the CIS. A futures commission merchant must comply with the segregation requirements of the Commodity Exchange Act.

Fidelity Bonds

Section 17(g) of the Investment Company Act and rule 17g-1 thereunder generally require that a CIS provide and maintain a bond, issued by a reputable fidelity insurance company, against larceny and embezzlement involving CIS assets. The bond must cover each officer and employee of the CIS who may have access to securities or funds of the CIS, unless the officer or employee has access solely through his position as an officer or employee of a bank.

18.8

Does the regulatory framework provide for the keeping of books and records in relation to transactions involving CIS assets and all transactions in CIS shares or units or interests?

Section 31 of the Investment Company Act and rules 31a-1, 31a-2 and 31a-3 thereunder require CIS, as well as certain majority-owned subsidiaries of CIS, to maintain and keep current the accounts, books and other documents relating to the CIS's assets. The CIS must keep records for all securities transactions and ledgers for all of the CIS's accounts, such as its income and expense accounts, and records showing the number of shares owned by each shareholder of record.

Rule 31a-1(b)(2)(iv) under the Investment Company Act requires a CIS, as well as certain majority-owned subsidiaries of the CIS, to maintain and keep current separate ledger accounts (or other records) showing, for each shareholder of record of the CIS, the number of shares of capital stock of the CIS held. Alternatively, the ledger accounts (or other records) may be maintained by a transfer agent or registrar. Transfer agents generally are regulated by the SEC under the Exchange Act, and are generally subject to recordkeeping requirements pursuant to section 17(a)(3) of that act and rules 17Ad-6, 17Ad-7 and 17Ad-9 thereunder. For further information please *see* responses to Questions 8.4 and 17.11 above.

Investors typically buy CIS shares through registered broker-dealers that, in turn, hold the shares with the CIS's transfer agent in an account. The account commingles all of the CIS's shares that are held by the broker-dealer for all of its customers. Section 17(a)(1) of the Exchange Act and rules 17a-3 and 17a-4 thereunder, and certain applicable rules that have been adopted by self regulatory organizations, require the broker-dealers to create and maintain records of each customer's ownership of a CIS's shares.

Also, anti-money laundering rules require an open-end CIS to maintain records of the information that is used to verify each customer's account when the account is opened.³⁴⁷ This

³⁴⁷ See rule 0-11 under the Investment Company Act which requires compliance with 31 U.S.C. 5318(l) and the implementing regulation at 31 CFR 103.131. 31 CFR 103.131 requires that a CIS have a written customer identification procedure that specifies the identifying information that will be obtained upon account opening,

information includes the name, date of birth, address, and identification numbers of the customer. The rule does not require an open-end CIS to obtain any additional information regarding the identities of individual shareholders whose shares are held through an omnibus account that is maintained by, for instance, a broker-dealer. In this case, the shareholder that appears on the open-end CIS's shareholder ledger is the broker-dealer who maintains the account. Information about those customers is kept by the entity that maintains the omnibus account, such as a broker-dealer (which also is subject to anti-money laundering rules). For further information, please see responses to Questions 8.5 and 8.6 above.

In addition, rule 204-2 under the Advisers Act requires CIS operators to maintain books and records, including a memorandum of each order given by a CIS operator for the purchase or sale of any security, of any instruction received by a CIS operator from a CIS concerning the purchase, sale receipt or delivery of a particular security, and of any modification or cancellation of any such order or instruction.

Section 17(a)(1) of the Exchange Act and rules 17a-3 and 17a-4 thereunder, and certain rules that have been adopted by self regulatory organizations require the broker-dealers that execute CIS portfolio transactions to maintain extensive records of these transactions.

18.9

Does the regulatory framework adequately provide for audit requirements (internal or external) in relation to the assets of a CIS?

Independent accountants must conduct an annual audit of a CIS's financial statements. For more detail, please *see* responses to Questions 17.6 and 17.13 above. CIS are not required to employ internal auditors.

18.10

Does the regulatory framework adequately provide for an orderly winding up of CIS business, if needed?

A CIS remains subject to all provisions of the Investment Company Act until it is deregistered pursuant to section 8(f) of the Investment Company Act. To deregister, the CIS must obtain an order from the SEC declaring that it has ceased to be a CIS and that its registration is no longer in effect. The SEC has authority to impose conditions on deregistration that are necessary for the protection of investors. Prior orders have generally been based on a finding that, among other things, the company has distributed substantially all of its assets to shareholders and is winding up its affairs or that the company has sold substantially all of its assets to another CIS or merged into or consolidated with another such CIS.

including, at a minimum, information regarding a customer's name, date of birth, address, and identification number.

Collective Investment Schemes - Principle 19

Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.

Assessment

Fully Implemented.

19.1

Does the regulatory framework require that all matters material to an evaluation of a CIS and the value of an investor's interest are disclosed to investors, and potential investors, in an easy to understand format?

Key information is required to appear in plain English in a standardized order at the front of a CIS's prospectus.³⁴⁸ Furthermore, an investor may be sent or given the key information in the form of a summary prospectus as long as the full prospectus is provided on an internet website.³⁴⁹ Additionally, items 11 and 23 of Form N-1A require an open-end CIS to disclose in its registration statement information concerning the value of the CIS, such as information about the purchase of CIS shares, the CIS's policy with respect to dividends and distributions, the tax consequences of buying and selling the CIS's shares, and procedures for pricing the CIS's shares. Items 5 and 10 of Form N-2 require a closed-end CIS to disclose in its registration statement information concerning the value of the CIS, such as information about the price to the public in each principal underwriter distribution, the CIS's policy with respect to dividends and distributions, the tax consequences of buying and selling the CIS's shares. Form N-8B-2 also requires a UIT to disclose in its registration statement information concerning its value, such as information about the method of valuation used to determine the offering price and redemption price of securities.

19.2

Does the regulatory framework include a general disclosure obligation to allow investors, and potential investors, to evaluate the suitability of the CIS for that investor or potential investor?

A CIS's prospectus should include all information that would be material to an investment decision by a prospective investor. A CIS must deliver a prospectus to an investor (a closed-end

³⁴⁸ With respect to plain English, *see* general instruction B.4(c) of Form N-1A and the plain English requirements of Rule 421 under the Securities Act. With respect to the standardized order, *see* general instruction C.3(a) of Form N-1A.

³⁴⁹ Rule 498 under the Securities Act.

CIS is not required to deliver a prospectus to an investor purchasing shares in the secondary market). An open-end or closed-end CIS prospectus generally includes information about the CIS's investment objectives and goals, principal investment strategies and the principal risks of investing in the CIS. A UIT prospectus contains detailed information concerning the securities comprising the unit of specified securities in which a shareholder will have an interest. An open-end CIS may, but is not required to, describe the types of investors for whom the CIS is intended or the types of investment goals that may be consistent with an investment in the CIS. For additional detail on the contents of a CIS's prospectus, *see* response to Question 19.3 below.

In addition, the U.S. federal securities laws, as well as rules with regard to suitability and disclosure of various self-regulatory organizations, such as FINRA, impose suitability requirements on the entities that recommend to investors that they purchase a CIS's shares.

19.3

Does the regulatory framework specifically require that the offering documents, or other publicly available information, include the following:

a) The date of issuance of the offering document?

Rule 423 under the Securities Act generally requires each prospectus used after the effective date of the registration statement to be dated approximately as of such effective date.³⁵⁰

Open-end CIS

Item 1 of Form N-1A requires an open-end CIS to include the date of the prospectus on the outside front cover page of the prospectus.

Closed-end CIS

Item 1 of Form N-2 requires a closed-end CIS to include the date of the prospectus on the outside front cover page of the prospectus.

UIT

Item 6 of Form N-8B-2 requires a UIT to include the date of execution and termination of the trust indenture.

³⁵⁰ Please *see* response to Question 17.5 above for a description of what constitutes the offering document under the U.S. federal securities laws. A CIS may not incorporate by reference into a prospectus information that is required to be included in the prospectus, except as specifically permitted. A CIS may incorporate by reference any or all of the SAI into the prospectus without delivering to investors the SAI with the prospectus. The SAI must be provided to investors upon request.

19.3

b) Information concerning the legal constitution of the CIS?

Open-end CIS

Item 15 of Form N-1A requires an open-end CIS to provide in its SAI its date and form of organization and to identify the state or other jurisdiction in which it was organized. Item 28 of Form N-1A requires an open-end CIS to include copies of its articles of incorporation or other corresponding documents as exhibits to its registration statement.

Closed-end CIS

Item 8 of Form N-2 requires a closed-end CIS to provide in its prospectus its date and form of organization and to identify the state or other jurisdiction in which it was organized. Item 24 of Form N-2 requires a closed-end CIS to include copies of its articles of incorporation or other corresponding documents as exhibits to its registration statement.

UIT

Items 5 and 6 of Form N-8B-2 requires UITs to identify the laws that govern the organization of the UIT as well as the dates of execution and termination of any indenture or trust agreement. The indenture or trust agreement also must be filed as an exhibit to the registration statement.

19.3

c) The rights of investors in the CIS?

A CIS's registration statement sets forth in detail the rights of investors in the CIS. A CIS's registration statement must disclose the rights that are material to an investor's decision to invest in the CIS, such as:

Open-end CIS

Item 10 of Form N-1A requires an open-end CIS to provide a description of the management, organization and capital structure of the CIS in its prospectus. Item 11 requires an open-end CIS to provide a description of shareholder's rights with regard to the purchase and redemption of shares in its SAI. Items 22 and 23 require additional disclosure in the SAI about holders' rights in the CIS including:

- Information about an open-end CIS's capital stock and other securities, which includes a requirement that an open-end CIS provide, for each class of capital stock, a discussion of the voting rights (including whether the rights of shareholders can be modified by other than majority vote); and

- Information about the purchase, redemption and pricing of shares, which describes how the open-end CIS's shares are offered to the public.

Closed-end CIS

Items 9 and 10 of Form N-2 require a closed-end CIS to provide a description of the management of the CIS. Item 10 requires information about the company's capital stock and other securities, which includes a requirement that a closed-end CIS provide a discussion of the voting rights (if the rights of shareholders can be modified by other than majority vote).

UIT

Item 10 of Form N-8B-2 requires the UIT to include shareholder information, including a description of shareholder's rights with regard to the purchase and redemption of shares.

In addition, a CIS's registration statement (including exhibits to the registration statement, such as a CIS's articles of incorporation, by-laws or trust indenture agreement, which define the rights of security holders) is publicly available to investors.

19.3

d) Information on the operator and its principals?

Open-end CIS

Item 5 of Form N-1A requires an open-end CIS to disclose information in the prospectus on the CIS's operator, including the operator's name, address, business experience and compensation. Item 17 of Form N-1A requires additional disclosure in the SAI on the CIS operator. Furthermore, Item 5 requires open-end CIS to state the name, title, length of service, and business experience of each member of a portfolio management team. Item 20 of Form N-1A further requires an open-end CIS to provide disclosure in its SAI regarding other accounts for which the CIS's portfolio manager is primarily responsible for the day-to-day portfolio management.

Closed-end CIS

Item 9 of Form N-2 requires a closed-end CIS to disclose information in the prospectus on the CIS's operator, including the operator's name, address, business experience and compensation. Item 20 of Form N-2 requires additional disclosure in the SAI on the CIS operator. Item 9 requires closed-end CIS to state the name, title, length of service, and business experience of each member of a portfolio management team. Item 21 of Form N-2 further requires a closed-end CIS to provide disclosure in its SAI regarding other accounts for which the CIS's portfolio manager is primarily responsible for the day-to-day portfolio management.

UIT

Items 25-30 of Form N-8B-2 requires the UIT to include information concerning the organization, personnel and affiliates of the depositor. Items 31-33 of Form N-8B-2 require the UIT to include information concerning the compensation of officers, directors and certain employees of depositor. This information includes the form of organization and business of the depositor, fees received from the trust, and information concerning controlling shareholders of the depositor or other affiliates and compensation thereof.

19.3

e) Information on the methodology of asset valuation?

Open-end CIS

Items 6, 11 and 23 of Form N-1A require an open-end CIS to disclose in the prospectus and the SAI information concerning the procedures for valuing the CIS's assets and pricing the CIS's shares.

Closed-end CIS

Item 1 of Form N-2 requires a closed-end CIS to identify on the cover page of the prospectus whether any national securities exchange lists the securities offered. Item 5 of Form N-2 requires a closed-end CIS to describe the valuation procedure used by the closed-end CIS in determining the price to the public when it is impracticable to state such a price.

UIT

Item 44 of Form N-8B-2 requires information concerning the method used to calculate the offering price. Item 46 of Form N-8B-2 requires information concerning the method used to calculate the redemption price.

19.3

f) Procedures for purchase, redemption and pricing of units?

Open-end CIS

Items 6, 11 and 23 of Form N-1A require an open-end CIS to disclose in the prospectus and the SAI information concerning the procedures for the purchase, redemption and pricing of units.

Closed-end CIS

Item 1 of Form N-2 requires a closed-end CIS to identify on the cover page of the prospectus whether any national securities exchange lists the securities offered. Item 5 of Form N-2

requires a closed-end CIS to describe the plan of distribution for shares in the CIS, which also includes information on the price of the shares.

UIT

Items 15, 16, 17, 35, 38, 44 and 46 of Form N-8B-2 include information concerning the procedures for purchase, redemption and pricing of the UIT securities. Item 15 requires a description of the procedures with respect to payments from purchasers and items 35 and 38 require a description of where sales will be made as well as a general description of the distribution method. Item 44 requires information concerning the method used to calculate the offering price. Item 17 requires a description of the withdrawal or redemption procedures, and item 46 requires information concerning the method used to calculate the redemption price.

19.3

g) Relevant, audited financial information concerning the CIS?

Open-end CIS

Item 13 of Form N-1A requires an open-end CIS to disclose in its prospectus its financial highlights for the past five years. Item 27 of Form N-1A requires an open-end CIS to provide in its SAI its audited (and, under certain circumstances, unaudited) financial statements.

Closed-end CIS

Item 4 of Form N-2 requires a closed-end CIS to disclose in the prospectus its financial highlights for the past ten years. Item 23 of Form N-2 requires the closed-end CIS to provide in its SAI its audited (and, under certain circumstances, unaudited) financial statements.

UIT

Item 54 of Form N-8B-2 requires a UIT to include a chart for the past ten fiscal years identifying the number of shares, asset value per share and dividends per share. The financial statements of the UIT are also part of the UIT's prospectus.

19.3

h) Information on the custodian (if any)?

Open-end CIS

Item 19 of Form N-1A requires an open-end CIS to disclose in the SAI the custodian's name and address and to generally describe the services performed by the custodian. If the custodian is not a commercial bank, trust company or depository, the open-end CIS must describe the nature of the business of that person.

Closed-end CIS

Item 20 of Form N-2 requires a closed-end CIS to disclose in the SAI the custodian's name and address and the nature of that person's business.

UIT

Item 48 of Form N-8B-2 requires a UIT to include in the prospectus the name, address, supervising authority, form and state of organization of the trustee or custodian. Item 49 of Form N-8B-2 requires a UIT to disclose in the prospectus the basis of the trustee's or custodian's fees as well as the aggregate amount for the last fiscal year. In addition, item 50 of Form N-8B-2 requires UITs to state whether the trustee or custodian may create a lien on the UIT's assets.

19.3

i) The investment policy(ies) of the CIS?

Section 8(b) of the Investment Company Act requires a CIS to disclose in its registration statement its investment strategies regarding: investment diversification, borrowing, the issuance of senior securities, underwriting, concentration of investments within a single industry, investments in real estate and commodities, making loans, and portfolio turnover.

Open-end CIS

Item 9 of Form N-1A requires an open-end CIS to describe in the prospectus its investment objectives and principal investment strategies, including the particular type or types of securities in which the open-end CIS principally invests or will invest. An open-end CIS is not required to list every type of market or instrument in which investments are made, but instead must disclose its principal investment strategies.³⁵¹ In determining what is a principal investment strategy, an open-end CIS must consider, among other things, the amount of the CIS's assets expected to be committed to the strategy, the amount of the CIS's assets expected to be placed at risk by the strategy, and the likelihood that the CIS may lose some or all of those assets from implementing the strategy. Item 16 of Form N-1A requires an open-end CIS to disclose in the SAI any investment strategy that is not a principal investment strategy.

Closed-end CIS

Item 8 of Form N-2 requires a closed-end CIS to describe in the prospectus its investment objectives and policies, including the types of securities in which the closed-end CIS principally invests or will invest. Item 8 also requires a closed-end CIS to disclose any types of investments that will be made other than those that constitute its principal portfolio emphasis. A closed-end CIS must identify all common stock issued by the closed-end CIS, if it is publicly held, including

³⁵¹ See instruction 2 to item 9(b)(1) of Form N-1A.

share price.³⁵² Item 17 of Form N-2 requires a closed-end CIS to disclose in the SAI additional information on its investment objectives and policies.

UIT

Item 11 of Form N-8B-2 requires a UIT to describe in the prospectus the kind and type of securities comprising the security holder's UIT interest, *e.g.*, bonds of railroad companies, common stock of industrial companies, preferred stock of public utility holding companies. Item 52 of Form N-8B-2 also requires a description of any UIT policies or indenture or trust agreement provisions governing the selection, substitution or elimination of securities. Section 26 of the Investment Company Act prohibits the substitution of a UIT's securities with any other security unless the SEC approves the substitution.

19.3

j) Information on the risks involved in achieving the investment objectives?

Open-end CIS

Items 2, 3, and 4 of Form N-1A require an open-end CIS to describe in the prospectus the principal risks of investing in the CIS, and item 16 of Form N-1A requires additional detail on risk in the SAI.

Under Form N-1A, an open-end CIS must include in its prospectus a risk/return summary of the principal risks of investing in the CIS. The summary must address the risks to which an open-end CIS's portfolio as a whole is subject and the circumstances that are reasonably likely to affect adversely the CIS's NAV, yield, and total return. An open-end CIS is permitted, but not required, to include disclosure in the narrative risk summary about the types of investors for whom the CIS is intended or the types of investment goals that may be consistent with an investment in the CIS. The summary also must include a bar chart and table illustrating the variability of the open-end CIS's returns. This information must be accompanied by a statement indicating that past performance of the open-end CIS is not necessarily an indication of how the CIS will perform in the future.

Closed-end CIS

Item 8 of Form N-2 requires closed-end CIS to describe the risks associated with an investment in the closed-end CIS. Closed-end CIS shares historically have traded at a discount from the NAV of the shares. Item 8 also requires a closed-end CIS to disclose in the prospectus whether its common stock has historically traded at an amount less than, equal to, or exceeding NAV. The CIS must also disclose any methods undertaken or to be undertaken to reduce any discount (such as the repurchase of closed-end CIS shares, ability to convert to an open-end CIS, and guaranteed distribution plans). If the closed-end CIS has no history of trading, it must disclose in the prospectus the tendency of closed-end CIS shares to trade at a discount from NAV.

³⁵² See item 8.5 of Form N-2.

UIT

There is no explicit requirement in Form N-8B-2 for information on the risks involved in the investment policies of the UIT. As noted above, a UIT invests in a fixed pool of securities.

19.3

k) The appointment of any external administrator or investment managers or advisers who have a significant and independent role in relation to the CIS (including delegates)?

Section 10 of the Investment Company Act requires at least 40% of the directors of an open-end or closed-end CIS to be independent of the CIS operator and other CIS affiliates. Independent directors are charged with various significant oversight requirements, but other officers of the CIS are not required to be independent.

Open-end CIS

Item 17 of Form N-1A requires disclosure in the SAI of specific information on the officers and directors of the open-end CIS. Information about an officer or director includes their name, address, age, positions held with the CIS, principal occupations for the last five years and the identification of other directorships held by a director. Each director must also disclose the dollar range of equity securities that he or she held in the CIS or in other CIS that are overseen by the director in the same CIS group. The SAI also includes a compensation table for all directors, members of the CIS's advisory board and for each of the three highest paid officers or affiliates that received from the CIS aggregate compensation for the most recently completed fiscal year exceeding \$60,000. Furthermore, Item 18 of Form N-1A requires disclosure of the name and address of, and the percentage of voting securities held by, each person who controls the CIS and an explanation of the effect of that control on the voting rights of other shareholders. Item 19 of Form N-1A requires disclosure regarding the CIS operator, CIS sub-operator, CIS principal underwriter and any other service providers.

Closed-end CIS

Item 9 of Form N-2 requires a closed-end CIS to disclose in its prospectus information on: (i) the responsibilities of the board of directors; (ii) the name, principal business address, experience, and services of each operator as well as a description of each operator's compensation; (iii) any person employed by or associated with the operator that provides day-to-day management of the CIS's portfolio; (iv) the identity of any administrator; (v) the name and principal business address of any custodian, transfer agent and dividend paying agent; and (vi) control persons. The SAI also includes a compensation table for all directors, members of the CIS's advisory board and for each of the three highest paid officers of affiliates that received from the CIS aggregate compensation for the most recently completed fiscal year exceeding \$60,000.

UIT

Item 48 of Form N-8B-2 requires information about the trustee or custodian of the UIT, including, among other things, the name and address and form of organization of the trustee and the fees and expenses of trustee for services to the UIT.

19.3

1) Fees and charges in relation to the CIS?

There are specific requirements that require the offering document to include the fees and charges of an open-end CIS, closed-end CIS or UIT. The following summary describes the requirements for the offering document of an open-end CIS, closed-end CIS and UIT.

Open-end CIS

Prospectus: The prospectus is the primary means by which information on open-end CIS fees and costs is disclosed to investors.

1. Fee Table (see item 3; instructions 2 and 3 of Form N-1A): An open-end CIS's prospectus is required to have a fee table at the beginning of the prospectus that identifies the amount of the following fees:
 - Maximum sales charges ("sales loads")
 - Maximum sales charge imposed on purchases (as a percentage of offering price)
 - Maximum deferred sales charge payable upon redemption (as a percentage of the offering price or NAV at time of redemption)
 - Maximum sales charge imposed on reinvested dividends or other distributions (as a percentage of offering price or other basis as described in fee table)
 - Redemption fee – presented as a percentage of amount redeemed.
 - Exchange fee – presented as the maximum fee for any exchange or transfer from one CIS to another, as a percentage of amount invested in the new CIS.
 - Account fee – presented as the maximum fee that may be charged to a typical shareholder, as a fixed amount or a percentage of the shareholder's net assets (must explain basis upon which percentage is calculated).
 - Management fees or investment advisory fees deducted from open-end CIS assets – presented as a percentage of average net assets.
 - Distribution and/or service fees that are deducted from open-end CIS assets under a distribution plan– presented as a percentage of average net assets (*e.g.*, the cost of printing prospectuses for prospective shareholders, compensation of brokers for sale of open-end CIS shares and shareholder services).³⁵³

³⁵³ Rule 12b-1 under the Investment Company Act prohibits an open-end CIS from using its own assets to pay, directly or indirectly, for any expenses that are primarily intended to result in the sale of its shares without complying with the requirements of the rule. Rule 12b-1 requires all distribution payments to be made subject to a written document (a "distribution plan") that must be approved by the shareholders of the CIS and the CIS's board

- Shareholder services expenses deducted from open-end CIS assets other than pursuant to a distribution plan must be disclosed under an appropriate caption or subcaption of “other expenses.”
- Other expenses that are deducted from open-end CIS assets – includes all expenses that must be presented in the statement of operations that a CIS must include in its financial statements, such as accounting, legal and custody expenses; these expenses must be presented in the fee table as a percentage of average net assets.
 - Other expenses do not include extraordinary expenses as determined under generally accepted accounting principles. If extraordinary expenses were incurred that materially affected an open-end CIS’s other expenses, a note to the fee table must disclose what the other expenses would have been had the extraordinary expenses been included.

If an open-end CIS’s fees and expenses that are listed in the fee table are subject to a contractual limitation that requires the waiver or reimbursement of the fees and expenses³⁵⁴ for at least one calendar year, an open-end CIS may add two lines to the fee table: one showing the amount of the reimbursement and the second showing the CIS’s net expenses after subtracting the fee reimbursement from the total CIS operating expenses. The period for which the expense reimbursement or fee waiver arrangement is expected to continue should be disclosed, including the expected termination date.

2. Fee Table Example (item 3): Immediately following the fee table, an open-end CIS must provide an example that illustrates the cost, shown as a dollar amount, of investing in the CIS. The example must assume an investment of \$10,000 over 1-, 3-, 5- and 10-year periods. If an open-end CIS imposes redemption fees, the CIS must provide two examples, one assuming a full redemption at the end of the period and the other assuming no redemption. Each example must assume that the investment grows by 5% each year and that the expenses remain the same over the time periods. The examples are intended to help investors compare the costs of investing in different CIS.
3. Financial Highlights (item 13): An open-end CIS must provide a tabular summary of its financial history, for each of its past five fiscal years or, if the CIS has been in operation for less than five years, the life of the CIS. Consistent with a CIS’s financial statements, the financial highlights must include a ratio of total expenses to average net assets for each period shown.
4. Other: Additional descriptions of some of the fees and expenses that are identified in the fee table are required in the prospectus, (*e.g.*, how sales loads are calculated (item 12(a)),

of directors, including a majority of its disinterested directors who have no financial interest in the CIS’s distribution arrangements. The distribution plan must describe all material aspects of the proposed financing of distribution. In addition, the CIS’s board must periodically review and monitor the distribution arrangement.

³⁵⁴ A CIS, often a new CIS, may have a fee waiver arrangement (*e.g.*, the CIS’s operator agrees to waive, or not collect, a portion of its investment advisory fee for a specified period of time) or a reimbursement arrangement (*e.g.*, the CIS’s operator may agree to reimburse the CIS for a portion of its expenses that exceed a specified level for a certain period of time).

descriptions of any rule 12b-1 fees (item 12(b)) and the dollar amount of the operator's compensation for the past year (item 10(a)(1)(ii)).

Statement of Additional Information: An open-end CIS must provide the following fee information in the SAI (delivered to investors upon request). Most of the fee information is more detailed than that presented in the prospectus. In certain cases, different information about a particular fee is given in the SAI (*e.g.*, aggregate dollar amount of fees paid to the operator for the past three fiscal years, while the prospectus includes the amount paid as a percentage of average net assets for last fiscal year). Also, the SAI contains some information that is not in the prospectus (*e.g.*, aggregate dollar amount of brokerage commissions paid in the last three fiscal years).

- Any open-end CIS fees and expenses that are paid by persons other than the CIS or its operator (item 19(c)).
- Additional detail concerning the amounts that are paid to an open-end CIS's operator, including the aggregate dollar amounts paid for the last three fiscal years and any credits or waivers that reduced the fees (item 19(a)(3)).
- Additional details of expenses related to any other management-related service agreement, including the total dollar amount paid and by whom for the past three fiscal years (item 19(d)).
- Additional detail relating to any remuneration or other compensation for last three fiscal years that was paid to any person, other than the operator or its employees or officers, who advises an open-end CIS or has the authority to determine what is bought or sold by the CIS (item 19(e)).
- Any dealer reallowances, which are front-end sales loads that are reallowed to dealers in an open-end CIS's shares, presented as a percentage of offering price (item 19(f)).
- Additional details of distribution plans, including the dollar amounts spent on specific kinds of distribution activities (*e.g.*, the cost of printing prospectuses for prospective shareholders and compensation of brokers for sale of an open-end CIS' shares and for shareholder services) (item 19(g)).
- Description of how brokerage transactions in an open-end CIS's portfolio securities are effected, including a general statement about brokerage commissions, markups or markdowns on principal transactions, and the aggregate dollar amount of brokerage commissions paid by the CIS for last three fiscal years (item 21(a)). Brokerage commissions that were paid to any affiliated person of an open-end CIS or an affiliated person of an affiliated person of a CIS in the last three fiscal years must be separately identified (item 21(b)). Brokerage and soft dollar practices, including any commission rebate or recapture arrangements (*e.g.*, an arrangement under which a portion of the commission charged by a broker-dealer for execution of an open-end CIS's securities transactions is used to pay CIS expenses) must also be described including the amount of transactions and related commissions (item 21(d)).

Closed-end CIS

Prospectus: Please note that with respect to closed-end CIS most investors acquire their shares in the secondary market and may not receive a prospectus because the prospectus delivery

requirements apply only to the primary offering. For such investors, the primary source of information on fees and expenses will be the annual and semi-annual reports which include the financial statements of the closed-end CIS. The prospectus for the primary offering, however, does include extensive fee information, which is similar to the fee information provided for open-end CIS.

1. Fee Table (see item 3 of Form N-2): The closed-end CIS prospectus is required to have a fee table at the beginning of the prospectus that identifies the amount of the following fees:
 - Maximum sales charges (“sales loads”) (as a percentage of offering price).
 - Dividend reinvestment and cash purchase plan fees (a note to the fee table should explain the basis on which such fees are imposed).
 - Any other transaction fee (maximum or basis on which fees are imposed).
 - Management fees or investment advisory fees deducted from the closed-end CIS’s assets (as a percentage of average net assets).
 - Interest payments on borrowed funds.
 - Other expenses that are deducted from the closed-end CIS’s assets – includes all expenses that must be presented in the statement of operations that a CIS must include in its financial statements, such as accounting, legal and custody expenses; these expenses must be presented in the fee table as a percentage of average net assets.

If a closed-end CIS’s fees and expenses that are listed in the fee table are subject to a contractual limitation that requires the waiver or reimbursement of the fees and expenses³⁵⁵ for at least one calendar year, a closed-end CIS may add two lines to the fee table: one showing the amount of the reimbursement and the second showing the closed-end CIS’s net expenses after subtracting the fee reimbursement from the total closed-end CIS’s operating expenses. A footnote to the fee table should describe the contractual arrangement. Otherwise, a closed-end CIS generally must disclose its fees and expenses in the fee table as if there were no reimbursement or waiver arrangement. The net amount of expenses after reimbursement or waiver can be presented in a footnote to the table, provided that the closed-end CIS discloses the period for which the expense reimbursement is expected to continue or whether it may be terminated at any time at the option of the closed-end CIS.

2. Fee Table Example (item 3): Immediately following the fee table, the closed-end CIS must provide an example that illustrates the cost, shown as a dollar amount, of investing in the closed-end CIS. The example must assume an investment of \$1,000 over 1-, 3-, 5- and 10-year periods. The example must assume that the investment grows by 5% each year and that the expenses remain the same over the time periods.
3. Financial Highlights (item 4): A closed-end CIS must provide a tabular summary of its financial history, for each of its past ten fiscal years or, if the CIS has been in operation for

³⁵⁵ As discussed above for open-end CIS, CIS may have a fee waiver arrangement (*e.g.*, the CIS’s operator agrees to waive, or not collect, a portion of its investment advisory fee for a specified period of time) or a reimbursement arrangement (*e.g.*, the CIS’s operator may agree to reimburse the CIS for a portion of its expenses that exceed a specified level for a certain period of time).

less than ten years, the life of the closed-end CIS. The financial highlights also must include a ratio of total expenses to average net assets for each period shown as well as the average commission rate paid.

4. **Other:** Additional descriptions of some of the fees and expenses that are identified in the fee table are required in the prospectus, (*e.g.*, description of adviser's compensation (item 9); plan of distribution including a discussion of price and sales loads (item 5)).

Statement of Additional Information: A closed-end CIS must provide the following fee information in the SAI. Most of the fee information is more detailed than that presented in the prospectus. In certain cases, different information about a particular fee is given in the SAI (*e.g.*, aggregate dollar amount of fees paid to the operator for the past three fiscal years, while the prospectus includes the amount paid as a percentage of average net assets for last fiscal year). Also, the SAI contains some information that is not in the prospectus (*e.g.*, aggregate dollar amount of brokerage commissions paid in the last three fiscal years).

- Any closed-end CIS fees and expenses that are paid by persons other than the closed-end CIS or its operator (item 20).
- Additional detail concerning the amounts that are paid to a closed-end CIS's operator, including the aggregate dollar amounts paid for the last three fiscal years and any credits or waivers that reduced the fees (item 20).
- Additional details of expenses related to any other management-related service agreement, including the total dollar amount paid and by whom for the past three fiscal years (item 20).
- Additional detail relating to any remuneration or other compensation for last three fiscal years that was paid to any person, other than the operator or its employees or officers, who advises the closed-end CIS or has the authority to determine what is bought or sold by the closed-end CIS (item 20).
- Description of how brokerage transactions in the closed-end CIS's portfolio securities are effected, including a general statement about brokerage commissions, markups on principal transactions, and the aggregate dollar amount of brokerage commissions paid by the closed-end CIS for last three fiscal years (item 21). Brokerage commissions that were paid to any affiliated person of a CIS or an affiliated person of an affiliated person of a closed-end CIS in the last three fiscal years must be separately identified (item 21). Brokerage and soft dollar practices, including any commission rebate or recapture arrangements (*e.g.*, an arrangement under which a portion of the commission charged by a broker-dealer for execution of a closed-end CIS's securities transactions is used to pay closed-end CIS expenses) must also be described including the amount of transactions and related commissions (item 21).

UIT

The UIT prospectus is delivered in connection with the sale of UIT securities in either a primary or secondary offering.

The UIT prospectus must include the following information (item 13(a) of Form N-8B-2) with respect to each load, expense, fee or charge to which principal payments, underlying securities, distributions, reinvested distributions or redeemed securities are subject:

- The nature of the load, fee, expense or charge;
- The amount;
- The identity of the person to whom the amounts are paid and their relationship to the UIT; and
- The nature of the services performed for the load, fee, expense or charge.

If not otherwise identified, the following must be disclosed (item 13(c) of Form N-8B-2):

- Total amount of deductions as a percentage of the net amount invested;
- Each different sales charge available as a percentage of the public offering price and as a percentage of the net amount invested;
- Any other charges which may be paid by shareholders in connection with the UIT or its securities;
- Whether the sponsor, underwriter, custodian, trustee or affiliate may receive profits or other benefits not otherwise disclosed through the sale or purchase of the UIT's securities and describe the nature and extent of such profits; and
- The percentage that the aggregate annual charges and deductions for maintenance and other expenses of the UIT bear to the dividend and interest income from the UIT's assets during the reporting period of the financial statements.

Note that most UITs disclose the fees and expenses in a table format and also include a fee example similar to the fee table and fee example in the open-end CIS prospectus. This format has been used to comply with the SEC's plain English rule (rule 461 under the Securities Act). The UIT fee information listed above (provided in response to item 13 of Form N-8B-2) cannot be presented any further back than page 3 of the prospectus (Form S-6, instruction 2).

Other information in the prospectus concerning a UIT's fees and expenses includes:

- Table with information concerning all fees received by the depositor in connection with the operation of the UIT during the period covered by any financial statements filed with the UIT's registration statement (*e.g.*, amount of sales loads received, amount of administration fees received, amount of other fees received, aggregate gross fees received) (item 26(a) of Form N-8B-2);
- Tables disclosing compensation rendered for services to the UIT for certain of the depositor's officers, directors, employees and other persons receiving compensation for services to the UIT (items 31, 32, 33 and 34 of Form N-8B-2);
- Table disclosing all fees received by each principal underwriter from the sale of UIT securities during the period covered by the financial statements filed with the registration statement;
- A schedule showing the components of the offering price including any fees or charges that impact the offering price of the securities of the UIT (item 44 of Form N-8B-2);

- A schedule of components showing the calculation of the redemption value of the securities issued by the UIT, including fees or expenses deducted from NAV (item 46 of Form N-8B-2);
- Basis of custodian fees and aggregate amount of custodian fees for the last fiscal year (item 49 of Form N-8B-2); and
- The financial statements of the UIT and the depositor also are included as part of the UIT prospectus (item 59 of Form N-8B-2, instruction 1 of Form S-6).

19.4

Does the regulatory authority have the power to hold back, or intervene, in an offering? For example, are there regulatory actions available in the event that the information is inaccurate, misleading or false, or does not satisfy the filing/approval requirements?

As background, note that, in order to sell its shares to the public, a CIS must register itself under the Investment Company Act and register the offering of its securities under the Securities Act. As described in more detail below, the SEC may, among other things, hold back or intervene in an offering if an offering document is found to be unsatisfactory.

First, under section 8 of the Securities Act, the SEC has the power to issue a “stop order” to suspend the effectiveness of a registration if it appears that a registration statement includes an untrue statement of material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading. Second, sections 8A and 10(b) of the Securities Act authorize the SEC to stop an offering after it has commenced by issuing a “cease and desist” order and suspending effectiveness of the registration statement or use of the prospectus if it includes any untrue statement of a material fact or omits to state any material fact required to be stated in those documents or necessary to make the statements in those documents not misleading.

Third, section 485(c) of Regulation C under the Securities Act provides that no amendment to a registration statement shall become effective if, prior to the effective date of the amendment, it should appear to the SEC that the amendment may be incomplete or inaccurate in any material respect and the SEC furnishes the registrant (such as a CIS) written notice that the effective date of the amendment is to be suspended. Fourth, section 8(e) of the Investment Company Act provides that, if it appears to the SEC that a registration statement has omitted material facts or contains material misstatements, the SEC shall notify the CIS. If the registration statement is not corrected, the SEC may revoke the CIS’s registration as an investment company.

In addition, as discussed in response to Question 17.4 above, the SEC has authority to institute a proceeding against a person or entity, or to seek an injunction or other equitable relief in federal court, for violations of the Investment Company Act. A person, such as a CIS or its operator, who makes any materially untrue statement in, or omits any material fact from, issuing documentation would violate section 34(b) of the Investment Company Act.

The SEC also has authority under sections 8A and 20 of the Securities Act to bring a cease and desist proceeding, injunctive action, or action for monetary penalties against a person or entity

for a violation of the Securities Act. For a discussion of liability under the Securities Act, please see response to Question 17.10 above.

19.5

Does the regulatory framework cover advertising material outside of the offering documents, in particular does it prohibit false or misleading advertising?

CIS may use brochures or advertisements and may market through various media, such as television, radio, internet, billboards, newspaper.

Like offering documents, all marketing materials are subject to the antifraud provisions of the U.S. federal securities laws and are prohibited from containing material misstatements or omissions.³⁵⁶ Different disclosure requirements may apply depending on the type of advertisement:

- Rule 135A under the Securities Act permits the distribution of certain “generic advertisements” that may not specifically refer by name to the securities of a particular CIS, the CIS itself or to any other securities that are required to be registered with the SEC. Generic advertisements are typically used by a CIS operator or distributor to describe the services and benefits of investing in CIS generally, rather than focusing on a particular CIS. Generic advertisements must contain the name and address of a registered broker or dealer or other person sponsoring the communication. Generic advertisements also may be used prior to the effectiveness of a CIS’s registration statement.
- Rule 482 under the Securities Act permits the distribution of certain marketing materials, called “482 ads,” that include performance information. 482 ads are considered “omitting” prospectuses under the Securities Act. A 482 ad need not contain all of the information included in a CIS’s prospectus filed as part of its registration statement. A 482 ad may not include, or be accompanied by, an application to purchase a CIS’s shares unless the CIS’s prospectus also accompanies the 482 ad. A 482 ad that includes performance information must also include “standardized” performance information. Standardized performance information must be calculated in accordance with a formula, and presented for particular periods, that have been specified by the SEC. Such a 482 ad also must include a disclaimer to the effect that past performance of the CIS is not necessarily an indication of how the CIS will perform in the future. CIS that advertise performance information must make available to investors total returns that are current to the most recent month-end.
- Supplemental sales literature, *i.e.*, sales literature that is issued after the effectiveness of a CIS’s registration statement and that is accompanied or preceded by a prospectus, generally may include any information that is not misleading. Supplemental sales literature may include, or be accompanied by, an application to purchase a CIS’s shares. Supplemental sales literature that includes performance information must include

³⁵⁶ See section 17(a) of the Securities Act and section 10(b) of the Exchange Act.

standardized performance information, but may also include other performance information (provided that it is not misleading). Supplemental sales literature that includes performance information also must include a disclaimer to the effect that past performance of the CIS is not necessarily an indication of how the CIS will perform in the future.

Advertisements issued electronically (*i.e.*, through the internet) generally are subject to the same requirements as other written marketing materials.

Section 24(b) of the Investment Company Act requires open-end investment companies and UITs and their underwriters to file copies of all of their advertisements and sales literature with the SEC.³⁵⁷ If a CIS's shares are sold by a FINRA member broker-dealer, FINRA requires the broker-dealer to file with FINRA any advertisement or sales literature that it uses to market the company. Advertisements and sales literature filed with FINRA are reviewed by FINRA. Advertisements and sales literature filed with the SEC may be reviewed by the SEC staff as part of an inspection of the open-end CIS or UIT to ensure that the material is not false or misleading.

19.6

Does the regulatory framework require that the offering documents be kept up-to-date to take account of any material changes affecting the CIS?

Most open-end CIS, unlike operating companies or closed-end CIS, continuously offer their shares for sale to the public. Each such open-end CIS must, therefore, have at all times a current, effective registration statement. As a result, an open-end CIS amends its registration statement at least annually to include updated financial information (or more frequently, if necessary, to reflect material changes in its operations).

In addition, the Securities Act requires a CIS that is making a continuous offering of its securities to maintain a "current" statutory prospectus. Specifically, section 10(a)(3) of the Securities Act requires that any prospectus used more than nine months after the registration statement's effective date must contain financial and other information as of a date not more than sixteen months prior to such use. A CIS making a continuous offering of its securities can update its prospectus by filing a post-effective amendment to its registration statement that contains updated financial statements and other information.

Rule 8b-16(b) under the Investment Company Act provides that a closed-end CIS must either amend its registration statement annually or transmit certain important information to shareholders in the closed-end CIS's annual report to shareholders.

³⁵⁷ Rule 24b-3 under the Investment Company Act provides that, if an advertisement is filed with a registered exchange, such as FINRA, it is deemed filed with the SEC.

19.7

Does the regulatory framework require a report to be prepared in respect of a CIS's activities either on an annual, semi-annual or other periodic basis?

Section 30(a) and (b) of the Investment Company Act and rule 30a-1 thereunder require CIS to file with the SEC a semi-annual report on Form N-SAR.³⁵⁸ Form N-SAR contains information that may be used by the SEC to aid in monitoring a CIS's operations and to obtain necessary compliance information. Open-end and closed-end CIS also must file a semi-annual report on Form N-CSR that contains certified shareholder reports.

Section 30(e) of the Investment Company Act requires that CIS prepare and send to their shareholders annual and semi-annual reports. The reports must include financial statements for the CIS, including a statement of assets and liabilities (a balance sheet), a statement of operations, a statement of changes in net assets, a schedule of portfolio holdings that shows the amount and value of each security owned by the CIS on that date, and a financial highlights schedule required by the CIS's registration statement. The financial highlights information shows financial results for a single share of a CIS. Only the annual reports must include audited financial statements (accompanied by a certificate of an independent public accountant).

Annual reports typically discuss the relevant market conditions and investment strategies used by the CIS operator that materially affected the CIS's performance during the last fiscal year (alternatively, this information may be included in a CIS's prospectus). Rule 30e-1 under the Investment Company Act requires annual and semi-annual reports to include specified information about any shareholder vote that was taken during the period covered by the report. A CIS may include in its shareholder reports information that is in addition to that, which is required, provided that the information is not misleading. CIS often include a letter to shareholders, performance data and tax information in their shareholder reports.

Additionally, Form N-Q under the Investment Company Act requires open-end and closed-end CIS to file a quarterly report that generally discloses the composition of a CIS's portfolio on a delayed basis.

Rule 30e-2 under the Investment Company Act provides that a UIT sponsor must provide semi-annual shareholder reports to shareholders, similar to those issued by an open-end or closed-end CIS, if the UIT's assets substantially consist of securities issued by an open-end or closed-end CIS. In addition, a UIT's trust indenture usually stipulates that there shall be an annual audited financial statement. This annual report provides information regarding the composition of the trust's portfolio, the number and value of units outstanding, cash inflows and outflows, and any disposition of a portfolio security and the proceeds obtained.

³⁵⁸ A UIT files on Form N-SAR annually, rather than semi-annually.

19.8

Does the regulatory framework require the timely distribution of periodic reports?

Rule 30b1-1 under the Investment Company Act provides that a CIS must file on Form N-SAR not more than sixty days after the close of the fiscal year and the fiscal second quarter. Section 30(e) of the Investment Company Act and rule 30e-1 thereunder require CIS to transmit reports to shareholders within sixty days after the close of the period for which each report is made.

19.9

Does the regulatory framework require that the accounts of a CIS be prepared in accordance with high quality, internationally acceptable accounting standards?

The financial statements in a CIS's annual and semi-annual reports must be prepared in accordance with generally accepted accounting principles.³⁵⁹ Regulation S-X under the Securities Act requires that an independent public accountant perform an examination (audit) of the CIS's annual report in accordance with generally accepted auditing standards and certify that the audit was made in accordance with generally accepted auditing standards and that the financial statements are prepared in accordance with generally accepted accounting principles.

³⁵⁹ See rule 4-01(a)(1) of Regulation S-X.

Collective Investment Schemes - Principle 20

Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.

Assessment

Fully Implemented

20.1

Are there specific regulatory requirements in respect of the valuation of CIS assets?

The regulations relating to the valuation of CIS portfolio securities are included in the Investment Company Act and SEC rules adopted thereunder.³⁶⁰ In general, these regulations provide that a CIS value securities for which market quotations are readily available at their current market value and other securities and assets at fair value as determined in good faith by the board of directors of the CIS.³⁶¹ In addition, the SEC has addressed many of the issues relating to CIS valuation and pricing in its Accounting Series Releases.³⁶²

Financial statements filed with the SEC generally must be prepared in accordance with generally accepted accounting principles.³⁶³ The AICPA Audit and Accounting Guide: *Investment Companies*, which is a source of generally accepted accounting principles,³⁶⁴ requires investment companies to report investments at fair value.³⁶⁵ Statement of Financial Statements No. 157, *Fair Value Measurements*, which was issued by the Financial Accounting Standards Board and

³⁶⁰ See sections 2(a)(41) and 22 of the Investment Company Act and rules 2a-4 and 22c-1 thereunder.

³⁶¹ Money market funds are governed by rule 2a-7 under the Investment Company Act, which permits such funds to price their securities using the amortized cost or penny-rounding methods. Rule 2a-7 also requires that the board of directors adopt written procedures to ensure that any amortized cost price per share be calculated at such intervals as the board determines appropriate and reasonable in light of current market conditions. If the price per share and the amortized cost deviate by more than ½ of 1% of the money market fund's total assets, the money market fund's board of directors must "promptly consider what action, if any, should be initiated by the board of directors."

³⁶² See, e.g., Accounting Series Rel. Nos. 113 (Oct. 21, 1969) (ASR 113); 118 (Dec. 23, 1970) (ASR 118); and 219 (May 31, 1977) (ASR 219).

³⁶³ See rule 4-01 of Regulation S-X, which provides that financial statements filed with the SEC which are not prepared in accordance with generally accepted accounting principles will be presumed to be misleading or inaccurate, despite footnote of other disclosures, unless the SEC has otherwise provided.

³⁶⁴ See Statement of Financial Accounting Standards No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, paragraph 3b.

³⁶⁵ See AICPA Audit and Accounting Guide: *Investment Companies* (May 1, 2008), paragraph 1.33.

is a source of generally accepted accounting principles,³⁶⁶ defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.³⁶⁷

20.2

Are there regulatory requirements that the net asset value of assets be calculated:

- a) *on a regular basis; and*
- b) *in accordance with high-quality, accepted accounting standards used on a consistent basis?*

Section 22(c) of the Investment Company Act and rule 22c-1 thereunder provide that interests in an open-end CIS generally may be redeemed only at a price based on the current NAV of such security, which is next computed after receipt of a tender of such security for redemption. Section 23 of the Investment Company Act generally prohibits a closed-end CIS from selling its common stock at a price below current NAV.

20.3

Are there specific regulatory requirements in respect of the fair valuation of assets where market prices are not available?

As discussed in response to Question 20.2 above, open-end CIS have to price their shares at current NAV and closed-end CIS are generally prohibited from selling their shares at a price below current NAV. With respect to open-end CIS, current NAV is defined in rule 2a-4 under the Investment Company Act to be “an amount which reflects calculations, whether or not recorded in the books of account, made substantially in accordance with,” among other things, current market value or, where market quotations for a security are not readily available, “fair value as determined in good faith by the board of directors.” The definition for closed-end CIS is similar. Fair value is defined by SFAS No. 157 as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” In addition to defining fair value, SFAS No. 157 also establishes a framework for measuring fair value and requires disclosures about fair value measurements.

³⁶⁶ See Statement of Financial Accounting Standards No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, paragraph 3a.

³⁶⁷ See Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, paragraph 5.

20.4

Are independent auditors required to check the valuations of CIS assets?

A CIS's independent auditors play a significant role in the CIS's valuation process by verifying the CIS's NAV calculations and testing the valuation process by which the CIS values its portfolio securities as part of the CIS's annual audit. In the case of securities for which market quotations are readily available, the independent auditor should verify independently all of the quotations used by the CIS at the balance sheet date. In the case of securities carried at fair value as determined by the board of directors, which could include illiquid assets or assets subject to suspension, the auditor does not function as an appraiser and is not expected to substitute his judgment for that of the CIS's directors. Rather, the auditor should review all information considered by the board or the operator, read the relevant minutes of directors' meetings, and assess the procedures established by the directors. If the auditor is unable to express an unqualified opinion because of the uncertainty inherent in the valuation of the securities based on the directors' subjective judgment, the auditor should nevertheless make appropriate mention in his certificate of whether under the circumstances the procedures appear to be reasonable and the underlying documentation appropriate.³⁶⁸ The independent auditor must also obtain a sufficient understanding of internal control over the valuation process to plan and perform the audit.³⁶⁹ For example, the auditor should determine whether the valuation methods used by a CIS conform with the stated valuation policies and disclosures contained in the CIS prospectus. In addition, because periodic computations of net asset value are based on the fair value of investments, the auditor may evaluate the systems and procedures used by the CIS during the period under audit in determining the fair value of investments. The auditors also may perform some checks on the pricing services or other outside vendors that the CIS uses to value portfolio securities. In some situations, the auditor may determine that it is necessary to obtain an estimate of fair value from more than one pricing source.³⁷⁰

20.5

Are there specific regulatory requirements in respect of the pricing upon redemption or subscription of interests in a CIS?

Rule 22c-1 requires that sales and redemptions must be effected at the current NAV next computed after receipt of an order to purchase or sell. Closed-end CIS do not redeem their shares, however they can repurchase them. Section 23 of the Investment Company Act generally prohibits a closed-end CIS from selling its common stock at a price below current NAV.

³⁶⁸ See ASR 118.

³⁶⁹ See Public Company Accounting Oversight Board Interim Auditing Standards, AU Section 319 *Consideration of Internal Control in a Financial Statement Audit* and AU Section 328 *Auditing Fair Value Measurements*.

³⁷⁰ See American Institute of Certified Public Accountants, *Investment Company Audit Guide* (May 2008).

20.6

Does regulation ensure that the valuations made are fair and reliable?

Yes. The CIS board is responsible for overseeing the valuation of CIS portfolio securities.³⁷¹ CIS boards must approve the valuation criteria and are responsible for continuously reviewing the CIS's valuation methods to assure that the valuations of the CIS's portfolio securities are fair and accurate.³⁷² To the extent necessary, CIS boards may appoint persons to assist them in the determination of such valuations, and to make the calculations pursuant to the CIS board's direction.³⁷³ As required by rule 38a-1 under the Investment Company Act, the CIS must adopt written policies and procedures to, among other things, regularly review the appropriateness and accuracy of the method used in valuing securities.³⁷⁴ The CIS's board of directors typically reviews the valuation activities at its periodic meetings to satisfy itself that valuations are being made in conformity with SEC regulations and the written procedures of the CIS. The decisions of the CIS board with respect to the valuation of a CIS's portfolio security should be documented and the supporting data retained for the inspection of the CIS's independent auditors.³⁷⁵ Additionally, as discussed in response to Question 20.4 above, independent auditors verify the CIS's NAV calculations.³⁷⁶

A UIT's valuation procedures are specified in the trust indenture. The sponsor is generally responsible for valuation and pricing of UIT assets.

20.7

Does regulation require the price of the CIS be disclosed or published on a regular basis to investors or prospective investors?

The U.S. federal securities laws do not require that the prices of a CIS be disclosed or published on a regular basis to investors other than in semi-annual reports. The price of a CIS is generally available, however, in financial publications and websites and may also be available on the CIS's or CIS operator's website. Financial publications generally publish pricing information for CIS on a daily basis and for closed-end CIS on a weekly basis.

³⁷¹ See ASR 118.

³⁷² See ASR 118.

³⁷³ See ASR 118.

³⁷⁴ See *Compliance Programs of Investment Companies and Investment Advisers*, Investment Company Act Rel. No. 26299 (Dec. 17, 2003).

³⁷⁵ See ASR 118.

³⁷⁶ See ASR 118.

20.8

Are there regulatory requirements, rules of practice, and/or rules addressing pricing errors? Are the relevant regulatory authorities able to enforce these rules?

The SEC may bring an enforcement action against a CIS or a CIS operator if a pricing error violates, or results in violation of, the U.S. federal securities laws. The SEC has brought enforcement actions against entities alleging that they did not have adequate oversight or review procedures to determine pricing deviations.³⁷⁷

In addition, there are industry practices, *e.g.* rules of practice, that exist for addressing pricing errors. Some open-end and closed-end CIS boards of directors have adopted these rules of practice. The standards are voluntary, and other CIS boards have adopted different standards that they consider to be reasonable.

The rules of practice are as follows:

- Financial adjustments may be made if the per share NAV error is greater than US\$0.01. In addition, if the NAV error is less than or equal to 0.5% of the current CIS NAV, then the CIS should determine its net loss or benefit during the error period. If the CIS incurred a net loss, the responsible party should reimburse the CIS. If the CIS had a net benefit, no action needs to be taken.
- If the NAV error is greater than 0.5% of the current CIS NAV, then, under most circumstances, adjustments should be made to compensate shareholders for any losses that they may have experienced as a result of the error.
- Errors of US\$0.01 or less per share generally are deemed immaterial and no retroactive corrective action will be taken.³⁷⁸
- If the correction to a shareholder's account is less than \$10 (or another *de minimis* amount), then an account adjustment generally will not be made.

The valuation procedures of a CIS generally provide for the reporting of any material pricing errors to the board of directors, and may call for the board to review or approve any corrective action that was taken. Pricing errors that are not considered material should be corrected on a going-forward basis. A CIS typically would not report pricing errors to the SEC unless the error is required to be reflected in its financial statements filed with the SEC.

³⁷⁷ See *In the Matter of the Bank of California, N.A.*, Investment Company Act Rel. No. 19545 (June 28, 1993). See also *In the Matter of Mitchell Hutchins Asset Management, Inc.*, Investment Company Act Rel. No. 22805 (Sept. 2, 1997); *Van Kampen American Capital Asset Management, Inc.*, Investment Advisers Act Rel. No. 1525 (Sept. 29, 1995).

³⁷⁸ See ASR 219.

If a shareholder has a dispute with a CIS or CIS operator about pricing errors, that shareholder may institute an action against the CIS or CIS operator in state or federal court. In addition, a shareholder may choose to privately arbitrate the dispute. The SEC does not institute private actions or arbitrations on behalf of shareholders.

20.9

Does the regulatory framework address the general or specific circumstances in which there may be suspension or deferral of routine valuation and pricing or of regular redemption?

Generally, under section 22(e) of the Investment Company Act, CIS may, but are not required to, suspend redemptions and postpone payment for redemptions already tendered for any period during which the NYSE is closed. A CIS also may suspend redemptions in two other situations. First, a CIS may suspend redemptions for any period during which trading on the NYSE is restricted, as determined by the SEC. Second, a CIS may suspend redemptions for any period during which an emergency exists, as determined by the SEC, as a result of which it is not practicable for the CIS to (1) liquidate its portfolio securities, or (2) fairly determine the value of its net assets.³⁷⁹

The SEC has the authority to adopt rules under the Investment Company Act to establish conditions under which an emergency will be deemed to exist, however, the SEC and its staff have historically dealt with any emergency situations on a case-by-case basis. Orders have been issued to a few CIS to suspend redemptions in specific emergency situations; the SEC may grant such an order, however, only if it determines that the order is necessary for the protection of the CIS's shareholders.³⁸⁰

In addition, all CIS are required to include a description of any restrictions on redemptions in their prospectuses.

³⁷⁹ See December 1999 Letter to the ICI Regarding Valuation (www.sec.gov/divisions/investment/guidance/tyle120899.htm.) In response to the market closure after September 11, for instance, most CIS were closed and did not accept purchase or redemption requests until the markets reopened on Monday, September 17, 2001.

³⁸⁰ See, e.g., *In the Matter of The Reserve Fund, on behalf of its two series, the Primary Fund and the U.S. Government Fund*, Investment Company Act Rel. No. 28386 (Sept. 22, 2008) (extraordinary market conditions); *In the Matter of Municipal Lease Securities Fund, Inc.*, Investment Company Act Rel. No. 17245 (Nov. 29, 1989) and 17258 (Dec. 8, 1989) (inability to determine value of assets); *In the Matter of Consolidated Asset Management Fund*, Investment Company Act Rel. No. 16318 (Mar. 17, 1988) (fund becoming subject to undetermined liabilities); *In the Matter of Western Guaranteed Income Trust*, Investment Company Act Rel. No. 16208 (Jan. 11, 1988) (improper accounting and recordkeeping); *In the Matter of Suspension of Redemption of Open-End Investment Company Shares Because of Current Weather Emergency*, Investment Company Act Rel. No. 10113 (Feb. 7, 1978) (severe weather).

The SEC recently proposed a new rule 22e-3 under the Investment Company Act, which would exempt money market funds from section 22(e) of the Investment Company Act to permit them to suspend redemptions in order to facilitate an orderly liquidation of the fund. The new rule would replace rule 22e-3T, a temporary rule that provides a similar exemption for money market funds participating in the Treasury Department's Guarantee Program. Proposed rule 22e-3 would permit all money market funds to suspend redemptions upon breaking a buck, if the board, including a majority of independent directors, approves liquidation of the fund, in order to liquidate in an orderly manner. The proposed rule is intended to reduce the vulnerability of investors to the harmful effects of a run on a fund, and minimize the potential for disruption to the securities markets.³⁸¹

20.10

Does the regulatory authority have the power to ensure compliance with the rules applicable to asset valuation and pricing? Is there evidence as to actions taken by the relevant regulatory authority in this area?

The SEC has the power to enforce compliance with the rules applicable to asset valuation and pricing through its examinations of registrants and through enforcement actions. As discussed in the responses to Questions 8.1, 10.1 and 17.8 above, OCIE conducts examinations of CIS, CIS operators, transfer agents, CIS administrators and broker-dealers that market CIS, to assess whether such entities are complying with the U.S. federal securities laws. OCIE reviews CIS asset valuation and pricing during its examinations of CIS, CIS operators, and third-party administrators that perform certain operational and administrative functions for CIS.

OCIE has conducted risk targeted examinations focused on the conditions and responsive compliance controls of multiple CIS relating to valuation procedures. OCIE also frequently reviews valuation and pricing practices in regular examinations of CIS.

During an examination of a CIS and its operator or third-party administrator, OCIE reviews the CIS's policies and procedures related to asset pricing and NAV calculations and assesses the accuracy of the calculations. OCIE also reviews the books and records relating to the pricing of CIS assets to ensure that accurate prices are used to calculate the CIS's NAV. For example, OCIE staff may review:

- whether the CIS's pricing procedures are approved and periodically evaluated by the CIS board;
- whether pricing sources are regularly re-evaluated, including pricing methodology used and accuracy of pricing provided;
- whether the CIS periodically obtains prices from another source, independent of the usual source, to check the accuracy of prices provided by the primary source, and whether the CIS follows-up with appropriate changes if warranted;

³⁸¹ See *Money Market Fund Reform*, Investment Company Act Rel. No. 28807 (June 30, 2009).

- whether the CIS conducts appropriate compliance checks and prepares appropriate documentation of these checks;
- whether the CIS has appropriate procedures to monitor for significant subsequent events that occur after closing prices are determined but before the CIS calculates its NAV, and whether such procedures are followed whenever a significant subsequent event occurs; and
- whether the CIS has controls to avoid or mitigate potential conflicts of interest relating to fair valuation.

Following the completion of an exam, if OCIE has identified rule violations or weaknesses related to asset price and NAV calculations, it will typically issue a deficiency letter informing the CIS or its operator. In some cases the seriousness of the violations or weaknesses may warrant a referral by examination staff to the SEC’s Division of Enforcement.

The SEC recently brought an enforcement action against a CIS operator and distributor for allegedly overvaluing CIS portfolio assets over an extended period of time and, later, selectively disclosing information about the overvaluations. In settlement, the CIS operator and distributor agreed to, among other things, hire a compliance consultant and compensate shareholders in the amount of \$33,000,000 for harm caused.³⁸² The SEC also has brought other enforcement actions related to allegations of inappropriate valuation.³⁸³

In addition, the SEC vigorously enforces prohibitions on “late trading”, that is the effecting of open-end CIS orders after an open-end CIS has set its daily NAV. Generally, rule 22c-1(a) promulgated under section 22(c) of the Investment Company Act provides that no transactions in shares of the open-end CIS shall be effected at a price based on anything other than the “current net asset value.” Thus, for example, the practice of accepting orders to buy or sell open-end CIS shares after the time as of which the CIS’s portfolio securities are valued for purposes of determining NAV, but receiving the previously determined NAV is a violation of rule 22c-1(a). The SEC has brought several enforcement actions charging both direct and indirect violations of law in this area.

³⁸² See, e.g., *In the Matter of Evergreen Inv. Mgmt. Co. LLC & Evergreen Inv. Serv., Inc.*, Investment Company Act Rel. No. 28759 (June 8, 2009) (<http://www.sec.gov/litigation/admin/2009/34-60059.pdf>).

³⁸³ See, e.g., *In the Matter of Allied Capital Corporation*, Securities Exchange Act Rel. No. 55931 (June 20, 2007) (<http://www.sec.gov/litigation/admin/2007/34-55931.pdf>) (closed-end CIS provided incomplete and inadequate valuation documentation to its board and also failed to implement sufficient accounting controls over its fair valuation process).

20.11

Does the regulatory framework require that the regulator:

- a) be kept informed of any suspension or deferral of redemption rights; and*
- b) have the power to take action, to demand, delay or stop the suspension or deferral of redemption rights?*

Generally, under section 22(e) of the Investment Company Act, a CIS cannot suspend the right of redemption or postpone the date of payment more than seven days after the tender of the security to the CIS or its agent designated for redemptions. As discussed in response to Question 20.9 above, there are certain exceptions to which the seven-day period does not apply. With respect to those exceptions, a CIS would be allowed to suspend redemptions and would have to amend its prospectus to discuss any suspension or deferral of redemption rights. Such an update would be filed with the SEC. If a CIS would like to suspend redemptions for any reason other than those discussed above, however, it must submit a request for an order from the SEC. The SEC may grant such an order, however, only if it determines that the order is necessary for the protection of the CIS's shareholders.

MARKET INTERMEDIARIES

Principles 21-24

Market Intermediaries – Principle 21

Regulation should provide for minimum entry standards for market intermediaries.

Assessment

Fully Implemented.

21.1

*Does the jurisdiction require that, as a condition of operating a securities business, the market intermediaries be licensed?*³⁸⁴

Broker-Dealers

To carry on business as a broker-dealer in the United States, a person generally must register with the SEC,³⁸⁵ and become a member of at least one SRO, typically FINRA (formerly known as NASD).³⁸⁶ A broker is generally defined as “any person engaged in the business of effecting transactions in securities for the account of others,”³⁸⁷ and a dealer as “any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise.”³⁸⁸

³⁸⁴ The IOSCO Methodology states: “Market intermediaries” generally include those who are in the business of managing individual portfolios, executing orders and dealing in, or distributing, securities. “Investment advisers” are those principally engaged in the business of advising others regarding the value of securities or the advisability of investing in, purchasing or selling securities.” The Methodology identifies three types of investment advisers: (1) those that “deal on behalf of customers”; (2) those that “do not deal on behalf of customers, but are permitted to have custody of client assets”; and (3) those that “neither deal on behalf of customers nor hold or have custody of customer assets nor manage portfolios, but who offer only advisory services without offering other investment services.” The Methodology explains that the principles may apply differently to different types of investment advisers. In the U.S., investment advisers do not fall within the first category; i.e., they do not “deal.” Therefore, some of the key questions are not applicable to the U.S. regulatory structure with respect to investment advisers.

³⁸⁵ Section 15(a) of the Exchange Act generally requires any broker or dealer that “make[s] use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers’ acceptances, or commercial bills)” to register with the SEC.

³⁸⁶ See Section 15(a)(8) of the Exchange Act. See response to Question 6.1(a) (broker-dealers that have a public customer business must be members of FINRA unless they limit their transactions to securities traded on an exchange of which they are a member).

³⁸⁷ Section 3(a)(4)(A) of the Exchange Act. The Exchange Act does not specifically define what is encompassed by “effecting transactions” in securities. To establish that someone is a broker, courts generally require a showing of “a certain regularity of participation in securities transactions at key points in the chain of distribution.” See *Massachusetts Financial Services, Inc. v. Securities Investor Protection Corp.*, 411 F. Supp. 411, 415 (D. Mass. 1976), *aff’d*, 545 F.2d 754 (1st Cir. 1976), *cert. denied*, 431 U.S. 904 (1977). See also *Securities*

A broker-dealer registers with the SEC by filing an application for registration on Form BD, which was adopted under the authority of the Exchange Act. Form BD requests extensive information about the background of the applicant, its principals, controlling persons, and employee, as well as the type of business in which the applicant proposes to engage, the identity of the applicant's direct and indirect owners, and other control persons including executive officers, and whether the applicant or any of its control affiliates has been subject to criminal prosecutions, regulatory actions, or civil actions in connection with any investment-related activity.³⁸⁹ In addition, the applicant must disclose whether it or any control affiliate has been subject to a bankruptcy petition, had a trustee appointed under the Securities Investor Protection Act (SIPA), has been denied a bond, or has any unsatisfied judgments or liens. An applicant must also comply with net capital and other requirements established by SEC rule under statutory authority.³⁹⁰ Within 45 days of the filing of a completed application, the SEC will either grant registration or begin proceedings to determine whether it should deny registration.³⁹¹

The SEC's order granting registration generally will not become effective until the broker-dealer has become a member of an SRO.³⁹² SRO rules may impose certain other clear and publicly available criteria, consistent with Sections 6(b), 15A(b) and (g) of the Exchange Act and rules and regulations thereunder. Among other things, SRO rules must be "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, . . . to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest."³⁹³

In accordance with Section 15A, FINRA has rules that (i) set standards for an application for membership with FINRA; (ii) require registration standards for those persons (persons associated with a broker-dealer) who service customer accounts or otherwise execute transactions in a broker-dealer's investment banking and securities business; (iii) set standards for fair and reasonable compensation in securities transactions with customers; (iv) dictate standards of conduct outside of compensation such as the suitability of recommended securities transactions, best execution of securities transactions, and the prohibition of front running customer transactions and the issuance of broker-dealer research to customers; (v) detail requirements for a

Industry Association v. Board of Governors of the Federal Reserve System, 468 U.S. 207, 218 (1984) ("a broker executes orders for the purchase or sale of securities solely as agent").

³⁸⁸ Section 3(a)(5) of the Exchange Act. Unlike a broker, which acts as agent, a dealer acts as a principal. As discussed in the response to Question 21.2, the definition of "dealer" does not include a "trader," which is a person who buys and sells securities for his or her own account, either individually or in a fiduciary capacity, but not as part of a regular business.

³⁸⁹ See Exchange Act Rule 15b1-1.

³⁹⁰ See Exchange Act Rule 15c3-1.

³⁹¹ See Section 15(b)(1). An applicant may consent to a longer time period for a SEC decision.

³⁹² See *id.*

³⁹³ Exchange Act Sections 6(b)(5) and 15A(b)(6).

system of supervision and review of that system of supervision; (vi) set standards for the issuance of research and management of research analysts' conflicts of interests that may affect the issuance of research; (vii) create financial and operational requirements that supplement the standards set forth in federal securities laws and rules; (viii) create quality of markets conduct rules generally and transaction reporting standards for executions in the over-the-counter market for listed and unlisted securities; and (ix) frame the investigative and disciplinary procedures used by FINRA in its examination and enforcement programs.

Broker-dealers may also need to register with the securities authority of one or more states, in accordance with the applicable laws of each state.³⁹⁴ Registration procedures of the SEC, the SROs and the states are coordinated through the CRD system operated by FINRA.³⁹⁵ See response to Question 21.2 for a description what “triggers” the registration requirement, and the exceptions and exemptions from the registration requirement.

Investment Advisers

To carry on business as an investment adviser in the United States, a person generally must register with the SEC or the securities authority of a state. See response to Question 21.2 for a description of what “triggers” the federal and state registration requirements, and the exclusions and exemptions from the federal registration requirements.

21.2

Are there minimum standards or criteria that all applicants for licensing must meet before a license is granted (or denied) and that are clearly and publicly available which:

a) Are fair and equitable for similarly situated intermediaries?

Broker-Dealers

There are clear and publicly available minimum standards that all broker-dealer applicants must meet in order to register with the SEC and become a member of an SRO. The standards for registration of broker-dealers are fair and equitable for similarly situated intermediaries, and all entities in similar situations are treated the same. The standards for SEC registration are set by statute and SEC rules adopted under the authority provided by the statute.³⁹⁶ Broker-dealers

³⁹⁴ Section 3(a)(16) of the Exchange Act defines “State” to mean “any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States.”

³⁹⁵ The Central Depository System or CRD was developed and is maintained jointly by NASAA and FINRA. CRD is an on-line registration data bank and application processing facility used by FINRA, the other SROs, state regulators, and the SEC in connection with the registration and licensing of broker-dealers and broker-dealers' personnel. CRD was created, in part, to centralize the registration process, allowing applicants to file in one place, rather than filing separately in multiple jurisdictions. *Broker-Dealer Registration and Reporting*, Exchange Act Release No. 41594 (July 2, 1999), 64 FR 37586 (July 12, 1999).

³⁹⁶ See Section 15 of the Exchange Act.

applying for registration with the SEC must provide the information required by Section 15(b)(2)(A) of the Exchange Act and the rules adopted thereunder. In addition, the conduct listed under Section 15(b)(4) of the Exchange Act serves as minimum standards or criteria for registration because that conduct provides the basis on which the SEC may deny, revoke, or suspend a broker-dealer's registration. (For more information, see response to Questions 21.3(a) and (b) below). The standards for SRO membership are set by SRO rules that have been approved by the SEC under the authority provided by the Exchange Act.³⁹⁷

Exceptions: Certain persons are excepted from the definition of a broker or dealer. These persons do not have to register as broker-dealers, and generally are not regulated by the SEC.

Banks

The Gramm-Leach-Bliley Act (GLBA) repealed the complete exemption from broker-dealer registration previously applicable to banks and replaced it with several specific exceptions for certain securities activities that banks may engage in without being considered a broker or a dealer.³⁹⁸ In September 2003, the SEC adopted rules to implement the "dealer" exceptions to the GLBA.³⁹⁹ In September 2007, the SEC and the Board of Governors of the Federal Reserve System jointly adopted Regulation R, which defines the scope of securities activities that banks may conduct without registering with the SEC as a securities broker and implements key "broker" exceptions for banks adopted by the GLB.⁴⁰⁰ Among other things, these rules implement the statutory exceptions that allow a bank, subject to certain conditions, to refer customers to a securities broker-dealer pursuant to a networking arrangement with the broker-dealer, and to continue to conduct securities transactions for its customers as part of the bank's trust and fiduciary, deposit "sweep," and custodial functions. The bank exceptions and exemptions only apply to banks, and not to their related entities.

Issuers

The original issuers of a security generally are not "brokers" because they sell securities for their own accounts and not for the accounts of others.⁴⁰¹ Moreover, issuers generally are not "dealers"

³⁹⁷ See Section 19(b) of the Exchange Act.

³⁹⁸ By statute, thrifts (savings associations) have the same status as banks and may avail themselves of the same targeted exceptions and exemptions from broker-dealer registration as banks.

³⁹⁹ See Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Exchange Act Release No. 47364 (Feb. 13, 2003).

⁴⁰⁰ See Definitions of Terms and Exemptions Relating to the "Broker" Exceptions For Banks, Exchange Act Release No. 56501 (Sept. 24, 2007).

⁴⁰¹ See *Regional Properties, Inc. v. Financial & Real Estate Consulting Co.*, 752 F.2d 178, 181 n. 4 (5th Cir. 1985).

because they do not buy and sell their securities for their own accounts as part of a regular business. Issuers whose activities go beyond selling their own securities may need to register as broker-dealers. Under certain conditions, an issuer may purchase and sell its own securities through a dividend reinvestment or stock purchase program without registering as a broker-dealer.⁴⁰²

Traders

The Exchange Act expressly excludes from the definition of “dealer” a person that buys and sells securities for such person’s own account, either individually or in a fiduciary capacity, but not as part of a regular business.⁴⁰³ This is generally referred to as the “trader exception.”

Exemptions: Additionally, certain persons or firms meeting the definition of a broker or dealer may be exempted from the requirement to register with the SEC. There are exemptions from registration under the Exchange Act for:

- A foreign broker-dealer that limits its U.S. activities to those permitted under Rule 15a-6;⁴⁰⁴
- A broker or dealer with a business that is exclusively intrastate, and that does not make use of any facility of a national securities exchange;⁴⁰⁵
- A broker or dealer that transacts only in exempted securities or commercial paper, bankers’ acceptances, or commercial bills;⁴⁰⁶

⁴⁰² See Exchange Act Release No. 35041 (Dec. 1, 1994), 59 FR 63393; 17 CFR 242.102(c) and Exchange Act Release No. 38067 (Dec. 20, 1996), 62 FR 520, 532 n.100 (Jan. 3, 1997).

⁴⁰³ See Section 3(a)(5)(B) of the Exchange Act.

⁴⁰⁴ All broker-dealers physically operating within the United States that induce or attempt to induce securities transactions must register with the SEC, even if their activities are directed only to foreign investors outside of the United States. In addition, foreign broker-dealers that, from outside of the United States, induce or attempt to induce securities transactions by any person in the United States, or that use the means or instrumentalities of interstate commerce of the United States for this purpose, also must register. See Securities Exchange Act Release No. 27017 (effective August 15, 1989), 54 FR 30013. See also letters re: Securities Activities of U.S.-Affiliated Foreign Dealers (April 9 and April 28, 1997).

⁴⁰⁵ See Section 15(a)(1) of the Exchange Act. If, however, these entities are banks or meet the requirements of the intrastate exception, they must register as municipal securities dealers. See Exchange Act Section 15B(a)(1) (requiring registration of municipal securities dealers not otherwise registered under Section 15(a)). Municipal securities brokers (other than banks) must register as general-purpose broker-dealers, unless they qualify for the intrastate exception.

⁴⁰⁶ “Exempted securities” include government and municipal securities, as well as securities issued by certain charitable funds or in connection with a qualified plan. See Section 12(A) of the Exchange Act. *But see* Exchange Act Section 15B(a)(1) (requiring registration of municipal securities dealers not otherwise registered under Section 15(a) as general-purpose broker-dealers), and *see* Exchange Act 15C(a)(1)(A) (requiring registration of government securities brokers and government securities dealers).

- Associated persons of registered broker-dealers;⁴⁰⁷ and
- Associated persons of an issuer who help to market the issuer's securities and who meet certain conditions.⁴⁰⁸

Investment Advisers

There are clear, publicly available minimum standards that all applicants must meet in order to register with the SEC. The standards are fair and equitable for similarly situated entities, and all entities in similar situations are treated the same. The SEC generally registers investment advisers organized in the United States and foreign investment advisers (*i.e.*, an investment adviser that is organized under the laws of a non-U.S. jurisdiction) that have \$25 million or more of assets under management or that provide advice to CIS. Smaller investment advisers generally must register with the state securities authorities of the state in which they are organized and in each of the states in which they do business as an investment adviser.⁴⁰⁹

In particular, the conduct listed in Section 203(e) of the Advisers Act serves as minimum standards or criteria for registration because that conduct provides the basis upon which the SEC may deny, revoke, or suspend an investment adviser's registration. (For more information, see response to Questions 21.3(a) and (b) below). In addition, under the Investment Company Act, which regulates the operations of CIS, an investment adviser that committed certain wrongful acts is prohibited from advising a CIS unless the SEC grants an order.

⁴⁰⁷ See Section 15(a)(1) of the Exchange Act. Section 2(a)(18) of the Exchange Act defines the term "person associated with a member" or "associated person of a member" to include any partner, officer, director, or branch manager of a registered broker-dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with the broker-dealer, or any employee of the broker-dealer. Associated persons are, however, subject to SRO qualification and registration requirements. See generally Rule 15b7-1 under the Exchange Act (requiring that any natural person associated with a broker-dealer who effects or is involved in effecting securities transaction to be registered or approved in accordance with the standards of the relevant SRO).

⁴⁰⁸ Exchange Act Rule 3a4-1 provides a safe harbor from broker-dealer registration for associated persons of issuers who help market the issuers' securities. The rule specifies that an associated person of an issuer must meet three preliminary conditions and any one of three alternative conditions in order to take advantage of the safe harbor. Persons who rely on the Rule 3a4-1 safe harbor may not receive transaction-related compensation. See Certain Persons Deemed Not to Be Brokers, Exchange Act Release No. 20943 (June 27, 1985).

⁴⁰⁹ Although state-registered advisers are governed primarily by state law, which is not addressed in this response, several provisions of the Advisers Act and SEC rules apply to them. For example, among other provisions, Section 206 of the Advisers Act, which prohibits fraudulent conduct, applies to state-registered advisers, as well as exempt or excluded advisers.

An investment adviser that has less than \$25 million in assets under management is not prohibited from registering with the SEC if it would be required to register with 30 or more state securities authorities. See Advisers Act Rule 203A-2(e).

Under the Advisers Act, the requirement to register as an investment adviser is triggered by engaging in certain activities. In particular, a person that meets the definition of investment adviser in Section 202(a)(11) of the Advisers Act must register with the SEC in the business of providing advice, making recommendations, issuing reports, or furnishing analyses on securities, either directly or through publications.

Exclusions: The Advisers Act expressly excludes the following persons or firms from the definition of an investment adviser.⁴¹⁰ These persons or firms do not register under the Advisers Act, and generally are not otherwise regulated by the SEC (with the exception of brokers and dealers).

- Domestic banks and bank holding companies, except that banks (or bank departments or divisions) and bank holding companies that advise registered investment companies (CIS) must register as investment advisers (savings and loan institutions, federal savings banks, foreign banks, and credit unions do not qualify for this exclusion);
- Lawyers, accountants, engineers, and teachers who perform advisory services that are solely incidental to their profession;
- Brokers and dealers whose performance of advisory services is solely incidental to the conduct of their business as brokers or dealers, and that do not receive any special compensation for their advisory services;
- Publishers of bona fide newspapers, news magazines, and business or financial publications of general and regular circulation,⁴¹¹ and
- Persons and firms whose securities-related advice, analyses, or reports are related only to securities that are direct obligations of, or obligations guaranteed by, the United States, or by certain U.S. government-sponsored corporations designated by the Secretary of the Treasury.
- In addition to these exclusions, the Advisers Act gives the SEC the authority to exclude, by rule or by order, other persons and firms not within the intent of the definition of investment adviser.

⁴¹⁰ See Section 202(a)(11)(A)-(F) of the Advisers Act.

⁴¹¹ A publisher may qualify for this exclusion if its publication satisfies three elements: (1) the publication must offer only impersonalized advice (*i.e.*, advice not tailored to the individual needs of a specific client, group of clients, or portfolio); (2) the publication must be “bona fide,” containing disinterested commentary and analysis rather than promotional material disseminated by someone touting particular securities, advertised lists of stocks “sure to go up,” or information distributed as an incident to personalized investment services; and (3) the publication must be of general and regular circulation rather than issued from time to time in response to episodic market activity or events affecting the securities industry. *Lowe v. SEC*, 472 U.S. 181 (1985).

Exemptions: Additionally, a person or firm meeting the definition of investment adviser may choose not to register with the SEC if the person or firm qualifies for one of six limited exemptions from registration.⁴¹² The Advisers Act exempts from registration any investment adviser:

- all of whose clients are residents of the same State in which the adviser maintains its principal business office, if the adviser does not provide advice or issue analysis or reports about securities listed on any national securities exchange;
- whose only clients are insurance companies;
- that during the previous twelve months has had fewer than 15 clients, does not hold itself out generally to the public as an investment adviser, and does not act as an investment adviser to a registered investment company, including a CIS, or a business development company (the “De Minimis Exception”);⁴¹³
- that is a charitable organization,⁴¹⁴ or, under certain circumstances, a trustee, director, officer, employee, or volunteer of such an organization;
- that is a church employee benefit plan,⁴¹⁵ a person or entity eligible to establish and maintain such a plan, and any trustee, director, officer, employee, or volunteer of such a plan; or
- that is registered with the CFTC as a commodity trading adviser whose business does not consist primarily of acting as an investment adviser (as defined above) and does not act as an adviser to: (1) a registered investment company; or (2) a company which has elected to be a business development company and has not withdrawn its election.

Private Fund Advisers: Private fund advisers (*e.g.* advisers to hedge funds and private equity funds) generally may rely on the De Minimis Exception to avoid registration as an investment adviser. The SEC tried to close this regulatory gap in 2004, at least partially, by adopting a rule requiring all hedge fund advisers to register under the Advisers Act.⁴¹⁶ That rulemaking was vacated by an appellate court in 2006.⁴¹⁷ The Treasury White Paper⁴¹⁸ includes a proposal to

⁴¹² See Section 203(b)(1)-(6) of the Advisers Act. Investment advisers exempt from registration are still subject to certain antifraud provisions included in the Advisers Act.

⁴¹³ In determining the number of clients for this purpose, a U.S. domestic investment adviser (*i.e.*, an investment adviser that is organized under U.S. law) is required to count its foreign clients. A foreign adviser is not required to count its foreign clients. Both domestic and foreign investment advisers must count all of their U.S. clients.

⁴¹⁴ The term “charitable organization” is defined in Section 3(c)(10)(D) of the Investment Company Act.

⁴¹⁵ The term “church employee benefit plan” is defined in Section 3(c)(14) of the Investment Company Act.

⁴¹⁶ Investment Advisers Act Release No. 2333 (Dec. 2, 2004).

⁴¹⁷ See *Goldstein v. S.E.C.*, 451 F.3d 873 (D.C. Cir. 2006).

require that all private fund advisers whose assets under management exceed some modest threshold be required to register as investment advisers with the SEC.⁴¹⁹

Prohibition on Registration: Even if an investment adviser is not excluded from the definition of investment adviser, and is not exempt from registration, the adviser may be prohibited from registering with the SEC.⁴²⁰ If an investment adviser is prohibited from SEC registration, it generally must register with one or more state securities regulatory authorities.⁴²¹ An adviser is prohibited from registering with the SEC unless the adviser:⁴²²

- has assets under management⁴²³ of \$25 million or more;
- advises a registered investment company; or
- is exempt from the prohibition by SEC rule or order.

An investment adviser registers with the SEC by filing an application for registration on Form ADV under the Advisers Act.⁴²⁴ Form ADV requests extensive information regarding the

⁴¹⁸ Financial Regulatory Reform: A New Foundation (June 17, 2009), available at: <http://media.ft.com/cms/a368929a-5b04-11de-be3f-00144feabdc0.pdf>.

⁴¹⁹ See Testimony by Andrew J. Donohue Concerning Regulating Hedge Funds and Other Private Investment Pools, Before the Subcommittee on Securities, Insurance, and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs (July 15, 2009) (available at: http://www.sec.gov/news/testimony/2009/ts071509ajd.htm#P17_3702). See also Testimony of Mary L. Schapiro Concerning SEC Oversight: Current State and Agenda, Before the United States House of Representatives Committee on Financial Services Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises (July 14, 2009) (available at: <http://www.sec.gov/news/testimony/2009/ts071409mls.htm>).

⁴²⁰ See Section 203A(a) of the Advisers Act.

⁴²¹ We note that some states do not require the registration of investment advisers that have a small number of clients.

⁴²² Under the Advisers Act, most state law is preempted with respect to advisers registered with the SEC, except that states may continue to: (1) enforce antifraud prohibitions; (2) require the filing of any documents that are filed with the SEC (solely for notice purposes) and a consent to service of process; and (3) require the payment of filing, registration, or licensing fees. See generally Sections 203A and 222 of the Advisers Act.

⁴²³ “Assets under management” are defined for purposes of this subsection of the Advisers Act to mean “the securities portfolios with respect to which an investment adviser provides continuous and regular supervisory or management services.” See Instruction to Item 5.F of Form ADV.

⁴²⁴ Form ADV consists of two parts. Part 1 of Form ADV is filed electronically through the IARD, and contains the information that the Commission reviews to grant, deny, or condition registration. See www.sec.gov/iard. It also is available to the public on the IAPD website (IAPD). See www.adviserinfo.sec.gov. On this website, a person can: (1) search for an investment adviser; (2) view Part 1 of the adviser’s current Form ADV; (3) check the adviser’s registration status; (4) link to a state regulator’s website; and (5) link to FINRA’s BrokerCheck website for information about broker-dealers and stockbrokers. IAPD contains information on all of the investment advisers that currently are registered with the SEC or a state. The website also contains information on all of investment advisers that were registered in the previous two years but are no longer registered. Part 2 of

adviser's background and business practices. Within 45 days after the filing of a Form ADV, the SEC must grant registration or begin proceedings to deny registration.⁴²⁵ The SEC may deny registration if it finds that the investment adviser has committed certain prohibited acts and that the public interest requires denial.⁴²⁶

Form ADV requires an investment adviser to disclose detailed information about itself. Form ADV is a public document, consisting of two parts. As indicated above, Part 1 of Form ADV currently is available through the SEC's website.

21.2

b) Are consistently applied?

Broker-Dealers

The standards for SEC registration of broker-dealers are consistently applied. The standards are set by statute and SEC rules adopted under the authority provided by the statute, and include detailed disclosure on Form BD and net capital requirements established by SEC rule under statutory authority.⁴²⁷

In order for a firm's registration with the SEC to be complete, the firm must be a member of an SRO. SRO rules may impose certain other clear and publicly available criteria, consistent with Sections 6(b), 15A(b) and (g) of the Exchange Act and rules and regulations thereunder.⁴²⁸

Form ADV provides information about an investment adviser for the use of its clients and prospective clients. Part 2 may serve as an investment adviser's "brochure," that must be provided to prospective clients and annually offered to current clients. Alternatively, an investment adviser may prepare its own brochure which must contain the information that is required by Part 2 of Form ADV. The Commission has proposed, but not yet adopted, changes to Part 2 that would modify the disclosure that is required of investment advisers and require a narrative brochure. *See Amendments to Form ADV*, Investment Advisers Act Release No. 2711 (March 3, 2008). The proposing release is available at the Commission's website at www.sec.gov/rules/proposed/2008/ia-2711.pdf. Investment advisers are not required to submit Part 2 to the Commission at this time, but as noted above must provide a brochure that contains the information to clients and also must maintain it in the investment advisers' books and records. As proposed, the revised Part 2 would be filed electronically with the Commission and made available on the IAPD website.

⁴²⁵ See Section 203(c)(2) of the Advisers Act.

⁴²⁶ The SEC may deny an investment adviser's registration under Section 203(e) of the Advisers Act on the same basis that it may revoke an adviser's registration, such as for making false or misleading statements in a Form ADV, or having been convicted of a felony in the past ten years. *See* response to Question 21.3(b).

⁴²⁷ In addition, under Section 15(b)(11) of the Exchange Act, a simplified "notice" broker-dealer registration is available for firms already regulated by the Commodity Futures Trading SEC that limit their securities business to securities futures products.

⁴²⁸ Among other things, SRO rules must be "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, . . . to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest." Exchange Act Sections 6(b)(5) and 15A(b)(6).

When a firm registers with a SRO, the firm is subject to that SRO's pre-membership process, including an examination. The firm may not engage in any securities business without the approval of the SRO upon completion of the pre-membership process. During the pre-membership process, the SRO assures that the firm is aware of applicable SEC and SRO rules, and ascertains that the firm will be in compliance with those rules once approval is granted.

Investment Advisers

The standards are consistently applied. Every entity that meets the definition of investment adviser and is not prohibited from registering or exempt from registration, must register.

21.2

c) Include an initial capital requirement, as applicable?

Broker-Dealers

See response to Question 22.1. Broker-dealers must meet an initial capital requirement. During the pre-membership process the broker-dealer must demonstrate that it has sufficient net capital to fulfill the requirements of the SEC's net capital⁴²⁹ and early warning⁴³⁰ rules. Under the SEC's net capital rule, broker-dealers that engage in businesses that present more risk must maintain higher levels of net capital.⁴³¹ SROs may also impose net capital or net worth requirements greater than those otherwise required under the SEC's rules.⁴³²

Investment Advisers

The SEC uses a disclosure-based approach to regulate investment advisers. The Advisers Act does not impose any minimum initial or ongoing capital requirements upon registered investment advisers. Staff notes that the operations of investment advisers, unlike other types of market intermediaries, generally do not pose to the securities markets the types of risks that are commonly addressed through capital requirements. Investment advisers that are also registered broker-dealers are subject to certain capital requirements.⁴³³

⁴²⁹ Exchange Act Rule 15c3-1 sets forth minimum capital requirements for U.S. broker-dealers.

⁴³⁰ Exchange Act Rule 17a-11 requires that broker-dealers promptly inform the SEC and its designated examining authority if its capital approaches its net capital requirement.

⁴³¹ See also NASD Rule 1014(7) (providing for the imposition of a reasonably determined higher net capital requirement for the initial operations of a broker-dealer).

⁴³² See, e.g. NYSE Rule 325.

⁴³³ Investment advisers that are also registered as broker-dealers have to meet all broker-dealer requirements, including capital requirements.

21.2

- d) *Include a comprehensive assessment of the applicant and all those in a position to control or materially influence the applicant that addresses “ethical attitude,” including past conduct, and appropriate proficiency requirements, such as, industry knowledge, skill and experience?*

Broker-Dealers

The standards also provide for a comprehensive assessment of the applicant and all those in a position to control or materially influence the applicant that addresses “ethical attitude,” including past conduct, and appropriate proficiency requirements, such as, industry knowledge, skill and experience.

Each broker-dealer must disclose the identity of all senior managers and directors on its Form BD, which it files with the SEC. Each broker-dealer that is a corporation must disclose the identity of all shareholders that beneficially own, have the right to vote, or have the power to sell or direct the sale of 25% or more of any class of a voting security of the broker-dealer on Form BD. Each broker-dealer that is a partnership must disclose the identity of all general partners and any limited or special partners that have the right to receive upon dissolution, or have contributed, 25% or more of the partnership’s capital on its Form BD. Each broker-dealer that is a trust must disclose the identity of the trust and each trustee on its Form BD. Each broker-dealer that is a LLC must disclose the identity of those members that have the right to receive upon dissolution, or have contributed, 25% or more of the LLC’s capital and all elected managers on its Form BD.

Form BD requires additional disclosures about the individuals or entities identified in the preceding paragraph. Criminal, regulatory, civil judicial, bankruptcy, and SIPC actions involving each of those individuals or entities generally are required to be disclosed on Form BD. In addition, negative actions by a bonding company with respect to the applicant for broker-dealer registration must generally be disclosed on Form BD. Form BD also requires the applicant to disclose any unsatisfied judgments or liens against the applicant.

The SROs also have access to the information provided on Form BD.

SROs also require that most individuals who work at a broker-dealer register with them using Form U4.⁴³⁴ In order to fulfill SRO requirements, all registered representatives, generally sales personnel, and principals, generally officers of the firm and other management personnel involved in the day-to-day operation of the firm’s investment banking or securities business, must prove themselves to be qualified in the areas in which they will work by passing qualifications examinations.⁴³⁵ These mandatory examinations test, among other things, the

⁴³⁴ See, e.g., NASD Rules 1021 and 1031.

⁴³⁵ See, e.g., NASD Rules 1021(b)(2), 1022(a) through (g) and 1032(a) through (h). SRO regulation, in turn, has largely focused on persons who are actively engaged in the investment banking or securities business. Under FINRA rules, for example, registration is permitted – but not required -- for a representative who performs “legal,

individuals' knowledge of securities industry laws, regulations, and rules; securities products; the operation and interrelation of financial markets; economic theory and kinds of risk; and corporate financing, accounting, and balance sheet analyses; and are both general⁴³⁶ and specialized.⁴³⁷ Principals must pass additional examinations that test their knowledge of supervisory rules in the areas of investment banking, trading and market making, retail sales activities, and financial responsibility rules.

Any individual seeking to enter the securities industry in a capacity that requires registration is required to complete a Form U4 and submit fingerprints. The Form U4 requires disclosure of administrative information, as well as information regarding criminal, regulatory and civil proceedings; customer complaints and arbitrations; terminations; and financial matters. FINRA reviews the Form U4 to determine, among other things, if the individual is subject to a statutory disqualification under Section 3(a)(39) of the Exchange Act. Individuals who are subject to a statutory disqualification may not associate with a FINRA member in any capacity unless and until the individual is approved under a special eligibility proceeding. Under FINRA rules, the member firm is responsible for submitting the Form U4 to FINRA via the CRD system. The CRD system is the securities industry online registration and licensing database used by FINRA, other SROs, the states and the SEC that contains information about registered and formerly registered securities industry personnel including the disclosure history (referenced above) that has been reported for such persons. In addition, as part of the registration process, FINRA will submit the fingerprints to the FBI for a criminal background check. The SROs also enforce ethical standards through application of their rules requiring member compliance with just and equitable principles of trade.

Investment Advisers

Under the Advisers Act, the SEC does not assess the qualifications of persons or firms seeking to become investment advisers, except to the extent that they have engaged in conduct specified in Section 203(e) of the Advisers Act that may prohibit them from acting as, or being employed by, an investment adviser. The SEC uses a disclosure-based approach to investment adviser regulation.⁴³⁸ A primarily disclosure-based approach is similar to the approach in other U.S. federal securities laws (*e.g.*, the Securities Act). This approach provides prospective clients with information to assess the adequacy of an adviser's background and experience.

compliance, internal audit, back-office operations, or similar responsibilities for a member.” NASD Rule 1031(a); *see also* NASD Rule 1060(a)(2) (exempting from registration persons “who are not actively engaged in the investment banking or securities business”).

⁴³⁶ *See, e.g.*, NASD Rules 1022(a) and 1032(a).

⁴³⁷ *See, e.g.*, NASD Rules 1022(b) and (f) and 1032(c) and (e).

⁴³⁸ Under this approach, an investment adviser must disclose in Part 2 of Form ADV the education and background of its executive officers and employees who determine general investment advice for clients. The investment adviser must give all of Part 2 (or a document that contains the same information) to its clients and prospective clients.

Under the Advisers Act, only an investment adviser, not the persons who are associated with the adviser, must register with the SEC.⁴³⁹ Under Section 203(f) of the Advisers Act, the SEC may bar, suspend, or place limitations on the activities of persons who are, or are seeking to become, associated with an investment adviser, if an event specified in Section 203(e) has occurred.

The lack of federal educational requirements for investment advisers and their employees does not prohibit states from imposing certain educational and professional training requirements upon investment adviser representatives (as defined under the Advisers Act) that have a place of business in that state. Many states also require the registration of the individual persons who are associated with state-registered investment advisers. The states may also impose certain educational and professional training requirements upon the representatives of SEC-registered investment advisers who have a place of business in that state. Under Section 203A(b)(1)(A) of the Advisers Act, a state may not compel the registration of an employee of an SEC registered investment adviser unless the employee is an investment adviser representative as defined under the Advisers Act who has a place of business in the state. An investment adviser representative is defined in Rule 203A-3(a) under the Advisers Act as a supervised person of an investment adviser (i) who has more than 5 clients who are natural persons and (ii) more than 10 percent of whose clients are natural persons. Certain “qualified clients” are excluded from the thresholds for counting natural persons. An investment adviser representative does not include supervised persons who do not regularly solicit, meet or otherwise communicate with clients, or who provide only impersonal investment advice.

21.2

- e) Include an assessment of the sufficiency of internal controls and risk management and supervisory systems in place, including relevant written policies and procedures?*

Broker-Dealers

Internal Controls: Under FINRA’s standards for admission, an applicant must have financial controls to ensure compliance with the federal securities laws, the rules and regulations thereunder, and the SRO’s rules.⁴⁴⁰ An applicant must also have compliance, supervisory, operational, and internal control practices and standards that are consistent with practices and standards regularly employed in the investment banking or securities business, taking into account the nature and scope of the applicant’s proposed business.⁴⁴¹ Further, the applicant must have a supervisory system, including written supervisory procedures, internal operating procedures (including operational and internal controls), and compliance procedures designed to

⁴³⁹ An “associated person” is defined in Section 202(a)(17) of the Advisers Act as a “person associated with an investment adviser” includes “any partner, officer, or director of [an investment adviser], or any person directly or indirectly controlling or controlled by such investment adviser, including any employee of such investment adviser.” A “person” is defined as a natural person or a company under Section 202(a)(16) of the Advisers Act.

⁴⁴⁰ NASD Rule 1014(a)(8).

⁴⁴¹ NASD Rule 1014(a)(9).

detect and prevent, to the extent practicable, violations of the federal securities law, the rules and regulations thereunder and the SRO's rules.⁴⁴²

Explicit delineation of the supervisory hierarchy, including the designation of a direct supervisor for each representative and the assignment of specific supervisory responsibilities to the supervisor, is a necessary part of a firm's supervisory structure.⁴⁴³ A broker-dealer must also implement measures to monitor compliance with its policies and procedures.⁴⁴⁴ In order to maintain compliance with federal securities laws and rules, a broker-dealer should have a comprehensive compliance system. In addition, under FINRA rules, the broker-dealer must designate a principal to serve as the broker-dealer's chief compliance officer and certify annually that the broker-dealer has a process to establish, maintain, test, and modify its supervisory procedures. Compliance officers at broker-dealers may be, but often are not, supervisors for purposes of failure to supervise liability under the federal securities laws.

The Exchange Act authorizes the SEC to impose sanctions on a firm or any associated person that fails to reasonably supervise a person subject to his or her supervision that commits a violation of the federal securities laws. The SEC's policy regarding failure to supervise is well-established and emphasizes the responsibility of broker-dealers and their supervisory personnel to supervise their employees.⁴⁴⁵ Potential liability for failure to supervise is an important component of the federal regulatory scheme for broker-dealers.

Risk Management: The SROs require their members to establish and maintain appropriate systems of customer protection, risk management, and internal controls.⁴⁴⁶ SRO rules also require a broker-dealer to adopt and maintain a written business continuity plan with procedures that are reasonably designed to enable it to meet its existing obligations to customers in the event of an emergency or a significant business disruption.⁴⁴⁷

⁴⁴² NASD Rule 1014(a)(10). *See also Kirkpatrick, Pettis, Smith, Polian Inc*, Exchange Act Release No. 48748 (Nov. 5, 2003) (a broker-dealer must develop a system for implementing its procedures that could reasonably be expected to prevent and detect securities law violations).

⁴⁴³ *See Signal Securities, Inc.*, Exchange Act Release No. 43350 (Sept. 26, 2000); NASD (FINRA) Rule 3010(a)(5) (requiring the assignment of each registered person to a person responsible for supervising their activities).

⁴⁴⁴ *See Signal Securities, Inc.*, *supra* note 58, quoting *Thomson & McKinnon*, Exchange Act Release No. 8310 (May 8, 1968).

⁴⁴⁵ Individual supervisors have a duty, among other things, to investigate warning signs that suggest that misconduct may be occurring and to act upon the results of such investigation. Supervisors may be held accountable for violations by subordinates. For example, an individual may be charged with a failure to supervise if that supervisor failed to follow firm procedures or failed to respond promptly to warning signs.

⁴⁴⁶ *See, e.g.*, NASD (FINRA) Rule 3010.

⁴⁴⁷ *See* NASD (FINRA) Rule 3510.

The standards require an assessment of the sufficiency of internal controls and risk management and supervisory systems in place, including relevant written policies and procedures for the broker-dealer's proposed operations. During the pre-membership process, the SRO will obtain relevant books and records of the firm. Based upon the types of business in which the firm wishes to engage, the SRO will review different types of books and records that are necessary to conduct and supervise those types of activity. Further, the SRO will obtain the firm's supervisory procedures for review. The SRO will also assure that the firm has an adequate number of supervisory personnel, as well as experienced personnel in key areas, to conduct the types of business in which it wishes to engage. Furthermore, FINRA also requires a business plan, compliance guide and an initial interview with the applicable FINRA District Office.

In addition, Exchange Act Rule 15c3-4, which applies to OTC derivatives dealers, requires that a firm establish, document, and maintain a system of internal risk management controls to assist it in managing the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks.

Investment Advisers

See response to Question 21.2(d) above.

An investment adviser has an obligation to comply with the U.S. federal securities laws, including the Advisers Act, and to conduct its business in accordance with its fiduciary obligations. The Advisers Act imposes requirements relating to certain written policies and procedures, and recordkeeping. OCIE Staff examine registered investment advisers for compliance with those requirements. *See* response to Question 21.7.

Under Rule 206(4)-7 of the Advisers Act, registered investment advisers must adopt and implement written compliance policies and procedures (CP&P) reasonably designed to prevent the violation of the Advisers Act by the investment adviser or any of its supervised persons.⁴⁴⁸ Each investment adviser should identify potential conflicts of interest with its clients and other compliance factors creating risks for clients and develop procedures addressing such conflicts and risks. The SEC has indicated that an adviser's CP&P should address, at a minimum, the following:⁴⁴⁹

- Portfolio management processes, including allocation of investment opportunities among clients;
- Trading practices, including best execution, soft-dollar arrangements and trade aggregation;

⁴⁴⁸ The term "supervised persons" is defined as any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser. *See* Section 202(a)(25) of the Advisers Act.

⁴⁴⁹ SEC Release No. IA-2204 (December 17, 2003).

- Proprietary trading of the investment adviser and personal trading activities of supervised persons;
- Accuracy of disclosures made to investors, clients and regulators, including advertisements;
- Safeguarding of client assets from conversion or inappropriate use by advisory personnel;
- Creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;
- Marketing advisory services, including the use of solicitors;
- Processes to value client holdings and assess fees based on those valuations;
- Safeguards for the privacy protection of client records and information; and
- Business continuity plans.

Rule 206(4)-7(c) requires an investment adviser to designate a single CCO to administer the CP&P. Once the CP&P have been adopted and implemented, an adviser must conduct an annual review to determine their adequacy and effectiveness. Investment advisers must maintain copies of their CP&P for at least 5 years.

21.3

Does the relevant authority have the power to:

- Refuse licensing, subject only to administrative or judicial review, if authorization requirements have not been met?*

Broker-Dealers

The SEC can refuse licensing, subject only to administrative or judicial review, if authorization requirements have not been met.⁴⁵⁰

The SEC may deny registration if it finds that the applicant has not filed a complete Form BD in accordance with related rules adopted under the authority of the Exchange Act. The SEC may also deny registration if it finds the applicant, or any person associated with the applicant, has filed false information with the SEC, or has been convicted within ten years preceding the application of a financial related felony or misdemeanor or substantially equivalent crime by a foreign court. The SEC may also deny registration if it finds the applicant, or any person associated with the applicant, is enjoined by a court from participation in the securities business, has willfully violated, or willfully aided the violation of, the federal securities laws, rules issued by the SEC pursuant to those laws, or the Commodity Exchange Act, or has failed to reasonably supervise, with a view to preventing such violations, a person subject to the applicant's, or any person associated with the applicant, supervision.

⁴⁵⁰ See Exchange Act Section 15(b)(1)(B) (setting forth procedures and grounds for denying registration).

The SEC may similarly deny registration if it finds the applicant is subject to any final order of a state securities commission (or any agency or officer performing like functions), state authority that supervises or examines banks, savings associations, or credit unions, state insurance commission (or any agency or office performing like functions), an appropriate Federal banking agency,⁴⁵¹ or the National Credit Union Administration, that--

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

The SEC may also deny registration if it finds similar findings have previously been made by a foreign financial regulatory authority.⁴⁵² *See* response to Question 6.1.

Within 45 days of the date of the filing of an application (or within such longer period as to which the applicant consents), the SEC is required either to by order grant the application, or institute proceedings to determine whether registration should be denied.⁴⁵³ The proceedings must include notice of the grounds for denial under consideration and opportunity for hearing, and shall be concluded within 120 days of the date of the filing of the application for registration.⁴⁵⁴

In addition, an SRO may condition or deny membership based on similar findings. It may also deny or condition membership based on, among other things, failure to meet standards of financial responsibility or operational capability.⁴⁵⁵

Investment Advisers

The SEC may deny an investment adviser's registration application if the adviser: (a) is "prohibited" from registering with the SEC (see response to Question 21.2, under the heading

⁴⁵¹ As defined in Section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813(q))

⁴⁵² *See generally* Exchange Section 15(b)(4).

⁴⁵³ *See* Exchange Act Section 15(b)(1)(B).

⁴⁵⁴ *See id.* The SEC may extend the time for concluding the proceeding if it finds good cause and publishes its reasons for doing so, or if the applicant consents.

⁴⁵⁵ *See, e.g.,* NASD Rule 1014(c). *See also* Exchange Act Sections 6(c) and 15A(g).

“Prohibition on Registration”);⁴⁵⁶ or (b) has engaged in conduct specified in Section 203(e) of the Advisers Act (see response to Questions 21.2 and 21.3).

If the SEC does not issue an order granting the registration application, Section 203(c)(2) of the Advisers Act requires the SEC to institute proceedings before the SEC, within 45 days from the date of the filing of an application to register with the SEC as an investment adviser, to determine whether the application should be denied. Section 203(c)(2) of the Advisers Act provides that the proceedings will include the provision of public notice of the grounds under consideration for denial and will provide an opportunity for hearing. The proceedings generally will be concluded within 120 days of the date of the filing of the investment adviser’s application to register. At the conclusion of the proceedings, the SEC by public order will grant or deny the application.

21.3

- b) Withdraw, suspend or condition a license where a change in control or other change results in a failure to meet relevant requirements on an ongoing basis?*

Broker-Dealers

SROs must have rules that provide that their members shall be appropriately disciplined for violation of the provisions of the Exchange Act, the rules and regulations thereunder, and the rules of the exchange by expulsion, suspension, limitation of activities, functions and operations, fine, censure, being suspended or barred from being associated with a member of any other fitting sanction. Sections 6(b)(7) and 15A(b)(8) of the Exchange Act require that the rules of an SRO must provide for a fair procedure for disciplining members and persons associated with members, denying membership, barring persons from being associated with members, and prohibiting or limiting access to services offered by the exchange or its members.⁴⁵⁷

In addition, the SEC has direct authority to condition, suspend and revoke a person’s registration as a broker-dealer.⁴⁵⁸ In addition, if a broker-dealer fails to comply with the federal securities laws, the SEC can impose a wide range of sanctions (including revoking the broker-dealer’s registration, or temporarily suspending or permanently barring a person from acting as a broker-dealer). The SEC also can order any person to cease and desist from violating or causing

⁴⁵⁶ An investment adviser that is prohibited from registering may apply to the SEC for an order exempting it from the prohibition so that it may register with the SEC. *See also* our response to Question 21.2, under “Prohibition on Registration,” for information about the prohibitions on SEC registration.

⁴⁵⁷ *See* Sections 6(b)(6)-(7) and 15A(b)(7)-(8) of the Exchange Act, 15 U.S.C. 78f(b)(6)-(7) and 78o-3(b)(7)-(8), respectively. *See also* Sections 6(d) and 15A(h) of the Exchange Act, 15 U.S.C. 78f(d) and 78o-3(h), respectively, which contain additional requirements regarding how an exchange or association may discipline its members.

⁴⁵⁸ If the SEC finds that a registered broker-dealer has ceased to conduct business as a broker-dealer or is no longer eligible to remain registered with the SEC, the SEC is authorized to cancel the broker-dealer’s registration. *See* Exchange Act Section 15(b)(5).

violations of the securities laws and may impose conditions on the operations of such person's business to ensure compliance with the securities laws. The SEC can impose monetary penalties and enter an order requiring an accounting and disgorgement in an administrative action or seek monetary penalties and other equitable relief (*e.g.*, disgorgement) in federal court. For less serious misconduct, the SEC may merely issue a censure.

The federal securities laws authorize the SEC, in its discretion, to institute administrative proceedings against broker-dealers and their associated persons or to sue any person in federal court for violations of the federal securities laws, including the Exchange Act.

Administrative Proceedings: Sections 15(b)(6) and (4) of the Exchange Act, respectively, authorize the SEC to sanction a broker-dealer, or a person associated with a broker-dealer, if it finds (after notice and an opportunity for a hearing) that the broker-dealer or an associated person has engaged in certain willful misconduct and if the sanctions are in the public interest. Specifically, the SEC may “censure, place limitations on the activities, functions, or operations” of a broker-dealer or associated person of a broker-dealer and may suspend the registration of the broker-dealer, or prohibit the associated person from acting as such, for a period of not more than twelve months. Additionally, the SEC may revoke the registration of a broker-dealer, or bar a person from being associated with any broker-dealer. Sections 15(b)(6) and (4) of the Exchange Act identify the types of misconduct for which the SEC may sanction broker-dealers and their associated persons. Under Section 21B of the Exchange Act, the SEC may, upon a proper showing and when in the public interest, impose civil money penalties in proceedings instituted pursuant to Sections 15(b) of the Exchange Act.⁴⁵⁹ Proceedings under Sections 15(b)(6) and (4) of the Exchange Act may be based on the entry of an injunction, criminal conviction, or a finding of a willful violation in an administrative proceeding. Under Section 21C of the Exchange Act, the SEC may issue a cease-and-desist order⁴⁶⁰ requiring a person to cease violating or causing the violation of the Exchange Act or the rules or regulations thereunder. See response to Question 6.1(c).

⁴⁵⁹ Under Section 21B of the Exchange Act, the SEC may impose civil penalties against a broker-dealer and its associated persons according to a three-part scale: (a) if the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and resulted in or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the wrongdoer, a maximum for each act or omission of \$100,000 for a natural person, or \$500,000 for any other person; (b) if fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement is involved, a maximum for each act or omission of \$50,000 for a natural person, or \$250,000 for any other person; and (c) in other cases, a maximum for each act or omission of \$5,000 for a natural person, or \$50,000 for any other person. Under Section 21B(3) of the Exchange Act, in any proceeding in which the SEC may impose a penalty under Section 21B of the Exchange Act, the SEC may enter an order requiring an accounting and disgorgement (that is, the payment of any gains obtained as a result of the violation), including reasonable interest.

⁴⁶⁰ A “cease-and-desist” order under Section 21C of the Exchange Act is an administrative order that the SEC may issue when it finds that a person has violated, is violating or is about to violate a provision of the Exchange Act or the rules or regulations thereunder. In any cease-and-desist proceeding under Section 21C of the Exchange Act, the SEC may enter an order requiring an accounting and disgorgement, including reasonable interest.

Civil Federal Court Actions: The SEC is authorized to institute an action seeking an injunction or other equitable relief under Section 21(d) of the Exchange Act against any person who has violated, is violating, or is about to violate, the Exchange Act, the rules thereunder, any self-regulatory organization's rules, or the rules of a registered clearing agency in which such person is a participant. The SEC similarly may seek an injunction against any person for aiding and abetting a violation of the Exchange Act. Under Section 21(d)(2) of the Exchange Act, a court may prohibit any person who violated the anti-fraud provision, Section 10(b), from serving as officers and directors of any issuer that has securities registered under Section 12 of the Exchange Act or that is required to file reports with the SEC under the Exchange Act. Upon a proper showing, a court may impose monetary penalties of varying amounts, depending upon the nature of the violation, as described in Section 21(d)(3) of the Exchange Act.⁴⁶¹ In addition, Section 21(d)(5) of the Exchange Act authorizes the SEC to seek any equitable relief that may be appropriate or necessary for the benefit of investors. Further, Section 21(d)(6) provides the civil court authority to prohibit persons from participating in an offering of a "penny stock" as defined in that section.

Criminal Actions: Any person who willfully violates any provision of the Advisers Act, or any rule, regulation or order promulgated by the SEC thereunder, is subject to criminal penalties under the Exchange Act. Section 32 of the Advisers Act provides for criminal sanctions, upon conviction, not to exceed \$5,000,000 or 20 years imprisonment for a natural person, and \$25,000,000 for a person other than a natural person. The SEC does not have the authority to prosecute criminal actions. Rather, criminal actions are referred to, and prosecuted by, the U.S. DOJ.

An Attorney General of a state and/ or a state securities regulator may also bring their own criminal or civil actions against broker-dealers operating in their jurisdiction for violations of state securities laws.

Investment Advisers

The SEC has the authority to condition, suspend and revoke a person's registration as an investment adviser. If the SEC finds that a registered investment adviser has ceased to conduct business as an investment adviser or is no longer eligible to remain registered with the SEC, the SEC is authorized to cancel the adviser's registration.⁴⁶² The SEC periodically seeks to cancel

⁴⁶¹ Under Section 21(d)(3)(B) of the Exchange Act, a court may assess civil penalties for each violation according to a three-part scale: (a) if the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and resulted in or created a significant risk of substantial losses to other persons, a maximum for each act or omission of \$100,000 for a natural person, or \$500,000 for any other person, or the pecuniary gain to the defendant as a result of the violation; (b) if fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement is involved, a maximum for each act or omission of \$50,000 for a natural person, or \$250,000 for any other person, or the pecuniary gain to the defendant as a result of the violation; and (c) in other cases, a maximum of \$5,000 for each act or omission for a natural person, or \$50,000 for any other person, or the pecuniary gain to the defendant as a result of the violation. The federal courts also possess the power to grant other equitable relief, such as disgorgement.

⁴⁶² See Section 203(h) of the Advisers Act. *If* an investment adviser indicates in its annual updating amendment that it is no longer eligible to register with the SEC because the amount of assets that it has under

the registrations of investment advisers that appear to no longer conduct business as investment advisers.

In addition, if an investment adviser fails to comply with the federal securities laws, the SEC can impose a wide range of sanctions (including, for serious misconduct, revoking the adviser's registration, and temporarily suspending or permanently barring a person from acting as an investment adviser). The SEC also can order any person to cease and desist from violating or causing violations of the securities laws and may impose conditions on the operations of such person's business to ensure compliance with the securities laws. The SEC can impose monetary penalties and enter an order requiring an accounting and disgorgement in an administrative action or seek monetary penalties and other equitable relief (*e.g.*, disgorgement) in federal court. For less serious misconduct, the SEC may merely issue a censure.

The U.S. federal securities laws authorize the SEC, in its discretion, to institute administrative proceedings against investment advisers and their associated persons or to sue such persons in federal court for violations of the federal securities laws, including the Advisers Act.

Administrative Proceedings: Sections 203(e) and (f) of the Advisers Act authorize the SEC to sanction an investment adviser, or a person associated with an investment adviser, if it finds (after notice and an opportunity for a hearing) that the investment adviser or an associated person has engaged in certain willful misconduct and if the sanctions are in the public interest. Specifically, the SEC may “censure, place limitations on the activities, functions, or operations” of an investment adviser or associated person of an investment adviser and may suspend the registration of the investment adviser, or prohibit the associated person from acting as such, for a period of not more than twelve months. Additionally, the SEC may revoke the registration of an investment adviser, or bar a person from being associated with any investment adviser. Sections 203(e) and (f) of the Advisers Act list the types of misconduct for which the SEC may sanction investment advisers and their associated persons based on the entry of an injunction, criminal conviction, or a finding of a willful violation in an administrative proceeding. Under Section 203(i), the SEC may, upon a proper showing and when in the public interest, impose civil money penalties in proceedings instituted pursuant to Sections 203(e) or (f).⁴⁶³ Under Section 203(k) of

management has fallen below \$25 million, the investment adviser must withdraw from SEC registration within 180 days. *See* Form ADV, Instructions for Part 1A, 2(h). If the investment adviser does not withdraw, the SEC may cancel the investment adviser's registration. *See* “Prohibition on Registration” in our response to Question 21.2.

⁴⁶³ Under Section 203(i) of the Advisers Act, the SEC may impose civil penalties for each violation according to a three-part scale: (a) if the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and resulted in or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the wrongdoer, a maximum for each act or omission of \$100,000 for a natural person, or \$500,000 for any other person; (b) if fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement is involved, a maximum for each act or omission of \$50,000 for a natural person, or \$250,000 for any other person; and (c) in other cases, a maximum for each act or omission of \$5,000 for a natural person, or \$50,000 for any other person. Under Section 203(j) of the Advisers Act, in any proceeding in which the SEC may impose a penalty under Section 203 of the Advisers Act, the SEC may enter an order requiring an accounting and disgorgement (that is, the payment of any gains obtained as a result of the violation), including reasonable interest.

the Advisers Act, the SEC may issue a cease-and-desist order⁴⁶⁴ requiring a person to cease violating or causing the violation of the Advisers Act or the rules or regulations thereunder.

Civil Federal Court Actions: The SEC is authorized to institute an action seeking an injunction and other equitable relief in federal court under Section 209(d) of the Advisers Act against any person who has violated, is violating, or is about to violate, the Advisers Act or the rules or regulations thereunder. The SEC similarly may seek an injunction against any person for aiding and abetting a violation of the Advisers Act. Under Section 209(e) of the Advisers Act, the SEC may seek monetary penalties in federal court from any person who has violated the Advisers Act, the rules or regulations thereunder, or a cease-and-desist order previously entered by the SEC pursuant to Section 203(k) of the Advisers Act. Upon a proper showing, a court may impose monetary penalties of varying amounts, depending upon the nature of the violation, as described in Section 209(e)(2) of the Advisers Act.⁴⁶⁵

Criminal Actions: Any person who willfully violates any provision of the Advisers Act, or any rule, regulation or order promulgated by the SEC thereunder, is subject to criminal penalties under the Advisers Act. Section 217 of the Advisers Act provides for criminal sanctions, upon conviction, not to exceed \$10,000 and/or imprisonment for no more than five years. The SEC does not have the authority to prosecute criminal actions. Rather, criminal actions are referred to, and prosecuted by, the U.S. DOJ.

21.3

- c) Take effective steps to prevent the employment of persons (or seek the removal of persons) who have committed securities violations or who are otherwise unsuitable from continuing to engage in intermediary activities, even if these persons are not separately licensed intermediaries if they can have a material influence on the firm?*

⁴⁶⁴ A “cease-and-desist” order under Section 203(k) of the Advisers Act is an administrative order that the SEC may issue when it finds that a person has violated, is violating or is about to violate a provision of the Advisers Act or the rules or regulations thereunder. In any cease-and-desist proceeding under Section 203(k) of the Advisers Act, the SEC may enter an order requiring an accounting and disgorgement, including reasonable interest.

⁴⁶⁵ Under Section 209(e)(2) of the Advisers Act, a court may assess civil penalties for each violation according to a three-part scale: (a) if the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and resulted in or created a significant risk of substantial losses to other persons, a maximum for each act or omission of \$100,000 for a natural person, or \$500,000 for any other person, or the pecuniary gain to the defendant as a result of the violation; (b) if fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement is involved, a maximum for each act or omission of \$50,000 for a natural person, or \$250,000 for any other person, or the pecuniary gain to the defendant as a result of the violation; and (c) in other cases, a maximum of \$5,000 for each act or omission for a natural person, or \$50,000 for any other person, or the pecuniary gain to the defendant as a result of the violation. The federal courts also possess the power to grant other equitable relief, such as disgorgement.

Broker-Dealers

Individuals who are subject to “statutory disqualification,” as defined in Section 3(a)(39) of the Exchange Act, are generally required to undergo a regulatory review before being permitted to become associated with, or to continue their association with, a broker-dealer, or granted membership in, or continue membership in, an SRO. In general, a wide range of events subjects a person to statutory disqualification.⁴⁶⁶ Most common among these events are convictions for

⁴⁶⁶ Section 3(a)(39) of the Exchange Act provides that:

A person is subject to a "statutory disqualification" with respect to membership or participation in, or association with a member of, a self-regulatory organization, if such person--

- 1) has been and is expelled or suspended from membership or participation in, or barred or suspended from being associated with a member of, any self-regulatory organization, foreign equivalent of a self-regulatory organization, foreign or international securities exchange, contract market designated pursuant to section 5 of the Commodity Exchange Act (7 U.S.C. 7), or any substantially equivalent foreign statute or regulation, or futures association registered under section 17 of such Act (7 U.S.C. 21), or any substantially equivalent foreign statute or regulation, or has been and is denied trading privileges on any such contract market or foreign equivalent;
- 2) is subject to--
 - a) an order of the Commission, other appropriate regulatory agency, or foreign financial regulatory authority--
 - i) denying, suspending for a period not exceeding 12 months, or revoking his registration as a broker, dealer, municipal securities dealer, government securities broker, or government securities dealer or limiting his activities as a foreign person performing a function substantially equivalent to any of the above; or
 - ii) barring or suspending for a period not exceeding 12 months his being associated with a broker, dealer, municipal securities dealer, government securities broker, government securities dealer, or foreign person performing a function substantially equivalent to any of the above;
 - b) an order of the Commodity Futures Trading Commission denying, suspending, or revoking his registration under the Commodity Exchange Act (7 U.S.C. 1 et seq.); or
 - c) an order by a foreign financial regulatory authority denying, suspending, or revoking the person's authority to engage in transactions in contracts of sale of a commodity for future delivery or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent thereof;
- 3) by his conduct while associated with a broker, dealer, municipal securities dealer, government securities broker, or government securities dealer, or while associated with an entity or person required to be registered under the Commodity Exchange Act [7 U.S.C.A. § 1 et seq.], has been found to be a cause of any effective suspension, expulsion, or order of the character described in subparagraph (A) or (B) of this paragraph, and in entering such a suspension, expulsion, or order, the Commission, an appropriate regulatory agency, or any such self-regulatory organization shall have jurisdiction to find whether or not any person was a cause thereof;
- 4) by his conduct while associated with any broker, dealer, municipal securities dealer, government securities broker, government securities dealer, or any other entity engaged in transactions in securities, or while associated with an entity engaged in transactions in contracts of sale of a commodity for future delivery or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent thereof, has been found to be a cause of any effective suspension, expulsion, or order by a foreign or international securities exchange or foreign financial regulatory authority empowered by a foreign government to administer or enforce its laws relating to financial transactions as described in subparagraph (A) or (B) of this paragraph;
- 5) has associated with him any person who is known, or in the exercise of reasonable care should be known, to him to be a person described by subparagraph (A), (B), (C), or (D) of this paragraph; or
- 6) has committed or omitted any act, or is subject to an order or finding, enumerated in subparagraph (D), (E), (H), or (G) of paragraph (4) of section 15(b), has been convicted of any offense specified in subparagraph

any felony or certain enumerated misdemeanors within the last ten years; temporary or permanent injunctions from violating the securities laws issued by a court of competent jurisdiction; or bars from association with a broker-dealer issued by the Commission, the Commodity Futures Trading Commission, or an SRO. The regulatory review process, which encompasses reviews first by the appropriate SRO and subsequently by the SEC, is designed to ensure that persons with criminal or disciplinary histories either are prohibited from entering the business or are subject to appropriate safeguards (e.g., enhanced supervision or prohibitions on certain activities).⁴⁶⁷

Those persons who are subject to statutory disqualification, but wish to enter, re-enter, or continue in the industry, must apply to the SRO under procedures adopted pursuant to the Exchange Act.⁴⁶⁸ If the SRO determines that it would be in the public interest to permit the individual to be associated as proposed with one of its members, it typically provides notice to the SEC.⁴⁶⁹ The SEC then has the opportunity to review the SRO's determination, and if appropriate, to direct that the SRO not permit the proposed employment.

Investment Advisers

See response to Questions 21.2 and 21.3(b).

21.4

Where licensing is the responsibility of a self-regulatory organization, is the process subject to appropriate oversight by the regulator?

Broker-Dealers

See response to Question 7.1(b). The SEC oversees the SRO licensing processes and procedures. Rules for admission to an SRO are reviewed by the SEC pursuant to Section 19(b) of the Exchange Act. Among other things, an SRO's rules may not be designed to permit unfair

(B) of such paragraph (4) or any other felony within ten years of the date of the filing of an application for membership or participation in, or to become associated with a member of, such self-regulatory organization, is enjoined from any action, conduct, or practice specified in subparagraph (C) of such paragraph (4), has willfully made or caused to be made in any application for membership or participation in, or to become associated with a member of, a self-regulatory organization, report required to be filed with a self-regulatory organization, or proceeding before a self-regulatory organization, any statement which was at the time, and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or has omitted to state in any such application, report, or proceeding any material fact which is required to be stated therein.

⁴⁶⁷ 7) See Exchange Act Rule 19h-1 (concerning processes for admission or continuance notwithstanding a statutory disqualification).

⁴⁶⁸ See, e.g., NASD (FINRA) Rule 9520 Series.

⁴⁶⁹ See Sections 6(c)(2) and 15A(g)(2) of the Exchange Act and Rule 19h-1 under the Exchange Act.

discrimination between broker-dealer, and may not impose any burden on competition that is not necessary or appropriate in the furtherance of the purposes of the Exchange Act.⁴⁷⁰

To effectively evaluate compliance with membership and licensing rules and requirements, OCIE conducts inspections of the SROs' processes for approving firms' membership as well as the SROs' processes for licensing individual registered representatives of those member firms. For example, OCIE conducts routine inspections of FINRA district offices that involve a review of FINRA records to determine if it has appropriately granted membership only to firms that meet all of the applicable requirements and to help ensure it has not granted membership to firms that are statutorily disqualified from membership. OCIE also inspects the SROs' disciplinary programs, which would include a review of disciplinary actions resulting in the termination of membership or licenses held by a member firm or its individual registered representatives to help ensure the SROs fairly and consistently apply the rules in such actions.

In addition, such oversight by the SEC has included a review of FINRA's procedures for authenticating individual representatives of member firms to ensure each one actually takes and passes the appropriate tests and requirements necessary to obtain the relevant license or licenses.

OCIE also conducts examinations of member broker-dealer firms to evaluate the SRO's regulatory efforts. OCIE's examinations of broker-dealers may include a review of the licenses held by the individual registered representatives of the broker-dealer. As part of this type of review, OCIE reviews records of the broker-dealer to ensure that the types of business activities conducted by the individual representatives are appropriate for the licenses that they hold with that broker-dealer.

Investment Advisers

The licensing of U.S. investment advisers is the responsibility of the SEC and the state securities regulatory authorities, not a self-regulatory organization. Although investment advisers generally are not subject to SRO oversight, investment advisers that are also registered as broker-dealers are subject to oversight by FINRA.

21.5

Are market intermediaries required to update periodically relevant information with respect to their license and to report immediately to the regulator (or licensing authority) material changes in the circumstances affecting the conditions of the license?

Broker-Dealers

A broker-dealer must promptly file an amendment to its Form BD if the information on the form is or becomes inaccurate for any reason.⁴⁷¹

⁴⁷⁰ See generally Sections 6(b) and 15A of the Exchange Act.

Form BD requires a broker-dealer to disclose the identity of all senior managers and directors on its Form BD, which it files with the SEC. Each broker-dealer that is a corporation must disclose the identity of all shareholders that beneficially own, have the right to vote, or have the power to sell or direct the sale of 25% or more of any class of a voting security of the broker-dealer on Form BD. Each broker-dealer that is a partnership must disclose the identity of all general partners and any limited or special partners that have the right to receive upon dissolution, or have contributed, 25% or more of the partnership's capital on its Form BD. Each broker-dealer that is a trust must disclose the identity of the trust and each trustee on its Form BD. Each broker-dealer that is a LLC must disclose the identity of those members that have the right to receive upon dissolution, or have contributed, 25% or more of the LLC's capital and all elected managers on its Form BD.

Form BD requires additional disclosures about the individuals or entities identified in it as described in the preceding paragraph. Criminal, regulatory, civil judicial, bankruptcy, and SIPC actions involving each of those individuals or entities generally are required to be disclosed on Form BD. In addition, negative actions by a bonding company with respect to the applicant for broker-dealer registration must generally be disclosed on Form BD. Form BD also requires the applicant to disclose any unsatisfied judgments or liens against the applicant.

In addition, broker-dealers that cease doing a securities business are required to withdraw from registration by filing Form BDW (Notice of Withdrawal from Registration) with the CRD.⁴⁷²

Investment Advisers

An investment adviser's Form ADV must be updated each year by filing an annual updating amendment.⁴⁷³ In addition, an investment adviser is obligated to amend its Form ADV to keep it current. If certain material information in an investment adviser's Form ADV becomes inaccurate, it must be amended promptly; other corrections or updates, including a required annual update, must be made within 90 days of the adviser's fiscal year end.⁴⁷⁴

In general, a registered investment adviser has a continuing obligation to report to the SEC, either prior to or after the events, information relating to material changes in its management or organization because: (1) that information generally must be described in the investment adviser's Form ADV; and (2) an adviser must keep current responses on its Form ADV by promptly amending to correct such responses that become materially inaccurate.⁴⁷⁵

⁴⁷¹ See Rule 15b3-1 under the Exchange Act. See also General Instruction A,2 to Form BD.

⁴⁷² See Section 15(b)(5) of the Exchange Act and Rule 15b6-1 thereunder.

⁴⁷³ See General Instruction 4 of Form ADV.

⁴⁷⁴ See General Instruction 4 of Form ADV.

⁴⁷⁵ See Form ADV, General Instruction 4.

Form ADV requires investment adviser to disclose the identity of all shareholders that beneficially own, have the right to vote, or have the power to sell or direct the sale of 25% of more of any class of a voting security of the investment adviser. Each investment adviser that is a partnership must disclose the identity of all general partners and those limited or special partners that have the right to receive upon dissolution, or have contributed 25% or more of the partnership's capital on its Form ADV. Each investment adviser that is a trust must disclose the identity of the trust and each trustee on its Form ADV. Each investment adviser that is organized as a limited liability company must disclose the identity of those members that have the right to receive upon dissolution, or have contributed, 25% or more of the company's capital and all elected managers on its Form ADV. Material changes with respect to any of these items require prompt amendment of the adviser's Form ADV.

If a registered investment adviser ceases to conduct business as an investment adviser or is otherwise no longer eligible to remain registered with the SEC, the adviser must withdraw its registration by filing with the SEC a Form ADV-W (Notice of Withdrawal from Registration).⁴⁷⁶

21.6

Is the following relevant information about licensed intermediaries available to the public:

- a) *The existence of a license, its category and status?*

Broker-Dealers

Completed Forms BD and broker-dealers' annual audited financial statements are publicly available through the SEC's public reference office. Form BD indicates the types of business conducted by a broker-dealer, as well as the states and SROs with which it is registered in addition to the SEC. In addition, FINRA collects, compiles, organizes, indexes, digitally converts and maintains regulatory information from broker-dealers and their registered associated persons, as well as from states and other sources. It maintains this information in the CRD system, and releases certain information derived from CRD to the investing public. This information is available free of charge to the investing public through FINRA's BrokerCheck system, and is provided pursuant to FINRA Rule 8312 under authority of Exchange Act Section 15A(i).

Form BD indicates the types of business conducted by a broker-dealer, as well as the states and SROs with which it is registered in addition to the SEC. The CRD system indicates the status of the broker-dealer's registration, and the types of examinations registered persons associated with a particular broker-dealer have taken and the specific securities licenses they hold, as well as the status of those licenses. As noted above, most of this information is also available through BrokerCheck.⁴⁷⁷

⁴⁷⁶ See Rule 203-2 under the Advisers Act.

⁴⁷⁷ FINRA Rule 8312 governs the information it makes available to the public through BrokerCheck. With respect to examinations and registered or licensed capacities held by individuals, BrokerCheck provides approved

Investment Advisers

There are no “categories” of licenses that are provided to an investment adviser by the SEC. An investment adviser will either be registered with the SEC, registered with a state securities commission, or will be unregistered. The public may confirm whether a person or firm is registered with the SEC either through the SEC’s web site, including the IARD system, or by consulting the SEC’s staff, via telephone or e-mail, or by contacting the investment adviser. The public also may confirm whether a person or firm is registered with a state by consulting with the state securities commission, either through the state’s web site or via telephone, or by contacting the investment adviser.

21.6

- b) The scope of permitted activities or identity of senior management and names of other individuals authorized to act in the name of the intermediary?*

Broker-Dealers

A broker-dealer is required to disclose the identity of all senior managers and directors on its Form BD. Each broker-dealer that is a corporation must disclose the identity of all shareholders that beneficially own, have the right to vote, or have the power to sell or direct the sale of 25% or more of any class of a voting security of the broker-dealer on Form BD. Each broker-dealer that is a partnership must disclose the identity of all general partners and any limited or special partners that have the right to receive upon dissolution, or have contributed, 25% or more of the partnership’s capital on its Form BD. Each broker-dealer that is a trust must disclose the identity of the trust and each trustee on its Form BD. Each broker-dealer that is a LLC must disclose the identity of those members that have the right to receive upon dissolution, or have contributed, 25% or more of the LLC’s capital and all elected managers on its Form BD.

Form BD requires additional disclosures about the individuals or entities identified in it as described in the preceding paragraph. Criminal, regulatory, civil judicial, bankruptcy, and SIPC actions involving each of those individuals or entities generally are required to be disclosed on Form BD. In addition, negative actions by a bonding company with respect to the applicant for broker-dealer registration must generally be disclosed on Form BD. Form BD also requires the applicant to disclose any unsatisfied judgments or liens against the applicant.

Form BD requires a broker-dealer to indicate the types of business it conducts. In addition, the SRO pre-membership process determines what types of businesses the SRO will approve the broker-dealer to conduct. The FINRA application process, for example, involves a membership interview between FINRA staff and the primary persons who will own, control and manage the applicant broker-dealer. Approval for membership with FINRA is contingent upon the

registrations, examinations passed by the person and the date passed. BrokerCheck does not release information regarding examination scores or failed examinations.

submission of a written Membership Agreement that will address, among other things, the applicant's proposed business activities.⁴⁷⁸

Investment Advisers

A registered investment adviser must list in its Form ADV the names of its executive officers and directors (Chief Executive Officer, Chief Financial Officer, Chief Operations Officer, Chief Legal Officer, Chief Compliance Officer, and individuals with similar status or functions).⁴⁷⁹ If this information becomes *materially* inaccurate, the adviser must promptly file an amendment to its Form ADV.⁴⁸⁰

A registered investment adviser is required to identify in its Form ADV every person that directly or indirectly controls the investment adviser, either as a direct owner or an indirect owner.⁴⁸¹ An investment adviser also must provide in its Form ADV certain information about any owner, such as whether it is a domestic or foreign entity.⁴⁸² In addition, an investment adviser must state in its Form ADV the general amount of voting control that an owner exercises over the investment adviser (in terms of percentage) and when such voting control was acquired.⁴⁸³ If this information in its Form ADV becomes *materially* inaccurate, then an investment adviser must promptly amend its Form ADV.⁴⁸⁴

Form ADV also requires a registered investment adviser to disclose the type(s) of services it provides (e.g., financial planning services, portfolio management for individuals and/or small businesses, portfolio management for investment companies, portfolio management for businesses or institutional clients (other than investment companies), pension consulting services, selection of other advisers, publication of periodicals or newsletters, security ratings or pricing services, market timing services, or others).

⁴⁷⁸ See NASD Rule 1017.

⁴⁷⁹ See Form ADV, Schedule A.

⁴⁸⁰ *Id.*

⁴⁸¹ See Form ADV, Part 1A, Item 10.

⁴⁸² See Form ADV, Schedules A and B.

⁴⁸³ *Id.*

⁴⁸⁴ See Form ADV, General Instruction 4.

21.7

Does the regulator routinely monitor, investigate and enforce securities laws and regulations affecting intermediary activities?

The SEC has a strong tradition of vigorous monitoring, investigation and enforcement of securities laws and regulations, including those that affect intermediary activities. The agency strives, however, to continually improve its performance of these functions and has taken determined action to re-assess its abilities and resources in light of its failure to detect the Madoff fraud. Although no financial regulatory system has the capacity to detect and prevent all misbehavior, the SEC is committed to continue to improve its systems for the protection of investors.

Broker-Dealers

OCIE conducts routine or cycle examinations designed to periodically test a registrant's compliance with applicable laws and regulations. OCIE also conducts "cause examinations," which are examinations initiated based upon complaints, tips, press reports, or other information suggesting the registrant might be violating securities laws, rules or regulations. Further, OCIE conducts risk-targeted sweep examinations, in which examination staff reviews multiple firms for a particular compliance risk. Finally, OCIE conducts special purpose examinations, in which examination staff reviews a firm for a potential issue or risk. *See* responses to Questions 8.1 and 10.1.

Sections 6(b), 15A and 19(g) of the Exchange Act require SROs to comply with certain standards, including enforcement of their members' compliance with the securities laws. The SROs are also required, among other things, to have rules designed to prevent fraud and provide for bringing disciplinary actions against members and persons associated with members. SRO disciplinary actions typically include the ability to fine, suspend and expel from the industry.

The SROs examine their own members, and under Section 17(b) of the Exchange Act, the SEC examines the SROs themselves to determine whether they are meeting their responsibilities. In addition to enforcing its own rules, the SEC can directly enforce the rules of an SRO if it finds that the SRO is unable or unwilling to take appropriate action against a person who violated an SRO rule.⁴⁸⁵ The SEC can also bring an enforcement action against the SRO.⁴⁸⁶ *See* response to Question 7.1(f).

Investment Advisers

See response to Questions 8.1 and 10.1.

⁴⁸⁵ Exchange Act Section 21(f).

⁴⁸⁶ *See* Exchange Act Section 19(h).

21.8

Does the regulatory scheme for investment advisers require that:

- a) If an investment adviser deals on behalf of customers, the capital and other operational controls applicable to other market intermediaries also should apply to the adviser?*

To the extent that an investment adviser deals on behalf of customers, the investment adviser would be subject to the broker-dealer regulatory regime, including capital and other operational controls. See response to Question 21.2.

21.8

- b) If the adviser does not deal, but is permitted to have custody of client assets, regulation provides for the protection of client assets, including segregation and periodic or risk-based inspections (either by the regulator or an independent third party)?*

Rule 206(4)-2 under the Advisers Act specifies the terms and conditions under which an investment adviser may maintain custody of client funds or securities (“Client Assets”).

First, such Client Assets must be maintained with a “qualified custodian,” defined as: (i) a bank as defined in Section 202(a)(2) of the Advisers Act or a savings association as defined in Section 3(b)(1) of the Federal Deposit Insurance Act⁴⁸⁷ that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act; (ii) a broker-dealer registered under Section 15(b)(1) of the Exchange Act, holding the client assets in customer accounts; (iii) a futures commission merchant registered under Section 4f(a) of the Commodity Exchange Act, holding the client assets in customer accounts, but only with respect to clients’ funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; and (iv) a foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients’ assets in customer accounts segregated from its proprietary assets.⁴⁸⁸

Second, the qualified custodian must maintain Client Assets either in a separate account for each client under that client’s name, or in accounts that contain only the Client Assets, under the adviser’s name as agent or trustee for the clients.⁴⁸⁹

Third, if an investment adviser opens an account with a qualified custodian on behalf of a client, either under the client’s name or under the adviser’s name as agent, the adviser must notify the client in writing of such qualified custodian’s name, address, and the manner in which the funds

⁴⁸⁷ 12 U.S.C. 1813(b)(1).

⁴⁸⁸ Advisers Act Rule 206(4)-2(c)(3).

⁴⁸⁹ Advisers Act Rule 206(4)-2(a)(1).

or securities are maintained, promptly when the account is opened and following any changes to this information.⁴⁹⁰

Fourth, an investment adviser relying on a qualified custodian to provide periodic account statements to the adviser's clients must have a reasonable basis for believing that the qualified custodian sends an account statement, at least quarterly, to each of such adviser's clients for which it maintains funds or securities, identifying the amount of funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period;⁴⁹¹ or

Fifth and finally, an adviser with custody of Client Assets who chooses to send account statements directly to its clients must send a quarterly account statement to each of such adviser's clients for whom the adviser has custody of Client Assets, identifying the amount of funds and of each security of which the adviser has custody at the end of the period, and setting forth all transactions during that period.⁴⁹² If an adviser chooses such an arrangement, an independent public accountant must verify all of those funds and securities by actual examination at least once during each calendar year at a time that is chosen by the accountant without prior notice or announcement to the adviser and that is irregular from year to year, and must file a certificate on Form ADV-E with the SEC within 30 days after the completion of the examination, stating that it has examined the funds and securities and describing the nature and extent of the examination.⁴⁹³ If such independent public accountant finds any material discrepancies during the course of such examination, the accountant must notify the SEC within one business day of the finding.⁴⁹⁴

In recent months, the SEC has brought several enforcement actions against investment advisers and broker-dealers alleging fraudulent conduct, including misappropriation or other misuse of investor assets.⁴⁹⁵ In light of this misconduct, the SEC is undertaking a comprehensive review of the rules regarding the safekeeping of investor assets in order to determine changes the SEC might make that would decrease the likelihood that client assets are misused, or would increase

⁴⁹⁰ Advisers Act Rule 206(4)-2(a)(2).

⁴⁹¹ Advisers Act Rule 206(4)-2(a)(3)(i). If the investment adviser is a general partner of a limited partnership (or managing member of a limited liability company, or holds a comparable position for another type of pooled investment vehicle), the account statements required under paragraphs (a)(3)(i) or (a)(3)(ii) of Rule 206(4)(2) must be sent to each limited partner (or member or other beneficial owner).

⁴⁹² Advisers Act Rule 206(4)-2(a)(3)(ii)(A).

⁴⁹³ Advisers Act Rule 206(4)-2(a)(3)(ii)(B).

⁴⁹⁴ Advisers Act Rule 206(4)-2(a)(3)(ii)(C).

⁴⁹⁵ See, e.g., *SEC v. Stanford International Bank, et al.*, Litigation Release No. 20901 (Feb. 17, 2009) (complaint alleges that the affiliated bank, broker-dealer, and advisers colluded with each other in carrying out an \$8 billion fraud); *SEC v. Bernard L. Madoff, et al.*, Litigation Release No. 20889 (Feb. 9, 2009) (complaint alleges that Madoff and Bernard L. Madoff Investment Securities LLC (a registered investment adviser and registered broker-dealer) committed a \$50 billion fraud).

the likelihood that fraudulent activities are discovered earlier and client losses are thereby reduced. As part of this review, the SEC has proposed amendments to Rule 206(4)-2 and related forms intended to provide additional safeguards under the Advisers Act when an adviser has custody of Client Assets.⁴⁹⁶ The amendments, among other things, would require registered investment advisers that have custody of Client Assets to undergo an annual surprise examination by an independent public accountant to verify client funds and securities. In addition, unless Client Assets are maintained by an independent qualified custodian (*i.e.*, a custodian other than the adviser or a related person), the proposed amendments would require the adviser or related person to obtain a written report from an independent public accountant that includes an opinion regarding the qualified custodian's controls relating to custody of Client Assets. Finally, the amendments would provide the SEC with better information about the custodial practices of registered investment advisers. The SEC has solicited public comment with respect to this proposed rule, and has established July 28, 2009 as the deadline for submission of such comments.

Additionally, Rule 204-2 under the Advisers Act requires an adviser that has custody of client assets to keep: (a) a journal or other records showing all purchases, sales, receipts and deliveries of securities (including certificate numbers) for such accounts and all other debits and credits to such accounts; (b) a separate ledger account for each such client showing all purchases, sales, receipts and deliveries of securities, the date and price of each such purchase and sale, and all debits and credits; (c) copies of confirmations of all transactions effected by or for the account of any such client; and (d) a record for each security in which any such client has a position, which record shall show the name of each client having any interest in each security, the amount or interest of each such client, and the location of each such security.

21.8

c) In the case of both (a) and (b), as well as advisers who manage client portfolios without dealing on behalf of clients or holding client assets, does regulation include:

i) Record-keeping requirements?

See response to Question 23.11.

ii) Clear and detailed requirements setting out the disclosures to be made by the adviser to potential clients, including: descriptions of the adviser's educational qualifications, relevant industry experience, disciplinary history (if any), investment strategies, fee structure and other client charges, potential conflicts of interest, and past investment performance (if relevant)?

⁴⁹⁶ Advisers Act Release No. 2876 (May 20, 2009).

Educational qualifications

Item 6 of Form ADV, Part 2 requires investment advisers to disclose the educational background of: (i) each member of the investment committee or group that determines general investment advice to be given to clients (or, if the applicant has no investment committee or group, each individual who determines general investment advice given to clients; and (ii) each principal executive officer of the adviser or each person with similar status or performing similar functions.

Relevant industry experience

Item 6 of Form ADV, Part 2 requires investment advisers to disclose the business background for the preceding five years of: (i) each member of the investment committee or group that determines general investment advice to be given to clients (or, if the applicant has no investment committee or group, each individual who determines general investment advice given to clients; and (ii) each principal executive officer of the adviser or each person with similar status or performing similar functions.

Disciplinary history

Item 11 of Form ADV, Part 1 requires an investment adviser to disclose information regarding the disciplinary history of the adviser and all of its “advisory affiliates.”⁴⁹⁷ Positive responses to any of the questions on Item 11 require detailed explanation on a separate Disclosure Reporting Page.

See also response to Question 21.3(c).

Investment strategies

An investment adviser must describe in its Form ADV the types of advisory activities that the adviser provides⁴⁹⁸ to its clients and the other types of business activities in which an adviser engages.⁴⁹⁹

⁴⁹⁷ “Advisory affiliates” are defined generally in Form ADV’s Glossary of Terms to include: (1) all of the investment adviser’s current employees (other than employees performing only clerical, administrative, support or similar functions); (2) all of the adviser’s officers, partners, or directors (or any person performing similar functions); and (3) all persons directly or indirectly controlling the adviser or controlled by the adviser.

⁴⁹⁸ *See* Form ADV, Part 1A, Item 5(G), and Part 2, Item 1(A).

⁴⁹⁹ *See* Form ADV, Part 1A, Item 6 and Part 2, Items 7 and 8.

Fee structure and other client charges

Items 1 and 13 of Form ADV, Part 2 require detailed disclosure regarding the investment adviser's fee structure, including disclosure of alternative fee arrangements and non-monetary forms of compensation.

In general, Section 205(a)(1) of the Advisers Act prohibits an investment adviser from entering into, extending, or renewing any investment advisory contract, or in any way to perform any investment advisory contract that provides for compensation to the investment adviser on the basis of a share of capital gains or capital appreciation of the funds or any portion of the funds of the client (collectively, "a performance fee"), unless: (a) the performance fee is based upon a percentage of assets under management; or (b) the client is a registered investment company or certain other entities with assets in excess of \$1 million, and the performance fee is a "fulcrum fee";⁵⁰⁰ or (c) the client is a qualified client.⁵⁰¹

Potential conflicts of interest

An investment adviser's fiduciary duty requires it to disclose to its clients and prospective clients any material facts that might cause the adviser, either consciously or unconsciously, to render advice that is not disinterested.⁵⁰² An investment adviser must disclose all material potential conflicts of interest between the adviser and its clients, even if the adviser believes that a conflict has not affected and will not affect the adviser's recommendations to its clients.⁵⁰³ In addition, investment advisers that exercise voting authority with respect to client securities generally must: (1) adopt written policies and procedures that are reasonably designed to ensure that the adviser votes proxies in the best interest of clients; (2) describe such policies and procedures to clients and provide copies upon request; and (3) disclose to clients how they may obtain information on how the adviser voted their proxies.⁵⁰⁴

Section 206(3) of the Advisers Act requires an investment adviser, prior to completion of a principal trade, to disclose to its client in writing when it is acting as a principal for its own account, and to obtain the consent of the client.⁵⁰⁵

⁵⁰⁰ A "fulcrum fee" is generally described as a fee that is averaged over a specified period of time that increases or decreases proportionately with the investment performance of the client's account in relation to the investment record of an appropriate securities index. *See* Rules 205-1 and 205-2 under the Advisers Act.

⁵⁰¹ Rule 205-3(d)(1) under the Advisers Act defines the term "qualified client."

⁵⁰² *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195-97 (1963). *See also* Sections 206(1) and (2) of the Advisers Act.

⁵⁰³ *Id.*

⁵⁰⁴ Rule 206(4)-6.

⁵⁰⁵ Section 204 and Rule 204-2(a)(7) under the Advisers Act would require an investment adviser to retain this written communication as part of its records.

Rule 204-2 under the Advisers Act requires investment advisers to create and maintain certain records relating to any proprietary trading activities in which they engage as part of their investment advisory business. Rule 204-2 under the Advisers Act requires an investment adviser to keep a record of every transaction in a security in which the investment adviser or any advisory representative of the investment adviser has, or by reason of the transaction acquires, any direct or indirect beneficial ownership, except: (a) transactions effected in any account over which neither the investment adviser nor any advisory representative of the investment adviser has any direct or indirect influence or control; and (b) transactions in securities that are: direct obligations of the Government of the United States; bankers' acceptances, bank certificates of deposit, commercial paper, and high quality short-term debt instruments, including repurchase agreements; or shares issued by registered open-end investment companies.

Additionally, Rule 204A-1 under the Advisers Act requires registered investment advisers to adopt codes of ethics setting forth standards of conduct and requiring compliance with federal securities laws. Codes of ethics must address personal trading and must require personnel to report personal securities holdings and transactions, including those in affiliated mutual funds. Codes of Ethics must also require personnel to obtain pre-approval of certain investments. Rule 204-2 under the Advisers Act requires advisers to keep copies of their codes of ethics and related records.

The Exchange Act may require investment advisers that engage in proprietary trading activities to register with, and be regulated by, the SEC as securities dealers.

Past investment performance

Investment advisers are not required to disclose past performance information. If an investment adviser chooses to do so, it must do so consistent with antifraud rules and regulations and with the applicable terms and provision of Rule 206(4)-1 under the Advisers Act. Rule 206(4)-1(a)(1) under the Advisers Act prohibits the use of testimonials in investment adviser advertising, while Rule 206(4)-1(a)(2) provides that an investment adviser invoking past specific investment recommendations in an advertisement must disclose all relevant recommendations, whether such recommendations cast the adviser in a favorable or unfavorable light. Additionally, Rule 206(4)-1(a)(3) prohibits an adviser from, among other things, representing that a graph, chart, formula, or other device being offered can, by itself, guide the investor as to the advisability and optimal timing of purchasing or selling specific securities. The investment adviser must prominently disclose the limitations of any such graph, chart, formula or device used in advertising.

21.8(c)

iii) Rules and procedures designed to prevent guarantees of future investment performance, misuse of client assets, and potential conflicts of interest?

Guarantees of future investment performance

The SEC regulates investment adviser advertising through the general antifraud provisions of Section 206 and Rule 206(4)-1 under the Advisers Act. A guarantee of future investment

performance would generally be considered an unlawfully fraudulent, deceptive or manipulative act.⁵⁰⁶ In particular, advertisements that promise certain and substantial profits based on prior performance or strategies would not generally be cured by disclaimers buried in the smaller text of the advertisement.⁵⁰⁷

Misuse of client assets

Misuse of client assets would generally violate the antifraud provisions of the Advisers Act. For a discussion of the procedures designed to prevent misuse of client assets, *see* response to Question 21.8(b). For a discussion of the remedies available to the SEC in the event an investment adviser is found to be misappropriating client assets, *see* response to Question 21.3(b).

Potential conflicts of interest

See response to Question 21.8(c)(ii).

⁵⁰⁶ *See, e.g., In the Matter of Spear & Staff*, 42 S.E.C. 549 (1965) (Registrant's advertisements were calculated to arouse, in an excessive and unwarranted manner, illusory hopes of immediate and substantial profit, and were violative of the Act's anti-fraud provisions and of Rule 206(4)-1(a) thereunder. They were deceptive and misleading in their over-all effect even though it might be argued that when narrowly and literally read, no single statement of a material fact was false.)

⁵⁰⁷ *See In the Matter of Jesse Rosenblum*, Investment Advisers Act Rel. No. 913 (May 17, 1984).

Market Intermediaries – Principle 22

There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.

Assessment

Fully Implemented.

22.1

Are there initial and ongoing minimum capital requirements for relevant market intermediaries?

Pursuant to Exchange Act section 15(c)(3)(A), “No broker or dealer [...] shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security [...] in contravention of such rules and regulations as the SEC shall prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers...”

In accordance with the Act, the SEC promulgated a number of financial responsibility rules including Rule 15c3-1 (commonly referred to as the “Net Capital Rule”). This rule requires that all broker-dealers maintain certain minimum level of liquid net capital at all times. All broker-dealers are subject to the SEC’s Net Capital Rule. If a firm’s net capital falls below the level of net capital it is required to maintain pursuant to the rule, that firm must cease doing a securities business. Although all broker-dealers must keep a minimum amount of capital, new firms are subject to more stringent capital requirements than firms that have been in the business for more than one year.

The SEC’s Net Capital Rule requires that firms exposed to more risk (either due to the types of business in which the broker-dealer engages or the age of the firm) maintain higher levels of liquid net capital. Under the Rule, a broker-dealer must take a deduction for 100% of the value of all assets that are not readily convertible into cash when calculating its net capital. In addition, a firm’s net capital can be calculated using either the standard or alternative method. Pursuant to the standard method, the firm must perform a calculation to determine its level of liquid net capital, then it must compare that amount to two separate numbers: 1) a minimum dollar amount set forth in the rule itself (the firm’s liquid net capital must exceed the minimum dollar amount set forth in the rule); and 2) its aggregate indebtedness to all other persons (the firm’s aggregate indebtedness cannot exceed 1500 percent, or 800 percent if the firm has been in business less than one year, of its liquid net capital). Broker-dealers may elect to calculate their capital using the alternative method. The liquid net capital of broker-dealers using the alternative method must not fall below the greater of \$250,000 or two percent of the amount its customers owe to it.

In addition, the SROs may prescribe net capital requirements in excess of the requirements of the SEC's Net Capital Rule.⁵⁰⁸

The Advisers Act does not impose any minimum initial or ongoing capital requirements upon registered investment advisers. *See* response to Question 21.2(c).

22.2

Are the capital adequacy requirements structured to result in capital addressed to the full range of risks to which market intermediaries are subject, e.g., market, credit, liquidity, operational, and legal, including reputational, risks?

There are differences in the net capital requirements applicable to broker-dealers based upon the types of business in which each firm engages and the perceived relative risk associated with these different types of activities. The Net Capital Rule uses risk factors, or haircuts, to adjust a firm's capital calculation. The larger a firm's position or risk, the larger the haircut the firm is required to take when calculating its net capital. Pursuant to the standard method of determining a firm's net capital requirement, a firm generally must not allow its aggregate indebtedness to all other people to exceed 1500 percent of its net capital (or 800 percent if the firm has been in business for less than a year) and must maintain at least a minimum dollar amount of net capital as set forth in the Net Capital Rule. The Net Capital Rule sets forth minimum dollar amounts that range from \$5,000 USD (for the least risky type of activity) to \$250,000 USD (for the most risky type of activity), as set forth in the below table:

⁵⁰⁸ *See e.g.*, NYSE Rule 325(d).

Type of Business	Minimum Dollar Requirement
Broker-dealers that do not receive, directly or indirectly, or hold funds or securities for customers or owe funds or securities to customers, and do not engage in any of the activities set forth below that would require the firm to maintain a higher net capital level.	\$5,000
A broker or dealer engages in the purchase, sale and redemption of redeemable shares of mutual funds or variable contracts directly from or to the issuer on other than an application-way basis. ⁵⁰⁹ A broker or dealer operating under this paragraph must promptly transmit all funds and promptly deliver all securities received in connection with its activities as a broker or dealer, and may not otherwise hold funds or securities for, or owe money or securities to, customers.	\$25,000
Brokers or dealers that receive, but do not hold, securities	\$50,000
<p>A “dealer” that writes over the counter options or effects more than ten non-riskless principal transactions in its proprietary account.</p> <p>A broker or dealer that is exempt from the provisions of 17 CFR 240.15c3-3 pursuant to paragraph (k)(2)(i) (<i>i.e.</i>, the firm promptly forwards all securities and maintains all customer cash balances in a special account) is only required to maintain \$100,000 USD.</p>	\$100,000
A broker-dealer that carries customer or broker-dealer accounts and receives or holds funds or securities for those persons. (However, a broker or dealer that is exempt from the provisions of 17 CFR 240.15c3-3 pursuant to paragraph (k)(2)(i) is only required to maintain \$100,000 USD.)	\$250,000

⁵⁰⁹ If a transaction is undertaken on an “application-way” basis it is completed directly between the mutual fund and the customer and the broker-dealer is not involved in the transfer of cash or securities. Transactions undertaken on “other than an application way basis” require participation of the broker-dealer and, therefore, a higher net capital requirement.

For instance, an established firm that engages only in the business of selling mutual funds on an application-way basis could not allow its aggregate indebtedness to all other people to exceed 1500 percent of its net capital, and its net capital could not fall below \$5,000 USD.

Further, larger U.S. broker-dealers generally choose to calculate their net capital based on the alternative method. Pursuant to the alternative method, the broker-dealer must maintain at least the greater of \$250,000 or 2% of aggregate debit items as calculated in the Reserve Computation under Rule 15c3-3.⁵¹⁰ This method would only be available to firms that hold customer funds and securities, and these debit items tend to increase in accord with the amount of customer business a firm does.

22.3

Are capital adequacy requirements sensitive to the quantum of risks undertaken; that is, does required capital increase as risk increases, e.g., in the event of large market moves?

There are differences in the net capital requirements applicable to broker-dealers based upon the types of business in which each firm engages and the perceived relative risk associated with these different types of activities. The Net Capital Rule uses risk factors, or haircuts, to adjust a firm's capital calculation. The larger a firm's position or risk, the larger the haircut the firm is required to take when calculating its net capital. Pursuant to the standard method of determining a firm's net capital requirement, a firm generally must not allow its aggregate indebtedness to all other people to exceed 1500 percent of its net capital (or 800 percent if the firm has been in business for less than a year) and must maintain at least a minimum dollar amount of net capital as set forth in the Net Capital Rule. The Net Capital Rule sets forth minimum dollar amounts that range from \$5,000 USD (for the least risky type of activity) to \$250,000 USD (for the most risky type of activity). A chart showing the minimum dollar amounts of net capital needed for certain broker-dealers is provided in response to Question 22.2.

In addition, all SROs have the ability to set capital requirements for broker-dealers at levels higher than that required pursuant to the SEC's rule. Many SROs also may prevent a firm from expanding its business or otherwise limit its business to the extent that it fails to maintain sufficient levels of net capital.⁵¹¹

⁵¹⁰ The Reserve Computation is calculated pursuant to a formula set forth in Exhibit A to Rule 15c3-3. Under the formula, a broker-dealer adds up various credit and debit line items. The credit items include cash balances in customer accounts and funds obtained through the use of customer securities. The debit items include monies owed by customers (e.g., from margin lending), securities borrowed by the broker-dealer to effectuate customer short sales, and required margin posted to certain clearing agencies as a consequence of customer securities transactions. If, under the formula, customer credit items exceed customer debit items, the broker-dealer must maintain cash or qualified securities in that net amount in a "Special Reserve Bank Account for the Exclusive Benefit of Customers." This account must be segregated from any other bank account of the broker-dealer. Generally, a broker-dealer with a deposit requirement of \$1 million or more must compute its reserve requirement on a weekly basis. The weekly computation determines the required minimum balance the broker-dealer must maintain in the reserve account.

⁵¹¹ See e.g., NYSE Rule 326(b) and NASD Rule 3130.

22.4

Are capital standards sufficient to allow an intermediary to absorb some losses and to wind down its business over a relatively short period without loss to its customers or disrupting the orderly functioning of the markets?

Customer securities and monies are segregated from proprietary positions and monies so that if a liquidation were to occur, those customer securities and funds would not be available to satisfy claims of creditors of the broker-dealer. The SEC's Rule 15c3-3,⁵¹² commonly called the "Customer Protection Rule," requires that every broker-dealer obtain and maintain possession and control of customer securities, and maintain a reserve account that contains (at least) the net dollar amount of cash the broker-dealer owes to its customers. The SEC's Rules 8c-1 and 15c2-1,⁵¹³ commonly called the "Hypothecation Rules," require that a broker-dealer segregate customer securities from its own proprietary securities, and prohibit a broker-dealer from hypothecating customers' fully-paid securities. In addition, the SROs have rules that restrict a broker-dealer's use of customer securities.⁵¹⁴ These rules serve to reduce the risk that a firm failure will have a widespread detrimental effect on the marketplace and customers and alert the SEC and SROs to a potential failure so that any impact may be minimized. Finally, the Net Capital Rule requires broker-dealers to maintain a minimum amount of capital, which is based upon the nature of the broker-dealer's business and whether the broker-dealer handles customer funds and securities. Those broker-dealers that handle customer funds and securities are required to maintain a higher level of net capital. *See* the response to Question 22.2.

The broker-dealer subsidiaries of The Bear Stearns Companies, Inc. and Lehman Brothers Holdings, Inc. were subject to net capital, customer protection, and bankruptcy rules and regimes that are designed to allow the broker-dealers to unwind without harming customers or causing market disruptions. In the failure of both Bear and Lehman, however, the holding companies and certain other affiliates were not subject to similar requirements, nor were these firms part of a bank holding company that had access to direct government financing of less liquid assets. The Bear Stearns broker-dealer was able to be transferred to JP Morgan Chase without any losses to customers. The vast majority of the Lehman broker-dealer was liquidated with minimal disruption to customers; however, the failure of Lehman Brothers Holdings had a significant impact on the financial markets. In light of these recent events, the SEC is reviewing the current regulatory framework to determine if changes are needed to prevent market disruptions. For example, the SEC is working with other domestic regulators to address financial regulatory reform.

⁵¹² 17 CFR 240.15c3-3.

⁵¹³ 17 CFR 240.8c-1 and 15c2-1.

⁵¹⁴ *See e.g.*, NYSE Rule 402 and NASD Rule 2330.

22.5

Are relevant market intermediaries required to maintain records such that capital levels can be readily determined at any time?

The capital levels of a broker-dealer and its compliance at all times with minimum capital requirements is monitored through the filing by the broker-dealer of periodic and annual reports, and through on-site inspections.⁵¹⁵ Compliance with capital levels is regularly monitored by the broker-dealer's designated examining authority,⁵¹⁶ however the SEC also may review a firm's filings or conduct a site inspection. The broker dealer must also provide an audited annual report to the SEC.

22.6

Are the detail, format, frequency and timeliness of reporting to the regulator and/or the SRO sufficient to reveal a significant deterioration in the capital adequacy position of market intermediaries?

Pursuant to Exchange Act Rule 17a-5(a),⁵¹⁷ all broker-dealers must file certain reports with the SEC either once each month or once each quarter, depending on the types of business in which the firm engages and the perceived relative risk of those types of business. However, the SEC has delegated the responsibility for receiving those reports to each firm's designated examining authority. Each report calculates a broker-dealers capital levels and it is reviewed by the designated examining authority. Broker-dealers are required to file those reports electronically. The SEC generally is able to access these reports electronically, and receives information regarding these reports in database format from the SROs.

In addition, pursuant to Exchange Act Rule 17a-11 (commonly called the "Early Warning Rule"), a broker-dealer must promptly notify the SEC and its designated examining authority if its net capital falls below 120% of its required net capital, or, if the firm computes its net capital using the alternative method, if the firm's net capital falls below 5% of aggregate debit items. Pursuant to Exchange Act Rule 17a-11, a broker-dealer must promptly notify the SEC's main office and the regional office of the SEC in whose region it resides. Further, the broker-dealer must notify its designated examining authority, and the CFTC, if it is registered therewith. Furthermore, the equity capital of a broker-dealer may not be withdrawn without written notice to the SEC, the designated examining authority, and, if applicable, the CFTC.

⁵¹⁵ 17 CFR 240.17a-5(a).

⁵¹⁶ Upon becoming registered as a broker-dealer with the SEC, each broker-dealer is assigned an SRO to be its designated examining authority, or DEA. The DEA is responsible for regular examinations of the broker-dealer as well as oversight of the broker-dealers' activities.

⁵¹⁷ 17 CFR 240.17a-5(a).

22.7

Is the financial position of the intermediary subject to audit by independent auditors to provide additional assurance that the financial position reflects the risk that the intermediary undertakes?

Pursuant to Exchange Act Rule 17a-5(d),⁵¹⁸ each broker-dealer must file an audited annual report with the SEC and with the broker-dealer's designated examining authority. Exchange Act Rule 17a-5(d)(1)(i) requires that the report be audited by "an independent public accountant." Further, Exchange Act Rule 17a-5(f)(1) sets forth the standards for qualification of an accountant, and Rule 17a-5(f)(3) states that the accountant "shall be independent in accordance with the provisions of Rules 2-01(b) and (c) of Regulation S-X."

If during the course of the audit, the independent public accountant finds material inadequacies that exist in the accounting system, internal accounting control, or procedures for safeguarding securities, the independent public accountant must inform the chief financial officer who must notify the SEC and the designated examining authority within 24 hours. If the chief financial officer fails to notify the SEC and the designated examining authority within 24 hours or the independent public accountant disagrees with statements contained in the notice, the independent public accountant must inform the SEC and the designated examining authority of the material inadequacy within 24 hours thereafter.⁵¹⁹

22.8

Does the regulator:

- a) Regularly review market intermediaries' capital levels?***
- b) Take appropriate action when these reviews indicate material deficiencies?***

An SRO inspects a broker-dealer member periodically, depending on the types of business the broker-dealer engages in and the perceived relative risk of those types of business. For instance, SROs inspect broker-dealers that hold customer funds and securities once each year. Other broker-dealers are also subject to on-site examinations by SROs, however they may be examined less frequently. In addition, the SRO reviews a broker-dealer's capital levels when periodic reports are filed.

The SEC may examine a broker-dealer on a routine or cyclical basis based upon some specific perceived risk, or as part of a risk-targeted sweep examination.

⁵¹⁸ 17 CFR 240.17a-5(d).

⁵¹⁹ 17 CFR 240.17-5(h)(2).

As stated in response to Question 22.6, pursuant to the “Early Warning Rule,” a broker-dealer must promptly notify the SEC, its designated examining authority, and, under certain circumstances, the CFTC if its net capital falls below a specific threshold amount. Pursuant to Exchange Act Rule 17a-11, a broker-dealer must promptly notify the SEC’s main office and the regional office of the SEC in whose region it resides. Further, the broker-dealer must notify its designated examining authority, and if it is a member thereof, the CFTC. The threshold amount is 120% of its required net capital, or, if the firm computes its net capital using the alternative method, if the firm’s net capital falls below 5% of aggregate debit items. See Question 22.9, which explains the action regulators can take if the reviews indicate material deficiencies.

22.9

Does the regulator have specific authority to impose restrictions on an intermediary’s regulated business activities and more stringent capital monitoring and/or reporting requirements if an intermediary’s capital deteriorates so as to endanger its capacity to fulfill its obligations or when it falls below minimum requirements? Is there evidence that the regulator exercises this authority?

The Exchange Act and the regulations promulgated thereunder prohibit a broker-dealer from continuing to do a securities business if the firm does not have sufficient net capital.⁵²⁰ Further, a broker-dealer is restricted from withdrawing capital if certain parameters have been broken.⁵²¹ The SROs also have rules that restrict the activities of a broker-dealer in financial difficulty.⁵²² The SROs have rules that allow the SRO to direct the intermediary to take specific corrective or prophylactic actions, such as reducing their business.⁵²³ The SEC may also petition the court to place a freeze on the broker-dealer’s assets.

The SEC and the SROs exercise this authority when needed. For example, Drexel Burnham Lambert Inc. was self-liquidated in 1990 after financial problems were found at the broker-dealer and its affiliates.

22.10

Does the capital framework address risks from outside the regulated entity, for example from unlicensed affiliates or from off-balance sheet risks?

The Net Capital Rule requires that a broker-dealer consolidate in a single computation, for purposes of calculating net capital and aggregate indebtedness, the assets and liabilities of any subsidiary or affiliate for which it guarantees, endorses, or assumes directly or indirectly the

⁵²⁰ 15 U.S.C. 78o(c)(3) and 17 CFR 240.15c3-1.

⁵²¹ 17 CFR 240.15c3-1(e)(2).

⁵²² See e.g., NYSE Rule 326(b) and NASD Rule 3130.

⁵²³ *Id.*

obligations or liabilities.⁵²⁴ Under certain circumstances a broker-dealer may be allowed to consolidate the assets and liabilities of any subsidiary or affiliate whose liabilities or obligations it does not guarantee, endorse, or assume. In addition, a broker-dealer must take a capital charge to the extent of any obligations it has assumed with respect to its affiliates.

In addition, Exchange Act Section 17(h) authorizes the SEC to prescribe recordkeeping and reporting requirements for registered broker-dealers, including municipal securities and government securities broker-dealers, concerning policies, procedures, or systems for monitoring and controlling financial and operational risks to the broker-dealer resulting from affiliate activities. These requirements must relate to associated persons of the broker-dealer whose “business activities are reasonably likely to have a material impact on the financial and operational condition” of the broker-dealer, including the broker-dealer’s “net capital, its liquidity, or its ability to finance its operations.” Further, the records must concern the broker-dealer’s “policies, procedures, or systems for monitoring and controlling financial and operational risks to it resulting from the activities” of its material associated persons and should “describe, in the aggregate, each of the financial and securities activities conducted by, and the customary sources of capital and funding” of associated persons whose business activities are reasonably likely to have a material impact on the broker-dealer.”

Accordingly, Rule 17h-1T sets forth the specific recordkeeping requirements applicable to broker-dealers and provides guidelines to be used in establishing which of the broker-dealer’s affiliates are “material” for purposes of the rules, *i.e.*, whose information is subject to these recordkeeping and reporting requirements. Material associated persons can be licensed or unlicensed. Included in these requirements are risk management policy information, financial data (including consolidating and consolidated financial statements, securities and other financial product position data), and financial instruments with off-balance sheet risk, among other things. Current Rule 17h-2T requires broker-dealers to file quarterly reports concerning these records on Form 17-H. The SEC’s Risk Assessment Program is an important source of information for the SEC staff when concerns arise regarding the financial condition of a broker-dealer, its holding company, or its affiliates.

Separately, in connection with broker-dealers that have been granted approval by the SEC to calculate net capital using model-based market risk and credit risk charges pursuant to Appendix E of the net capital rule (“alternative net capital,” or “ANC” broker-dealers), the SEC receives the consolidated and consolidating financial statements for the ANC broker-dealer’s ultimate holding company (UHC), the UHC’s most recent capital measurements computed in accordance with Basel standards, as reported to the UHC’s principal regulator; and certain regular risk reports provided to the persons responsible for managing group-wide risk as the SEC may request from time to time.

⁵²⁴

17 CFR 240.15c3-1c.

Market Intermediaries – Principle 23

Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.

Assessment

Fully Implemented.

23.1

Is an intermediary required to have:

- a) An appropriate management and organization structure?*
- b) Adequate internal controls?*
- c) Senior management that is required to bear primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the whole firm?*

Broker-Dealers

Pursuant to Exchange Act section 15(c)(3)(A), “No broker or dealer [...] shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security [...] in contravention of such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers including, but not limited to, the acceptance of custody and use of customers’ securities and the carrying and use of customers’ deposits and credit balances. Such rules and regulations shall [...] require the maintenance of reserves with respect to customers deposits or credit balances...”

Pursuant to Exchange Act section 17(a), “Every [...] registered broker or dealer [...] shall make and keep for prescribed periods such records, furnish copies thereof, and make and disseminate such reports as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors...”⁵²⁵

⁵²⁵ 15 U.S.C. 78q(a).

In accordance with these paragraphs, the SEC promulgated a number of rules including the Net Capital Rule, the Early Warning Rule, the Free Credit Balance Rule,⁵²⁶ the Customer Protection Rule,⁵²⁷ the Hypothecation Rules,⁵²⁸ the Books and Records Rules,⁵²⁹ the broker-dealer reporting requirements,⁵³⁰ and the Quarterly Count Rule.⁵³¹ Each of these rules is designed to assure a broker-dealer has appropriate controls in place to protect the interests of their clients and to properly manage risk.

The SEC's Net Capital Rule is discussed more fully above in response to Principle 22. The SEC's Early Warning Rule is discussed more fully above in response to Questions 22.6 and 22.8. The SEC's Free Credit Balance Rule restricts broker-dealers from using customers' free credit balances in the operation of the broker-dealer's business unless certain disclosures are made to the customer on an ongoing basis. The SEC's Customer Protection Rule requires that every broker-dealer obtain and maintain possession and control of customer securities,⁵³² and maintain a separate customer reserve account that contains (at least) the net dollar amount of cash the broker-dealer owes to its customers. The SEC's Hypothecation Rules require that a broker-dealer segregate customer securities from its own proprietary securities, and prohibit a broker-dealer from hypothecating customers' fully-paid securities. The SEC's Books and Records Rules require that a broker-dealer create and maintain certain books and records relating to its business. The broker-dealer reporting requirements require that a broker-dealer file certain financial information with the SEC every month or quarter (depending on the firm's business), file annual audited financial statements with the SEC, and send copies of the annual audited financial statement and a bi-annual unaudited financial statement to each customer. The SEC's Quarterly Count Rule requires that broker-dealers count positions owed to customers and securities on hand and reconcile those two numbers on a quarterly basis.

In addition, certain regulatory requirements (including the Net Capital and Reserve rules, as well as the Federal Reserve Board's Regulation T requirements) compel firms take certain risk-reducing steps. For instance, the Net Capital Rule requires that a firm subtract a "haircut" when calculating net capital to account for the market risk of their proprietary positions. Further, Regulation T serves to reduce a broker-dealer's exposure to credit risk by limiting the amount of margin it may extend to customers on securities. The Reserve Rule, in requiring that a broker-dealer promptly obtain customer securities, serves to decrease the firm's exposure to market risk.

⁵²⁶ 17 CFR 240.15c3-2.

⁵²⁷ 17 CFR 240.15c3-3.

⁵²⁸ 17 CFR 240.8c-1 and 15c2-1.

⁵²⁹ 17 CFR 240.17a-3 and 17a-4.

⁵³⁰ 17 CFR 240.17a-5.

⁵³¹ 17 CFR 240.17a-13.

⁵³² Customer securities must be specifically identified and held free and clear of any liens.

The SEC's Risk Assessment rules require that certain broker-dealers that hold customer assets maintain books and records regarding certain affiliated persons and entities. In addition, these rules require that those broker-dealers submit quarterly and annual reports concerning these affiliated persons and entities.

A broker-dealer is also required to have internal controls and procedures for safeguarding securities that are sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination in the accounting system, the internal accounting controls, and the procedures for safeguarding securities are included in the scope of the annual audit. Additionally, as specific objectives, a broker-dealer's annual audit shall include reviews of the practices and procedures followed by the broker-dealer: (i) in making the periodic computation of aggregate indebtedness and net capital under rule 17a-3(a)(11) and the reserve required by Rule 15c3-3(e); (ii) in making the quarterly securities examinations, counts, verifications, and comparisons and the recordation of differences required by Rule 17a-13; (iii) in complying with the requirement for prompt payment for securities of Section 4(c) of Regulation T of the Federal Reserve; and (iv) in obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by 17 CFR 240.15c3-3. Such review shall include a determination as to the adequacy of the procedures described in the records required to be maintained pursuant to 17 CFR 240.15c3-3(d)(4).⁵³³ Further, the reporting requirements require that the auditors include with the annual audited report a statement as to any material inadequacies found in the course of the audit.⁵³⁴

These financial responsibility and reporting rules set forth specific requirements with which a broker-dealer must comply. For instance, a broker-dealer is required to be in capital compliance at all times, and is required to reconcile all securities positions at least once daily. While these rules are fairly specific, the SEC allows broker-dealers flexibility as to how they will comply with those rules. So long as a broker-dealer's risk management procedures and internal controls facilitate a broker-dealer's compliance with the rules, they are considered to be adequate.

In addition, an OTC derivatives dealer is required to establish, document, and maintain a system of internal risk management controls to manage the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks.⁵³⁵ The internal risk control system must include certain elements, including a risk control unit that reports directly to senior management, periodic and annual reviews of the risk management system, and separation of duties for personnel responsible for entering into a transaction and personnel responsible for recording the transaction in the books and records.

Finally, pursuant to SRO rules, each broker-dealer must implement a supervisory system reasonably designed to achieve compliance with applicable securities laws, regulations and rules. The SROs generally specify that the supervisory system should include designation of one or

⁵³³ 17 CFR 240.17a-5(g).

⁵³⁴ 17 CFR 240.17a-5(j).

⁵³⁵ 17 CFR 240.15c3-4.

more persons responsible for reviewing the supervisory system implemented by the member and either take (or advise senior management to take) action to achieve the member's compliance with applicable securities laws and regulations and the SRO's rules or report to management regarding the efforts taken.

SROs also require broker-dealers to appoint a chief compliance officer. SRO rules further require chief executive officers to certify annually that the broker-dealer has in place policies and procedures to establish, review, and modify compliance procedures. The chief compliance officer must meet with the compliance officer at least once annually to discuss the compliance processes.

Investment Advisers

Although the Advisers Act does not contain any specific requirements regarding the management and organizational structure of investment advisers, an investment adviser is required to disclose information regarding its management and organizational structure on its Form ADV.

Regarding adequate internal controls, *see* response to Question 21.2(e).

See response to Question 21.2(e). Rule 206(4)-7(c) under the Advisers Act requires an investment adviser to designate a single CCO to administer the CP&P. In addition, all supervisors, including senior management, are subject to liability for failure to supervise. Section 203(e)(6) of the Advisers Act provides that a person shall not be deemed to have failed to supervise any person if: (i) the adviser had adopted procedures reasonably designed to prevent and detect violations of the federal securities laws; (ii) the adviser had a system in place for applying the procedures; and (iii) the person had reasonably discharged his supervisory responsibilities in accordance with the procedures and had no reason to believe the supervised person was not complying with the procedures.

23.2

Is an intermediary required to cause an independent, periodic evaluation of its internal controls and risk management processes to be performed? Where the firm elects an evaluation performed by an independent auditor, is that auditor required to report material breakdowns in controls to senior management and to the regulator?

Broker-Dealers

As stated above in response to Question 23.1, the SEC has promulgated certain rules designed to ensure that broker-dealers implement internal controls to manage risk. In addition, the Exchange Act requires that a broker-dealer have supervisory procedures in place and a system for applying such procedures. To the extent that segregation of duties and functions is necessary to comply with securities laws, regulations and rules, a broker-dealer's procedures and systems must provide for such segregation of duties and functions. Every broker-dealer is required to periodically inspect all aspects of its business, and must be audited annually by an independent

public accountant. In addition, broker-dealers are subject to regulatory examinations by the SEC, the SROs and by state inspectors.

Pursuant to Exchange Act Rule 17a-5(d),⁵³⁶ all broker-dealers must file an audited annual report with the SEC and with the broker-dealer's designated examining authority at least once each year. Exchange Act Rule 17a-5(d)(1)(i), requires that the report shall be audited by "an independent public accountant." Exchange Act Rule 17a-5(g) specifies that the audit objectives include a review of each broker-dealer's accounting system, internal accounting controls, procedures for safeguarding securities, and certain specified practices and procedures, and report any material inadequacies found in the course of that review. To the extent that a firm's management information systems were inadequate to fulfill the regulatory requirements, the independent public accountant performing the audit would have a duty to report that fact in its audit.⁵³⁷ The independent accountants generally present their findings to the firm's officers and audit committee (a group of corporate directors). In addition, the annual audit must be provided to the SEC and the firm's designated examining authority (and to certain state regulators that require that it be provided to them).

If during the course of the audit, the independent public accountant finds material inadequacies that exist in the accounting system, internal accounting control, or procedures for safeguarding securities, the independent public accountant must inform the chief financial officer who must notify the SEC and the designated examining authority within 24 hours. If the chief financial officer fails to notify the SEC and the designated examining authority within 24 hours or the independent public accountant disagrees with statements contained in the notice, the independent public accountant must inform the SEC and the designated examining authority of the material inadequacy within 24 hours thereafter.⁵³⁸

Further, OCIE and SROs examine broker-dealers periodically to assess compliance with securities laws, regulations and rules. OCIE may inspect a broker-dealer based on a routine or cycle or based upon some specific perceived risk. SROs generally inspect broker-dealer members periodically, depending on the types of business the broker-dealer engages in and the perceived relative risk of those types of business. For instance, SROs inspect broker-dealers that hold customer funds and securities once each year. Other broker-dealers are also subject to on-site examinations by SROs, however they may be examined less frequently.

During examinations of broker-dealers, the Staff may review a broker-dealer's operational risk management, including the firm's systems for trade capture, confirmation, valuation, reconciliation and risk monitoring reporting, and their relationship to the firm's general ledger, stock record and risk reporting systems. In addition, during examinations of broker-dealers, the Staff may review a broker-dealer's risk management procedures and systems, including whether broker-dealer's senior management is appropriately reviewing and monitoring risk controls at the

⁵³⁶ 17 CFR 240.17a-5(d).

⁵³⁷ 17 CFR 240.17a-5(j).

⁵³⁸ 17 CFR 240.17-5(h)(2).

firm, and that the firm has appropriately assessed operational risk and implemented risk control measures.

According to SRO rules, internal examinations of certain aspects of the firm's business must be performed at least once each year.⁵³⁹ Pursuant to SRO rules, information regarding internal inspections must be presented to senior management.⁵⁴⁰ The internal inspections may be reported to the firm's management, but are not required to be reported to outside agencies. However, the firm must be able to evidence to regulators that such internal inspection was performed.

The SEC, SROs, and state regulatory agencies are not required to report the results of examinations to any party, however they generally inform the broker-dealer itself of any examination deficiencies so the broker-dealer can amend its policies to avoid similar future deficiencies.

Investment Advisers

See responses to Questions 21.2(e) and 23.1(c). While an investment adviser's CCO is not independent of the investment adviser, the SEC has made clear that the CCO must have enough seniority and authority within the investment adviser's organization to conduct an independent compliance review and compel others to comply with the CP&P.⁵⁴¹

As discussed in response to Question 21.8(b), an adviser with custody of Client Assets who chooses to send account statements directly to its clients must have an independent public accountant verify all of those funds and securities by actual examination at least once during each calendar year at a time that is chosen by the accountant without prior notice or announcement to the adviser and that is irregular from year to year, and must file a certificate on Form ADV-E with the SEC within 30 days after the completion of the examination, stating that it has examined the funds and securities and describing the nature and extent of the examination.⁵⁴² If such independent public accountant finds any material discrepancies during the course of such examination, the accountant must notify the SEC within one business day of the finding.⁵⁴³ An investment adviser otherwise is not required to engage an independent auditor

⁵³⁹ *See e.g.*, NASD Rule 3010(c). The SROs have many rules relating to the internal organization and operational conduct of broker-dealers. These rules are referenced throughout this principle. We also note that the NASD and NYSE have merged into FINRA and are in the process of combining their rules into one rulebook. Until the completion of the rulebook consolidation process, the FINRA rulebook includes NASD Rules and Incorporated NYSE Rules in addition to the new consolidated FINRA Rules. NASD, NYSE, and FINRA Rules are referenced throughout this document.

⁵⁴⁰ *See e.g.*, NYSE Rule 342.30.

⁵⁴¹ SEC Release No. IA-2204 (December 17, 2003).

⁵⁴² Advisers Act Rule 206(4)-2(a)(3)(ii)(B).

⁵⁴³ Advisers Act Rule 206(4)-2(a)(3)(ii)(C).

who is required to report material breakdowns in controls to senior management and to the regulator.

23.3

Is the intermediary required to provide for an efficient and effective mechanism for the resolution of investor complaints?

Broker-Dealers

Generally broker-dealer customer agreements require that members arbitrate disputes through SRO forums. All disputes related to a firm's securities activities are a proper subject for arbitration if they arise from activities within six years. The rules of the SROs require SRO members to arbitrate any eligible dispute submitted by a customer. Customers are not, however, required by SRO rules to arbitrate these disputes. Rather, customers generally agree to arbitrate these disputes in the contracts they sign when they open brokerage accounts.⁵⁴⁴

The SEC's oversight of the securities arbitration process is directed at ensuring that the process is fair and efficient. In this regard, the SEC oversees the arbitration programs of the SROs, including FINRA, through inspections of the SRO facilities and the review of SRO arbitration rules. The Staff conducts inspections to identify areas where procedures should be strengthened and to encourage remedial steps either through changes in administration or through the development of rule changes. The Staff also evaluates whether the SROs are following and enforcing applicable rules.

Investment Advisers

An investment adviser is not required to provide a particular mechanism for the resolution of investor complaints. As discussed below, an investment adviser, however, is a fiduciary and must act with utmost good faith with respect to its clients and must act in the interests of its clients. An investment adviser's client may sue the investment adviser under state law (and, under certain circumstances, federal law) for failure to meet any obligation of the investment advisory contract between the investment adviser and the client. In addition, Section 215 of the Advisers Act provides an investment adviser's client with a limited private right of action for violations of the Advisers Act.⁵⁴⁵ In particular, a client may sue to void its advisory contract and for restitution. Although the Advisers Act does not provide a broad private right of action in the event that an adviser violates its provisions, other provisions of the U.S. federal securities laws do provide for private rights of action (*e.g.*, Rule 10b-5 provides a private right of action when there is fraud in connection with the sale of a security).

⁵⁴⁴ In 1987, the Supreme Court decided *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 222 (1987), which determined that customers who sign predispute arbitration agreements with their brokers may be compelled to arbitrate claims arising under the Securities Exchange Act of 1934.

⁵⁴⁵ See *Transamerica Mortgage Advisors, Inc. et al. v. Harry Lewis*, 444 U.S. 11 (1979).

23.4

If an intermediary has control of, or is otherwise responsible for, assets belonging to a customer which it is required to safeguard, are there regulations that require proper protection for them (for example, segregation and identification of those assets) by the intermediary? Do these measures facilitate the transfer of positions; assist in the orderly winding up in the event of financial insolvency and otherwise provide protection from misuse by the intermediary?

As indicated previously in response to Question 23.1, Exchange Act section 15(c)(3)(A) requires that the SEC promulgate rules imposing financial responsibility requirements on broker-dealers. In accordance with this requirement, the SEC promulgated a number of rules to protect customer assets including the Free Credit Balance Rule,⁵⁴⁶ the Customer Protection Rule,⁵⁴⁷ the Hypothecation Rules,⁵⁴⁸ and the Quarterly Count Rule.⁵⁴⁹

The SEC's Free Credit Balance Rule restricts broker-dealers from using customer's free credit balances in the operation of the broker-dealer's business unless certain disclosures are made to the customer on an ongoing basis. The SEC's Customer Protection Rule requires that every broker-dealer obtain and maintain possession and control of customer securities,⁵⁵⁰ and maintain a separate customer reserve account that contains (at least) the net dollar amount of cash the broker-dealer owes to its customers. The SEC's Hypothecation Rules require that a broker-dealer segregate customer securities from its own proprietary securities, and prohibit a broker-dealer from hypothecating customers' fully-paid securities. The SEC's Quarterly Count Rule requires that broker-dealers count positions owed to customers and securities on hand and reconcile those two numbers on a quarterly basis.

Rule 17a-3(a)(3) requires that each broker-dealer maintain ledger accounts, that itemize separately as to each customer account, all purchases, sales, receipts and deliveries of securities and commodities, and all other debits and credits to the account.

In addition, the SROs have rules that restrict a broker-dealer's use of customer securities.⁵⁵¹ Finally, SIPA⁵⁵² assures that, in the case of a liquidation, customer assets are promptly returned to customers. Pursuant to SIPA, a SIPC trustee is appointed to administer the liquidation of a

⁵⁴⁶ 17 CFR 240.15c3-2.

⁵⁴⁷ 17 CFR 240.15c3-3.

⁵⁴⁸ 17 CFR 240.8c-1 and 15c2-1.

⁵⁴⁹ 17 CFR 240.17a-13.

⁵⁵⁰ Customer securities must be specifically identified and held free and clear of any liens.

⁵⁵¹ See e.g., NYSE Rule 402 and NASD Rule 2330.

⁵⁵² 15 U.S.C. 78aaa *et seq.*

broker-dealer that owes cash or securities to customers. In addition, to the extent that the liquidated broker-dealer no longer has certain customer assets, SIPC will make up for that shortfall (up to \$500,000 per customer, \$100,000 of which may be cash) using assessments it has obtained from its broker-dealer members.

For investment advisers, *see* response to Question 21.8(b)

23.5

Is an intermediary required to obtain and retain basic information from a customer about concerns and issues involving investment objectives relevant to the service to be provided?

Broker-Dealers

Broker-dealers must obtain certain information regarding customers that open accounts, including the customer's employment status, net worth, annual income, and investment objectives.⁵⁵³ Firms are required to update this customer account record information at least once every three years.⁵⁵⁴ In addition, pursuant to Exchange Act Rule 17a-3(a)(9), a broker-dealer must obtain a record in respect of each cash and margin account with such member, broker or dealer indicating the name and address of the beneficial owner of the account.⁵⁵⁵ Furthermore, broker-dealers generally have an obligation to recommend only those specific investments or overall investment strategies that are suitable for their customers. The concept of suitability appears in specific SRO rules and has been interpreted by the courts as an obligation under the antifraud provisions of the federal securities laws.

The SROs have implemented rules to require that broker-dealer members obtain information from their clients upon establishing the relationship or opening an account.⁵⁵⁶ NASD Rule 3110(c)(2), and NYSE Rules 405 and 721.10 specifically delineate certain additional information that must be obtained from the customer, including information regarding the customer's financial circumstances and investment objectives.

Investment Advisers

Investment advisers under the Advisers Act owe their clients the duty to provide only suitable investment advice. To fulfill this suitability obligation, an investment adviser must make a

⁵⁵³ 17 CFR 240.17a-3(a)(17).

⁵⁵⁴ Exchange Act Release No. 44992 (November 2, 2001).

⁵⁵⁵ 17 CFR 240.17a-3(a)(9).

⁵⁵⁶ *See e.g.*, NYSE Rule 405, NASD Rule 3110, and FINRA Rule 2360.

reasonable determination that the investment advice provided is suitable for the client based on the client's financial situation and investment objectives.⁵⁵⁷

23.6

Is an intermediary required to “know its customer” before providing specific advice to a customer?

Broker-Dealers

Broker-dealers generally have an obligation to recommend only those specific investments or overall investment strategies that are suitable for their customers. The concept of suitability appears in specific SRO rules and has been interpreted by the courts as an obligation under the antifraud provisions of the federal securities laws. In addition, Exchange Act Rule 17a-3(a)(17) requires broker-dealers to obtain basic information about customers that open accounts including name, address, taxpayer identification number, employment status, net worth, annual income, and investment objectives.

NASD Rule 3110(c)(2), and NYSE Rules 405 and 721.10 specifically delineate certain additional information that must be obtained from the customer, including information regarding the customer's financial circumstances and investment objectives.

Investment Advisers

In order for an investment adviser to provide to its clients investment advice that is suitable to the client, the investment adviser would need to know the financial circumstances and investment objectives of the client. An investment adviser and its client, however, usually negotiate the terms of their relationship. The client therefore may choose only to disclose information that the client feels is appropriate, and may, for instance, withhold information regarding its financial circumstances.⁵⁵⁸

⁵⁵⁷ See *Status of Investment Advisory Programs under the Investment Company Act of 1940*, Investment Company Act Rel. No. 22579 (Mar. 24, 1997) (in the context of adopting a final rule providing for a nonexclusive safe harbor from the definition of investment company for certain investment advisory programs).

⁵⁵⁸ In addition, anti-money laundering regulation in the U.S. has resulted in another form of “know your customer” requirements. The Patriot Act amended the Bank Secrecy Act to require that the Treasury, along with the SEC and other federal regulators, adopt regulations setting forth minimum standards for financial institutions with regard to the identification and verification of customers in connection with the opening of accounts. Broker-dealers and certain CIS are required to implement customer identification programs. Investment advisers currently are not included in the definition of “financial institution,” but the FinCEN, a bureau within Treasury, has indicated publicly that it is considering whether and to what extent it should impose requirements under the Bank Secrecy Act, including customer identification programs, on investment advisers. See FR Doc. E8-26205 (Oct. 29, 2008).

23.7

Can a customer obtain an agreement or contract or a written form of the general and specific business conditions that sets forth the terms on which the customer will be dealing?

Broker-Dealers

Written contracts are only required for certain types of accounts (e.g., margin accounts,⁵⁵⁹ options accounts⁵⁶⁰ and discretionary accounts⁵⁶¹). However, many firms have a customer sign a customer agreement despite the fact that they are not required to do so to help ensure that they are able to enforce certain contractual provisions against the customer: for instance, to enforce arbitration clauses.

With relation to margin accounts, Rule 15c2-1 simply requires that the firm obtain the written consent of the customer to hypothecate securities in that account and to commingle that customer's securities with the securities of any other customer through that hypothecation. SRO rules require that a customer opening an options account agree in writing that the account shall be handled in accordance with the Rules of the exchange and the rules of the options clearing corporations and that the customer will not violate position and exercise limits set forth in the FINRA Rules.⁵⁶²

With relation to discretionary accounts, FINRA rules require that a broker-dealer obtain the prior written consent of the customer before exercising any discretionary authority over the account. Further, broker-dealers must obtain a written acknowledgement from the customer, prior to executing any penny stock transactions for the customer, that the customer has received the required penny stock disclosure document.

Investment Advisers

The investment advisory contract forms the basis for the relationship between the investment adviser and its clients. Section 205 of the Advisers Act and the rules thereunder contain a number of provisions relating to items required to be or prohibited from being included in an investment advisory contract.

⁵⁵⁹ 17 CFR 240.15c2-1(a)(1) and 17a-3(a)(9)(iii).

⁵⁶⁰ *See e.g.*, FINRA Rule 2360.

⁵⁶¹ NYSE Rules 408 and 724, and NASD Rules 2510(b). 17 CFR 240.17a-3(a)(17)(ii).

⁵⁶² *See e.g.*, FINRA Rule 2360.

23.8

Is an intermediary required to provide general or specific disclosures to customers of information needed to make a balanced and informed investment decision?

Broker-Dealers

Penny Stock Disclosures: Prior to effecting transactions in penny stocks for a customer, a firm must provide customer a standardized disclosure document about the risks associated with penny stocks and obtain from the customer a manually signed and dated written acknowledgement of receipt of the document. The text of the disclosure document is set forth in Schedule 15G. Penny stocks are low priced shares of small companies not traded on U.S. exchanges or NASDAQ.

Disclosure of Credit Terms in Margin Transactions: Prior to extending credit to a customer a broker-dealer generally must provide a written statement to the customer describing the terms of the credit arrangement.⁵⁶³ In addition, the broker-dealer must provide the customer with quarterly account statements.

Day Trading Risk Disclosure Statement: NASD Rule 2361, which applies to firms that are promoting a day-trading strategy, and to new accounts opened by all non-institutional customers at those firms, requires such firms to deliver a risk disclosure statement, discussing the unique risks posed by day trading, to all non-institutional customers before opening an account for such customers.

The rule mandates that the disclosure statement include several factors that a customer is advised to consider before engaging in day trading, including that

- the customer may lose all of the funds that he or she uses for day trading;
- day trading usually requires significant resources; and
- day trading on margin or short selling may result in losses beyond the customer's initial investment.

Additionally, the disclosure statement would include a provision stating that day trading is inappropriate for persons of limited resources and limited investment or trading experience, as well as inadvisable for customers with low risk tolerance.

Firms are permitted to develop an alternative risk disclosure statement, provided such statement is substantially similar to the statement mandated by the rule, and is filed with and approved by FINRA's Advertising/Investment Companies Regulation Department.

Options Disclosure Document and Options Clearing Corporation Prospectus: Under SRO rules, a firm must deliver to its customer the current Options Disclosure Document at or prior to

⁵⁶³ Exchange Act Rule 10b-16.

the time a customer's account is approved for options trading.⁵⁶⁴ The firm also must deliver to each customer who was previously furnished the Options Disclosure Document a copy of any amendment to the Options Disclosure Document no later than the time of the delivery to the customer of a trade confirmation in the category of options to which the amendment pertains. In addition, a firm must deliver a current prospectus of the Options Clearing Corporation to each customer who requests one.

Security Futures Risk Disclosure Statement: Under SRO rules, a firm must deliver to its customer the current Security Futures Risk Disclosure Statement at or prior to the time a customer's account is approved for trading security futures.⁵⁶⁵ The firm also must deliver each new or revised security futures risk disclosure statement to every customer having an account approved for such trading or, in the alternative, no later than the time a trade confirmation is delivered to each customer that enters into a security futures transaction.

Prospectus Delivery: If a broker-dealer is participating in a distribution that is registered under the Securities Act of 1933, the broker-dealer must: 1) deliver a preliminary prospectus to purchasers 48 hours prior to sending a confirmation if the issuer has not previously filed certain periodic financial condition reports;⁵⁶⁶ 2) take reasonable steps to provide a preliminary prospectus to any person who requests one in writing between filing and effectiveness; 3) take reasonable steps to provide a final prospectus to any person who requests in writing during the period between effectiveness and the completion of distribution; and 4) make available copies of the preliminary & final prospectus during similar periods to its associates who may be selling the offering. In addition, if the broker-dealer is the managing underwriter for the offering, SEC rules impose heightened obligations to help ensure that all broker-dealers participating in the distribution get sufficient copies of the preliminary & final prospectus on a timely basis so that they can meet their delivery requirements.

Disclosure of control of issuer: Broker-dealers controlling, controlled by, or under common control with, an issuer of a security must disclose such control in writing to customers for whom it effects transactions in such security. This disclosure must take place at or before the completion of the applicable transaction.

Disclosure of interest: Broker-dealers participating in the distribution of, or otherwise financially interested in, the distribution of a security must disclose such participation or interest in writing to customers for whom it effects transactions in such security. This disclosure must take place at or before the completion of such transaction.

The disclosure requirements are designed to help investors obtain information material to their investment decision.

⁵⁶⁴ FINRA Rule 2360.

⁵⁶⁵ FINRA Rule 2370.

⁵⁶⁶ See 17 C.F.R. 240.13a-1 *et seq.* and 17 C.F.R. 15d-1 *et seq.*

Investment Advisers

For purposes of responding to this question, SEC staff distinguishes documents that the federal securities laws require to be delivered to investors, such as the annual reports of issuers, the confirmation of the purchase or sale of a security (“required documents”), and those documents that are not required to be delivered, such as CIS sales material or advertisements (“non-required documents”). Except as noted below, the federal securities laws generally do not specifically require registered investment advisers to provide their clients with required documents and non-required documents.⁵⁶⁷ Rather, those delivery requirements would apply to the extent that an investment adviser is also a registered broker-dealer or a bank.

In addition to any information that the adviser is required to provide to clients under applicable law and regulations, an investment adviser’s duty to provide required and non-required documents to its clients generally will depend upon the investment adviser’s contractual relationship with each client (*i.e.*, the investment adviser’s duties as described in the advisory contract).⁵⁶⁸ For instance, if an advisory client maintains a discretionary account with an adviser (*i.e.*, the investment adviser is authorized to make investment decisions for the client without consulting with the client), the advisory contract typically designates the adviser to receive all required documents that are provided by the issuers of the securities that the client holds in the discretionary account. In contrast, if the client has a non-discretionary account with the investment adviser, and the client’s assets are held with a broker-dealer in the name of the client, the advisory contract typically designates the client to receive all required documents. Whether an investment adviser has an obligation to provide non-required documents similarly depends on the terms of the contract between the investment adviser and the client.

Rule 204-3 under the Advisers Act requires investment advisers to provide certain written disclosures to prospective and existing clients (a “brochure”). The brochure is designed to ensure that existing and prospective clients receive certain basic information about the background and business practices of the investment adviser, such as the types of advisory services provided, the methods of securities analysis used, fee structure, and the education and business background of the adviser and certain associated persons. For more information please see response to Question 21.2, (describing certain disclosure requirements of Part 1A of Form ADV and describing the content of Part 2 of Form ADV, which comprises the information required in a brochure), Question 21.8(b) (describing the obligations of an investment adviser that has custody of client assets) and Question 24.2 (describing the circumstances in which an investment adviser must disclose its financial condition).

⁵⁶⁷ See, *e.g.*, Section 4 of the Securities Act (governing prospectus delivery obligations of issuers, underwriters and dealers), Rule 14b-1 under the Exchange Act (obligations of registered broker-dealers in connection with the prompt forwarding of certain proxy communications to beneficial owners of securities).

⁵⁶⁸ An investment adviser’s fiduciary duty, which requires it to disclose certain information, is discussed above in response to Question 21-8(c)(ii)(6).

Please note that the advisory contract may require the investment adviser to provide the client with additional information. The investment advisory contract also dictates the types of information that must be provided to the client by the adviser.

23.9

Is an intermediary required to provide a customer with a full and fair statement of account (and information regarding remuneration received by the intermediary for services provided to the customer)?

Broker-Dealers

A broker-dealer is generally required to send its customers written trade confirmations,⁵⁶⁹ account statements,⁵⁷⁰ and other reports disclosing activities and transactions it has taken on the customer's behalf. These confirmations and statements serve a basic investor protection function by conveying information that: (1) allows customers to verify the terms of their transactions; (2) would alert customers to potential conflicts of interest; (3) acts as a safeguard against fraud; and (4) allows customers a means of evaluating the costs of their transactions and the quality of the broker-dealer's execution and order-handling.

In particular, Exchange Act Rule 10b-10 requires the disclosure of , among other things, the date, time, identity, and number of securities bought or sold; the capacity of the broker-dealer (*e.g.* agent or principal); yields on debt securities; and under specified circumstances, the amount of compensation the broker-dealer will receive from the customer and any other parties.

In addition, Exchange Act Rule 15c3-3 requires that a broker-dealer inform a customer that transacts in or holds security futures products as to whether the customer's security futures product assets will be held in a securities account or in a futures account and what protections apply to that account.

Pursuant to Exchange Act Rule 15c3-2, a broker-dealer holding customer funds must provide each customer with a statement of account, at least once each quarter, reflecting the credit balance in the customer's account.

In addition, SRO Rules require that a broker-dealer send each customer an account statement at least quarterly.⁵⁷¹ However, SRO rules also require that if a customer holds or transacts in options in an account, the account statement for that account should be sent monthly.⁵⁷²

⁵⁶⁹ 17 CFR 240.10b-10.

⁵⁷⁰ 17 CFR 240.15c3-2, and NASD Rules 2340 and 2860(b)(15) and NYSE Rules 409 and 730.

⁵⁷¹ *See e.g.*, NASD Rule 2340 and NYSE Rule 409.

⁵⁷² *See e.g.*, FINRA Rule 2360.

Investment Advisers

The Advisers Act generally does not require an investment adviser to send account statements to its clients. An investment adviser may use a broker-dealer to effect trades and the broker-dealer would be responsible for generating such documents. However, many investment advisers do send monthly or quarterly account statements to their clients.

Rule 206(4)-2 under the Advisers Act requires an investment adviser that has custody of client assets to send each client, not less frequently than once every three months, an itemized statement showing the client's funds and securities in the adviser's custody or possession at the end of such period, and all debits, credits, and transactions in such client's account during such period. For more information about Rule 206(4)-2, *see* response to Question 21.8(b).

Investment advisers that are also registered broker-dealers are required under the Exchange Act to provide their customers with account statements.

23.10

Is the intermediary required to have a person or group of persons responsible for monitoring its compliance with legal and regulatory requirements as well as with its internal policies and procedures?

Broker-Dealers

As stated above in response to Questions 23.1 and 23.2, the SEC has promulgated certain rules designed to ensure that broker-dealers implement internal controls to manage risk. Included among these rules is the requirement that an independent public accountant perform a yearly review of each broker-dealer's accounting system, internal accounting controls, procedures for safeguarding securities, and certain specified practices and procedures, and report any material inadequacies found in the course of that review. To the extent that a firm's risk identification and management were found to be inadequate, the independent public accountant performing the audit would have a duty to report that fact in its audit.

Furthermore, broker-dealers and their supervisory personnel have an obligation under the Exchange Act reasonably to supervise persons subject to their supervision with a view to preventing violations of the securities laws. Thus, broker-dealers may be found liable for failing to supervise their associated persons who make unsuitable recommendations. Ultimately, the test is whether the supervision was reasonable under the circumstances.

In addition, the SROs require that a broker-dealer conduct periodic internal inspections.⁵⁷³ Staff and the SROs conduct periodic examinations of broker-dealers as well. For instance, SROs inspect broker-dealers that hold customer funds and securities once each year. Other broker-dealers are also subject to on-site examinations by SROs, however they may be examined less

⁵⁷³ *See e.g.*, NYSE Rule 342(b)(2) and NASD Rule 3010(c).

frequently. For additional information regarding the SEC's broker-dealer examination program, *see* the responses to Questions 8.1, 10.1, and 10.3.

Pursuant to SRO rules, each broker-dealer must implement a supervisory system reasonably designed to achieve compliance with applicable securities laws, regulations and rules.⁵⁷⁴ The SROs generally specify that the supervisory system should include designation of one or more persons responsible for reviewing the supervisory system implemented by the member and either take (or advise senior management to take) action to achieve the member's compliance with applicable securities laws and regulations and the SRO's rules or report to management regarding the efforts taken.⁵⁷⁵

Finally, an OTC derivatives dealer is required to establish, document, and maintain a system of internal risk management controls to manage the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks.⁵⁷⁶ The internal risk control system must include certain elements, including a risk control unit that reports directly to senior management, periodic and annual reviews of the risk management system, and separation of duties for personnel responsible for entering into a transaction and personnel responsible for recording the transaction in the books and records.

Investment Advisers

See response to Question 21.1(e). Rule 206(4)-7(c) under the Advisers Act requires an investment adviser to designate a CCO for these purposes. *See also* response to Question 23.1 regarding responsibilities of senior management.

23.11

Is an intermediary required to create and maintain adequate and reliable books and records, including accounting records? Is the intermediary required to maintain those books and records in a way that allows full supervision by the regulator?

Broker-Dealers

As stated previously in response to Question 23.1, Exchange Act section 17(a) states, "Every [...] registered broker or dealer [...] shall make and keep for prescribed periods such records, furnish copies thereof, and make and disseminate such reports as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors...." In accordance with this paragraph, the SEC promulgated a number of rules including the Books and Records Rules.⁵⁷⁷ Exchange Act Rule 17a-5, the SEC's broker-dealer reporting

⁵⁷⁴ *See e.g.*, NYSE Rule 342 and NASD Rule 3010(b).

⁵⁷⁵ *See e.g.*, NYSE Rule 342.30 and NASD Rule 3010(a)(8).

⁵⁷⁶ 17 CFR 240.15c3-4.

⁵⁷⁷ 17 CFR 240.17a-3 and 17a-4.

requirements,⁵⁷⁸ requires that each broker-dealer submit financial statements audited by an independent accountant at least once each year.⁵⁷⁹ In addition, Exchange Act Rule 17a-3 requires that each firm create blotters and ledgers that accurately reflect the financial position of the firm,⁵⁸⁰ create a trial balance and calculate its net capital at least once each month,⁵⁸¹ create a memorandum of each brokerage order, or any other instruction, for the purchase or sale of securities,⁵⁸² make copies of confirmation of all purchases and sales of securities,⁵⁸³ create an account record that includes information such as the customer's name, address, taxpayer identification number, net worth, and employment status,⁵⁸⁴ and make records of customer complaints.⁵⁸⁵

Broker-dealers are required to maintain these books and records for specific periods of time and to produce such records promptly to SEC examiners under Exchange Act Rule 17a-4. For an additional discussion on the books and records rules *see* Questions 8.4 and 8.5.

Investment Advisers

The Advisers Act imposes extensive recordkeeping requirements on registered investment advisers. Generally, Rule 204-2 under the Advisers Act requires an adviser to maintain business accounting records as well as records that relate to the fiduciary nature of its business. For example, advisers must maintain, among other things, the following:

- General and auxiliary ledgers reflecting asset, liability, reserve, capital, income and expense accounts;
- A memorandum of any order given and instructions received by the adviser from clients for the purchase, sale, delivery or receipt of securities (including terms and conditions of any order, who recommended and placed the order, the account and date of entry and who executed the order);
- Trial balances, financial statements, any internal audit papers relating to adviser's business;

⁵⁷⁸ 17 CFR 240.17a-5.

⁵⁷⁹ 17 CFR 240.17a-5(d).

⁵⁸⁰ 17 CFR 240.17a-3(a)(1) through (5).

⁵⁸¹ 17 CFR 240.17a-3(a)(11).

⁵⁸² 17 CFR 240.17a-3(a)(6).

⁵⁸³ 17 CFR 240.17a-3(a)(8).

⁵⁸⁴ 17 CFR 240.17a-3(a)(17).

⁵⁸⁵ 17 CFR 240.17a-3(a)(18).

- Original or copies of certain communications sent to or received by the adviser (including responses to requests for detailed investment advice, placement or execution of securities orders, receipt or delivery of securities or funds);
- A list of and documents relating to the adviser's discretionary client accounts (including powers of attorney or grants of authority);
- Copies of publications and recommendations the adviser distributed to 10 or more persons and a record of the factual basis and reasons for the recommendation;
- A record of certain securities transactions in which the adviser or advisory representatives have a direct or indirect beneficial ownership interest.

Additional records must be maintained in certain circumstances (*e.g.*, if an investment adviser has custody of client assets). Generally, all required books and records must be maintained and preserved in an adviser's office for two years after the last entry date and three additional years in an easily accessible place. Records may be stored on computer, magnetic disk or tape, subject to certain conditions ensuring safekeeping and accessibility.

Section 204 of the Advisers Act provides that all records of an investment adviser are subject at any time, or from time to time, to such reasonable periodic, special, or other examinations by representatives of the SEC as the SEC deems necessary or appropriate in the public interest or for the protection of investors. In addition, Rule 204-2 requires an investment adviser to maintain and preserve all books and records in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such year, the first two years in an appropriate office of the investment adviser. Accordingly, there are no restrictions on the ability of the SEC to request a review of an investment adviser's books and records.

23.12

Is the intermediary required to establish and maintain appropriate systems of customer protection, risk management and internal and operational controls, including policies, procedures, and controls relating to all aspects of its business intended reasonably to ensure:

- a) An effective exchange of information between the firm and its clients, including required disclosures of information to clients?***
- b) The integrity of the firm's dealing practices, including the treatment of all clients in a fair, honest and professional manner?***
- c) The safeguarding of both the firm's and its clients' assets against unauthorized use or disposition?***
- d) The maintenance of proper accounting and other applicable records and the reliability of the information?***
- e) Compliance with all relevant legal and regulatory requirements?***

- f) Appropriate segregation of key duties and functions, particularly those duties and functions which, when performed by the same individual, may result in undetected errors or may be susceptible to abuses which expose the firm or its clients in inappropriate risks?*

Broker-Dealers

The SEC has articulated a broker-dealer duty of fair dealing towards its customers that is derived from the anti-fraud provisions of the federal securities laws. Under the so-called “shingle” theory, by virtue of engaging in the brokerage profession, a broker-dealer impliedly represents to those persons with whom it transacts business that it will deal fairly with them, consistent with the standards of the profession. This essential representation implies certain duties that have been articulated by the SEC over time through enforcement actions and interpretive statements, and include the obligation to: execute orders promptly, disclose material information, charge prices reasonably related to the prevailing market, and fully disclose any conflicts of interest.

Many of the SEC rules pertaining to customer protection are derived from the anti-fraud provision of the federal securities laws (e.g., §§10(b) and 15(c) of the Exchange Act). In interpreting the anti-fraud provisions, the SEC has sought not only to prevent fraudulent activity by broker-dealers, but also to promote informed decision-making by customers. For example, Rule 10b-10 requires broker-dealers, at or before completion of a transaction, to give or send to the customer written notification providing information with respect to a customer’s securities transaction. The required information includes disclosure of the date, time identity, price, number of shares involved, and the broker-dealer’s capacity and compensation. Rule 10b-16 prohibits a broker-dealer from extending credit to a customer in connection with a securities transaction, unless the broker-dealer has established procedures aimed at disclosing information to the customer, in writing, regarding the terms of interest charges to the account.

On the federal level, broker-dealers and other financial institutions are subject to the financial privacy provisions of Subtitle A of Title V the Gramm-Leach-Bliley Act (GLBA) and the SEC’s implementing Regulation S-P. Under Regulation S-P, broker-dealers must have written policies and procedures relating to administrative, technical, and physical safeguards for customers’ nonpublic personal information. These policies and procedures must be in writing, and they must be designed to insure the security and confidentiality of customer records and information, protect against any anticipated threats or hazards to the security or integrity of those records, and protect those records and information against unauthorized access or use that could result in substantial harm or inconvenience to any customer.

The GLBA and Regulation S-P require brokers-dealers to provide notice of their privacy policies and practices to their customers at the start of the customer relationship and not less than annually thereafter. Broker-dealers also must provide a privacy notice and reasonable opportunity to opt out to consumers with whom they do not have an ongoing relationship before disclosing nonpublic personal information about them to nonaffiliated third parties. Regulation S-P provides a number of exceptions from its notice and opt out requirements. These include exceptions for disclosures of nonpublic personal information to other financial institutions under joint marketing agreements and with certain service providers, disclosures made for everyday

business purposes, such as maintaining or servicing accounts, disclosures made with the consent or at the direction of a consumer, disclosures for particular purposes such as protecting against fraud, disclosures to consumer reporting agencies, and disclosures to law enforcement agencies.

In general, a privacy notice must describe an institution's policies and practices with respect to disclosing nonpublic personal information to affiliates and nonaffiliated third parties. It also must provide a consumer a reasonable opportunity to opt out of certain types of disclosures to nonaffiliated third parties. A privacy notice also must provide, where applicable under the FCRA, a notice and an opportunity for a consumer to opt out of disclosures of certain information to affiliates. In addition, Regulation S-P includes restrictions on the use and disclosure of nonpublic personal information received from another financial institution, and it prohibits the disclosure of unencrypted account numbers for direct marketing purposes.

On the state level, broker-dealers are subject to financial privacy requirements that may be more protective than those provided by the GLBA and Regulation S-P. For example, approximately 40 states have laws that require broker-dealers to notify individuals affected by information security breaches, and California and Vermont have adopted "opt-in" regimes under which personal information about a consumer generally may not be disclosed to a nonaffiliated third party without the consumer's affirmative consent. State criminal laws, and civil causes of action under common law and state statutory provisions, provide additional privacy protections.

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

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

Additionally, the SROs have several key rules relating to suitability, excessive trading, fees, and mark-ups. In general, the FINRA requires the observance of high standards of commercial honor and just and equitable principles of trade.⁵⁸⁶ The suitability rules generally require broker-

⁵⁸⁶ See FINRA Rule 2010.

dealers to evaluate the financial circumstances and needs of their customers and to make a determination that any security recommended to a customer is “suitable” for that customer in light of the customer’s financial circumstances and investment intent.⁵⁸⁷ Where a broker-dealer engages in excessive trading to generate commissions, he also may be liable under the anti-fraud provisions of the federal securities laws for “churning.” The FINRA reviews all offerings to determine whether the “underwriting or other terms or arrangements in connection with or relating to the distribution of the securities, or the terms or conditions relating thereto, are unfair or unreasonable.”⁵⁸⁸ Finally, the FINRA also has a mark-up rule providing a guideline as to the reasonableness of the difference between the amount charged to the customer and the prevailing market price for the security.⁵⁸⁹

Pursuant to SRO rules, each broker-dealer must implement a supervisory system reasonably designed to achieve compliance with applicable securities laws, regulations and rules.⁵⁹⁰ The SROs generally specify that the supervisory system should include designation of one or more persons responsible for reviewing the supervisory system implemented by the member and either take (or advise senior management to take) action to achieve the member’s compliance with applicable securities laws and regulations and the SRO’s rules or report to management regarding the efforts taken.⁵⁹¹

Furthermore, as indicated previously in response to Questions 23.1 and 23.2, the SEC has promulgated a number of rules to safeguard customer assets including the Free Credit Balance Rule,⁵⁹² the Customer Protection Rule,⁵⁹³ the Hypothecation Rules,⁵⁹⁴ and the Quarterly Count Rule.⁵⁹⁵

Rule 17a-3(a)(3) requires that each broker-dealer maintain ledger accounts, that itemize separately as to each customer account, all purchases, sales, receipts and deliveries of securities and commodities, and all other debits and credits to the account. In addition, the SROs have rules that restrict a broker-dealer’s use of customer securities.⁵⁹⁶

⁵⁸⁷ See e.g., NASD Rule 2310, NYSE Rule 405.

⁵⁸⁸ NASD Rule 2440.

⁵⁸⁹ See NASD Rule IM-2440.

⁵⁹⁰ See e.g., NYSE Rule 342.30 and NASD Rule 3010(a)(8).

⁵⁹¹ See e.g., NYSE Rule 342.30 and NASD Rule 3010(a)(8).

⁵⁹² 17 CFR 240.15c3-2.

⁵⁹³ 17 CFR 240.15c3-3.

⁵⁹⁴ 17 CFR 240.8c-1 and 15c2-1.

⁵⁹⁵ 17 CFR 240.17a-13.

⁵⁹⁶ See e.g., NYSE Rule 402 and NASD Rule 2330.

Finally, the SIPA⁵⁹⁷ is designed to assure that, in the case of a liquidation, customer assets are promptly returned to customers. Pursuant to SIPA, a SIPC trustee is appointed to administer the liquidation of a broker-dealer that owes cash or securities to customers. In addition, to the extent that the liquidated broker-dealer no longer has certain customer assets, SIPC will make up for that shortfall (up to \$500,000 per customer, \$100,000 of which may be cash) using assessments it has obtained from its broker-dealer members.

See also the responses to Questions 23.1-23.11.

Investment Advisers

See responses to Questions 21.2(e), 21.8(b), 21.8(c)(ii), 23.8, and 23.11.

Additionally, Section 206 of the Advisers Act imposes a fiduciary duty on an investment adviser to act in the utmost good faith with respect to its clients. An investment adviser is required to treat all clients fairly where conflicts of interest arise between several of the firm's clients.

Also, Section 204A of the Advisers Act requires an investment adviser to establish, maintain, and enforce written procedures to prevent the misuse of material non-public information by the investment adviser or any person associated with the investment adviser.

An investment adviser is not required generally to segregate key duties and functions. However, an investment adviser is required to appoint a CCO to monitor and periodically review the adviser's compliance program (*see* response to Question 21.2(e)).

23.13

Is an intermediary required:

- a) *To endeavor to avoid a conflict of interests arising between its interests and those of its customers or between its customers?*
- b) *Where the potential for conflicts arise, to have mechanisms in place to ensure fair treatment of all its customers such as proper disclosure, internal rules of confidentiality, declining to act where conflict cannot be avoided?*

Broker-Dealers

For research analysts, the historical conflict of interest has been between providing independent analysis of companies that the intermediary was also seeking as an investment banking client. The Sarbanes-Oxley Act (codified in relevant part at 15 USC 78o-6) requires the Commission or

⁵⁹⁷ 15 U.S.C. 78aaa *et seq.*

the SROs to implement rules designed to “foster greater public confidence in securities research, and to protect the objectivity and independence of securities analysts.” This statute lays out certain specific prohibitions that must be in the rules implemented under the statute. These prohibitions are designed to address the most egregious of the conflicts that analysts face. Specifically, Sarbanes-Oxley requires:

- Restricting pre-publication review of research reports by investment banking personnel or other personnel not directly responsible for research (other than legal/compliance);
- Limiting the supervision and compensatory evaluation of analysts to officials other than investment banking personnel;
- Prohibiting retaliation against research by investment banking personnel for opinions expressed in research reports;
- Establish quiet periods when the intermediary is prohibited from publishing research after it has participated in a public offering of securities;
- Establish structural and institutional safeguards that assure that analysts are separated by appropriate informational partitions within the firm “from the review, pressure, or oversight of those whose involvement in investment banking activities might potentially bias their judgment or supervision;”
- Requiring a number of disclosures on research reports and public appearances including analysts’ investments in the subject company of the report/appearance and whether the subject company has been a client of the intermediary.

These required prohibitions were implemented in SRO rules (NASD Rule 2711 and NYSE Rule 472), which were approved by the Commission (the Commission also adopted Regulation AC in regards to analyst conflicts of interest). The SRO rules contain other provisions beyond what is required in Sarbanes-Oxley as well, such as a prohibition on the promise of favorable research and analyst trading black-out periods. The Commission’s Regulation AC (17 CFR 242.500 - 505) requires that intermediaries obtain certification from their analysts that the opinions expressed in research reports and public appearances are the analyst’s actual opinions. It also requires a certification that the analyst was not compensated for a specific recommendation or view expressed by the analyst in a research report or public appearance (or provides details as to how such compensation is paid).

Finally, Exchange Act Rules 15c1-5 and 15c1-6 require a broker-dealer to disclose to the customer if it has any control, affiliation or interest in a security it is offering or with the issuer of such security.

Investment Advisers

Section 206 of the Advisers Act imposes a fiduciary duty on an investment adviser to act in the utmost good faith with respect to its clients, and to provide full and fair disclosure of all material facts, particularly when the adviser’s interests may conflict with its clients.⁵⁹⁸ As a fiduciary, an adviser owes its clients undivided loyalty, should not engage in any activity in conflict with the

⁵⁹⁸ See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195-197 (1963).

interest of any client, and should take the steps reasonably necessary to fulfill his fiduciary obligations. Thus, an investment adviser must not only refrain from effecting, on its own behalf, securities transactions which are inconsistent with its fiduciary obligations; it should also be reasonably certain that persons associated with it are not improperly utilizing the information which they obtain in the conduct of the investment advisory business in such manner as to adversely affect the interest of clients or limit the adviser's ability to fulfill its fiduciary obligations.⁵⁹⁹

The Advisers Act also imposes the following specific client obligations:

Code of Ethics: *See* response to Question 21.8(c)(ii) above.

Performance Fees: Section 205(a)(1) of the Advisers Act prohibits an investment adviser from entering into, extending, or renewing any investment advisory contract, or in any way to perform any investment advisory contract that provides for compensation to the investment adviser on the basis of a share of capital gains or capital appreciation of the funds or any portion of the funds of the client (collectively, “a performance fee”), unless: (a) the performance fee is based upon a percentage of assets under management; or (b) the client is a registered investment company or certain other entities with assets in excess of \$1 million, and the performance fee is a “fulcrum fee”;⁶⁰⁰ or (c) the client is a qualified client.⁶⁰¹

Best Execution: As a fiduciary, an investment adviser has an obligation to seek to obtain “best execution” of a client’s securities transactions. To comply with this duty, an investment adviser must execute securities transactions for clients in such a manner that the client’s total cost or proceeds in each transaction is the most favorable under the circumstances.

Agency Cross Trades for Advisory Clients: Section 206(3) of the Advisers Act and Rule 206(3)-2 thereunder address certain transactions involving investment adviser client accounts. In particular, Section 206(3) of the Advisers Act prohibits an investment adviser, acting as principal for his own account, from purchasing or selling any security from or to a client, without disclosing to such client in writing before the completion of the transaction the capacity in which he is acting and obtaining the consent of the client. Section 206(3) also prohibits an investment adviser, acting as broker for a person other than the client, from knowingly effecting any sale or purchase of any security for the account of the client, without disclosing to such client in writing

⁵⁹⁹ *See Adoption of Amendment to Rule 204-2 under the Investment Advisers Act of 1940*, Investment Advisers Act Rel. No. 203 (Aug. 11, 1966).

⁶⁰⁰ A “fulcrum fee” is generally described as a fee that is averaged over a specified period of time that increases or decreases proportionately with the investment performance of the client's account in relation to the investment record of an appropriate securities index. *See* Rules 205-1 and 205-2 under the Advisers Act.

⁶⁰¹ Rule 205-3(d)(1) under the Advisers Act defines the term “qualified client.”

before the completion of the transaction the capacity in which he is acting and obtaining the consent of the client.⁶⁰²

Rule 206(3)-2 under the Advisers Act permits an investment adviser to obtain from clients “blanket consents” to certain of the transactions to which Section 206(3) applies. Specifically, Rule 206(3)-2 provides that an investment adviser may effect an “agency cross transaction” for its client, if the client has executed a written consent prospectively authorizing the investment adviser to effect any agency cross transaction for such client. An agency cross transaction is defined under Rule 206(3)-2 as “a transaction in which a person acts as an investment adviser in relation to a transaction in which such investment adviser, or any person controlling, controlled by or under common control with such investment adviser, acts as broker for both such advisory client and for another person on the other side of the transaction.” The written consent may be obtained only after full written disclosure that, with respect to agency cross transactions, the investment adviser or such other person will act as broker for, receive commissions from, and have a potentially conflicting division of loyalties and responsibilities regarding both parties to such transactions. Rule 206(3)-2 requires an investment adviser relying on the rule to send to its client specified information about the agency cross transactions that the client engaged in through the adviser.

Custody of Client Assets: Please *see* response to Question 21.8(b) for a discussion of the requirements that are applicable to investment advisers that have custody of their clients’ assets.

Cash Payments for Client Solicitations: Rule 206(4)-3 prohibits an investment adviser from paying a cash fee to a solicitor for solicitation activities if the solicitor is: (a) subject to a SEC order under Section 203(f) of the Advisers Act; or (b) convicted within the previous ten years of any felony or misdemeanor described in Section 203(e)(2)(A)-(D) of the Advisers Act; or (c) who has been found by the SEC to have engaged, or has been convicted of engaging, in any of the conduct specified in paragraphs (1), (5), or (6) of Section 203(e) of the Advisers Act; or (d) is subject to an order, judgment or decree described in Section 203(e)(4) of the Advisers Act.

Section 206(4)-3 provides that an investment adviser may pay a solicitor that may be a partner, officer, director, or employee of a person that controls the investment adviser (*e.g.*, solicitor is an officer of the investment adviser) provided that the status of such solicitor and any affiliation between the investment adviser and the solicitor is disclosed to the client at the time of the solicitation or referral. An adviser also may pay a cash solicitation fee for solicitation activities for the provision of impersonal advisory services only.

Rule 206(4)-3 also provides that an investment adviser may pay a cash solicitation fee for services other than impersonal advisory services if such fee is paid pursuant to a written agreement to which the adviser is a party and the written agreement: (a) describes the solicitation activities to be engaged in by the solicitor on behalf of the investment adviser and the compensation to be received therefore; (b) contains an undertaking by the solicitor to perform his

⁶⁰² The prohibitions of Section 206(3) of the Advisers Act do not apply to any transaction with a customer of a broker or a dealer if such broker or dealer is not acting as an investment adviser in relation to the transaction.

duties under the agreement in a manner consistent with the instructions of the investment adviser and the provisions of the Advisers Act and the rules thereunder; and (c) requires that the solicitor, at the time of any solicitation activities for which compensation is paid or to be paid by the investment adviser; provide the client with a current copy of the investment adviser's written brochure and a separate written disclosure document. The separate written disclosure document must contain: (a) the name of the solicitor; (b) the name of the investment adviser; (c) the nature of the relationship, including any affiliation, between the solicitor and the investment adviser; (d) a statement that the solicitor will be compensated for his solicitation services; (e) the terms of such compensation arrangement, including a description of the compensation paid or to be paid to the solicitor; and (f) the amount, if any, for the cost of obtaining his account if the client will be charged in addition to the advisory fee.

In addition, the investment adviser must receive from the client a signed and dated acknowledgement of receipt of the investment adviser's brochure and the separate written disclosure document, prior to, or at the time of, entering into any written or oral investment advisory contract with such client.

Section 204A of the Advisers Act requires that investment advisers must maintain and enforce written policies and procedures that are reasonably designed to prevent the misuse of material nonpublic information, which includes the misuse of material nonpublic information about the adviser's securities recommendations, and client securities holdings and transactions. Advisers' duty of care also requires that they safeguard this sensitive information.⁶⁰³ The adviser is responsible for preparing, reviewing, and updating these procedures.⁶⁰⁴ Advisory contracts also may contain confidentiality provisions.

In addition, Regulation S-P includes a number of provisions designed, in part, to protect clients against the risks associated with unauthorized access to information about the consumer contained in a consumer report, such as fraud and related crimes, including identity theft. Under Regulation S-P, an investment adviser is generally prohibited from providing non-public personal information about a client to an unaffiliated third-party unless the adviser provides the client with an initial and annual privacy notice giving the client the option of withholding consent to the sharing of information. If the client decides to withhold his or her consent, the adviser is prohibited from sharing information with unaffiliated third-parties. Regulation S-P also requires investment advisers to adopt written policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information, including taking reasonable measures to protect against unauthorized access to or use of the information in connection with its disposal.⁶⁰⁵

⁶⁰³ See Section 204A of the Advisers Act and *Investment Adviser Codes of Ethics*, Investment Advisers Act Rel. No. 2256 (July 2, 2004).

⁶⁰⁴ See *Compliance Programs of Investment Companies and Investment Advisers*, Investment Advisers Act Rel. No. 2204 (Dec. 17, 2003).

⁶⁰⁵ See Regulation S-P ("Privacy of Consumer Financial Information") [17 CFR Part 248.30]; *Privacy of Consumer Financial Information (Regulation S-P)*, Investment Advisers Act Rel. No. 1883 (June 22, 2000); *Disposal of Consumer Report Information*, Investment Advisers Act Rel. No. 2332 (Dec. 2, 2004).

Market Intermediaries – Principle 24

There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.

Assessment

Fully Implemented

24.1

Does the regulator have clear plans for dealing with the eventuality of a firm's failure, including a combination of activities to restrain conduct, to ensure assets are properly managed and to provide information to the market as necessary?

SEC staff has a contingency plan for responding to a broker-dealer failure. Although each broker-dealer failure is unique and presents different issues, generally SEC staff will collect as much information as possible before taking any action. Usually, SEC staff and the firm's designated examining authority know that the firm is approaching financial difficulty because the firm has filed telegraphic notice pursuant to Exchange Act Rule 17a-11. SEC staff may collect reports that have been filed by the relevant broker-dealer, contact the broker-dealer's designated examining authority, and, if the firm is an introducing firm, contact the firm's clearing firm. Further, SEC staff may attempt to have an on-site inspection initiated, either by SEC staff or by the staff of the firm's designated examining authority – these examinations may be conducted at any time. To the extent that it becomes apparent that a broker-dealer is in or is approaching financial difficulty, SEC staff must contact SIPC to inform it of the status of the situation so that it can assess whether it should initiate a liquidation proceeding.⁶⁰⁶

If a firm's net capital falls below the required level, the firm must immediately cease doing a securities business,⁶⁰⁷ and must inform the SEC and its DEA. If a broker-dealer fails or is in danger of failing to meet its obligations to customers, and the firm is insolvent or not in compliance with applicable financial responsibility rules, the broker-dealer may be liquidated under SIPA.

This question is not applicable to investment advisers. *See* response to Question 22.1.

⁶⁰⁶ 15 U.S.C. 78eee(a)(1).

⁶⁰⁷ 15 U.S.C. 78o(c)(3) and 17 CFR 240.15c3-1.

24.2

Are there early warning systems or other mechanisms in place to give the regulator notice of a potential default by a market intermediary and time to address the problem and to take corrective action?

Broker-Dealers

Under the net capital rule, broker-dealers must file certain reports with the SEC either once per month or once per quarter, depending on the type of business in which the firm engages. If a firm is not in capital compliance, which is a required calculation in these reports, it must cease doing securities business. Furthermore, pursuant to Exchange Act Rule 17a-11 (commonly called the “Early Warning Rule”), a broker-dealer must promptly notify the SEC if its net capital falls below a specific threshold amount, 120% of its required net capital, or, if the firm computes its net capital using the alternative method, if the firm’s net capital falls below 5% of aggregate debit items. Pursuant to Exchange Act Rule 17a-11, a broker-dealer must promptly notify the SEC’s main office and the regional office of the SEC in whose region it resides. Further, the broker-dealer must notify its designated examining authority, and, if applicable, the CFTC. In addition, if a broker-dealer wants to withdraw any equity capital or redeem or repurchase stock or make any unsecured advance or loan to a stockholder, partner, sole proprietor, employee or affiliate, it must first give the SEC notice.⁶⁰⁸

A broker-dealer also must file an annual audit with the SEC and its designated examining authority under Rule 17a-5(d). If during the course of the audit, the independent public accountant finds material inadequacies that exist in the accounting system, internal accounting control, or procedures for safeguarding securities, the independent public accountant must inform the chief financial officer who must notify the SEC and the designated examining authority within 24 hours. If such chief financial officer fails to notify the SEC and the designated examining authority within 24 hours or the independent public accountant disagrees with statements contained in the notice, the independent public accountant must inform the SEC and the designated examining authority of the material inadequacy within 24 hours thereafter.⁶⁰⁹

Finally, a broker-dealer must maintain a separate customer reserve account that contains at least the net dollar amount of cash the broker-dealer owes to customers. If a broker-dealer fails to make a required deposit in its reserve bank account or special account, as required by Rule 15c3-3, the broker-dealer must immediately notify the SEC and its designated examining authority and promptly thereafter confirm such notification in writing.⁶¹⁰

⁶⁰⁸ 17 CFR 240.15c3-1(e)(1).

⁶⁰⁹ 17 CFR 240.17-5(h)(2).

⁶¹⁰ 17 CFR 240.15c3-3(i).

Investment Advisers

Not applicable. See responses to Question 21.1(c) and Question 22.1

24.3

Does the regulator have the power to take appropriate actions: In particular, can it:

- a) Restrict activities by the intermediary with a view to minimizing damage and loss to investors?*
- b) Require the intermediary to take specific actions, for example, moving client accounts to another intermediary?*
- c) Request appointment of a monitor, receiver, curator or other administrator or, in the absence of such power, can the regulator apply to the relevant authorities to take possession or control of the assets held by the intermediary or by a third party on behalf of the intermediary?*
- d) Require that relevant information concerning a firm's failure (i.e. a firm's trading status) be disclosed to the market?*
- e) Apply other available measures intended to minimize customer, counterparty and systemic risk in the event of intermediary failure, such as customer and settlement insurance schemes or guarantee funds?*

Broker-Dealers

The Exchange Act and the regulations promulgated thereunder prohibit a broker-dealer from continuing to do a securities business if the firm does not have sufficient net capital.⁶¹¹ Further, a broker-dealer is restricted from withdrawing capital if certain parameters have been broken.⁶¹² The SROs also have rules that restrict the activities of a broker-dealer in financial difficulty.⁶¹³ The SROs have rules that allow the SRO to direct the intermediary to take specific corrective or prophylactic actions, such as reducing their business.⁶¹⁴ The SEC may also petition the court to place a freeze on the broker-dealer's assets.

⁶¹¹ 15 U.S.C. 78o(c)(3) and 17 CFR 240.15c3-1.

⁶¹² 17 CFR 240.15c3-1(e)(2).

⁶¹³ See e.g., NYSE Rule 326(b) and NASD Rule 3130.

⁶¹⁴ *Id.*

If SIPC determines that any member of SIPC has failed or is in danger of failing to meet its obligations to customers, and is either: insolvent or is unable to meet its obligations as they mature; the subject of a proceeding in which a receiver, trustee, or liquidator for such debtor has been appointed; not in compliance with applicable requirements under the Exchange Act or rules of the SEC or any SRO with respect to financial responsibility or hypothecation of customers' securities; or unable to make such computation as may be necessary to establish compliance with such financial responsibility or hypothecation rules: then SIPC may, upon notice to such member, file an application for a protective decree with any court of competent jurisdiction.⁶¹⁵ If the court issues a protective decree, the court must appoint, as trustee for the liquidation of the business of the debtor and as attorney for the trustee, such persons as SIPC, in its sole discretion, specifies.⁶¹⁶

Under a SIPA liquidation, customers of a failed brokerage firm get back all securities (such as stocks and bonds) that already are registered in their names or are in the process of being registered. After this first step, the firm's remaining customer assets are then divided on a pro rata basis with securities and cash shared in proportion to the size of claims. If sufficient assets are not available in the firm's customer accounts to satisfy claims within these limits, the reserve funds of SIPC are used to supplement the distribution, up to a ceiling of \$500,000 per customer, including a maximum of \$100,000 for cash claims. In this way, SIPA seeks to protect investors from the loss of securities or cash left with a failed broker-dealer.

To the extent that a broker-dealer is a publicly traded company, it has an ongoing obligation to inform its shareholders and the marketplace of material information. Further, to the extent that a broker-dealer, in the process of self-liquidating, transfers customer accounts to another broker-dealer, the broker-dealer must inform those customers of where their assets are/will be held.

The broker-dealer subsidiaries of The Bear Stearns Companies, Inc. and Lehman Brothers Holdings, Inc. were subject to net capital, customer protection, and bankruptcy rules and regimes that are designed to allow the broker-dealers to unwind without harming customers or causing market disruptions. In the failure of both Bear and Lehman, however, the holding companies and certain other affiliates were not subject to similar requirements, nor were these firms part of a bank holding company that had access to direct government financing of less liquid assets. The Bear Stearns broker-dealer was able to be transferred to JP Morgan Chase without any losses to customers. The vast majority of the Lehman broker-dealer was liquidated with minimal disruption to customers; however, the failure of Lehman Brothers Holdings had a significant impact on the financial markets. In light of these recent events, the SEC is reviewing the current regulatory framework to determine if changes are needed to prevent market disruptions. For example, the SEC is working with other domestic regulators to address financial regulatory reform.

⁶¹⁵ 15 U.S.C. 78eee(a)(3).

⁶¹⁶ 15 U.S.C. 78eee(b)(3).

Investment Advisers

The Advisers Act does not expressly provide for the SEC to take action if an investment adviser encounters financial difficulty. *See* responses to Question 21.1(c) and Question 22.1. The SEC has the power to take action, however, if an investment adviser's financial difficulties are related to a violation of the U.S. federal securities laws. The SEC can request that a federal court appoint a monitor, receiver, curator or other administrator.⁶¹⁷

The SEC would not provide notice to an investment adviser's clients or the general public about an investment adviser's financial condition. Information about an investment adviser's financial condition may otherwise be public (for instance, an investment adviser that has custody of a client's assets is required to include with its Form ADV a balance sheet for its most recent fiscal year. An investment adviser's Form ADV is a public document). In addition, Sections 206(1) and (2) of the Advisers Act generally require an investment adviser to disclose to its clients and prospective clients all material facts, including material facts relating to an investment adviser's financial condition and resources.⁶¹⁸ In addition, Section 206(4) of the Advisers Act and Rule 206(4)-4 thereunder expressly require an investment adviser that has discretionary authority (express or implied), or custody over a client's assets, or that requires prepayment of more than \$500 in fees per client (six months or more in advance) to disclose to all clients and prospective clients all material facts that may impair the ability of the investment adviser to meet its contractual commitments to its clients. An investment adviser that has custody of a client's assets, or requires prepayment 6 or more months in advance of more than \$500 in fees from its clients, also must provide a balance sheet as an exhibit to its Form ADV.⁶¹⁹

The Advisers Act does not provide for the SEC to take actions intended to minimize customer, counterparty and systemic risk in the event of intermediary failure, such as customer and settlement insurance schemes or guarantee funds.

24.4

Do the regulator's processes and procedures for addressing financial disruption include communication and cooperation with other regulators, both domestic and foreign, where appropriate, and is there evidence that contact arrangements are in place and that such cooperation occurs?

For broker-dealers, *see* response to Principles 11 and 12.

⁶¹⁷ It is well-established that a court has the authority to grant any form of ancillary relief where necessary and proper to effectuate the purposes of the federal securities laws. *See SEC v. Materia*, 745 F.2d 197,200 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985). Included in the court's equitable powers is the authority to appoint receivers. *See, e.g., SEC v. First Fin. Group*, 645 F.2d 429, 439 (5th Cir. 1981).

⁶¹⁸ *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195-197 (1963).

⁶¹⁹ *See* Rule 206(4)-4 of the Advisers Act; Form ADV, Part 2, Item 14 (the balance sheet is filed as Schedule G); and Rule 206(4)-2 of the Advisers Act (governing an investment adviser's custody of client assets).

For investment advisers, *see* response to Questions 17.3 and 11.3(d).

SECONDARY MARKETS

Principles 25-29

Secondary Markets – Principle 25

The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.

Assessment

Fully Implemented.

25.1

Does the establishment of an exchange or trading system require authorization?

Exchanges and Associations

In the United States, an exchange⁶²⁰ must register with the SEC as a national securities exchange, or be exempt from registration, before it may begin operations.⁶²¹ Section 19(a) of the Exchange Act sets forth the SEC's responsibilities and obligations upon the filing of an exchange application. Specifically, the SEC must publish notice of the application for public comment and thereafter, within 90 days of publication,⁶²² the SEC must by order grant the registration or institute proceedings to determine whether the application should be denied. Section 19(a)(1) of the Exchange Act provides that the SEC "shall grant such registration if it finds that the requirements of this title and the rules and regulations thereunder with respect to the applicant are satisfied." The SEC must deny a registration if it can not make this finding. Once registered, a national securities exchange becomes an SRO.⁶²³

⁶²⁰ The term "exchange" is defined in Section 3(a)(1) of the Exchange Act as "any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange."

⁶²¹ Section 5 of the Exchange Act prohibits any broker, dealer, or exchange from using any facility of an exchange to effect any transaction in a security unless such exchange is either registered as a national securities exchange under Section 6 of the Exchange Act or exempt from registration.

⁶²² The SEC has the authority to extend the time for consideration for up to ninety days if it finds good cause for such extension and publishes its reasons for so finding or for such longer period as to which the applicant consents. *See* Section 19(a)(1)(B) of the Exchange Act, 15 U.S.C. 78s(a)(1)(B).

⁶²³ Section 3(a)(26) of the Exchange Act, 15 U.S.C. 78c(a)(26), defines a SRO as, among other things, any national securities exchange or registered securities association.

Section 6(a) of the Exchange Act provides the general requirements for the content of an exchange application. Specifically, Section 6(a) of the Exchange Act provides that an applicant must include the rules of the exchange⁶²⁴ as well as such other information that the SEC may, by rule, prescribe. The SEC adopted Rule 6a-1 and Form 1 to set forth the additional materials that must be submitted as part of an exchange application. Rule 6a-1 provides, among other things, that an application for registration as a national securities exchange or exemption from registration based on limited volume shall be made on Form 1. In addition to the “rules of an exchange,” Form 1 requires that an applicant include the following in its registration application: (i) written rulings, settled practices having the effect of rules, and interpretations of the rules of the exchange; (ii) information about operators of any electronic trading system that is used to effect transactions; (iii) current financial statements for any subsidiary or affiliate of the applicant; (iv) the manner of operation of the trading system, including, among other things, the means of access; the procedures for entering and displaying quotes; procedures of execution, reporting and clearing and settling transactions; and fees; (v) all membership forms; (vi) all forms relating to members’ financials, including minimum net capital requirements; (vii) listing applications; (viii) audited financial statements of the applicant prepared according to GAAP; (ix) lists of officers, governors and members of all standing committees; (x) for exchanges with one or more owners, shareholders or partners that are not also members of the exchange, lists of shareholders that who either own 5% or more of a class of voting shares, or if a partnership, then all general partners and those limited/special partners that have a right to receive upon dissolution or have contributed 5% or more of the capital; (xi) the applicant’s criteria for membership and the conditions and process for suspension or termination of membership; (xii) a list of all members; and (xiii) a schedule for all securities listed on the exchange, all securities traded on the exchange pursuant to unlisted trading privileges, all securities exempt from registration and traded on the exchange, and other securities traded on the exchange.

Another category of registered markets is registered securities associations. Section 15A of the Exchange Act provides the requirements for registration as a national securities association. The SEC analyzes and either approves or disapproves any entity seeking to become an association. As with national securities exchanges, applicants to be a national securities association must submit a registration application with the SEC on a Form X-15AA-1 and updates on Forms X-15AJ-1 and X-15AJ-2. Under Section 15A of the Exchange Act, an association must meet similar substantive criteria outlined above for exchange applicants. In addition, Section 15A(b)(1) of the Exchange Act requires the SEC determine that, by reason of the number and geographical distribution of its members and the scope of their transactions, such association will be able to carry out the purposes of the Section 15A. To date, only the Financial Industry

⁶²⁴ The term “rules of an exchange” is defined in Section 3(a)(27) as “the constitution, articles of incorporation, bylaws, and rules, or instruments corresponding to the foregoing, of an exchange . . . , and such stated policies, practices, and interpretations of such exchange . . . as the SEC, by rule, may determine to be necessary or appropriate in the public interest or for the protection of investors to be deemed to be rules of such exchange...” The SEC exercised its rulemaking authority to adopt Rule 19b-4 under the Exchange Act, which, among other things, defines the phrase “stated policies, practices or interpretations.” Specifically, a “stated policy, practice or interpretation” means generally any material aspect of the operation of the facilities of the SRO or any statement made available to the membership, participants, or specified persons thereof that establishes or changes any standard, limit, or guideline with respect to the rights, obligations or privileges of specified persons or the meaning, administration, or enforcement of an existing rule. See Rule 19b-4(b), 17 CFR 240.19b-4(b).

Regulatory Authority is registered as a national securities association. The principal function of any association is regulating its members through a continuous program of rulemaking and interpretation, surveillance, and enforcement of the applicable federal securities laws, and its own ethical standards through its disciplinary process. Similar to national securities exchanges, the SEC evaluates the self-regulatory authority of an association in determining whether the association, and through the association its members, are fulfilling their statutory and regulatory obligations.

Alternative Trading Systems

In addition to exchanges and associations, ATSS operate electronic markets.⁶²⁵ In order to accommodate traditional market structures and provide sufficient flexibility to ensure that new markets promote fairness, efficiency, and transparency, the SEC adopted Exchange Act Reg ATS 1998. Under Reg ATS, an entity that falls within the definition of an exchange may register as an exchange or as a broker-dealer. If the entity chooses to register as an exchange, it must meet all the requisite statutory and regulatory obligations discussed above applicable to exchanges. If an ATS chooses to register as a broker-dealer, it must be a member of an SRO and comply with additional reporting and record-keeping requirements set forth under Reg ATS. The reporting and access requirements vary depending on the ATS' activities and trading volume. Similar to any other broker-dealer, an ATS must have sufficient clearing capabilities in place by either becoming a member of a registered clearing agency, or being affiliated with a member of a registered clearing agency through with the ATS can clear and settle trades. In either case, the ATS's application to be either an exchange or a broker-dealer must be approved by the SEC.

Over-the-Counter Derivatives

Within the past year, the SEC has taken several actions designed to address concerns related to the market in credit default swaps (CDS). The over-the-counter (OTC) market for CDS has been a source of concern to the SEC and other financial regulators because of the systemic risk posed by CDS, highlighted by the possible inability of parties to meet their obligations as counterparties and the potential resulting adverse effects on other markets and the financial system.

The SEC's authority over the CDS OTC market is limited because the Exchange Act that excludes both a non-security-based and a security-based swap agreement from the definition of

⁶²⁵ See Regulation of Exchanges and Alternative Trading Systems, Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70843, 70881 (December 22, 1998) ("Regulation ATS Release"). See also Exchange Act Rules 300-303, 17 CFR 242.300-303. Rule 300 of Regulation ATS defines an "alternative trading system" as any organization, association, person or group of persons, or system: (1) that constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of Section 240.3b-16 of this chapter; and (2) that does not: (i) set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person or group of persons, or system; or (ii) discipline subscribers other than by exclusion from trading.

“security.”⁶²⁶ However, in order to foster the prompt establishment of a central counterparty (CCP) for CDS, the SEC granted conditional exemptions with respect to CDS that are not swap agreements (“non-excluded CDS”) from certain provisions of the federal securities laws. The SEC worked in close coordination with other financial regulatory authorities in evaluating each CCP.⁶²⁷

A CCP for CDS is an important means for reducing the counterparty risks inherent in the CDS market, and thereby help mitigate potential systemic impacts. The SEC granted temporary, nine-month exemptions, subject to conditions to ICE Trust, the Chicago Mercantile Exchange, LIFFE Administration and Management and LCH.Clearnet Ltd., ICE Trust Europe Ltd, and Eurex Clearing AG from the requirement to register as a clearing agency under Section 17A of the Exchange Act solely to perform the functions of a clearing agency for non-excluded CDS transactions. The SEC also temporarily exempted eligible contract participants and others from certain Exchange Act requirements with respect to non-excluded CDS cleared by each of the above CCPs.⁶²⁸ The SEC also approved interim final temporary rules providing exemptions under the Securities Act of 1933 and Exchange Act for non-excluded CDS in order to facilitate the operation of one or more CCPs for the CDS market. In addition, the SEC granted certain exemptions to exchanges that effect transactions in such non-excluded CDS and to brokers and dealers that effect transactions in non-excluded CDS on exchanges, and is designed to facilitate the development of one or more CDS exchanges.

⁶²⁶ A “swap agreement” is “any agreement, contract, or transaction between eligible contract participants (as defined in section 1a(12) of the Commodity Exchange Act. . .) . . . the material terms of which (other than price and quantity) are subject to individual negotiation.” 15 U.S.C. 78c note.

⁶²⁷ In November 2008, the President’s Working Group on Financial Markets stated that the implementation of a CCP for CDS was a top priority and, in furtherance of this recommendation, the SEC, the Federal Reserve Board and the CFTC signed a Memorandum of Understanding that establishes a framework for consultation and information sharing on issues related to CCPs for CDS.

⁶²⁸ See Securities Exchange Act Release No. 59578 (Mar. 13, 2009), 74 FR 11781 (Mar. 19, 2009) (temporary exemption in connection with CDS clearing by Chicago Mercantile Exchange Inc.), Securities Exchange Act Release No. 59527 (Mar. 6, 2009), 74 FR 10791 (Mar. 12, 2009) (temporary exemption in connection with CDS clearing by ICE US Trust LLC), Securities Exchange Act Release No. 59164 (Dec. 24, 2008), 74 FR 139 (Jan. 2, 2009) (temporary exemption in connection with CDS clearing by LIFFE A&M and LCH.Clearnet Ltd.) Securities Exchange Act Release No. 60372 (July 23, 2009), 74 FR 37748 (temporary exemption in connection with ICE Clear Europe Ltd.), Securities Exchange Act Release No. 60373 (July 23, 2009), 74 FR 37740 (temporary exemption in connection with Eurex AG), and other SEC actions discussed therein.

25.2

Are there criteria for the authorization of exchange and trading system operators that:

a) Require analysis and authorization of the market by a competent authority?

Exchanges and Associations

The SEC must analyze and authorize the registration application of any prospective exchange or association for compliance with the requirements of Sections 6 and 15A of the Exchange Act, as applicable – *see* the response to Question 25.1 above, for more details about this process.

In addition to satisfying the requirements of Section 6 and 15A of the Exchange Act, a prospective exchange or association, respectively, must demonstrate its ability to operate as part of the national market system as contemplated in Section 11A of the Exchange Act. In particular, an applicant must satisfy the national market system requirements set forth in Regulation NMS. Regulation NMS contains rules that govern quotations in the national market system, including quotation collection and reporting requirements, firm quotation requirements, and quotation access and trade-through prevention requirements. Specifically, Regulation NMS addresses four main areas: (i) trade-throughs; (ii) market access; (iii) sub pennies; and (iv) market data. The Order Protection Rule⁶²⁹ requires trading centers to establish policies and procedures reasonably designed to prevent the execution of trades at prices inferior to automated quotations that are the best quote of another exchange or FINRA, subject to applicable exceptions. The Access Rule⁶³⁰ requires fair and non-discriminatory access to quotations, establishes a limit on access fees to harmonize the pricing of quotations across different trading centers, and requires rules addressing locked and crossed markets. The Sub-Penny Rule⁶³¹ prohibits market participants from accepting, ranking, or displaying orders for securities priced \$1.00 or more in increments smaller than a penny. The market data provisions, among other things, modify the way the markets allocate data revenues to reward aggressive quoting and reduce distortions caused by the existing formulae. In addition, Regulation NMS has rules that govern transaction reporting, and require the publication of order execution quality statistics.

The Exchange Act contains several other specific provisions that must be satisfied by a prospective exchange or association. First, an exchange must demonstrate that its members are not permitted to trade for their own accounts, for the accounts of associated person, or for accounts with respect to which an associated person exercises investment discretion, unless such trading is consistent with the exemptions set forth in Section 11(a) of the Exchange Act and the rules thereunder. There are statutory exceptions to these prohibitions, including trading by a dealer acting as a market maker.⁶³² The SEC also excepted by rule, certain classes of

⁶²⁹ 17 CFR 242.611.

⁶³⁰ 17 CFR 242.610.

⁶³¹ 17 CFR 242.612.

⁶³² *See* Section 11(a)(1) of the Exchange Act, 15 U.S.C. 78k(a)(1).

transactions from these prohibitions.⁶³³ Section 11(b) of the Exchange Act provides for the regulation of specialists and odd-lot dealers. If an exchange plans on having members act as specialists or odd-lot dealers, the rules of the exchange must reflect the appropriate rules for their registration and activities.⁶³⁴

Alternative Trading Systems

The SEC must analyze and authorize the application for an ATS to be an exchange or broker-dealer, consistent with Section 6 or 15 the Exchange Act, as applicable. This application process is described in further detail in the response to Question 25.1 above.

If an ATS choose to register as an exchange, it must meet the requirements for exchange registration, as described in the response to Question 25.1 above and also above in the response to this Question 25.2.

If an ATS chooses to register as a broker-dealer, it must be a member of an SRO and it must: (1) file with the SEC a notice (an “initial operations report”) and quarterly amendments on Form ATS and comply with additional reporting and record-keeping requirements set forth under Reg. ATS (including maintaining an audit trail of transactions),⁶³⁵ (2) under certain circumstances, comply with order display, execution access, and fair access requirements for traded securities;⁶³⁶ (3) under certain circumstances, follow procedures to ensure the capacity, integrity and security of the ATS system;⁶³⁷ (4) submit to the examination, inspection, and investigation by the SEC or its SRO;⁶³⁸ and (5) refrain from using the terms “exchange,” “stock market” or similar terms in its name.⁶³⁹ Some of these requirements vary depending on the ATS’s activities and trading volume. Specifically, an ATS that trades five percent or more of the volume of in national market system securities must be: (1) linked to a national securities exchange or registered securities association so that the best priced orders in those securities placed in the

⁶³³ Generally, if a member (except a specialist) wants to execute a transaction of a physical exchange floor for its own account, the member would have to yield priority to all non-members who seek execution at the same price. Section 11(a)(1)(G) of the Exchange Act, 15 U.S.C. 78k(a)(1)(G), and Rule 11a1-1(T) thereunder, 17 CFR 240.11a1-1(T). This section is intended to prevent members of an exchange from having an advantage over non-members by virtue of their time and place opportunities on an exchange. This section does not generally apply to electronic, off-floor orders. *See* Rule 11a2-2(T) under the Exchange Act, 17 CFR 240.11a2-2(T). As the markets have moved to more electronic models, the time/place advantages of members that Section 11(a) of the Exchange Act was intended to address have lessened.

⁶³⁴ *See* Rule 11b-1 under the Exchange Act, 17 CFR 240.11b-1.

⁶³⁵ *See* Regulation ATS Rule 301(b)(2), 17 CFR 242.301(b)(2).

⁶³⁶ *See* Regulation ATS Rule 301(b)(3) and (b)(5), 17 CFR 242.301(b)(3) and (b)(5).

⁶³⁷ *See* Regulation ATS Rule 301(b)(6), 17 CFR 242.301(b)(6).

⁶³⁸ *See* Regulation ATS Rule 301(b)(7), 17 CFR 242.301(b)(7).

⁶³⁹ *See* Regulation ATS Rule 301(b)(11), 17 CFR 242.301(b)(11).

ATS are disseminated into the public quote stream,⁶⁴⁰ and (2) generally must establish objective standards to grant or deny access to the trading system and apply them in a non-discriminatory manner.⁶⁴¹ In addition, such ATS must comply with the rules that govern execution priority and obligations that are imposed by the SRO to which the ATS is linked.

Similar to any other broker-dealer, an ATS must have sufficient clearing capabilities in place by either becoming a member of a registered clearing agency, or being affiliated with a member of a registered clearing agency through which the ATS can clear and settle trades. Moreover, all ATSs must comply with the antifraud, anti-manipulation and other applicable provisions of the federal securities laws.

25.2

*b) Seek evidence of operational or other competence of the operator of an exchange or trading system as a secondary market?*⁶⁴²

In addition to the requirements listed above, the SEC considers other factors to evaluate the operational or other competence of an exchange or trading system.

Funding

While the Exchange Act does not set forth the levels of funding for maintaining the self-regulatory function, the SEC has considered the funding of the self-regulatory functions of an exchange in the context of recent exchange demutualizations. In these filings, the SEC has approved rules designed to ensure that fees, fines, or dues collected by an exchange are not used for commercial purposes.⁶⁴³ Further, the SEC has recognized that the level of funding may differ among the SROs. Specifically, appropriate levels of funding may be dependant on the SRO's business model, trading systems, regulatory responsibilities, and types of members.⁶⁴⁴

⁶⁴⁰ See Regulation ATS Rule 301(b)(3), 17 CFR 242.301(b)(3).

⁶⁴¹ See Regulation ATS Rule 301(b)(5), 17 CFR 242.301(b)(5).

⁶⁴² Principles, Section 13.3.

⁶⁴³ See e.g., Securities Exchange Act Release Nos. 53382 (February 27, 2006) (order approving the New York Stock Exchange business combination with Archipelago Holdings, Inc.); 55216 (January 31, 2007) (order approving NYSE Regulation Inc. policies regarding exercise of power to fine NYSE members and use money collected as fines).

⁶⁴⁴ See Securities Exchange Act Release No. 50700 (November 18, 2004), 69 FR 71256 (December 8, 2004) ("SRO Concept Release").

Systems Capacity

If an ATS has twenty percent or more of the trading volume in any single security, the ATS must follow certain procedures to ensure adequate systems capacity, integrity and contingency planning.⁶⁴⁵

Statutory Disqualifications

As noted above, in the response to Question 7.1(i), the SEC has stated that persons responsible for operating an SRO should not have a disciplinary history and, with respect to founders and/or prospective managers of an applicant, they should not be subject to a “statutory disqualification,” as defined in Section 3(a)(39) of the Exchange Act. In connection with evaluating whether an applicant exchange or association is able to enforce compliance with the Exchange Act, the rules and regulations thereunder and an exchange’s or association’s own rules, the SEC reviews the persons that are listed as the exchange operators for compliance with this standard.

25.2

- c) Require the operator of an exchange or trading system that assumes principal, settlement, guarantee or performance risk to comply with prudential and other requirements designed to reduce the risk of non-completion of transactions (e.g., mandatory margin assessment and collection, capital or financial resources, member contributions, guaranty fund, credit or position limits)?*

In the United States, the clearance and settlement of securities transactions generally occurs through a series of registered clearing agencies and a registered centralized securities depository, which are member-owned organizations that operate independently from exchanges or trading systems. There are separate IOSCO principles that apply specifically to central counterparties (i.e., clearing agencies) and securities depositories. Two clearing agencies registered with the SEC, the National Securities Clearing Corporation (NSCC) and the Fixed Income Clearing Corporation (FICC) have prepared self-assessments under the IOSCO Recommendations for Central Counterparties (RCCP) and the sole securities depository registered with the SEC as a clearing agency, the Depository Trust Company (DTC), has prepared a self-assessment under the IOSCO Recommendations for Securities Settlement Systems (RSSS). These self-assessments include a discussion of the clearing agency’s risk management and how it reduces the risk of non-completion of transactions. See the responses to RCCP Recommendation 6, Default Procedures (Key Question 1(c)), and SSS Recommendation 12, Protection of Customers’ Securities.

A “clearing agency” is defined in Section 3(a)(23) of the Exchange Act as any entity that acts as an intermediary in making payments or deliveries of securities in connection with securities transactions; provides facilities for the comparison of data regarding the terms of settlement of securities transactions (to reduce the number of settlements of securities transactions) or for the allocation of securities settlement responsibilities. Such term also means any person, such as a

⁶⁴⁵ See Regulation ATS Rule 301(b)(6), 17 CFR 242.301(b)(6).

security depository, who (i) acts as a custodian of securities in connection with a book-entry settlement system where the settlement of securities transactions (including securities that are loaned or pledged) can occur without the physical delivery of securities certificates, or (ii) otherwise permits or facilitates the settlement of securities transactions without physical delivery of securities certificates.

In the United States, most equity and corporate debt transactions are cleared by the NSCC and settled at DTC. There are only a small number of registered clearing agencies in the United States. The most active clearing corporations are the NSCC, the Government Securities Clearing Corporation (GSCC), the Options Clearing Corporation (OCC), and the Mortgage Backed Securities Clearing Corporation (MBSCC). The DTC is the primary securities depository institution in the United States.

Clearing Agency Registration

Prior to performing the functions of a clearing agency, clearing corporations and securities depositories are required to register with the SEC pursuant to Section 17A(b) of the Exchange Act and Rule 17Ab2-1 thereunder or obtain an exemption from registration.

To register, the clearing agency must complete Form CA-1 and submit certain materials as exhibits. In the Form CA-1, the clearing agency must provide documentation about its operational, organizational, and other rules, procedures, or practices concerning its exposure to and ways to mitigate financial loss. Specifically, the application must provide detailed information about the following:

- Business organization, *i.e.* who controls the entity, the corporate officers and managers, their business experience, its by-laws and rules, and its contracts with national securities exchanges and associations.
- Financial information, including a certified balance sheet.
- Operational capacity, including its ability to prevent unauthorized access to its systems, the measures and procedures the clearing agency has taken to safeguard securities and funds, and a description of its computer systems and backup systems.
- Access to services, including a list of the clearing agency's participants, a description of the criteria for admitting participants or limiting membership. Furthermore, the SEC analyzes whether the clearing agency's rules provide for adequate access by qualified participants, fair representation of shareholders and participants, equitable pricing, prohibitions on fixing prices charged by its participants, discipline of participants, and whether the rules impose an undue burden on competition.

Once the form is completed and filed with the SEC, the staff conducts a review of the clearing agency's organization, capacity, and rules to determine whether the clearing agency complies with a clearing agency's obligations under the Exchange Act. These obligations include such things as the clearing agency's ability to facilitate the prompt and accurate clearance and settlement of transactions, safeguard investor funds and securities, remove impediments to and

perfect the mechanism of a national clearance and settlement system, and generally protect investors. The clearing agency's rules should also provide for adequate access by qualified participants, fair representation of shareholders and participants, equitable pricing, prohibitions on fixing prices charged by its participants, discipline of participants, and not impose an undue burden on competition.

TM has developed standards to serve as guidelines for the registration of clearing agencies which illuminate the criteria set forth in Section 17A of the Act, and laid them out in a release referred to as the "Standards Release". The release discusses: (1) participation standards, (2) fair representation, (3) the clearing agency's capacity to enforce its rules and to discipline its participants in accordance with fair procedures, (4) the safeguarding of funds; (5) obligations to participants and clearing funds.

Risk Management

Clearing agencies adopt rules and procedures to mitigate their exposure to risks in the clearance and settlement system. From strict membership standards to utilizing technological in processing, clearing agencies use many means to minimize potential losses.

Counterparty Risk

Clearing corporations guarantee matched trades by becoming a party to each side of the transaction. As a result, the primary risk that clearing corporations face is counterparty risk: the risk that one of the two sides to a securities transaction will be unable to complete the contract by its terms. Should one party fail to perform, the clearing corporation is still obligated to deliver securities or remit payment to the other party. The clearing corporation will then deal with the defaulting member separately. *See* responses to RCCP Recommendation 3: Measurement and management of credit exposures.

In order to mitigate this risk, the clearing corporations in the United States have strict membership standards to determine that every member is creditworthy upon admission to the clearing corporation. *See* responses to RCCP Recommendation 2: Participation requirements. Clearing corporation members are also required to make deposits to a clearing fund to protect the clearing corporation in the event of an insolvency by a member. Usually these deposits are cash, letters of credit, or certain U.S. government guaranteed bonds. *See* responses to RCCP Recommendation 4: Margin requirements, Recommendation 5: Financial resources, and Recommendation 7: Custody and investment risk.

DTC's rules and procedures also provide for collateralization controls and net debit caps to protect against the inability of one or more participants to pay for their settlement obligations. *See* response to Key Question 1 of RSSS Recommendation 9: CSD Risk Controls to address Participants' Failures to Settle. DTC's collateralization controls prevent the completion of transactions that would cause a participant's net debit to exceed the total available collateral in its account. This is designed to assure that a participant that fails to pay for its settlement obligation will have sufficient collateral in its account to liquidate in the event it were insolvent. DTC's net debit cap controls limit the net settlement debit that each participant can incur to an amount,

based upon activity level, which is less than DTC's total liquidity. This helps ensure that DTC will have sufficient liquidity to complete settlement should any single participant fail to settle. *See* response to Key Questions 3 of RSSS Recommendation 9: CSD Risk Controls to address Participants' Failures to Settle.

Market Risk

Clearing agencies minimize market risk is to net trades on a multilateral basis. For example, at NSCC, the Continuous Net Settlement (CNS) system is an automated book-entry accounting system that results in each member having one net receive or deliver obligation for each security it trades and one payment or receive obligation at the end of the day. For a description of NSCC's CNS system, *see* the executive summary to RCCP.

25.2

- d) Permit the regulator to impose ongoing conditions (as appropriate) on the operator of an authorized exchange or regulated trading system, such as the obligation to establish rules, policies and procedures to prevent fraudulent behavior, treat all members or participants fairly, and have the capacity to carry out the market's and the competent authority's obligations?*

Continued compliance with the initial registration requirements, as noted above, is a condition for continued registration. Registered exchanges and associations are both required to maintain rules, policies, and procedures consistent with their statutory obligations, and to have the capacity to carry out their obligations, and to prevent fraudulent and manipulative acts and practices. Registered ATSS also are required to maintain rules, policies, and procedures designed to provide fair access and to have the capacity to carry out its obligations their obligations. *See* response to Question 25.2(a) above for further discussion.

The federal securities laws also prohibit fraudulent or deceptive conduct. Specifically, the anti-fraud and anti-manipulation provisions are found in Sections 9(a) and 10(b) of the Exchange Act, and Rule 10b-5 thereunder. Exchange Act Section 9(a) addresses manipulation of securities listed on a national securities exchange and is complimented by Exchange Act Section 10(b), providing a regulatory umbrella for all securities. Additional prohibitions are found in Sections 17(a) and 14(e) of the Exchange Act. Section 17(a) bars fraudulent conduct in the "offer or sale" of securities. With regard to tender offers, Section 14(e) prohibits untrue statements of material fact or the misleading omission of material facts, or any fraudulent, deceptive, or manipulative acts or practices.

25.3

Does regulation require an assessment of:

- a) The reliability of all arrangements made by the operator for the monitoring, surveillance and supervision of an exchange or trading system and its members or*

*participants to ensure fairness, efficiency, transparency and investor protection, as well as compliance with securities legislation?*⁶⁴⁶

The Exchange Act requires all registered securities exchanges and associations to be able to enforce compliance by their members and persons associated with their members with the provisions of the Exchange Act, the rules and regulations thereunder, and their own rules.⁶⁴⁷ To this end, the SEC evaluates each applicant's ability to surveil their members and their trading and to address any potential violations of the market's rules or the U.S. federal securities laws. All markets must tailor their surveillance functions to their market's dynamics. The SEC has broad authority to review the applications submitted by applicants seeking to register as a national securities exchange or registered securities association. To register as an exchange or association requires that extensive information be submitted to the SEC on a wide range of topics, including all arrangements for monitoring, surveillance and supervision of the trading system and its participants. The SEC must determine whether the applicant has provided enough information and made sufficient arrangements with reliable and capable third parties (if applicable), to implement systems that will meet the applicable statutory standards set forth in Section 6 of the Exchange Act for national securities exchanges, and Section 15A for registered securities associations. A broker in the United States that conducts business with the public must also become a member of a registered securities association, which is FINRA. FINRA adopts rules that govern the broker's interaction with customers, including sales practice and suitability rules. The Exchange Act requires that an exchange or association applicant have in place arrangements to address all of the types of conduct and activity listed. The SEC evaluates the sufficiency of the applicant's arrangements by assessing its mechanisms for the compliance with the applicable federal securities law and regulation, and in the case of activity or conduct relating to public customers, by reference to the applicable FINRA rule. ATs are registered as broker-dealers and are subject to the FINRA rules that cover the types of conduct and activity performed.

OCIE staff conducts several types of examinations and inspections: (i) routine or cycle examinations and inspections, which test an entity's compliance with applicable laws and regulations; (ii) cause examinations and inspections, which focus on entities or issues that examiners learn of through complaints, tips, press reports, or other information indicating an entity might be engaged in possible fraudulent activities or otherwise be potentially violating the securities laws; and (iii) risk-targeted examination sweeps, that focus on particular compliance risks. These include the staff's inspections of the SROs' regulatory programs, including their examination, surveillance, investigative and enforcement programs, among others. *See* the response to Question 7.2 above for further discussion of OCIE's examination and inspection role. The SEC can also review SRO disciplinary action against a member, and denials of membership in, or access to, an SRO.⁶⁴⁸

⁶⁴⁶ Principles, Section 13.3.

⁶⁴⁷ *See* Sections 6(b)(1) and 15A(b)(2) of the Exchange Act, 15 U.S.C. 78f(b)(1) and 78o-3(b)(2).

⁶⁴⁸ *See* Section 19(d)(2) of the Exchange Act, 15 U.S.C. 78s(d)(2).

25.3

- b) The market's dispute resolution and appeal procedures or arrangements as appropriate, its technical systems standards and procedures related to operational failure, information on its record keeping system, reports of suspected breaches of law, arrangements for holding client funds and securities, if applicable, and information on how trades are cleared and settled?*

Dispute Resolution and Appeal Procedures

SROs have an obligation to have rules that are designed, among other things to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and in general to protect investors and the public interest.⁶⁴⁹ SROs' arbitration rules generally are designed to facilitate the resolution of disputes involving members, associated persons of members, and customers.⁶⁵⁰ SRO rules typically require members and associated persons of members to arbitrate any eligible dispute upon a customer's request.⁶⁵¹ The SEC reviews SRO rules pursuant to Section 19(b), including arbitration rules, before they can become effective. SROs have adopted certain "obvious error rules". Obvious error rules are designed to provide a quick resolution for trades that were executed at the wrong price. An SRO's obvious errors rules are based on clear and objective criteria and subject to specific and objective procedures. Typically requests for relief under obvious error rules must be submitted within 15-20 minutes. The review of SRO rules and procedures for dispute resolution is conducted through the SRO rulemaking process (as described in the response to Question 7.1(d) above) and through the OCIE examination and inspection process (as described in the response to Question 7.2(a)(i) above).

In addition, investors and market participants have the ability to bring actions against any person that (1) makes a material misrepresentation or omission; (2) with scienter; (3) in connection with the purchase or sale of a security; (4) in which the investor has relied upon the misrepresentation or omission; (5) results in economic loss; and (6) there is causation to the loss.

⁶⁴⁹ Exchange Act Sections 6(b)(5) and 15A(b)(6), 15 U.S.C. 78f(b)(5) and 78o-3(b)(6). *See also* Section 9, 10, and 15(c) of the Exchange Act, 15 U.S.C. 78i, j, o, (the anti-manipulation and anti-fraud provisions of the Exchange Act) and also Rule 10b-5 under the Exchange Act, 17 CFR 240.10b-5.

⁶⁵⁰ *See e.g.*, FINRA Rule 12000 Series for the Code of Arbitration Procedure for Customer Disputes and FINRA Rule 13000 Series for the Code of Arbitration Procedure for Industry Disputes. FINRA also conducts arbitrations on behalf of other SROs. *See e.g.*, Securities Exchange Act Release No. 56208 (Aug. 6, 2007), 72 CFR 45077 (Aug. 10, 2007) (order approving changes to NYSE arbitration rules to conform to the arbitration rules for FINRA, f/k/a National Securities Dealers Association, Inc., to reflect FINRA's regulation of mutual NYSE and FINRA members).

⁶⁵¹ *See e.g.*, FINRA Rule 12200.

Technical System Standards and Procedures Related to Operational Failure

To evaluate whether the exchanges and other trading systems have addressed their systems capacity needs, the SEC has put in place the Automation Review Program (ARP). ARP Staff conducts reviews of the information technology systems operated by the exchanges, clearing agencies, and certain high-volume ATSS to evaluate whether the systems have sufficient capacity and resiliency to accommodate conditions of increased volume and disruptions to normal operations. The ARP group is part of TM and is staffed by information technology experts who regularly confer and meet with members of the exchanges' information technology staff. In addition to reviewing the systems capability of an exchange, the ARP Staff will consider whether an exchange has sufficient capital to maintain its automated systems, and staff with technical expertise.

Information on its Records Keeping System

All SROs and other markets (*i.e.*, ATSS) have adopted rules and procedures governing audit trails and implementing audit trails to aid in the surveillance of their market. In general, an audit trail requires information about the parties to trade, the security, the type of order, the time of the trade, the number of shares to which the order applies, and the price of the trade. Individual markets can, and often do, require additional information, such as special handling requests, the type of account for which an order was submitted etc.

Exchange Act Rule 605 of Regulation NMS focuses on providing information regarding order execution quality. Rule 605 requires market centers that trade "national market system securities," which include securities traded on the national securities exchanges and associations, to make available to the public monthly electronic reports that include uniform statistical measures of execution quality.

Reports of Suspected Breaches of Law

As part of its duty as a front-line regulator, each SRO is itself responsible for investigating and disciplining any breaches of the SRO's rules, the Exchange Act and/or rules thereunder.⁶⁵² The SEC also may, in its discretion, investigate and prosecute any violations of the Exchange Act and the rules thereunder.⁶⁵³

Arrangements for Holding Client Funds and Securities

The Exchange Act provides that the SEC must set financial responsibility rules for broker-dealers. In accordance with the Act, the SEC promulgated a number of rules including the

⁶⁵² See Exchange Act Section 6(b)(1) and (6), and Section 15A(b)(2) and (7). 15 U.S.C. 78f(b)(1) and (6), and 78o-3(b)(2) and (7).

⁶⁵³ See Section 21 of the Exchange Act, 15 U.S.C. 78u.

Customer Protection Rule,⁶⁵⁴ the Hypothecation Rules,⁶⁵⁵ and the Quarterly Count Rule.⁶⁵⁶ The SEC's Customer Protection Rule requires that every broker-dealer obtain and maintain possession and control of customer securities, and maintain a reserve account that contains (at least) the net dollar amount of cash the broker-dealer owes to its customers. The SEC's Hypothecation Rules require that a broker-dealer segregate customer securities from its own proprietary securities, and prohibit a broker-dealer from hypothecating customers' fully-paid securities. The SEC's Quarterly Count Rule requires that broker-dealers count positions owed to customers and securities on hand and reconcile those two numbers on a quarterly basis. In addition, the SROs have rules that govern a broker-dealer's use, custody, and control of customer funds and securities, and the consequences thereof.⁶⁵⁷

Information on How Trades are Cleared and Settled

In the United States, the clearance and settlement of securities transactions generally occurs through a series of registered clearing agencies and a registered centralized securities depository, not exchanges or markets. *See* the response to Question 25.2(c) for further details on this and the self-assessments pursuant to IOSCO RSSS and RCCP prepared by DTC, NSCC, and FICC.

25.3

- c) The mechanisms that must be in place to identify and address disorderly trading conditions and to deal with any contravening conduct that is detected,⁶⁵⁸ including details of procedures for trading halts,⁶⁵⁹ other trading limitations and assistance available to the regulator in circumstances of potential trading disruption on the system?*

There are a variety of emergency intervention tools available to the exchanges, associations, and the SEC, including trading halts, trading suspensions, and the SEC's emergency authority. It is important to note that the SEC generally supports keeping markets open, and that if a catastrophic event arises, the SEC would normally seek a consensus from the exchanges and associations on the necessity of closing markets -- as was the case on September 11, 2001. Additionally, note that the markets, not the SEC, typically make most trading halt and market closure decisions. The markets can impose trading halts and suspensions for a variety of reasons. For example, a market can halt trading (or delay the opening) in securities on the trading floor because of an order imbalance (that is, an imbalance of buy and sell interest), or for

⁶⁵⁴ 17 CFR 240.15c3-3.

⁶⁵⁵ 17 CFR 240.8c-1 and 15c2-1.

⁶⁵⁶ 17 CFR 240.17a-13.

⁶⁵⁷ *See e.g.*, NYSE Rule 402 and NASD Rule 2330.

⁶⁵⁸ Principles, Section 13.3 bullet point 9 on Supervision of System and Participants by the Operator.

⁶⁵⁹ *See Indexation: Securities Indices and Index Derivatives*. (February 2003). pp. 28-29: "More aggressive surveillance can be applied to supplement the design characteristics inherent in non-diversified indices..."

regulatory reasons, such as pending corporate news. A market can also halt trading (or delay the opening) in equity options due to a trading halt (or delayed opening) in the underlying stock. A market can halt trading (or delay the opening) in index options if officials believe that there have been trading halts (or delayed openings) in many underlying stocks or if trading in necessary hedging vehicles, such as index futures, has been halted or restricted (*e.g.*, by futures price limits). Finally, a market also has the authority to suspend trading in all securities on that market, adopt abbreviated trading hours or close the exchange if such actions would be in the public interest. The listing standards of the markets address when a listed company is required to notify the market of certain material events.⁶⁶⁰ Upon notification by a listed issuer, a market may institute a regulatory trading halt to allow the news of the material event to be disseminated to investors.⁶⁶¹ Trading halts can also be imposed by means of circuit breakers. Generally speaking, under the circuit breaker halts all trading in stock, options, and futures markets halt for a certain periods of time if the Dow Jones Industrial Average declines by certain set amounts during certain set times.⁶⁶²

The SEC may also suspend trade and issue emergency orders under certain circumstances. Pursuant to Section 12(k)(1)(A) of the Exchange Act, the SEC, if the public interest and the protection of investors so require, can issue an order summarily to suspend all trading in a specific security for up to 10 business days. Pursuant to Section 12(k)(1)(B) of the Exchange Act, the SEC, if the public interest and the protection of investors so require, can issue an order summarily to suspend all trading in securities for up to 90 calendar days. The SEC must first notify the President of its decision and the President must not disapprove. Pursuant to Section 12(k)(2) of the Exchange Act, the SEC, in an emergency, may by order summarily take such action (for no more than 10 business days) to alter, supplement, suspend, or impose requirements or restrictions with respect to any matter or action subject to SEC or exchange/association regulation that the SEC determines is necessary in the public interest and for the protection of investors: (1) to maintain or restore fair and orderly securities markets; or (2) to ensure prompt, accurate, and safe clearance and settlement of transactions in securities. A market emergency is defined as “sudden and excessive fluctuations of securities prices generally, or a substantial threat thereof, that threaten fair and orderly markets, or a substantial disruption of the safe or efficient operation of the national system for clearance and settlement of securities, or a substantial threat thereof.”⁶⁶³ Finally, the SEC may request that securities exchanges impose regulatory trading halts (or delayed openings) in securities traded on their markets.⁶⁶⁴

⁶⁶⁰ See *e.g.*, NYSE Listed Company Manual Section 202 and 204; and Nasdaq IM-4120-1.

⁶⁶¹ See *e.g.*, NYSE Listed Company Manual Section 202.07 and Nasdaq Rule 4120(a).

⁶⁶² See *e.g.*, NYSE Rule 80B. See also *e.g.*, CBOE Rule 6.3B, ISE Rule 703 (following NYSE’s lead in initiating trading halts in the event of unusual market conditions).

⁶⁶³ Section 12(k)(6) of the Exchange Act, 15 U.S.C. 78l(k)(6).

⁶⁶⁴ See Nasdaq IM-4120-3.

25.4

With respect to securities and market participants:

- a) *Is the regulator informed of the types of securities to be traded and does it approve the rules governing the admission of the securities to trading or listing?*

An SRO's listing criteria are set out in the SRO's rules that are submitted to the SEC for approval pursuant to the Section 19(b) rule filing process. Pursuant to Section 19(b) of the Exchange Act and Rule 19b-4, every SRO files with the SEC any proposed rule, or any proposed change to a rule, of the SRO.⁶⁶⁵ Generally, the SEC publishes these rules for comment by interested persons, and approves the proposed rule change only if the SEC finds that the rule change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder. In addition, pursuant to Section 19(b)(3)(A), certain rules and rule changes are effective by operation of law. *See* the response to Question 7.1(d) for a detailed description of the rule filing process.

SRO listing rules may impose qualitative and quantitative conditions for initial listing and continued listing, including matters pertaining to corporate governance of the issuer, shareholder rights and conformity of the issuer's financial statements to accepted accounting and auditing standards. As part of the listing requirements, the exchanges and associations also require issuers to make timely disclosure of information that would be material to investors or likely to have a significant effect on the price of an issuer's securities. Section 10A(m) and Rule 10A-3 thereunder also directs each national securities exchange and registered securities association to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements set forth in the statute and rule.⁶⁶⁶

Exchange Act Rule 19-4(e) provides that the listing and trading of certain derivative products (defined as an "option, warrant, hybrid securities product or any other security whose value is based, in whole or in part, upon the performance of, or interest in, an underlying instrument"),

⁶⁶⁵ Clearing agencies registered with the SEC are SROs that file proposed rule changes under Section 19(b) and Rule 19b-4. However, because clearing agencies provide post-trade processing services, they do not have rules related to securities trading or listing.

⁶⁶⁶ In general, under Exchange Act Section 10A(m), 15 U.S.C. 78j-1, and Rule 10A-3 thereunder, 17 CFR 240.10A-3, national securities exchanges and registered securities associations are prohibited from listing any security of an issuer that is not in compliance with the following standards: (1) each member of the audit committee of the issuer must be independent according to specified criteria; (2) the audit committee of each issuer must be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the issuer, and each such registered public accounting firm must report directly to the audit committee; (3) each audit committee must establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, including procedures for the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters; (4) each audit committee must have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties; and (5) each issuer must provide appropriate funding for the audit committee, as determined by the audit committee.

however, are not deemed to be a proposed rule change, and an SRO need not file with the SEC prior to listing and trading such a qualified product if the SEC has approved the SRO's trading rules, procedures and listing standards for the product class that would include the new derivative securities product. Pursuant to Rule 19b-4(e), the SRO must also have a surveillance program for the product class, and fulfill certain record keeping and reporting requirements.

25.4

b) Where applicable, does the regulator or the market take product design and trading conditions into account in order to admit a product for trading?

With respect to the rules governing the trading of a product, all securities traded on any SRO must meet certain listing standards, which are rules submitted to the SEC under Section 19(b) of the Exchange Act and Rule 19b-4, as described above. The trading rules are designed to prevent market abuse and manipulation and ensure a fair, orderly, efficient, transparent and liquid market. Section 6(b)(5) and Section 15A(b)(6) of the Exchange Act, in turn, specifically require that the SEC find that the rules of the exchange and the association, respectively, are “designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect the investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers....”

The listing of new products is normally subject to the 19(b) rule filing process. The SEC has adopted a paragraph (e) to Exchange Act Rule 19b-4 to allow new derivative securities products to be listed without a proposed rule change, provided that the new derivative securities product meets the definition therein⁶⁶⁷ and provided that the SEC has approved the SRO's trading rules, procedures, and listing standards for the product class that would include the new derivatives securities product.

In the rare case where the SEC on its own decides to issue rules governing the trading of a product, rather than reviewing proposed rules filed by an SRO, the SEC is subject to standards regarding notice and comment set forth in the Administrative Procedure Act applicable to all federal agencies. Under Section 19(c) of the Exchange Act, the SEC has broad authority to amend the rules of an SRO as it deems necessary or appropriate to insure the fair administration of the SRO, to conform its rules to the requirements of the Exchange Act and rules thereunder, or otherwise in furtherance of the purposes of the Exchange Act through a rulemaking process that provides notice and an opportunity for the SROs and the public to comment.

⁶⁶⁷ Rule 19b-4(e) defines a “new derivative securities product” as “any type of option, warrant, hybrid securities product or any other security, other than a single equity option or a security futures product, whose value is based, in whole or in part, upon the performance of, or interest in, an underlying instrument.” 17 CFR 240.19b-4(e).

25.4

c) Does the regulatory framework provide for fair access to the exchange or trading system through oversight of the related rules for participation?

The regulatory framework provides for fair access. Pursuant to Sections 6(b)(2) and 15A(b)(3) of the Exchange Act, a national securities exchange or registered securities association must have rules that permit any registered broker-dealer or natural person associated with a broker-dealer to become a member of the exchange or association. An exchange or association's ability to deny membership to its market is limited pursuant to Sections 6(c) and 15A(g) of the Exchange Act. An exchange or association, generally, must deny membership to any non-registered broker-dealer and may deny membership to any broker-dealer that is subject to a statutory disqualification. A denial on the grounds of a statutory disqualification must be reported to the SEC. Further, an exchange or association may deny membership to a broker-dealer that does not meet financial responsibility or operational capability standards, does not have the minimum level of training, experience or competence prescribed by the exchange's rules. In addition, an exchange or association may deny membership to a broker-dealer that has engaged or is likely to engage in acts or practices that are inconsistent with just and equitable principles of trade.

Each national securities exchange or registered securities association has rules that proscribe the means by which a registered broker-dealer may apply to become a member. In addition to not permitting an exchange or association to exclude any registered broker-dealer,⁶⁶⁸ the exchange's or association's rules may not be designed to permit unfair discrimination between broker-dealers⁶⁶⁹ and may not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.⁶⁷⁰ Further, Sections 6(b)(4) and 15A(b)(5) of the Exchange Act requires that the rules of an exchange or association provide for an equitable allocation of reasonable dues, fees, and other charges among its members and other persons using its facilities. The SEC has plenary authority to review exchange or association rules that govern the admission of members pursuant to Section 19 of the Exchange Act. Section 6(d)(3), Section 15A(h)(3), and Section 19(d) of the Exchange Act provide that the SEC may review denials of membership in, or access to, an SRO.

If an exchange denies membership or participation to an applicant, it must provide the SEC of notice of such action.⁶⁷¹ A denial of membership or participation by an exchange is reviewable by the SEC.⁶⁷² The SEC will dismiss an appeal if the SEC finds that the SRO's action is based

⁶⁶⁸ Other than pursuant to Sections 6(c) and 15A(g) of the Exchange Act, 15 U.S.C. 78f(c) and 78o-3(g), as discussed above.

⁶⁶⁹ Sections 6(b)(5) and 15A(b)(6) of the Exchange Act, 15 U.S.C. 78f(b)(5) and 78o-3(b)(6).

⁶⁷⁰ Sections 6(b)(8) and 15A(b)(9) of the Exchange Act, 15 U.S.C. 78f(b)(8) and 78o-3(b)(9).

⁶⁷¹ Section 19(d)(1) of the Exchange Act, 15 U.S.C. 78s(d)(1). See Rule 19d-1, 17 CFR 240.19d-1, for the required contents of the notice that a SRO must make to the SEC.

⁶⁷² Section 19(d)(2) of the Exchange Act, 15 U.S.C. 78s(d)(2).

on fact and that the rules were applied in a manner that is consistent with the Exchange Act.⁶⁷³ If the SEC cannot make such a finding, it will set aside the SRO's action and require it to admit the applicant to membership or participation.⁶⁷⁴

Accordingly, the ability to trade on a national securities exchange is readily attainable by those qualified, registered broker-dealers who seek membership. In recent years, many markets have demutualized and moved away from a "membership" structure to a trading permit structure, making opportunities to access such exchanges greater because, unlike membership-based exchanges historically, there is typically no limit on the number of trading permits that a fully electronic exchange issues. However, some exchanges that still have trading floors, though demutualized, have retained their limits on access.⁶⁷⁵ The SEC, however, may increase or remove limitations on the number of memberships for an exchange if it finds that such limitations impose burdens on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.⁶⁷⁶

In addition, Rule 610(a) of Regulation NMS prohibits an SRO from imposing unfairly discriminatory terms that prevent or inhibit any person from obtaining efficient access through a member of the SRO to the quotations in a national market system stock displayed in the SRO trading facility. This anti-discrimination provision provides non-members indirect access to quotes by members. This provision prohibits, for example, different fees or order priority rules based on the identity of a member's customer. Paragraph (c) of Rule 610 also limits the amount of fees that may be charged by a trading facility to access its best bids and offers. Generally, the rules provide that a trading center may not impose a fee for the execution of an order against a "protect quotation," as defined, of the trading center that exceed or accumulate to more than \$0.003 per share or for a stock priced less than \$1.00, that exceed or accumulate to more than 0.3% of the quotation price.

With regard to trading systems, Alternative Trading Systems (ATSs) are also subject to certain fair access standards. ATSs that account for five percent or more of the average daily trading volume in any equity security, municipal security, investment grade or non-investment grade corporate debt must comply with the fair access requirements of Rule 301(b)(5)(ii) of the Exchange Act. Specifically, Rule 301(b)(5)(ii) states that these ATSs must establish written standards for granting access to trading on their systems and maintain these standards in their records. ATSs, like exchanges and associations, are free to have reasonable standards for access, but an ATS is prohibited from unreasonably prohibiting or limiting any persons with respect to

⁶⁷³ Section 19(f) of the Exchange Act, 15 U.S.C. 78s(f).

⁶⁷⁴ *Id.*

⁶⁷⁵ NYSE is an example of this. Exchanges are not allowed to decrease market access below membership levels in effect at the time of exchange registration or May 1, 1975. *See* Section 6(c)(4) of the Exchange Act, 15 U.S.C. 78f(c)(4).

⁶⁷⁶ *Id.*

access to services of the ATS with respect to any such securities, when trading exceeds the five percent volume threshold, and must not apply these standards in an unfairly or discriminatorily manner.

25.5

With respect to fairness of order execution procedures:

- a) *Are order routing procedures clearly disclosed, applied fairly and not inconsistent with relevant securities regulation (e.g., requirements with respect to precedence of client orders and prohibition of front-running or trading ahead of customers)?*

As noted above, Section 6 of the Exchange Act requires that all applicants seeking to register as a national securities exchange file a registration form, a “Form 1”, with the SEC, which would include its proposed rules (including its order routing procedures). The Form 1 requires the applicant to provide comprehensive information about the system and the system operator. Applicants seeking to register as a national securities association file Form X-15AA-1 when registering. Form X-15AA-1 also requires that any rules, which would include any order routing procedures, be filed with the SEC. Therefore, an SRO’s order routing procedures are clearly disclosed to the regulator and to market participants in the context of the registration of the SRO.

The SEC evaluates whether a system’s order routing procedures are fairly applied and not inconsistent with relevant securities requirements by evaluating the application consistent with the Exchange Act’s mandates to only approve an application for registration if the SEC finds that the applicant is so organized and has the capacity to carry out the purposes of the Exchange Act. Thus, an SRO’s order routing procedures can only be approved if they are consistent with relevant securities laws and regulations, including those with respect to precedence and front-running or trading ahead of customer orders. Furthermore, one of the stated purposes of the Exchange Act is to prohibit the “unfair discrimination between customers, issuers, brokers, or dealers.” Thus, an applicant seeking to register as a national securities exchange or registered securities association would only obtain approval to register if its rules were not unfairly discriminatory.

In addition, order routing rules/procedures and actual order routing practices are disclosed publicly via two rules adopted by the SEC in December 2000 that improve public disclosure of order routing practices. Under Exchange Act Rule 606 of Regulation NMS, broker-dealers that route customer orders in equity and option securities are required to make publicly available quarterly reports that, among other things, identify the venues to which customer orders are routed for execution. In addition, broker-dealers are required to disclose to customers, on request, the venues to which their individual orders were routed. By making visible the execution quality of the securities markets, the rules are intended to spur more vigorous competition among market participants to provide the best possible prices for investor orders.

Furthermore, a SRO's rules must be designed to prevent fraudulent and manipulative acts and practices and promote just and equitable principles of trade.⁶⁷⁷ Specifically, the SROs have rules that govern how a broker-dealer may trade for its own account when representing customer orders. Pursuant to these SRO rules, broker-dealers are generally prohibited from trading for their own account when they hold an order for the same security that may be executed at the same price.⁶⁷⁸ Failure to execute the customer's order first can result in a violation of SRO rules. The SEC carefully reviews any changes to these rules to evaluate whether and how investor protections are effected.

In addition, as noted above in the response to Question 7.1(c) above, a broker-dealer has a legal duty to seek to obtain best execution of customer orders. The SEC has adopted its own rule, Exchange Act Rule 611 under Regulation NMS, to support a broker-dealers' duty of best execution. Rule 611 helps to ensure that investors' orders are not executed at prices inferior to the best protected quotations, as defined,⁶⁷⁹ across the markets.

Sections 6(b)(5) and 15A(b)(6) of the Exchange Act require that the rules of an SRO be designed to, among other things, prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade. In addition, the rules of an SRO must be designed as to not permit unfair discrimination between customers, issuers, brokers, or dealers. Moreover, an SRO's rules must provide for the equitable allocation of reasonable dues, fees and other charges among its members and issuers and other persons using its facilities. The SEC reviews all prospective SRO rules to evaluate whether they satisfy these standards. Further, the SEC reviews the prospective rules of the markets to evaluate whether the members of the markets have unfair trading advantages over non-members, or investors generally. For example, the SEC carefully reviews the operations of the SROs' trading systems to ensure that investor orders are able to compete freely with orders of market professionals and are executed on an equitable basis, such as price/time priority.⁶⁸⁰ In addition, the SEC has adopted its own rule geared at helping to ensure that public orders are represented in the markets. Specifically, Exchange Act Rule 604 of Regulation NMS provides that exchange specialists and over-the-counter market makers must display public customer limit orders that improve the bid or offer of the specialist or market maker.⁶⁸¹ In addition, specialists and market makers must include the size of public customer limit orders that are priced equal to the specialist's or market maker's bid or offer. This rule helps to ensure that public customer orders are able to compete in the market for quality executions.

⁶⁷⁷ Sections 6(b)(5) and 15A(b)(6) of the Exchange Act, 15 U.S.C. 78f(b)(5) and 78o-3(b)(6).

⁶⁷⁸ See e.g., NYSE Rule 92 and NASD IM-2110-2 and NASD Rule 2111.

⁶⁷⁹ See Rule 600(a)(58), 17 CFR 242.600(a)(58).

⁶⁸⁰ The SEC has stated that it believes that it is beneficial for orders in the same securities directed to an exchange to interact with each other as it promotes efficient trading and protects investors by assuring that orders executed pursuant to a single set of priority rules that are consistently and fairly applied. See e.g., Securities Exchange Act Release No. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (Order approving the application of the Nasdaq Stock Market LLC as a national securities exchange).

⁶⁸¹ 17 CFR 242.604.

As noted above, the SEC carefully considers prospective exchange rules to evaluate whether they provide members with unfair trading advantages. Specifically, the SEC will analyze any proposed rule that gives a member a trading advantage against the obligations the member has to the market. For example, exchange specialists and market makers are permitted to trade for their own account ahead of public orders in certain instances due to their obligations to maintain a fair and orderly market.⁶⁸²

The SROs also have rules addressing fraudulent or deceptive conduct. For example, NYSE Rule 476(a) prohibits fraudulent acts. FINRA Rule 2020 prohibits any transaction or inducement to purchase or sell a security by means of any manipulative, deceptive, or otherwise fraudulent device or contrivance.

Any prospective SRO must demonstrate its ability to operate as part of the national market system as contemplated in Section 11A of the Exchange Act. In particular, an applicant must comply with the Order Protection Rule⁶⁸³, which requires trading centers to establish policies and procedures reasonably designed to prevent the execution of trades at prices inferior to automated quotations that are the best quote of another exchange or the FINRA, subject to applicable exceptions. The Access Rule⁶⁸⁴ requires fair and non-discriminatory access to quotations, establishes a limit on access fees to harmonize the pricing of quotations across different trading centers, and requires rules addressing locked and crossed markets.

The Exchange Act contains several additional provisions relating to order execution that must be satisfied by a prospective SRO. First, an SRO must demonstrate that its members are not permitted to trade for their own accounts, for the accounts of associated person, or for accounts with respect to which an associated person exercises investment discretion, unless such trading is consistent with the exemptions set forth in Section 11(a) of the Exchange Act and the rules thereunder. There are statutory exceptions to these prohibitions, including trading by a dealer acting as a market maker.⁶⁸⁵ The SEC also excepted by rule, certain classes of transactions from these prohibitions.⁶⁸⁶

⁶⁸² See e.g., Securities Exchange Act Release No. 53539 (March 22, 2006), 71 FR 16353 (March 31, 2006) (Order approving NYSE Hybrid). See also Section 11(b) of the Exchange Act, 15 U.S.C. 78k(b), and Rule 11b-1 thereunder, 17 CFR 240.11b-1.

⁶⁸³ 17 CFR 242.611.

⁶⁸⁴ 17 CFR 242.610.

⁶⁸⁵ See Section 11(a)(1), 15 U.S.C. 78k(a)(1).

⁶⁸⁶ Generally, if a member (except a specialist) wants to execute a transaction of a physical exchange floor for its own account, the member would have to yield priority to all non-members who seek execution at the same price. Section 11(a)(1)(G) of the Exchange Act, 15 U.S.C. 78k(a)(1)(G), and Rule 11a1-1(T) thereunder, 17 CFR 240.11a1-1(T). This section is intended to prevent members of an exchange from having an advantage over non-members by virtue of their time and place opportunities on an exchange. This section does not generally apply to electronic, off-floor orders. See Rule 11a2-2(T) under the Exchange Act, 17 CFR 240.11a2-2(T). As the markets

Section 11(b) of the Exchange Act provides for the regulation of specialists and odd-lot dealers. If an exchange plans on having members act as specialists or odd-lot dealers, the rules of the SRO must reflect the appropriate rules for their registration and activities.⁶⁸⁷

25.5

b) Are execution rules disclosed to the regulator and to market participants, and consistently applied to all participants?

All rules and rule changes are required to be filed with the SEC and, once approved or effective, must be posted on the SRO's website. Further, an SRO must post any proposed new rules or rule amendments filed with the SEC on its website. With regard to the consistent application of execution rules, as noted above, the SEC carefully reviews the operations of the SROs' trading systems to evaluate whether investor orders are able to compete freely with orders of market professionals and are executed on an equitable basis, such as price/time priority.⁶⁸⁸ In addition, the SEC has adopted its own rule geared at ensuring that the public orders are represented in the markets. Specifically, Exchange Act Rule 604 of Regulation NMS provides that exchange specialists and over-the-counter market makers must display public customer limit orders that improve the bid or offer of the specialist or market maker.⁶⁸⁹ In addition, specialists and market makers must include the size of public customer limit orders that are priced equal to the specialist's or market maker's bid or offer. This rule helps to ensure that public customer orders are able to compete in the market for quality executions.

25.5

c) Where applicable, does the regulator review the trade matching or execution algorithm of automated trading systems for fairness?

The duty of best execution governs order execution quality in the United States, as do other provisions of the securities laws and regulations, including the anti-fraud provisions. This duty of best execution is also generally codified in SRO rules. These rules, in turn, are disclosed to the regulator and to market participants through the rule filing process, as well as via the SRO's website. OCIE conducts examinations of SROs and broker-dealers for compliance with the

have moved to more electronic models, the time/place advantages of members that Section 11(a) of the Exchange Act was intended to address have lessened.

⁶⁸⁷ See Rule 11b-1 under the Exchange Act, 17 CFR 240.11b-1.

⁶⁸⁸ The SEC has stated that it believes that it is beneficial for orders in the same securities directed to an exchange to interact with each other as it promotes efficient trading and protects investors by assuring that orders executed pursuant to a single set of priority rules that are consistently and fairly applied. See e.g., Exchange Act Release No. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (Order approving the application of the Nasdaq Stock Market LLC as a national securities exchange).

⁶⁸⁹ 17 CFR 242.604.

securities laws and rules and SRO rules, including rules regarding best execution. The SEC reviews order matching and execution systems to evaluate compliance with the applicable statutory standards as stated in Section 6 of the Exchange Act for national securities exchanges and Section 15A for registered securities associations, among other provisions. OCIE also examines broker-dealers that operate as ATSSs, and may review, as applicable, a firm's algorithmic trading system or proprietary trading systems to ensure they fairly allocate and execute orders, do not discriminate among certain types of orders, and do not use non-public information about order flow obtained through the firm's other business activities to benefit the firm's own account. The ATS reviews may also focus on the firm's order handling practices and processes for selecting trading venues for order execution.

25.6

With respect to trading information:

a) Do similarly situated market participants have equitable access to market rules and operating procedures?

The U.S. federal securities laws, including all statutes, rules and regulations, are readily available from many public sources. For example, the SEC's public web site has a link to all current federal securities laws and contains notices of all pending changes to the federal securities laws.

Rule 19b-4(m) requires that each SRO post and maintain a current and complete version of its rules on its web site. The web sites must be updated to reflect any additions or changes to the rules of the SRO that have been filed with the SEC or otherwise become effective within two business days after the SRO receives notification of the approval or issuance of a notice pursuant to Section 19(b)(3)(A) of the Exchange Act.

All proposed additions or changes to a SRO's rules are publicly available. Proposed rule changes filed with the SEC by a SRO pursuant to Section 19(b) of the Exchange Act are published by the SEC for public comment. In addition, SROs must post proposed rule changes and any amendments thereto on its web site within two business days of filing such proposed rule change or amendment with the SEC.⁶⁹⁰

25.6

b) Are there adequate arrangements for transparency?

SEC, exchange, and association rules require real-time reporting of quotes and transactions occurring on exchanges or in the over-the-counter market, which are made widely available to the public on fair, reasonable and non-discriminatory terms. There is no exception for the real-time reporting of block trades.

⁶⁹⁰ Rule 19b-4(1), 17 CFR 240.19b-4(1).

The dissemination of post-trade information (and pre-trade information) for equities and options is governed by national market system plans (“Plans”) that operate in accordance with Exchange Act and rules thereunder.⁶⁹¹ The Plans require participants, who are the exchanges and associations, to collect and promptly report both pre-trade and post-trade information to Plan processors. The processors are then responsible for receiving the pre-trade and post-trade information from the participants, consolidating the information, and disseminating it to the public, including all market participants; thus, information is made available to all interested parties on the same basis. Pursuant to the applicable Plans, the SROs must report the stock symbol, volume, and price at which transactions were executed to the Plan processor generally within 90 seconds after the time of execution. If a transaction is not reported within 90 seconds, the SRO must designate the last sale price as “late” on the report to the Plan processor.

With respect to the frequency and timing of pre-trade information, pursuant to Exchange Act Rule 602 of Regulation NMS and the required reporting plans, the exchanges and associations must submit the best bids and offers of their members and quotation sizes to the plan processor within approximately one minute. Rule 600(b)(8) limits the definition of “bid” and “offer” to a price communicated to a broker-dealer or customer at which a member is willing to buy or sell one or more round lots of a security; mere indications of interest are excluded from the definition. With respect to post-trade information, the reporting plans require the exchanges and associations to report the stock symbol, volume (in round lots), and price at which transactions were executed to the central processor generally within 90 seconds after the time of execution. If a transaction is not reported within 90 seconds, the exchange or association must designate the last sale price as “late” on the report to the central processor.

ATs are also subject to certain transparency requirements with regards to NMS stock for which they have a certain amount of trading volume. Under Exchange Act Rule 301(b)(3), for any NMS stock in which the ATS displays subscriber orders to any person and for which the ATS had 5% of the aggregate average trading volume, the ATS must provide to an exchange or association the best buy and sell prices for such NMS for inclusion in the quotation data made available to vendors under Rule 602 of Regulation NMS.⁶⁹² Some ATs, however, are dark pools that do not display any data, and thus would not be subject to this rule even if they were to account for 5% of the aggregate trading volume in an NMS stock.

⁶⁹¹ See Regulation NMS Release. The Consolidated Tape Association (CTA) Plan and Consolidated Quotation (CQ) Plan govern the reporting requirements for equity securities; the Options Price Reporting Authority (OPRA) “Plan for Reporting of Consolidated Options Last Sale Reports and Quotation Information” governs the reporting requirements for options.

⁶⁹² Regulation ATS Rule 301(b)(3), 17 CFR 240.301(b)(3).

25.6

c) Are adequate records (i.e., audit trails) available to reconstruct trading activity within a reasonable time?

The exchanges and associations must also keep a transaction record of all trades for audit purposes. All exchanges, associations, and other markets (*i.e.*, ATSS) have adopted procedures governing audit trails and implementing audit trails to aid in the surveillance of their markets. In general, an audit trail requires information about the parties to trade, the security, the type of order, the time of the trade, the number of shares to which the order applies, and the price of the trade. Individual markets can, and often do, require additional information, such as special handling requests, the type of account for which an order was submitted etc.

SROs are required to keep certain other records.⁶⁹³ Specifically, Section 17(a) of the Exchange Act provides that every SRO must make and keep for prescribed periods of time such records, furnish such copies thereof, and make and disseminate such reports as the SEC, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors or otherwise in furtherance of the purposes of the Exchange Act.

The SEC exercised this rulemaking authority by adopting Rule 17a-1, which provides that an SRO must keep and preserve at least one copy of all documents, including all correspondence, memoranda, papers, books, notices, accounts and such other records as shall be made or received by it in the course of its business as such and in the conduct of its self-regulatory activity. Section 17(b) of the Exchange Act authorizes representatives of the SEC to conduct “reasonable, periodic, special or other exams” of “[a]ll records” of an SRO. These examinations may be conducted at any time or from time to time as the SEC “deems necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the [Exchange Act.]”

In addition, Exchange Act Rule 605 of Regulation NMS requires market centers that trade “national market system securities,” which include securities traded on the national securities exchanges, to make available to the public monthly electronic reports that include uniform statistical measures of execution quality.

Likewise, an alternative trading system is subject to record keeping and reporting requirements, including the maintenance of an audit trail for all orders and transactions entered into the system, under the rules of Regulation ATS.⁶⁹⁴ These rules facilitate effective oversight and supervision by the SEC. In addition, trades executed on an alternative trading system are subject to post-trade reporting rules promulgated by the SROs.

⁶⁹³ Section 17(a) of the Exchange Act, 15 U.S.C. 78q(a), and Rule 17a-1.

⁶⁹⁴ Regulation ATS Rules 302 and 303, 17 CFR 242.302 and 303.

Finally, the SEC continues to study how the audit trail for securities transactions may be improved to enhance the ability of regulators and self-regulatory organizations to supervise the trading markets

25.6

- d) Is the system capable of disclosing the types of information that it is designed to make available, and, conversely, of providing safeguards to preserve the confidentiality of other information, the disclosure of which is not intended?*

Exchanges, associations, and ATNs are required to disclose certain types of information in accordance with the requirements of the Exchange Act and rules, including with Regulation NMS and the national market system plans. For example, they are required to disseminate quotations and transaction information for NMS securities consistent with Exchange Act Rules 602 and 603 of Regulation NMS.⁶⁹⁵ In addition, on a monthly basis, exchanges and associations are required to publish order execution quality information consistent with Exchange Act Rule 605 of Regulation NMS.⁶⁹⁶ As discussed further above in the response to Question 7.3(a), exchanges, associations, and ATNs have a duty to safeguard any material, non-public information they receive under their duty of trust or confidence.

⁶⁹⁵ See 17 CFR 242.602 and 603.

⁶⁹⁶ See 17 CFR 242.605.

Secondary Markets – Principle 26

There should be ongoing regulatory supervision of exchanges and trading systems, which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.

Assessment

Fully Implemented.

26.1

Does the regulatory system include:

- a) A program whereby the regulator or an SRO, subject to oversight by the regulator, monitors day-to-day trading activity on the exchange or trading system (through a market surveillance program), monitors conduct of market intermediaries (through examinations of business operations) and collects and analyzes the information gathered through these activities?*

Subject to SEC oversight, the SROs⁶⁹⁷ have the primary responsibility for the daily surveillance of trading activities and regulatory compliance. The SROs are responsible for establishing, reviewing, and enforcing standards of conduct for their members, and for fair and orderly operation of trading or other facilities they provide. As noted above, the SEC has the authority to inspect both the SROs and market participants to determine whether the various anti-fraud, anti-manipulation, and reporting regulations are being complied with. The SEC can also obtain surveillance and/or trading data from the SROs.

Section 19(g)(1) of the Exchange Act provides that every SRO shall comply with the provisions of the Exchange Act, the rules and regulations thereunder and its own rules, and absent reasonable justification or excuse enforce compliance, in the case of an SRO, with such provisions by its members and persons associated with its members. Accordingly, an SRO must have procedures to surveil its market and its members for securities laws violations, including violations to the SRO's own rules.⁶⁹⁸ When considering an application for registration as an SRO, the SEC will consider whether an applicant has adequate surveillance measures, as well as sufficient resources, including staff expertise and capital, to monitor its markets. Surveillance mechanisms are not standardized among the markets and the SEC recognizes that surveillance

⁶⁹⁷ Clearing agencies are SROs under Section 19(b) of the Exchange Act; however, this response does not include clearing agencies because they provide post-trade processing and do not monitor day-to-day trading activity.

⁶⁹⁸ See Exchange Act Sections 6(b)(1) and 15A(b)(2), 15 U.S.C. 78f(b)(1) and 78o-3(b)(2).

procedures may vary depending on the nature and structure of the market and the securities traded on a particular exchange. At a minimum, the SEC has said that an applicant should demonstrate that the officers that manage the day-to-day surveillance function must be familiar with federal securities laws and the role of an SRO.⁶⁹⁹ In addition, as part of its surveillance responsibilities, an SRO must have the capability to maintain an order audit trail for all transactions in its system.⁷⁰⁰

In addition to national securities exchanges, the SEC and SROs regulate alternative trading systems. Alternative trading systems must comply with Regulation ATS.⁷⁰¹ Under Regulation ATS, an alternative trading system is exempt from registration as a national securities exchange, but must register as a broker-dealer, and in that capacity is subject to SEC and SRO oversight. Regulation ATS also includes certain other rules and obligations that provide the SEC with information necessary to monitor trading activity.

26.1

b) Regulatory oversight mechanisms to verify compliance by the exchange or trading system with its statutory or administrative responsibilities, particularly as they relate to the integrity of the markets, market surveillance, the monitoring of risks, and the ability to respond to such risks?

Securities markets are required to maintain certain operational capability standards such that market participants can be confident in its ability to handle securities transactions directed to it. Securities markets in the US are required to maintain a level of operational capability such that they are not at risk of failure. Specifically, Sections 6(b)(1) and 15A(b)(2) of the Exchange Act provides that an exchange or association must have the capacity to be able to carry out the purposes of the Exchange Act and the rules and regulations thereunder and to comply, and to enforce compliance by its members and persons associated with members, with the Exchange Act, rules, and the rules of the SRO. Further, the SEC has stated that national securities exchanges and registered securities associations are expected to maintain sufficient systems capacity to handle foreseeable trading volume.⁷⁰² In this regard, the SEC requires that applicants for registration as a national securities exchange or registered securities association have adequate computer system capacity, integrity, and security to support the operation of the exchange. To evaluate whether the exchanges and associations have adequately addressed their systems capacity needs, the SEC has put in place the ARP as discussed in more detail above. In addition to reviewing the systems capability of an exchange, the SEC will consider whether an exchange or association has sufficient capital to maintain its automated systems, and staff with

⁶⁹⁹ *Id.*

⁷⁰⁰ *Id.*

⁷⁰¹ *See* Regulation ATS, 17 CFR 240.300 et al.

⁷⁰² *See* Regulation ATS Release.

technical expertise.⁷⁰³ The securities markets are also required to have rules that preserve the integrity of the market and that protect against risks to market integrity. Sections 6(b)(5) and 15A(b)(6) of the Exchange Act require that an exchange's or association's rules are designed to, among other things, prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect investors and the public interest. Sections 6(b)(4) and 15A(b)(5) of the Exchange Act provides that an exchange's or association's rules contain provisions that allow for an equitable allocation of reasonable dues, fees and other charges among its members, issuers, and other persons using the facilities of the exchange. While the Exchange Act does not set forth the levels of funding for maintaining the self-regulatory function, the SEC has considered the funding of the self-regulatory functions of an SRO in the context of recent exchange demutualizations. In these filings, the SEC has sought to ensure that fees, fines, or dues collected by an SRO are not used for commercial purposes, and that mechanisms have been established that are designed to ensure a proper level of funding of the SRO regulatory function.⁷⁰⁴ Further, the SEC has recognized that the level of funding may differ among the SROs. Specifically, appropriate levels of funding may be dependant on the SRO's business model, trading systems, regulatory responsibilities, and types of members.⁷⁰⁵

26.1

c) Provides the regulator with adequate access to all pre-trade and post-trade information available to market participants.

All of the records of national securities exchanges, registered securities associations, and registered clearing agencies are subject, at any time, or from time to time, to such reasonable periodic, special, or other examinations by representatives of the SEC.⁷⁰⁶ Registered exchanges and associations are required to keep certain records.⁷⁰⁷ Specifically, Section 17(a) of the Exchange Act provides that every exchange and association must make and keep for prescribed periods of time such records, furnish such copies thereof, and make and disseminate such reports as the SEC, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors or otherwise in furtherance of the purposes of the Exchange Act.

The SEC exercised this rulemaking authority by adopting Rule 17a-1, which provides that national securities exchange, national securities association, registered clearing agency and the Municipal Securities Rulemaking Board must keep and preserve at least one copy of all

⁷⁰³ *Id.*

⁷⁰⁴ *See e.g.*, Exchange Act Release Nos. 53382 (February 27, 2006)(order approving the New York Stock Exchange business combination with Archipelago Holdings, Inc.); 55216 (January 31, 2007)(order approving NYSE Regulation Inc. policies regarding exercise of power to fine NYSE members and use money collected as fines).

⁷⁰⁵ *See* Securities Exchange Act Release No. 50700 (November 18, 2004)(SRO Concept Release).

⁷⁰⁶ Section 17(b) of the Exchange Act, 15 U.S.C. 78q(b).

⁷⁰⁷ Section 17(a) of the Exchange Act, 15 U.S.C. 78q(a), and Rule 17a-1, 17 CFR 240.17a-1.

documents, including all correspondence, memoranda, papers, books, notices, accounts and such other records as shall be made or received by it in the course of its business as such and in the conduct of its self-regulatory activity. Section 17(b) of the Exchange Act authorizes the SEC to conduct “reasonable, periodic, special or other exams” of “[a]ll records” maintained by an SRO. These examinations may be conducted at any time or from time to time as the SEC “deems necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the [Exchange Act.]”.

There are also several national market system plans that the SEC has approved to coordinate the reporting of quotes and transaction information in accordance with the requirements of the Exchange Act and rules thereunder. The Consolidated Tape Association Plan/Consolidated Quotation Plan coordinates the dissemination of real-time trade and quote information in equity securities. The Options Price Reporting Authority Plan provides, through market data vendors, last sale information and current options quotations from participant option exchanges.

26.2

Does the regulatory framework require that amendments to the rules of the exchange or trading system must be provided to, or approved by, the regulator?

As discussed in further detail above, in the response to Question 7.1(d), all SROs must file all proposed changes to their rules with the SEC.

An ATS must provide a description of its operations to the SEC, and keep such materials current.⁷⁰⁸ In addition, an ATS is required to provide quarterly transaction report summaries to the SEC.⁷⁰⁹

26.3

When the regulator determines that the exchange or trading system is unable to comply with the conditions of its approval, or with securities law or regulation, is there a mechanism that permits the regulator to:

- a) Re-examine the exchange or trading system and impose a range of actions, such as restrictions or conditions on the market operator?***

As described in the response to Question 7.2 above, the SEC examines the exchange’s rules and its system regularly for compliance with the Exchange Act and rules as well as its own rules. To the extent that the exchange is not in compliance with any of those laws or rules, the SEC the authority to, among other things, restrict or suspend an SRO’s activities, as further described below in the response to paragraph (b) of this Question 26.3.

⁷⁰⁸ Regulation ATS Rule 301(b)(2), 17 CFR 242.301(b)(2).

⁷⁰⁹ Regulation ATS Rule 301(b)(9), 17 CFR 242.301(b)(9).

26.3

b) Withdraw the exchange or trading system's authorization?

The SEC has the authority under Section 19(a)(3) of the Exchange Act to cancel, suspend, or revoke an SRO's registration. Section 19(a)(3) states that "[a] self regulatory organization may, upon such terms and condition as the SEC, by rule, deems necessary or appropriate in the public interest or for the protection of investors, withdraw from registration by filing a written notice of withdrawal with the SEC. If the SEC finds that any SRO is no longer in existence or has ceased to do business in the capacity specified in its application for registration, the SEC, by order, shall cancel its registration."

Section 19(h) of the Exchange Act generally provides the SEC with the authority to impose penalties on SROs and their members for certain violations of the federal securities laws and/or exchange rules. Specifically, the SEC has the authority (a) to suspend or revoke the registration of an SRO; (b) to censure or impose limitations on its activities; and (c) remove from office or censure officers or directors of an SRO for violations of the Exchange Act or the SRO's rules.⁷¹⁰ The SEC also has the authority to suspend or expel any member or person associated with a member from an SRO for violations of the federal securities laws or rules.⁷¹¹ Under Sections 21(d) and (e) of the Exchange Act, the SEC has the authority to enforce an SRO's rules and to compel an SRO to enforce its rules with regard to its members by filing an action in federal court; relief available includes, among other things, monetary penalties, injunctive action, and any form of equitable relief.

⁷¹⁰ Section 19(h)(1) of the Exchange Act, 15 U.S.C. 78s(h)(1).

⁷¹¹ Section 19(h)(2) and (3) of the Exchange Act, 15 U.S.C. 78s(h)(2) and (3).

Secondary Markets – Principle 27

Regulation should promote transparency of trading.

Assessment

Fully Implemented.

27.1

Does the regulatory framework include:

- a) *Requirements or arrangements for providing pre-trade (e.g., posting of bids and offers) and post-trade (e.g., last sale price and volume of transaction) information to market participants on a timely basis?*

The securities laws and rules and national securities exchange and association rules require real-time reporting of quotes and transactions occurring on exchanges or in the over-the-counter market, which are made widely available to the public on fair, reasonable and non-discriminatory terms. In Section 11A(a)(1)(C) of the Exchange Act, Congress found that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure “the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities.” To this end, in Section 11A(a)(2) of the Exchange Act, Congress directed the SEC to use its authority under the Exchange Act to facilitate the establishment of a national market system for securities in accordance with this finding, among others. The SEC adopted Regulation NMS, consistent with this directive in the Exchange Act, to strengthen and modernize the national market system. Rule 601 under Regulation NMS requires exchanges and associations to file transaction reporting plans for approval with the SEC. It also requires broker-dealers that are members of an exchange or association to promptly transmit to the SRO all information necessary for the effective transaction reporting plan filed by the SRO. Rule 602 under Regulation NMS requires exchanges and associations to establish procedures and mechanisms for collecting bids, offers, quotation sizes, and aggregate quotation sizes from responsible brokers or dealers and for making such bids, offers, and sizes available to vendors.⁷¹² Under this rule, responsible brokers or dealers are required to promptly submit to the exchange or association, pursuant to such procedures, their best bids, best offers, and quotation sizes for any NMS security. Each exchange and association is then required to collect, process, and make available to vendors the best bid, best offer, and aggregate quotation sizes for each subject security. With respect to the

⁷¹² Rule 600(b)(8) under Regulation NMS limits the definition of “bid” and “offer” to a price communicated to a broker-dealer or customer at which a member is willing to buy or sell one or more round lots of a security; mere indications of interest are excluded from the definition.

frequency and timing of pre-trade information, pursuant to Exchange Act Rule 602 of Regulation NMS and the required reporting plans, the exchanges and associations must submit the best bids and offers of their members and quotation sizes to the plan processor within approximately one minute.

The SEC and SRO rules require real-time reporting of transactions occurring on exchanges or in the over-the-counter market and of all quotes that are communicated on exchanges. Real-time reporting of quotes made in the over-the-counter market is also required if the quotation is communicated by a registered market-maker, by any OTC market-maker whose executed volume in the security is greater than one percent of the aggregate trading volume in such security, or by an alternative trading system that trades five percent or more of the volume in national market system securities. There is no exception for the real-time reporting of block trades, other than the plans that allow trades to be reported within 90 seconds which are discussed below.

The dissemination of post-trade information (and pre-trade information) for equities and options is governed by national market system plans (“Plans”) that operate in accordance with Exchange Act rules.⁷¹³ The Plans require participants, who are the SROs, to collect and promptly report both pre-trade and post-trade information to Plan processors. The processors are then responsible for receiving the pre-trade and post-trade information from the participants, consolidating the information, and disseminating it to the public, including all market participants; thus, information is made available to all comparable parties on the same basis (fees charged to non-professionals are typically much lower than fees paid by professionals). Pursuant to the applicable Plans, the SROs must report the stock symbol, volume, and price at which transactions were executed to the Plan processor generally within 90 seconds after the time of execution. However, the 90 second requirement generally only applies to over-the-counter transactions because exchanges report transactions on a real-time or near real-time basis. Last sale and trade data is reported on the “consolidated tape,” a high-speed, electronic system that constantly reports the latest price and volume data on sales of exchange-listed stocks. If a transaction is not reported within 90 seconds, the SRO must designate the last sale price as “late” on the report to the Plan processor. The SROs must also keep a transaction record of all trades for audit purposes.

With respect to the frequency and timing of pre-trade information, under Rule 602 of Regulation NMS and the required reporting plans, the SROs must submit the best bids and offers of their members and quotation sizes to the plan processor within approximately one minute. However, for both competitive and regulatory reasons, SROs submit best bids and offers much faster than one minute, normally within milliseconds.⁷¹⁴

⁷¹³ See Regulation NMS Release. The Consolidated Tape Association (CTA) Plan and Consolidated Quotation (CQ) Plan govern the reporting requirements for equity securities; the Options Price Reporting Authority (OPRA) “Plan for Reporting of Consolidated Options Last Sale Reports and Quotation Information” governs the reporting requirements for options.

⁷¹⁴ For example, in order for its quotations to qualify for protection under Rule 611, Order Protection Rule, a trading center must be able to receive an order, execute it, report the execution and update its quotation within one second.

27.1

b) Requirements or arrangements that information on completed transactions be provided on an equitable basis to all participants?

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

27.2

Where an authorized exchange or trading system’s operator permits derogation from the objective of real-time transparency, are:

a) The conditions clearly defined?

The only way that an authorized exchange or trading system operator typically can derogate from the rules governing real-time transparency is if the SEC grants them an exemption, pursuant to SEC Rule 601(f) (for post-trade transparency) or SEC Rule 602(d) (for pre-trade transparency). In each case, the SEC may grant such exemption unconditionally or on specified terms and conditions, if the SEC determines that such exemption is consistent with the public interest, the protection of investors and the removal of impediments to and perfection of the mechanism of a national market system. As discussed above, the national market system plans (“Plans”) require SROs to collect and promptly report both pre-trade and post-trade information. Generally, the only transactions that are excluded from the Plans are those that are not comparable to regular open-market transactions, such as exercised options, purchases pursuant to a tender offer, and primary-market issuance (*e.g.* an IPO).

27.2

b) Does the operator and/or the regulator have access to the complete information to be able to assess the need for derogation and if necessary, to prescribe alternatives?

As discussed above, the dissemination of post-trade information (and pre-trade information) for equities and options is governed by national market system plans (“Plans”) that operate in accordance with Exchange Act rules. Pursuant to Rule 608 under the Exchange Act, the text of the Plan or amendment thereto must be filed with the SEC together with a statement of the purpose of such plan or amendment and to the extent applicable any supporting documents

required the rule. The SEC reviews the Plan or the amendment and publishes it for notice and comment from interested persons. No Plan or amendment is effective unless approved by the SEC, with some limited exceptions for routine filings. Although the SEC has the authority to grant exemptions from the pre-trade and post-trade transparency requirements in Rules 602(d) and 601(f), the SEC may request access to information it needs to assess the need for an exemption to derogate from the real-time transparency requirements in considering whether to issue an exemption. The SEC also has the discretion not to issue such an exemption and may suggest alternatives to an exemption to the requesting market.

Secondary Markets – Principle 28

Regulation should be designed to detect and deter manipulation and other unfair trading practices.

Assessment

Fully Implemented.

28.1

Does the regulatory system prohibit the following with respect to securities admitted to trading on authorized exchanges and regulated trading systems:

- a) Market or price manipulation?*
- b) Misleading information?*
- c) Insider Trading?*
- d) Front running?*
- e) Other fraudulent or deceptive conduct and market abuses?*

The U.S. federal securities laws broadly prohibit market participants from engaging in fraud. The most generally applied antifraud provisions are contained in Securities Act Section 17(a), Exchange Act Section 10(b), and Rule 10b-5 thereunder. Section 17(a) of the Securities Act prohibits fraud, material misstatements, and omissions of fact “in the offer or sale of any security.” Rule 10b-5 implements Section 10(b) of the Exchange Act, which prohibits any person, in connection with a purchase or sale of any security, from using or employing any manipulative or deceptive device or contrivance in contravention of the SEC’s rules and regulations. Rule 10b-5 under the Exchange Act makes it unlawful for any person, directly or indirectly, to use any device, scheme or artifice to defraud, to make any untrue statements of material fact or to omit to state a material fact necessary in order to make the statements made not misleading, and to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

The SROs also have rules addressing fraudulent or deceptive conduct. For example, NYSE Rule 467(a) prohibits conduct inconsistent with just or equitable principles of trade, including front-running. FINRA Rule 2020 prohibits any transaction or inducement to purchase or sell a

security by means of any manipulative, deceptive, or otherwise fraudulent device or contrivance.⁷¹⁵ Similarly, MSRB Rule G-17 provides that each broker, dealer, and municipal securities dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice.

28.1

a) *Market or price manipulation*

The U.S. federal securities laws broadly prohibit market manipulation, including engaging in wash sales or other attempts to create a false or misleading appearance of active trading in any security, as well as effecting a series of transactions to raise or depress the price of a security for the purpose of inducing transactions in the security by others. Section 10(b) of the Exchange Act empowers the SEC to promulgate rules barring manipulative and deceptive conduct, and Section 15(c) prohibits fraudulent and manipulative conduct by broker-dealers. Section 9 of the Exchange Act outlaws manipulative practices in connection with the trading of exchange-listed securities and also provides a private remedy for investors injured by the prohibited manipulative conduct. More specifically, Section 9(a)(6) gives the SEC the authority to promulgate rules prohibiting “pegging, fixing or stabilizing” securities prices. Section 9 applies only to securities that are listed on a national exchange. Section 10(b) is broader and applies to all securities transactions utilizing an instrumentality of interstate commerce. It empowers the SEC to prescribe rules that it deems necessary and appropriate to protect investors and the public interest. Section 15(c) of the Exchange Act covers the over-the-counter markets and municipal securities. Several additional provisions of, and rules under, the Exchange Act govern specific manipulation activities.⁷¹⁶ These requirements and prohibitions are supplemented by rules of the SROs and the Municipal Securities Rulemaking Board.

Typical market manipulation cases, in violation of Section 10(b) and Rule 10b-5 and/or Section 9(a) of the Exchange Act, involve executed orders with prices that are reported to the tape, which give the false impression to the market and investors of legitimate investor interest. Section 9(a)(1) requires that the person engaging in matched orders/wash trades have the specific purpose of trading in this fashion in order to create a false or misleading appearance of active trading in the security (registered on an exchange). Section 9(a)(2) requires proof of manipulative intent, specifically, the intent to induce the purchase or sale of the securities, which is a higher burden of proof than the scienter element of Section 10(b).⁷¹⁷ Section 9(a)(3) prohibits inducing others to buy or sell a security by disseminating information stating that the

⁷¹⁵ See also, FINRA Rule 2010.

⁷¹⁶ See e.g., Sections 9(b) and (e), 13(e), 14(e), 10(a) and (b), and 15(c) of the Exchange Act; Rules 10b-1, 10b-3, 10b-5, 10b-9, 10b-10, 14e-3, 14e-4, 14e-5, 10b-16, 10b-17, 10b-18, 15c1-2, 15c1-3, 15c1-5, 15c1-6, 15c1-7, 15c1-8, 15c1-9, 15c2-1, 15c2-4, 15c2-5, 15c2-7, 15c2-8, and 15c2-11 thereunder; and Regulation M.

⁷¹⁷ See *SEC v. Kwak*, 2008 US Dist. Lexis 10201 (D.C. Conn. 2008); *Michael Batterman*, Exchange Act Rel. No. 12278, 46 SEC 304 (March 29, 1976) (settled order); *Harold T. White*, 3 SEC 466 (June 21, 1938) (SEC opinion).

price of a security will likely rise or fall because of market operations of a group of persons, which market operations are for the purpose of raising or depressing the price of the security.⁷¹⁸ Finally, Section 9(a)(4) of the Exchange Act prohibits a person purchasing or offering to purchase, or selling or offering to sell, securities registered on a national securities exchange from making statements which at the time and in the light of the circumstances under which they were made, false or misleading with respect to any material fact, and that he or she has reasonable grounds to believe are false and misleading for the purpose of inducing the purchase or sale of such securities.

Matched Orders / Wash Sales

Matched orders and wash sales are violations of Section 9(a)(1) (for exchange listed securities) or of Section 10(b) (for over-the-counter securities). Matched orders are “orders of substantially the same size, at substantially the same time, and at substantially the same price...by or for the same or different parties.”⁷¹⁹ Wash trades involve a trade between two accounts where, after the trade, there is no change in beneficial ownership in the security traded.⁷²⁰ Wash trades and matched orders may be manipulative devices and, if carried out with the intent to defraud or with reckless disregard for the impact of the trading on the market, they may violate 10b-5.

Reg M and Reg SHO

The SEC has long recognized that securities offerings present special opportunities and incentives for market manipulation. The SEC adopted Regulation M to protect the integrity of the securities trading market as an independent pricing mechanism by governing the market activities of underwriters, broker-dealers, and other distribution participants, as well as issuers, selling security holders, and their affiliated purchasers, in connection with a securities offering.⁷²¹ The regulation is aimed at preventing such persons from artificially influencing the market price for the offered security in order to facilitate a distribution. Although the general antifraud and anti-manipulation provisions of the U.S. securities laws continue to apply to all securities transactions, Regulation M takes a prophylactic approach. Rather than addressing manipulation after the fact, Regulation M seeks to prevent it by precluding persons having an interest in an offering from engaging in specified market activities during a distribution.⁷²² In

⁷¹⁸ See *In the Matter of the Proceeding under Sec. 9(a)(3) regarding Abbott, Proctor & Paine*, Exchange Act Rel. No. 1214 (May 22, 1937); *W.E. Hutton*, Exchange Act Rel. No. 932 (Nov. 13, 1936).

⁷¹⁹ Exchange Act § 9(a)(1), 15 U.S.C. § 78i(a)(1); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206 n. 25 (1976); see also, *In the Matter of William Lowe*, Exchange Act Rel. No. 41308, 1999 SEC LEXIS 761 (April 19, 1999).

⁷²⁰ *Swartwood, Hesse, Inc.*, 1989 SEC LEXIS 5160 (March 6, 1989) (Initial Decision) (affirmed in part by the SEC, 1992 SEC LEXIS 2412 (Sept. 22, 1992)).

⁷²¹ See Exchange Act Rel. No. 38067 (Dec. 20, 1996).

⁷²² See *id.*

contrast to the more general anti-manipulation provisions, proof of manipulative intent or purpose in an enforcement action is not necessary to establish a Regulation M violation.

Regulation SHO is designed to reduce failures to deliver securities on transactions in equity securities, and to target potentially problematic short selling and abusive “naked” short selling. Short selling involves a sale of a security that the seller does not own or a sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller.⁷²³ In order to deliver the security to the purchaser, the short seller will borrow the security, typically from a broker-dealer or an institutional investor. Typically, the short seller later closes out the position by purchasing equivalent securities on the open market and returning the security to the lender. In general, short selling is used to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand, or to hedge the risk of an economic long position in the same security or in a related security.⁷²⁴ Regulation SHO contains detailed provisions regarding when a security can be marked “long” versus “short,” borrowing or obtaining a source of borrowable securities prior to effecting a short sale (the “locate” requirement), closing out fails to deliver in equity securities, and restrictions applicable to selling long. Rule 10b-21, a “naked” short selling antifraud rule, highlights the liability of persons that deceive broker-dealers, participants of a registered clearing agency and purchasers about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate source or share ownership and who fail to deliver such securities by settlement date.⁷²⁵ A seller misrepresenting its short sale locate source or ownership of shares may intend to fail to deliver securities in time for settlement and, therefore, engage in abusive “naked” short selling. Although abusive “naked” short selling is not defined in the federal securities laws, it refers generally to selling short without having stock available for delivery and intentionally failing to deliver stock within the standard three-day settlement cycle. Although abusive “naked” short selling as part of a manipulative scheme is always illegal under the general anti-fraud provisions of the federal securities laws, including Section 10(b) and Rule 10b-5 under the Exchange Act, Rule 10b-21 highlights the specific liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement, including persons that deceive their broker-dealer about their locate source or ownership of shares and fail to deliver by settlement date.

⁷²³ See 17 CFR 242.200(a).

⁷²⁴ See, e.g., Exchange Act Rel. No. 54891 (Dec. 7, 2006), 71 FR 75068, 75069 (Dec. 13, 2006) (“2006 Price Test Elimination Proposing Release”); 2003 Regulation SHO Proposing Release, 68 FR at 62974.

⁷²⁵ See Exchange Act Rel. No. 58774 (Oct. 14, 2008), 73 FR 61666 (Oct. 17, 2008) (“Naked Short Selling Antifraud Rule”).

Other Manipulative Practices

Some examples of other types of manipulative practices include the following:

- “Marking the close” is “the practice of repeatedly executing the last transaction of the day for a security in order to affect its closing price.”⁷²⁶ Federal courts have recognized that marking-the-close violates the antifraud provisions of the federal securities laws.⁷²⁷
- Spoofing involves traders who submit small orders in order to “bait” market makers to adjust their quotes to reflect the order on one side of the market and as soon as the quote is adjusted, immediately submit a second order for a larger share amount to “hit” the market maker’s quote while also canceling the initial, bait order. The market maker is left with the obligation to fill the second order to its detriment.⁷²⁸

28.1

b) Misleading Information

Anyone who makes material misrepresentations in connection with the purchase or sale or offer or sale of a security is liable under the antifraud provisions. In addition, persons may be liable for omissions of material facts necessary to make statements not misleading, or for material omissions where they have an affirmative duty to disclose. For example, broker-dealers are liable under the antifraud provisions for failure to disclose material information to their customers where they have a duty to make such disclosure. In connection with omissions, the Supreme Court has stated that there is no general duty to affirmatively disclose material information.⁷²⁹ A failure to disclose material information is only fraudulent if there is a duty to make such disclosure arising out of “a fiduciary or similar relation of trust and confidence.”⁷³⁰ Courts and the SEC have found such a relationship based on a finding that the broker-dealer owes a fiduciary duty to its customer or under the “shingle theory,” which requires a broker-dealer to act in a fair and equitable manner. In addition, if a person makes a statement that was

⁷²⁶ *SEC v. Schiffer*, 1998 U.S. Dist. LEXIS 8579, at * 26 n. 26 (S.D.N.Y. June 11, 1998).

⁷²⁷ *See, e.g., Schiffer*, 1998 U.S. Dist. LEXIS 8579 at * 26 (granting preliminary injunction where evidence demonstrated that defendant/CEO manipulated his company’s stock price by marking-the-close); *T.H.C., Inc. v. Fortune Petroleum Corp.*, 1999 U.S. Dist. LEXIS 4039, at *10-11 (S.D.N.Y. March 31, 1999) (denying motion to dismiss where defendant/broker dealer was alleged to have manipulated stock price in part by “timing transactions to occur at the close of the market in order to set the closing price.”

⁷²⁸ *See Frazee*, Exchange Act Rel. No. 47522 (March 18, 2003); *Blackwell*, Exchange Act Rel. No. 45018 (Nov. 5, 2001); *Shenker*, Exchange Act Rel. No. (45017 (Nov. 5, 2001); *Monski*, Exchange Act Rel. No. 44250 (May 3, 2001); *Fishman*, Exchange Act Rel. No. 40115 (June 24, 1998).

⁷²⁹ *See Basic v. Levinson*, 485 U.S. 224, 239 n.17 (1988) (“Silence, absent a duty to disclose, is not misleading under Rule 10b-5.”); *Chiarella v. U.S.*, 445 U.S. 222 (1980).

⁷³⁰ *Chiarella*, 445 U.S. at 228.

misleading at the time it was made or becomes misleading, he has an obligation to make any additional statements necessary to make the original statement not misleading.⁷³¹

Many types of fraudulent schemes involve material misrepresentations or material omissions. A few examples are as follows:

- A frequently used market manipulation scheme is the “pump and dump,” in which false favorable publicity is used to dupe unsuspecting investors into buying the security, which “pumps” up the price of the security.⁷³² Typically, a fake press release is disseminated to the media, or to the public through a spam fax/email campaign. The information causes a security’s price to skyrocket and the fraudster sells his shares in the elevated market for an enormous profit. Following the scam, the price bottoms out and investors, lured into the hyped market, lose their investment.⁷³³
- When a registered representative at a broker-dealer recommends a security, he must affirmatively disclose all material adverse facts, including any economic self-interest, so that his customers may evaluate his overlapping motivations.⁷³⁴ Persons that make secret payments of cash, kickbacks, gifts, and gratuities in connection with securities transactions violate the antifraud provisions.⁷³⁵ Because they are secret and taint the

⁷³¹ See *U.S. v. Skelly*, 442 F.3d 94, 97 (2d Cir. 2006) (a “middleman may be liable for fraud if he . . . tells [the purchaser] misleading half truths” but not if he simply fails to disclose information that he is under no obligation to reveal); *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 944 (7th Cir. 1989) (“incomplete disclosures or ‘half-truths’ implicate a duty to disclose whatever additional information is necessary to rectify the misleading statements”); *Siemers v. Wells Fargo & Co.*, 2006 WL 2355411, *5 (N.D. Cal. 2006) (to be liable under the omissions provision of Rule 10b-5, there must be “an affirmative statement that was materially misleading because of a failure to make additional disclosure”); *Wallace Computers Svcs, Inc. v. David Noyes & Co.*, 1994 WL 23110, *4, Fed. Sec. L. Rep. P 98,130 (N.D. Ill. 1994).

⁷³² See *SEC v. Softpoint, Inc.*, 958 F. Supp. 846, 862-63 (S.D.N.Y. 1997), *aff’d*, 159 F.3d 1348 (2d Cir. 1998) (table) (false press releases and reports designed to increase stock price violated the antifraud provisions); *SEC v. Aqua Vie Beverage Corp.*, 2007 WL 2025231 (D. Idaho 2007) (fax tout sheets projecting \$7 million in revenues lacked reasonable basis and violated the antifraud provisions).

⁷³³ See *SEC v. Richard Karp*, Lit. Rel. No. 21054 (May 21, 2009).

⁷³⁴ See, e.g., *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1172 (2d Cir. 1970); *c.f. SEC v. Hasho*, 784 F. Supp. 1059, 1110 (S.D.N.Y. 1992) (applying shingle theory, salespersons falsely stated that they would receive no commissions on certain of their customers’ transactions and failed to disclose the amount of commissions they were earning on other customer transactions).

⁷³⁵ See, e.g., *United States v. Brown*, 79 F.2d 321, 325 (2d Cir. 1935) (stating that the defendant engaged in deceitful conduct by paying a bribe to a broker to advise a customer to misrepresent a fact (i.e., that the broker’s advice was not corrupted)); *United States v. Blitz*, 533 F.2d 1329, 1338 (2d Cir.), *cert. denied*, 429 U.S. 819 (1976); *United States v. Haddy*, 134 F.3d 542, 544-46 (3d Cir. 1998) (affirming conviction of defendants who paid kickbacks to brokers as part of overall scheme); *United States v. Feyrer*, 333 F.3d 110, 112-13 (2d Cir. 2003) (affirming conviction of corporate officer who engaged in a scheme to bribe brokers to solicit stock of corporation); *SEC v. Alliance Leasing Corp.*, 2000 U.S. Dist. LEXIS 5227, at *32 (S.D. Cal. Mar. 17, 2000) (payment of 30% commissions on securities sales was material fact as a matter of law); *SEC v. Softpoint, Inc.*, 958 F. Supp. 846, 863 (S.D.N.Y. 1997) (payments to brokerage firms under kickback agreement was material information).

registered representative's recommendation, they also constitute a knowing failure to disclose material information relevant to a securities transaction by the registered representative at the broker-dealer.⁷³⁶

- Reporting violations occur when there is a lack of accurate information about an issuer or when false or misleading information is being disseminated to the public by the issuer or a third party. Such conduct violates the antifraud provisions of the federal securities laws.⁷³⁷
- The SEC can issue, under appropriate circumstances, an order suspending trading. Exchange Act Section 12(k)(1)(A) authorizes the SEC “[i]f in its opinion the public interest and the protection of investors so require, . . . by order . . . summarily to suspend trading in any security (other than an exempted security) for a period not exceeding 10 business days. . . .” Often, a suspension is issued to alert the investing public that there is insufficient public information about the issuer upon which an informed investment judgment can be made or that the market for the securities may be reacting to manipulative forces or deceptive practices. Consequently, the SEC typically considers, in determining whether or not a 10-day suspension should be instituted, whether or not there is sufficient public information upon which to base an informed investment decision or whether the market for the security appears to reflect manipulative or deceptive activities.⁷³⁸
- Transfer agents can also play a role in manipulative schemes. The SEC has brought enforcement actions against transfer agents for misconduct, including conspiring with the issuer to manipulate securities in violation of the federal securities laws and regulations.⁷³⁹ In some fraudulent schemes, legal counsel has misled the transfer agents by drafting false legal opinion letters to, for example, fraudulently induce the removal of restrictive legends on shares.⁷⁴⁰ These types of schemes may include an “opinion mill,” which issues fraudulent legal opinions used by promoters in a pump-and-dump scheme,

⁷³⁶ See, e.g., *SEC v. Savino*, 2006 WL 375074 (S.D.N.Y. Feb. 16, 2006) (undisclosed kickbacks of cash, gifts, and gratuities from one trader to another trader in return for order flow and favorable pricing); *United States v. Blitz*, 533 F.2d 1329 (2d Cir.), cert. denied, 429 U.S. 819 (1976) (undisclosed payments to brokers for purchasing securities or procuring purchasers); *SEC v. Feminella*, 947 F. Supp. 722 (S.D.N.Y. 1996) (kickbacks to agent of broker-dealer's customer to obtain securities business).

⁷³⁷ *Stansbury Holdings Corp.*, 2003 SEC LEXIS 1639, at *15 (July 14, 2003); *WSF Corp.*, 2002 SEC LEXIS 1242, at *14 (May 8, 2002).

⁷³⁸ See Exchange Act Rule 15c2-11(a)(3). Under Exchange Act Rule 15c2-11, following a ten-day trading suspension, a broker or dealer cannot publish a quotation for the stock of an issuer registered under Section 12 in an interdealer quotation system until, inter alia, “the broker or dealer has a reasonable basis under the circumstances for believing that the issuer is current in filing annual, quarterly, and current reports.”

⁷³⁹ See *SEC v. CIBC Mellon Trust Co.*, Lit. Rel. No. 19081 (February 16, 2005).

⁷⁴⁰ See *SEC v. Albert J. Rasch, Jr., et al.*, Lit. Rel. No. 21024 (May 5, 2009).

and others, to sell securities in violation of the registration provisions of the federal securities laws.

- A fraudulent scheme that occurs in the municipal financing area is a “pay to play” in which decision-makers for a municipality (often political officials) accept payments from financial firms for the investment business of the municipality.⁷⁴¹
- Mutual funds often have several classes of shares. Class A shares generally have an up front fee, or front-end load, which is reduced with the size of the investment. Class B shares have no front-end load, but instead include a back-end load when the mutual fund is sold. Mutual funds often require a large minimum initial investment (“breakpoints”) before investors can qualify to purchase Class A shares. In the case of these larger investments, where the Class A front-end load is reduced, Class A shares are often better investments than Class B shares. However, in many instances, broker-dealers obtain higher commissions for selling Class B shares than for Class A shares, creating a conflict of interest. Therefore, where a broker-dealer recommends such mutual funds, in certain circumstances, it should disclose the various class expenses and fees and how they will impact the expected return on an investment.⁷⁴²

28.1

c) *Insider Trading*

Insider trading is a specific form of fraud that undermines confidence in the securities markets. In general, U.S. insider trading prohibitions apply to persons trading on the basis of material, non-public information obtained or used in breach of a duty. The fundamental prohibition against “insider trading” under the U.S. federal securities laws is not based on an explicit statutory prohibition against insider trading. Instead, U.S. courts have interpreted the general antifraud provisions of the Exchange Act (Section 10(b) and Rule 10b-5 thereunder), to prohibit insider trading.

The SEC brings enforcement actions under two theories of insider trading, classical and misappropriation. Under the classical or traditional theory, a person violates the antifraud

⁷⁴¹ See *SEC v. Henry Morris, et al.*, Lit. Rel. No. 21018 (April 30, 2009) (charging Aldus Equity Partners, L.P. and one of its founding principals, Saul Meyer, in connection with a multi-million dollar kickback scheme involving New York's largest pension fund); *SEC v. Larry P. Langford, et al.*, Lit. Rel. No. 20545 (April 30, 2008) (charging the President of the County Commission of Jefferson County, Alabama with accepting cash and benefits from the chairman of a local broker-dealer in return for selecting the broker-dealer to participate in every municipal bond offering and security-based swap agreement transaction during 2003 and 2004).

⁷⁴² See, e.g., *Flanagan, Kindschi, and Spectrum Administration, Inc.*, Exchange Act Rel. No. 49979 (July 7, 2004) (SEC opinion on EAJA claim) (legal theory that respondents committed fraud by failing to disclose fully the difference between Class A and Class B shares of mutual funds has substantial justification); *Sandra K. Simpson*, Exchange Act Rel. No. 45923, 2002 SEC LEXIS 1278 (May 14, 2002) (SEC opinion) (“[Respondent] arranged the purchases to avoid breakpoints, and thereby improperly maximized the brokerage commissions.”).

provisions when he or she buys or sells securities on the basis of material, non-public information and is an insider of the corporation whose securities are traded. Under the classical theory, traditional insiders, such as officers, directors and employees, in possession of material, non-public information have a fiduciary duty to the issuer and its shareholders to publicly disclose such information or to abstain from trading.⁷⁴³ If the insider trades while in possession of the material, non-public information, the insider's failure to disclose the information prior to trading operates as a fraud.⁷⁴⁴

Under the misappropriation theory, a person violates the antifraud provisions when he or she misappropriates non-public information, "in breach of a duty owed to the source of the information," and trades on the basis of this information.⁷⁴⁵ Because the misappropriator gains access to the confidential information to serve the ends of the fiduciary relationship, he becomes duty bound not to appropriate the information for his own use.⁷⁴⁶ The misappropriation theory reaches outsiders who would not ordinarily be deemed fiduciaries of the corporate entities in whose stock they trade.⁷⁴⁷ Under both the classical and misappropriation theories, it is also unlawful for a "tippee" to trade on material, nonpublic information that the tippee knew or should have known was communicated in breach of a duty.⁷⁴⁸

In addition, Section 16(b) of the Exchange Act imposes liability for short-swing profits in the issuer's stock upon all persons required to file reports under Section 16(a) of the Exchange Act (officers, directors and beneficial owners of more than ten percent of any class of equity security). These statutory insiders must disgorge to the issuer any profit realized as a result of a purchase and sale or sale and purchase of covered equity securities occurring within a six-month period.

Section 14(e) of the Exchange Act and Rule 14e-3 thereunder establish a specific insider trading prohibition in the context of tender offers. Together, these provisions prohibit trading while in possession of material, nonpublic information if any person has taken substantial steps toward a tender offer, and the person knows or had reason to know that the information was nonpublic and came from a proscribed source such as the offeror.

⁷⁴³ *Chiarella v. United States*, 445 U.S. 222, 230 (1980) ("corporate insiders...have an obligation to place the shareholder's welfare before their own.").

⁷⁴⁴ *Id.*, at 228.

⁷⁴⁵ *United States v. O'Hagan*, 521 U.S. 642, 652 (1997) ("[T]he misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.").

⁷⁴⁶ *See United States v. Chestman*, 947 F.2d 551, 569 (2d Cir. 1991) (*en banc*).

⁷⁴⁷ *See U.S. v. Cherif*, 933 F.2d 403,411 (7th Cir. 1991) (after his termination, an employee is obligated to continue to protect any confidential information entrusted to him by his employer during employment).

⁷⁴⁸ *See Dirks v. SEC*, 463 U.S. 646, 660 (1983).

28.1

d) Front Running

The SEC also brings enforcement actions for violations of the antifraud provisions of the federal securities laws for front running. One example of this practice is a broker-dealer that trades an equity based on information from its research and analyst departments before customers are provided the information.

Trading ahead is a similar type of manipulation in which a broker-dealer fills an agency order through a proprietary trade for the firm's proprietary account – and thereby improperly 'steps in front' of, or 'trades ahead' of, another agency order – simply to allow the firm to take advantage of market conditions. Prior to SROs prohibiting this conduct through their own rules, the SEC found that a broker-dealer must disclose when it is trading ahead of customer orders, applying the shingle theory.⁷⁴⁹ The *E.F.Hutton* opinion is the basis for FINRA IM-2110-2, referred to as the "Manning Rule," which restricts broker-dealers' ability to trade ahead of customer limit orders. Additionally, FINRA Rule 2111 prohibits broker-dealers from trading ahead of customer market orders under certain circumstances.⁷⁵⁰

28.1

e) Other fraudulent or deceptive conduct and market abuses?

The SEC investigates and enforces a wide variety of misconduct under the antifraud provisions of the Exchange Act.⁷⁵¹ As noted, the antifraud provisions apply broadly to "any" fraudulent, manipulative, or deceptive devices. Some examples of these fraudulent practices and market abuses include:

- Interpositioning involves a two-step process that allows the broker-dealer firm (or a specialist firm) to generate a profit from the spread between two opposite trades. The SEC has repeatedly held that interpositioning violates the antifraud provisions of the federal securities laws when it results in customers not receiving the best available market price.⁷⁵² For example, in *In the Matter of Thomson & McKinnon*, Exchange Act Rel. No. 8310 (May 8, 1968), the SEC stated:

⁷⁴⁹ See *E.F. Hutton & Co.*, Exchange Act Rel. No. 25887, 49 S.E.C. 829 (July 6, 1988) (upholding NASD sanction).

⁷⁵⁰ See also FINRA Rule 5280 (prohibiting trading ahead of research reports).

⁷⁵¹ See e.g., *In re AOL Time Warner Sec. & "ERISA" Litig.*, Fed. Sec. L. Rep. (CCH) ¶92,812 (S.D.N.Y. 2004) ("10b-5(a) and (c) claims need not contain the magic words 'wash sales, matched orders, or rigged prices' to be valid").

⁷⁵² See, e.g., *In the Matter of Synovus Securities, Inc.*, Exchange Act Rel. No. 34313 (July 5, 1994) (broker-dealer and its president placed customer orders with a personal friend of the president who was able to promptly sell the bonds to or buy the bonds from other brokers at a profit and customers did not get the best market price); *In the*

In view of the obligation of a broker to obtain the most favorable price for his customer, where he interposes another broker-dealer between himself and a third broker-dealer, he prima facie has not met that obligation and he has the burden of showing that the customer's total cost or proceeds of the transaction is the most favorable obtainable under the circumstances.⁷⁵³

- Unauthorized trading occurs when a broker purchases or sells stock on behalf of an investor who has not authorized the transaction.⁷⁵⁴ In addition to violating the antifraud provisions of the federal securities laws, FINRA has a number of rules that address unauthorized trading and related aspects.⁷⁵⁵
- Churning is excessive trading in an account that usually results in buy/sell activities against the financial interests of the customer. To distinguish churning from straight excessive trading (which is an element of churning as well as a separate violation of FINRA rules), scienter must be established. This is often done by showing a benefit to the broker.⁷⁵⁶ In addition, a broker must be shown to have control over the accounts. This can either be explicit, in the case of a discretionary account, or de facto, in the case of a nondiscretionary account, where the customer lacks the ability to independently evaluate the broker's recommendations.⁷⁵⁷
- Scalping is the practice "whereby the owner of a security recommends that security for investment and then immediately sells it at a profit upon the rise in the market price

Matter of Edward Sinclair, Exchange Act Rel. No. 9115 (Mar. 24, 1971), *aff'd*, 444 F.2d 399 (2d Cir. 1971) (order clerk in OTC department of broker-dealer interposed a broker-dealer between his firm and best available market price in return for split of profits with the interposed broker); *In the Matter of Delaware Management Company, Inc.*, Exchange Act Rel. No. 8128 (July 19, 1967) (investment adviser incurred unnecessary brokerage costs and charges for its customers by interposing a broker between itself and other broker-dealers who made markets in the securities); *In the Matter of H.C. Keister & Company*, Exchange Act Rel. No. 7988 (Nov. 1, 1966) (in exchange for payments, trader for a large broker-dealer interpositioned a small broker-dealer between its customers' orders and the best available market prices); *see also SEC v. Ridenour*, 913 F.2d 515 (8th Cir. 1990) (Ridenour, a bond salesman, violated the antifraud provisions based on his secret interpositioning of his personal trading account between his customers' securities transactions and the fair market price of the trades).

⁷⁵³ *See also, In the Matter of Edward Sinclair*, Exchange Act Rel. No. 9115 (Mar. 24, 1971), *aff'd*, 444 F.2d 399 (2d Cir. 1971) (order clerk in OTC department of broker-dealer interposed a broker-dealer between his firm and best available market price in return for split of profits with the interposed broker).

⁷⁵⁴ *See, e.g., Edgar B. Alacan*, Exchange Act Rel. No. 49970 (July 6, 2004); *William C. Piontek*, Exchange Act Rel. No. 48903 (Dec. 11, 2003).

⁷⁵⁵ *See* FINRA Rules 2510 and 2310-2(4)(iii).

⁷⁵⁶ *See, e.g., Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 767 F.2d 1498 (11th Cir. 1985).

⁷⁵⁷ *See, e.g., Al Rizek*, Exchange Act Rel. No. 41725 (Aug. 11, 1999).

which follows the recommendation.”⁷⁵⁸ Failure to disclose such activity is a violation of Section 10(b) and Rule 10b-5.⁷⁵⁹

- Revenue sharing occurs when a broker-dealer is paid by a mutual fund in exchange for promoting the funds to the broker-dealer’s customers. Although revenue sharing is not fraudulent per se, if a broker-dealer makes a recommendation of a mutual fund with which it has a revenue sharing arrangement, it must disclose this to the customer. Revenue sharing has been found to be a material fact that, if not disclosed, constitutes deceptive and misleading conduct.⁷⁶⁰
- A broker-dealer has a legal duty to seek to obtain best execution of customer orders.⁷⁶¹ Failure to satisfy the duty of best execution can constitute fraud because a broker-dealer, in agreeing to execute a customer’s order, makes an implied representation that it will execute it in a manner that maximizes the customer’s economic gain in the transaction.⁷⁶²

⁷⁵⁸ *SEC v. Huttoe*, 1998 WL 34078092, *7 (D.D.C. 1998).

⁷⁵⁹ *See Zweig v. Hearst Corp.*, 594 F.2d 1261 (9th Cir. 1979) (financial columnist failed to disclose his scalping activities); *SEC v. Park d/b/a Tokyo Joe*, 99 F. Supp. 2d 889, 899-900 (N.D. Ill. 2000) (holding that a scalper must “disclose his interest in the targeted stock”); *Richmark Capital Corp.*, Exchange Act Rel. No. 48757 (Nov. 7, 2003) (SEC opinion) (by recommending that customers purchase security without disclosing its own concurrent sales, broker-dealer omitted material information, which prevented customers from making informed investment decisions).

⁷⁶⁰ *See In re AIG Advisor Group*, 2007 WL 1213395, *7-9 (E.D.N.Y. 2007) (where broker-dealers received kickbacks in form of revenue sharing and directed brokerage from mutual funds in exchange for recommending the funds to customers, such payments concerned conflict of interest that are not immaterial as a matter of law and must be disclosed).

⁷⁶¹ *See, e.g., Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 269-70, 274 (3d Cir.), *cert. denied*, 525 U.S. 811 (1998); *Herzog, Heine, Geduld, LLC*, Exchange Act Rel. No. 54148 (July 14, 2006) (settled case); *Instinet, LLC and INET ATS, Inc.*, Exchange Act Rel. No. 52623 (settled case) (Oct. 18, 2005); *Knight Securities L.P.*, Exchange Act Rel. No. 50867 (Dec. 16, 2004) (settled case); *Certain Market Making Activities on Nasdaq*, Exchange Act Rel. No. 40900 (Jan. 11, 1999) (settled case) (*citing Sinclair v. SEC*, 444 F.2d 399 (2d Cir. 1971); *Arleen Hughes*, 27 SEC 629, 636 (1948), *aff’d sub nom. Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949)). *See also* Regulation NMS, Securities Act Rel. No. 51808 (June 9, 2005), 70 Fed. Reg. 37496, 37538 (June 29, 2005) (“Reg NMS”) (“A broker-dealer’s duty of best execution derives from common law agency principles and fiduciary obligations, and is incorporated in SRO rules and, through judicial and SEC decisions, the antifraud provisions of the federal securities laws.”); NASD Notice to Members 06-58 (Nov. 8, 2006) (“As amended, Rule 2320(a) now requires that a recipient member provide best execution to all transactions for or with a customer of another broker-dealer . . . The duty to provide best execution to customer orders received from other broker-dealers arises only when an order is routed from the originating broker-dealer to the recipient member for the purpose of order handling and execution. The duty of best execution does not apply in instances when another broker-dealer is simply executing a customer order against a member’s quote.”)

⁷⁶² *See Newton*, 135 F.3d at 273 (“[T]he basis for the duty of best execution is the mutual understanding that the client is engaging in the trade – and retaining the services of the broker as his agent – solely for the purpose of maximizing his own economic benefit, and that the broker receives her compensation because she assists the client in reaching that goal.”); *Marc N. Geman*, Exchange Act Rel. No. 43963 (Feb. 14, 2001) (citing *Newton*, but concluding that respondent fulfilled his duty of best execution). *See also* Payment for Order Flow, Exchange Act Rel. No. 34902 (Oct. 27, 1994), 59 Fed. Reg. 55006, 55009 (Nov. 2, 1994) (“Payment for Order Flow Final Rules”).

If the broker-dealer intends not to act in a manner that maximizes the customer's benefit when he accepts the order and does not disclose this to the customer, the broker-dealer's implied representation is false.⁷⁶³

- In connection with securities sold with a mark-up, a broker-dealer violates Section 10(b) and Rule 10b-5 if it knowingly or recklessly sells a security to a customer at a price not reasonably related to the prevailing market price (“excessive markups”) without disclosing the fact to the customer because courts have held that not paying market price is a material fact.⁷⁶⁴
- Suitability violations implicate Exchange Act Sections 10(b), 15(c), and the rules thereunder, as well as Section 17(a) of the Securities Act.⁷⁶⁵ A broker-dealer must have an adequate and reasonable basis for recommending an investment to a customer.⁷⁶⁶ The SEC has relied on the shingle theory as a basis for identifying a broker-dealer suitability duty under the antifraud provisions of the Exchange Act. Under this duty, the broker-dealer must reasonably believe that its securities recommendations are suitable for its customer in light of the customer's financial needs, objectives and circumstances.⁷⁶⁷ The SROs have rules addressing these violations. For example, FINRA has adopted NASD Conduct Rule 2310. Both NASD Rule 2310 and MSRB Rule G-19 address the responsibilities of a broker-dealer to make suitable recommendations to “non-institutional” customers and require the broker-dealer to make reasonable effort to obtain certain information about his customer. NASD Rule 2310 is followed by a number of interpretations in IM-2310- through IM-2310-3 that cover among other things, the trading of penny stocks, speculative low-priced securities, and mutual funds. In addition, IM-2310-3 discusses a firm's suitability obligations to institutional customers.
- Account intrusions may result in a number of fraudulent activities. One type of fraud that may be conducted through account intrusions involves using matched buy and sell orders

⁷⁶³ See *Newton*, 135 F.3d at 273-274.

⁷⁶⁴ See, e.g., *Grandon v. Merrill Lynch & Co.*, 147 F.3d 184, 189-90 (2d Cir. 1998) (shingle theory); *Ettinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 835 F.2d 1031, 1033 (3d Cir. 1987); *Charles Hughes & Co. v. SEC*, 147 F.2d 434 (2nd Cir. 1943) (applying shingle theory, court found broker-dealer impliedly represents that price is reasonably related to the prevailing market price); *SEC v. Rauscher Pierce Refsnes, Inc.*, 17 F. Supp.2d 985, 996-7 (D. Ariz. 1998) (shingle theory).

⁷⁶⁵ *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 600 (2d Cir. 1978); *Mauriber v. Shearson/ American Express, Inc.*, 567 F. Supp. 1231 (S.D.N.Y. 1983); *Olde Discount Corp.*, Exchange Act Rel. No. 40423 (Sept. 10, 1998) (settled order).

⁷⁶⁶ *Hanley v. SEC*, 415 F. 2d 589, 596 (2d Cir. 1969).

⁷⁶⁷ *F.J. Kaufman and Co.*, Exchange Act Rel. No. 27535, 50 SEC 164 (Dec. 13, 1989) (SEC opinion) (“The suitability rule thus requires a broker-dealer to make a customer-specific determination of suitability and to tailor his recommendations to the customer's financial profile and investment objectives.”); *Richard N. Cea*, Exchange Act Rel. No. 8662, 44 SEC 8 (Aug. 6, 1969) (SEC opinion).

in the hacker's own account with orders the hacker places in the intruded accounts in order to create losses in the intruded account and profits for the intruder. After gaining access to account holders' user names and passwords, the hacker places orders to buy securities in his account and places matching orders to sell the same securities in the intruded accounts at market or below market prices. Once the trade is executed, the hacker places orders to sell the securities in his account at inflated prices, and places matching orders to buy the same securities at the inflated price in the intruded accounts. By intruding into online brokerage accounts of unsuspecting investors and placing unauthorized trades in the accounts, the hacker engages in a scheme to defraud the unwitting investors who were the victims of his intrusions and the online broker-dealers who service the intruded accounts.⁷⁶⁸

28.2

Does the regulatory approach to detect and deter such conduct include an effective and appropriate combination of:

- a) Direct surveillance, inspection, reporting, such as, for example, securities listing or product design requirements (where applicable), position limits, audit trail requirements, quotation display rules, order handling rules, settlement price rules or market halts complemented by enforcement of the law and trading rules?***

See responses to Principles 10, 14, and Question 28.3.

Subject to SEC oversight, the SROs have responsibility for the enforcement of their rules; those responsibilities include enforcement of trading and conduct rules and consequently SROs engage in daily surveillance of trading activities and regulatory compliance. The SEC also has and uses the authority to inspect both the SROs and market participants to evaluate whether the various antifraud, anti-manipulation and reporting regulations are being observed. The SEC can also obtain surveillance and/or trading data from the SROs. Exchange Act Section 11A established the National Market System (NMS). Among other things, it requires that market centers adopt plans to report, consolidate and disseminate market data. The SROs also have rules that require the reporting of certain transaction-related information. For example, NASD Rule 6420 imposes requirements with regard to the reporting of transactions. Specifically, the rule requires the report to include the stock symbol, number of shares, price, and type of transaction and time of execution. The Exchange Act requires all SROs to police their members and their trading to address any potential violations of the market's rules or the U.S. federal securities laws. All markets must tailor their surveillance functions to their market's dynamics.

⁷⁶⁸ See generally *SEC v. Van T. Dinh*, Civil Action No. 03-CV-11964-RWZ (D. Mass. filed Oct. 9, 2003) (defendant permanently enjoined from violating the antifraud provisions of the federal securities laws in connection with unauthorized intrusion and trading in an online brokerage account).

The SEC may suspend trading in a particular security or a group of securities pursuant to Section 12(k) of the Exchange Act.⁷⁶⁹ Further, Rules 12d2-1 and 12d2-2 of the Exchange Act grant national securities exchanges the authority to suspend or remove a security from trading. Additionally, NASD Rule 4120 gives the Nasdaq the authority to halt trading in any security. NASD Rule 4330 grants the Nasdaq the authority to suspend or terminate the inclusion of an otherwise qualified security. In addition, Sections 12(d) and 12(j) of the Exchange Act, 15 U.S.C. 78l, empower the SEC to deregister and de-list securities for the protection of investors. Section 12(d) provides SEC authority to approve or reject, voluntary and involuntary deregistration and de-listing of shares requests from issuers or exchanges, pursuant to rules of the applicable exchange. Under Rule 13d-1 of the Exchange Act, any person acquiring more than 5% ownership of the class of any equity security must file a statement reporting such ownership to the SEC within 10 days of acquisition.

28.2

b) Effective, proportionate and dissuasive sanctions for violations?

See responses to Principle 9.

The SEC is responsible for non-criminal enforcement of the federal securities laws and it prosecutes cases in U.S. federal courts and in administrative proceedings. As in other civil cases, the SEC's burden of proof is that of preponderance of the evidence.

The SEC may seek either temporary or permanent injunctive relief in a U.S. federal district court "whenever it shall appear to the SEC that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation."⁷⁷⁰ In civil suits, the SEC seeks injunctions, which are orders that prohibit future violations; a person who violates an injunction is subject to fines or imprisonment for contempt. The SEC also may ask a federal court for emergency relief, generally in the form of a temporary restraining order (TRO). The SEC may also request that a court issue an order "freezing" assets to preserve the ability to obtain monetary relief at the successful conclusion of the case and potentially return money to defrauded investors.

⁷⁶⁹ See, e.g., *Texscan Corp.*, Exchange Act Rel. No. 29112 (Apr. 22, 1992) (SEC suspended trading because recent market activity could have been the result of manipulative conduct or other illegal activity). See also *Sloan v. SEC*, 547 F.2d 152 (2d Cir. 1976), *aff'd*, 436 U.S. 103 (Mar. 15, 1978) (Court held that there was sufficient evidence of probable manipulation and false statements as to company's soundness and value to justify SEC's conclusion that it was in the public interest to summarily suspend trading pursuant to Section 12(k)).

⁷⁷⁰ Securities Act §20(b). Similar provisions are found in the Exchange Act, the Trust Indenture Act and the Investment Company and Investment Advisers Acts.

In a civil action, in addition to injunctive relief, the SEC may, and typically does, seek other equitable relief to remedy the harm caused by the violation.⁷⁷¹ Such relief may include an accounting or disgorgement⁷⁷² of ill-gotten gains where a defendant has profited from a violation of law. The SEC is also authorized to seek civil money penalties and court orders barring a defendant from serving as an officer or director of a public company or from participating in an offer of penny stock.

The SEC may also institute administrative proceedings against a person or an entity regulated by the SEC or any person that it believes has violated or is about to violate the law. This type of enforcement action is litigated before an SEC administrative law judge and is subject to appeal directly to the SEC. Administrative proceedings provide for a variety of relief, including: a censure; a limitation on activities (in the case of a regulated entity or associated person of a regulated entity) such as suspension or revocation of registration (in the case of a regulated entity); suspension of up to twelve months or bar from the industry (in the case of an associated person); a cease-and-desist order, accounting or disgorgement ordered with respect to any person; or civil money penalties against regulated persons. In a cease-and-desist proceeding, administrative relief may also include an order that would require a person to comply or take steps to effect compliance with the law.

In both civil injunctive actions and administrative proceedings, the SEC has the power to enter into enforceable settlements. In the typical settlement, the settling party neither admits nor denies the SEC's allegations. In a civil action, the SEC requests that a court issue an order reflecting the settlement. In administrative proceedings, a settlement order is entered by the SEC and contains findings of fact by the SEC.

Enforcement by SROs

Sections 6(b), 15A, and 19(g) of the Exchange Act require SROs to comply with certain standards, including enforcement of compliance with the federal securities laws, rules, and SRO rules by SRO members. The SROs are also required, among other things, to have rules designed to prevent fraud and provide for bringing disciplinary actions against members and persons associated with members. SRO disciplinary actions typically include the ability to fine, suspend, and expel from the industry.

⁷⁷¹ Exchange Act §21(d)(5) provides that “[i]n any action or proceeding brought or instituted by the SEC under any provision of the securities laws, the SEC may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors.”

⁷⁷² Disgorgement of ill-gotten gains is a well-established remedy created by case law. The amount of disgorgement ordered “need only be a reasonable approximation of the profits causally connected to the violation,” and any risk of uncertainty “should fall on the wrongdoer whose illegal conduct created that uncertainty.” *SEC v. Patel*, 61 F.3d 137, 179 (2d Cir. 1995). The measure of disgorgement need not be tied to the losses suffered by defrauded investors, and a district court may order disgorgement regardless of whether the disgorged funds will be paid to such investors as restitution.

The SROs examine their own members, and under Section 17(b) of the Exchange Act, the SEC examines the SROs themselves to determine whether they are meeting their responsibilities. The SEC can directly enforce the rules of an SRO if it finds that the SRO is unable or unwilling to take appropriate action against a person who violated an SRO rule or if doing so is otherwise necessary or appropriate in the public interest or for the protection of investors.⁷⁷³ The SEC can also bring an enforcement action against the SRO itself.

28.3

Are there arrangements in place for:

- a) The continuous collection and analysis of information concerning trading activities?*
- b) Providing the results of such analysis to market and regulatory officials in a position to take remedial action if necessary?*
- c) Monitoring the conduct of market intermediaries participating in the market?*
- d) Triggering further inquiry as to suspicious transactions or patterns of trading?*

See responses to Principles 10 and 26.

Regarding Question 28.3(a), generally, the SROs collect and analyze information relating to trading activities. All stock trades are reported to either the Securities Industry Automation Corporation (SIAC) or NASDAQ. Both of these entities are securities information processors that disseminate consolidated quotation and transaction data to the public. SIAC processes transaction reporting for listed securities, other than NASDAQ listed securities. NASDAQ receives the information related to trades in NASDAQ securities as well as trades in over-the-counter securities. In addition, as described below, FINRA and NYSE have implemented order audit trail systems to capture order details throughout the lifecycle of a trade.

FINRA's Order Audit Trail System (OATS) was established in response to the SEC's order that FINRA (then NASD) design and implement an audit trail system that would capture a time-sequenced record of orders and transactions from receipt of an order through execution or cancellation of that order.⁷⁷⁴ Brokerage firms entering orders into the marketplace are responsible for reporting order details to OATS. OATS captures new orders, cancels, cancel/replaces, and executions for all OTC equity securities.

⁷⁷³ Exchange Act § 21(f).

⁷⁷⁴ *In the Matter of National Association of Securities Dealers, Inc.*, Exchange Act Rel. No. 37538 (Aug. 8, 1996).

The NYSE established its Front End Systemic Capture (FESC) and Order Tracking System or OTS in response to an SEC Order.⁷⁷⁵ Specifically, the SEC ordered the NYSE to design and implement an audit trail that would capture a time-sequenced record of orders, quotations, and transactions from the receipt of an order by any NYSE member firm, documenting the life of the order through the execution or cancellation of that order. FESC captures order information at the point of sale and OTS captures order information at the point of receipt. Brokerage firms entering listed orders into the marketplace are responsible for reporting order details to FESC and OTS. FESC and OTS capture new orders, cancels, cancel/replaces, and executions for all listed orders.

The SROs monitor trade reports electronically and their programs are designed to identify unusual trading activity which is then reviewed by the exchanges or FINRA to determine if any regulations have been violated. This is done intra-day as well as after the close of the trading day.

Regarding Question 28.3 (b), the SROs regularly review the analysis of information relating to trading activities for violations of SRO rules. The SROs may take remedial action for violations of such rules or refer violations of federal securities laws and regulations to the SEC.

Regarding Question 28.3 (c), generally, all broker-dealers must be registered with the SEC and also be a member of a SRO. SROs are subject to the SEC's oversight and adopt rules, pursuant to SEC review under Exchange Act Section 19(b) which governs a broker-dealer's conduct in the market and with customers. The federal securities laws, rules, and SRO rules contain general and specific antifraud provisions and other provisions designed to maintain high industry standards.

The SROs examine broker-dealers in regular cycles (cycle examinations) for compliance with the federal securities laws, rules, and SRO rules. The SEC examines the largest broker-dealers in regular cycles. In addition to cycle examinations, broker-dealers are subject to "for cause" examinations for numerous reasons, including tips or complaints from customers and other firms, reports in the media, and the SEC's own investigative efforts. Broker-dealers that are found not to be compliant with the federal securities laws and/or SRO rules may be subject to a range of disciplinary actions, including monetary penalties, restrictions on their activities and, in some instances, expulsion from the industry. The SEC also has an office within the Division of Enforcement that monitors the markets for suspicious activity.

Regarding Question 28.3 (d), as part of their surveillance programs, the SROs review exception reports for suspicious transactions or patterns of trading. Exceptions flagged by the surveillance reports are reviewed within the SRO for violations of SRO rules or securities laws and regulations. Potential violations of federal securities laws and regulations may be referred to the SEC for further investigation.

In addition, the United States' anti-money laundering regime is designed to allow broker-dealers to confidentially report suspicious transactions and activities that customers and/or other firms

⁷⁷⁵ *In the Matter of New York Stock Exchange, Inc.*, Exchange Act Rel. No. 41574 (June 29, 1999).

have undertaken or have attempted to undertake. The activities underlying these reports can result in further investigation by the SEC or in a referral to the appropriate SRO.

At the SEC, OCIE protects investors through administering the SEC's nationwide examination and inspection program. Examiners in Washington DC and in the SEC's 11 regional offices conduct examinations of the nation's registered entities, including SROs, broker-dealers, transfer agents, investment companies, investment advisers, and NRSROs. The purpose of examinations is to detect fraud and other violations of the securities laws, foster compliance with those laws, and help ensure that the SEC is continually made aware of developments and areas of potential risk in the securities industry.

Within the SEC, the Division of Trading and Markets has an Office of Interpretation and Guidance (OIG). The OIG is staffed by the Division and provides interpretation to the industry, the markets, and market participants. Through a hotline and email, the OIG handles any number of issues within the Exchange Act on an expedited basis. The OIG receives information that leads to, among other things, inquiries and investigations by the Division of Enforcement. The OIG receives approximately 15,000 communications each year.

28.4

If there is potential for domestic cross-market trading, are there inspection, assistance and information sharing requirements or arrangements in place to monitor and/or access domestic cross-market trading abuses?

See the responses to Principles 9 and 11.

In the United States there are mechanisms for information sharing and surveillance among the markets. The ISG is an industry organization created in 1983 to coordinate intermarket surveillance among the SROs by cooperatively sharing regulatory information pursuant to a written agreement between the parties. The goal of the ISG's information sharing is to coordinate regulatory efforts to address potential intermarket trading abuses and manipulations.

28.5

If there are foreign linkages, substantial foreign participation, or cross-listings, are there cooperation arrangements with relevant foreign regulators and/or markets that address manipulation or other abusive trading practices?

See responses to Principles 11, 12, and 13. The SEC has entered into numerous MOUs, both bilateral and multilateral, with various domestic and foreign regulators concerning consultation, cooperation, and information-sharing. Many of these MOUs, including the IOSCO MMOU, are aimed at cooperation in securities enforcement matters, while others facilitate regulatory cooperation in the supervision of financial services firms and the oversight of markets.

Secondary Markets – Principle 29

Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.

Assessment

Fully Implemented.

29.1

Does the market authority have a mechanism in place that is intended to monitor and evaluate continuously the risk of open positions or credit exposures that are sufficiently large to expose a risk to the market or to a clearing firm that includes:

- a) Qualitative or quantitative trigger levels appropriate to the market for the purpose of identifying large exposures, continuous monitoring and an evaluative process?*
- b) Access to information, if needed, on the size and beneficial ownership of positions held by direct customers of market intermediaries?*
- c) The power to take appropriate action against a market participant that does not provide relevant information needed to evaluate an exposure (e.g., require liquidation of positions, increase margin requirements and/or revoke trading privileges)?*
- d) The general power to take appropriate action, such as to compel market participants carrying or controlling large positions to reduce their exposures or to post increased margin?*

Broker-Dealers

Broker-dealers must be in net capital compliance at all times. Broker-dealers with large securities positions are required to haircut those positions to account for the market risk of the position to the firm.⁷⁷⁶ To the extent that a broker-dealer's net capital falls below 25% of its haircuts on proprietary positions, it is restricted from withdrawing large amounts of capital from the firm. Further, if the market value of a securities position exceeds 10 percent of the tentative net capital of the broker-dealer, the broker-dealer must apply an additional haircut to the amount in excess. To the extent that a broker-dealer's net capital falls below the amount it is required to maintain, the firm must immediately notify the SEC and its designated examining authority

⁷⁷⁶ 17 CFR 240.15c3-1(c)(2)(vi)(M).

(DEA). Information regarding haircuts is included in the FOCUS reports filed with a broker-dealer's designated examining authority (an SRO) on a monthly or quarterly basis.⁷⁷⁷

Broker-dealers are required to submit reports regarding outstanding options positions to the extent that those positions exceed certain specified parameters (an aggregate position of 200 or more option contracts on the same side of the market covering the same underlying security or index).⁷⁷⁸ In addition, to the extent any option position exceeds certain limits, the firm is required to decrease the position.⁷⁷⁹ These reports generally must be submitted on the day that the position parameters are exceeded or change.

Any individual or entity that becomes the beneficial owner of 10 percent or more of the float of any class of securities must file a report with the SEC disclosing such ownership interest.⁷⁸⁰

Broker-dealers are required to create and maintain records regarding all securities positions⁷⁸¹ and the accounts to which they belong.⁷⁸² This information includes the size of every position held in each account, and the identity and address of the beneficial owner of each account. Broker-dealers are required to provide this information to the SEC upon request.⁷⁸³

Rules 13d-1 and 16a-1 require reports on the beneficial owners of publicly traded securities. As such, a "direct customer" must file the required information with the SEC directly; however a broker-dealer may assist the customer in completing the form. These filings are helpful because a customer may hold incremental positions with many broker-dealers. Forms required to be filed pursuant to these rules are public.

The SEC staff also meets regularly with the largest securities firms, which have applied to use Appendix E of Rule 15c3-1 for calculating market and credit risk deductions at the U.S. broker-dealer level. Currently, six broker-dealers are performing the alternative net capital computation. Once applications for using the alternative net capital approach of Appendix E are approved, the firms are subject to monthly, quarterly, and annual reporting requirements. In addition to meetings with other control functions, the SEC's Broker-Dealer Risk Office meets at least monthly with the credit and market risk departments of these firms to discuss the firm's risk management practices and the firm's risk profile, including concentrated market and credit risk exposures.

⁷⁷⁷ 17 CFR 240.17a-5(a).

⁷⁷⁸ *See e.g.*, NASD Rule 2860(b)(5).

⁷⁷⁹ *See e.g.*, NASD Rule 2860(b)(6).

⁷⁸⁰ 17 CFR 240.13d-1 through 7 and 17 CFR 240.16a-1 through 13.

⁷⁸¹ 17 CFR 240.17a-3(a)(5).

⁷⁸² 17 CFR 240.17a-3(a)(3), (5), and (9).

⁷⁸³ 17 CFR 240.17a-4(j).

A broker-dealer must comply with applicable securities laws, rules and regulations, including making and keeping specified records and reports. To the extent that a broker-dealer fails to provide information requested by the SEC,⁷⁸⁴ the SEC may take appropriate action against the broker-dealer.

A broker-dealer must also comply with the rules of each SRO of which it is a member. To the extent that a broker-dealer fails to furnish information requested by an SRO, the SROs have rules as to what action the SRO may take. Those actions may include trading limits, forced liquidation, increased margin requirements, revocation of trading privileges, suspension from trading, and imposition of higher capital charges. In addition, an SRO may take steps to shut the broker-dealer down, either through imposition of a suspension or bar, or by revocation of the broker-dealer's membership (pursuant to the SEC's registration rules, a broker-dealer must be a member of at least one SRO in order to do business).

The margin rules also help SROs control the risk of open positions. Although minimum initial margin levels are set by the Federal Reserve Board's Regulation T,⁷⁸⁵ the SROs are responsible for setting margin maintenance requirements.⁷⁸⁶ In addition, the SROs may set initial margin levels higher than those set pursuant to Regulation T.⁷⁸⁷ Thus, an SRO could increase the margin level for a particular security, forcing an individual or entity to post additional margin or reduce a position in order to comply with the new margin level.

In addition, the SEC recently announced a series of actions it is taking to increase the availability of short sale-related information. These actions are intended to provide a wealth of short sale-related information to the SEC and other regulators, as well as to the public generally, and include: (i) working with the SROs to publish daily aggregate short selling volume information in each individual equity security; (ii) working with the SROs to publish individual short sale transaction data in all exchange-listed securities on a one-month delayed basis; and (iii) increasing the publication of fails to deliver data for all transactions in equity securities from quarterly to twice per month and expanding such disclosure to all fails to deliver rather than only those fails to deliver that are above a specific threshold level. The SEC is also considering whether additional measures are needed to further enhance market quality and transparency, as well as address short selling abuses. As part of its consideration process, the SEC has announced that it intends to hold a public roundtable on September 30, 2009. As part of that roundtable, the SEC will solicit views on possible additional short sale disclosure measures, such as requiring public disclosure of individual large short positions.

⁷⁸⁴ 15 U.S.C. 78q(b)(1) and 17 CFR 240.17a-4(j).

⁷⁸⁵ 15 U.S.C. 78g(a).

⁷⁸⁶ *See e.g.*, NYSE Rule 431(c) and (f)(8)(A).

⁷⁸⁷ *See e.g.*, NYSE Rule 431(b)(3) and (f)(8)(A).

Clearing Agencies

A clearing agency generally acts as a central counterparty that assumes the credit risk of each party to a trade by substituting itself as buyer to the seller and seller to the buyer.⁷⁸⁸ This “novation” of the bilateral trade greatly reduces risk of loss to both buyer and seller and, as a result, reduces systemic risk because the parties to a trade are no longer directly exposed to the credit risk of the counterparty. For this reason, a clearing agency contributes greatly to the goal of market stability. However, because of the significant risk assumed by the clearing agency, it must have thorough and robust risk management procedures in place including the ability to measure and manage the open positions and credit exposures of its participants. In addition, clearing agencies generally receive trade submissions throughout the day, in many cases in real-time, and have the capability to conduct intraday monitoring. They also generally have risk procedures in place to put a participant on heightened surveillance based on its activities. *See* the responses to RCCP Recommendation 3, Measurement and Management of credit exposures, and SSS Recommendation 9, CSD Risk Controls to address Participants’ Failures to Settle. Clearing agencies use statistical models to measure the potential risk of loss associate with open positions. *See* the responses to Recommendation 3, Measurement and Management of Credit Exposures, which describes the risk margin methodology used by clearing agencies. DTC requires that all settlement obligations of participants be fully collateralized. *See* the response to SSS Recommendation 9, CSD Risk Controls to Address Participants’ Failures to Settle (Key Question 2). Most clearing agencies treat their participants as principles and do not distinguish between proprietary and customer positions. *See* RCCP Recommendation 6, Default Procedures (Key Question 1(c)), and SSS Recommendation 12, Protection of Customers’ Securities.

Under Section 17A of the Exchange Act, clearing agencies are SROs and must have the capacity to enforce compliance with their rules by participants. In addition, the rules of each clearing agency must provide that its participants be appropriately disciplined for violation of any provision of the rules of the clearing agency by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, or any other fitting sanction. *See* Key Question 2 under Recommendation 2 of the RCCP, Participation Requirements, and Key Question 3 to Recommendation 14 of the SSS, Access, which address the circumstances under which a central counterparty can suspend or terminate participants’ membership and the arrangements a central counterparty has in place to facilitate the suspension and orderly exit of participants that no longer meet the participation requirements.

As part of the ongoing monitoring and risk management, clearing agencies generally have authority to require increased margin and/or collateral deposits. Clearing agencies generally do not compel participants to reduce their exposures, although increased margin calls may cause a participant to reduce its exposure. *See* response to RCCP Recommendation 4: Margin requirements. The securities depository registered with the SEC requires that all settlement obligations of participants be fully collateralized. *See* Key Question 2 to SSS Recommendation 9, CSD Risk Controls to Address Participants’ Failures to Settle.

⁷⁸⁸ The Mortgage-Backed Securities Division of FICC does not novate trades.

Three clearing agencies registered with the Commission, DTC, NSCC, and FICC, have prepared revised assessments pursuant to the IOSCO CPSS Recommendations for Securities Settlement Systems (SSS) and Central Counterparties (RCCP). These assessments respond to many of the questions raised in Principle 29 as the questions relate to clearing agencies. Where relevant, the responses below include cross-references to the SSS and RCCP assessments. At the direction of IMF staff, the US FSAP Securities Working Group did not provide a separate response to Principle 30 as it will be addressed by the work of the Securities Settlement Systems Working Group.

The ability of clearance and settlement systems to monitor and evaluate large credit exposures with respect to securities transactions have shown remarkable robustness and resiliency through the recent period of financial stress. Among other things, Section 17A of the Exchange Act mandates that the rules of registered clearing agencies be designed to assure the safeguarding of securities and funds. The conservative risk management practices of the clearing agencies registered with the SEC have consistently demonstrated that they collect sufficient high quality, liquid collateral to meet settlement obligations in the event of a participant default. In particular, the DTCC clearing agency subsidiaries successfully closed out the Lehman Brothers, Inc. bankruptcy (participant exposure of over \$500 billion) without accessing clearing agency participant funds,⁷⁸⁹ successfully managed the transfer of accounts and positions due to the acquisition of Bear Stearns by JP Morgan Chase, and successively closed out all open participant trades with Bernard Madoff Investment Securities through December 12, 2008 without loss to clearing agency participants.

29.2

Do arrangements, whether formal or informal, exist to enable markets and regulators to share information on large exposures of common market participants or on related products with regulators and markets:

- a) In the domestic jurisdiction?*
- b) In other relevant jurisdictions?*

Broker-Dealers

Arrangements continue to be developed for the sharing of large trader and other concentration risk, both domestically and to a less extent, cross-border. In addition, the SEC has entered into bilateral agreements with various agencies that allow the SEC to share information on a timely basis with those agencies.

⁷⁸⁹ See DTCC Press Release dated October 30, 2008. Lehman Brothers, Inc. was a leading participant in DTCC's subsidiary clearing agencies and OTC derivatives business. It ranked as a top three user of DTCC's Mortgage Backed Securities Division (MBSD); in the top five largest users of the Government Securities Division (GSD) and Deriv/SERV and in the top 10 participants of NSCC and DTC. Lehman Brothers International (Europe) was a participant of DTCC's European Central Counterparty Ltd. (EuroCCP) subsidiary.

Information regarding large options positions is shared on a case by case basis, as appropriate. If such is the case, the regulator or market participant may share certain information with another regulator (for instance, an SRO may discuss a large option position at a firm with the SEC staff).

Clearing Agencies

All records of a clearing agency are subject to examination by the SEC and the appropriate regulatory agency at any time, or from time to time as is deemed necessary or appropriate for the public interest, the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act.⁷⁹⁰ The SEC has the authority to examine the records of a clearing agency at any time and communicates with clearing agencies on a regular basis, although it does not have formal arrangement regarding large exposures of common market participants. In addition, the SEC has entered into MOUs with other domestic regulatory agencies regarding the clearance and settlement of financial products. *See* responses to RCCP Recommendation 15, Regulation and Oversight (Key Question 4).

Clearing agencies generally do not operate outside of the U.S. and have limited foreign participants and linkages. Although a clearing agency holding company does own a non-U.S. clearing agency (and recently announced its attention to acquire another one) the operations of the U.S. and non-U.S. clearing agencies are totally separate even after the acquisition. As a result, there is not a formal mechanism in place to share information about the credit exposures of clearing agency participants. However, the SEC routinely cooperates and coordinates with other regulatory authorities outside of the U.S., including entering into memorandums of understanding, and shares information with such authorities regarding clearing agencies, particularly in times of market crises.

Furthermore, there are a number of formal and informal mechanisms established to monitor the broader financial system in which the SEC participates. The PWG is led by the Secretary of the Treasury and includes the Federal Reserve, the SEC, and the CFTC. The PWG meets on a periodic basis to discuss issues that affect many different types of firms including banks, broker dealers, and commodity dealers, and develop common approaches to address key risks. The approaches and principles derived by the PWG are made public by the Treasury. Internationally, the Joint Forum involves supervisors of banks, bank holding companies, insurance companies, and broker dealers. The Joint Forum also considers issues and key risks that affect the broad financial system and develops principles that are designed to address these concerns. Similar to the PWG, the principles developed by the Joint Forum are made public.

SEC staff also participates in a multi-jurisdictional supervisory group, the Senior Supervisors Group (SSG). In the fall of 2007, seven supervisory agencies from five countries⁷⁹¹ undertook a

⁷⁹⁰ *See* Section 17(b) of the Exchange Act. The Federal Reserve Board is the appropriate regulatory agency of the The Depository Trust Company and the SEC coordinates with the Federal Reserve Board with respect to examining the records of DTC.

⁷⁹¹ The French *Commission Bancaire*, the German *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFIN), the Swiss *Eidgenössische Bankenkommision*, the U.K. Financial Services Authority and, in the United States, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and the Federal Reserve.

review of risk management practices at financial institutions in their respective jurisdictions. This work was undertaken in direct response to a request from the FSF, whose working group was preparing a separate report to the Finance Ministers and Central Bank Governors of the G-7 countries on the underlying causes of the then-recent financial market turmoil. With the widening and deepening of the credit crises throughout 2008, the SSG continues to review other key risk management areas, such as counterparty credit risk management and credit valuation adjustment, credit event management and a second review of risk management practices lessons learned in light of the events during late 2008. The SSG has since expanded its membership to include financial supervisors from Canada and Japan.

In addition, the SEC has an MOU for information sharing arrangement with the Federal Reserve and is in regular contact with other financial regulators both in the US and abroad about key developments they are observing and the risks they pose to individual firms and the broader marketplace. These include observations about issues at broker dealers, mutual funds, and insurance companies, and are used to inform views about emerging issues. The SEC is also a member of many of the international supervisory colleges that have recently come into existence. These colleges serve as more formal venues for the various domestic and international regulators to discuss issues on supervision practices and firm specific issues.

The SEC staff is in frequent contact weekly with senior officers at regulated broker-dealers and asset managers, among others, in order to help understand market developments that could adversely impact systemic institutions or markets.

See also the response to Principles 11 and 12.

29.3

Does a market authority make its default procedures available to market participants, including specifically information concerning:

- a) The general circumstances in which action may be taken?***
- b) Who may take it?***
- c) The scope of actions which may be taken?***

Broker-Dealers

To the extent that a broker-dealer must liquidate, the United States bankruptcy laws would apply. In addition, if a broker-dealer holds customer funds or securities, the Securities Investor Protection Act⁷⁹² may also apply. Finally, if the broker-dealer is a member of a clearing agency, the clearing agency rules may apply to the rights of the clearing agency to close out any open exposures to its defaulting clearing members. These laws and rules are publicly available.

The United States securities regulations are designed to achieve an orderly liquidation of a broker-dealer that is in financial difficulty. Generally, before a broker-dealer becomes illiquid it must cease doing a securities business (*i.e.*, when a firm's net capital falls below the required amount, it must cease doing a securities business: this generally occurs before the firm becomes illiquid). Customer securities and monies are segregated from proprietary positions and monies so that if a liquidation were to occur, those customer securities and funds would not be available to satisfy claims of creditors of the broker-dealer. To the extent that a broker-dealer approaches financial difficulty, a broker-dealer must file telegraphic notice with the SEC and its DEA.⁷⁹³ These laws and regulations are publicly available.

In addition, the Securities Investor Protection Act of 1970⁷⁹⁴ assures that, in the case of a liquidation, customer assets are promptly returned to customers. Pursuant to SIPA, a SIPC trustee is appointed to administer the liquidation of a broker-dealer that owes cash or securities to customers. In addition, to the extent that the liquidated broker-dealer no longer has certain customer assets, SIPC will make up for that shortfall (up to \$500,000 per customer, \$100,000 of which may be cash) using assessments it has obtained from its broker-dealer members.

Clearing Agencies

Clearing agencies are required to publish their rules and procedures on their website, including rules and procedures relating to participant defaults. *See* the Responses to RCCP Recommendation 14, Transparency, and SSS Recommendation 17, Transparency. Clearing agencies take action with respect to a participant default pursuant to their published rules and procedures. *See* Key Question 2 under Recommendation 2 of the RCCP, Participation Requirements, and Key Question 3 to Recommendation 14 of the SSS, Access, which address the circumstances under which a central counterparty can suspend or terminate participants' membership and the arrangements a central counterparty has in place to facilitate the suspension and orderly exit of participants that no longer meet the participation requirements. The scope of the action is set forth in the published rules and procedures of each clearing agency. A clearing agency will generally suspend or cease to act for a participant that is in default to the clearing agency. *See* RCCP Recommendation 2, Participation Requirements (Key Question 2) and SSS Recommendation 14, Access (Key Question 3). *See also* RCCP Recommendation 6, Default

⁷⁹² 15 U.S.C. 78aaa, et. seq.

⁷⁹³ 17 CFR 240.17a-11.

⁷⁹⁴ 15 U.S.C. 78aaa et seq.

Procedures and SSS Recommendation 9, CSD Risk Controls to address Participants' Failures to Settle.

29.4

Do default procedures and/or national law permit markets and/or the clearing and settlement system(s) promptly to isolate the problem of a failing firm by addressing its open proprietary positions and positions it holds on behalf of customers or otherwise protect customer funds and assets from an intermediary's default under national law?

Broker-Dealers

The Exchange Act provides that the SEC must set financial responsibility rules for broker-dealers. In accordance with the Act, the SEC promulgated a number of rules including the Customer Protection Rule,⁷⁹⁵ the Hypothecation Rules,⁷⁹⁶ and the Quarterly Count Rule.⁷⁹⁷ These rules help protect customer property and assure that customers have first priority in the event of a broker-dealer liquidation.

The SEC's Customer Protection Rule requires that every broker-dealer obtain and maintain possession and control of customer securities, and maintain a reserve account for the exclusive benefit of customers that contains (at least) the net dollar amount of cash the broker-dealer owes to its customers. The SEC's Hypothecation Rules require that a broker-dealer segregate customer securities from its own proprietary securities, and prohibit a broker-dealer from hypothecating customers' fully-paid securities. The SEC's Quarterly Count Rule requires that broker-dealers count positions owed to customers and securities on hand and reconcile those two numbers on a quarterly basis. In addition, the SROs have rules that restrict a broker-dealer's use of customer securities.⁷⁹⁸ Combined, these rules serve to reduce the risk that a firm failure will have a widespread detrimental effect on the marketplace and customers and alert the SEC and SROs to a potential failure so that any impact may be minimized.

In addition, the SEC's Books and Records Rules require that a broker-dealer create and maintain certain books and records relating to its business, including: ledger accounts as to each customer account and each account of the broker-dealer that itemize every purchase, sale, receipt and delivery of securities and commodities, and all other debits and credits; and a securities record or ledger reflecting for each security which accounts hold the security and what quantity the account holds, and where the securities positions are held (*e.g.*, in a vault, at DTC, in transfer, etc.). These records can be used to distinguish firm and customer positions, deposit collateral, and accrual proceeds, and identify the underlying nature of participants in omnibus accounts.

⁷⁹⁵ 17 CFR 240.15c3-3.

⁷⁹⁶ 17 CFR 240.8c-1 and 15c2-1.

⁷⁹⁷ 17 CFR 240.17a-13.

⁷⁹⁸ *See e.g.*, NYSE Rule 402 and NASD Rule 2330.

The net capital rule requires that all broker-dealers maintain certain minimum level of liquid net capital at all times. All broker-dealers are subject to the SEC's Net Capital Rule. If a firm's net capital falls below the level of net capital it is required to maintain pursuant to the rule, that firm must cease doing a securities business. New firms are subject to more stringent capital requirements than firms that have been in the business for more than one year. The SEC's Net Capital Rule serves multiple purposes. It serves to: 1) ensure that a firm has sufficient liquid assets to meet ongoing liabilities as they come due; 2) allow for orderly liquidation on the failure of a firm and may go to repay liabilities to customers to the extent that the firm has not otherwise sufficiently segregated or reserved for those liabilities to customer subject to Exchange Act Rule 15c3-3 (commonly referred to as the "Customer Protection Rule");⁷⁹⁹ and 3) protect the financial system from systemic risk.

The early warning rule requires that a broker-dealer file telegraphic notice with the SEC and its DEA if: its net capital is reduced to an amount within a certain percentage of the amount it is required to have by the rule; it fails to make and keep current books and records; or, it is informed by its independent public accountant of the existence of a material inadequacy. To the extent a broker-dealer is experiencing financial difficulty, its SRO may restrict its activities or cause it to reduce its business.⁸⁰⁰

Although bankruptcy code provisions do apply, they generally allow a financial institution to liquidate financial instruments and close-out open positions in order to reduce exposure to an insolvent firm. For example, a financial institution holding a repurchase agreement or stock loan with a broker-dealer that becomes illiquid may liquidate collateral to close out that position. In addition, if a broker-dealer were to self-liquidate, it may transfer customer positions to another broker-dealer.

The broker-dealer subsidiaries of The Bear Stearns Companies, Inc. and Lehman Brothers Holdings, Inc. were subject to net capital, customer protection, and bankruptcy rules and regimes that are designed to allow the broker-dealers to unwind without harming customers or causing market disruptions. In the failure of both Bear and Lehman, however, the holding companies and certain other affiliates were not subject to similar requirements, nor were these firms part of a bank holding company that had access to direct government financing of less liquid assets. The Bear Stearns broker-dealer was able to be transferred to JP Morgan Chase without any losses to customers. The vast majority of the Lehman broker-dealer was liquidated with minimal disruption to customers; however, the failure of Lehman Brothers Holdings had a significant impact on the financial markets. In light of these recent events, the SEC is reviewing the current regulatory framework to determine if changes are needed to prevent market disruptions. For example, the SEC is working with other domestic regulators to address financial regulatory reform.

⁷⁹⁹ 17 CFR 240.15c3-3.

⁸⁰⁰ See e.g., NYSE Rule 326(b) and NASD Rule 3130.

Clearing Agencies

Section 17A(b)(3)(F) requires that the rules of a registered clearing agency be designed to assure the prompt and accurate clearance and settlement of securities and the safeguarding of securities of funds which are in the custody or control of the clearing agency or for which it is responsible. Registered clearing agencies such as DTC, NSCC, and FICC have rules granting them clear authority to take over accounts, and manage positions, and utilize the participant's collateral to meet the participant's settlement obligations. The primary purpose of these rules is to minimize any losses that might result to the clearing agency and to its participants as a result of the default and to cause the least disruption to clearing participants and to the securities markets in general. Articles 8 and 9 of the Uniform Commercial Code provide legal certainty with respect to a clearing agency's lien on participants' collateral and provisions in the U.S. Bankruptcy Code, FDIA, FDICIA, and the SIPA provide legal certainty regarding a clearing agency's authority to liquidate or transfer a position and to apply margin or draw down liquidity resources in the event of the insolvency of a participant. *See* the responses to RCCP and SSS Recommendations 1, Legal Risk.

Generally, clearing agencies treat their participants as principals and do not distinguish between the participants' customer and proprietary positions.⁸⁰¹ *See* the response to RCCP Recommendation 6, Default Procedures (Key Question 1(c)), and SSS Recommendation 12, Protection of Customers' Securities.

The rules of clearing agencies, however, include procedures to allow participants to keep customer positions separate from proprietary positions. For example, DTC allows participants to use delivery exemptions to prevent automated book-entry delivery of customer fully-paid securities and the rules of the NSCC allow participants in certain circumstances to move open long positions to a fully paid for subaccount. *See* responses to RCCP Recommendation 6, Default Procedures.

Clearing participants that clear customer positions are registered broker-dealers and, as such, are subject to the SEC's customer protection rules in Rule 15c3-3 and the rules regarding the hypothecation of customer securities in Rule 8c-1. In addition, the insolvency of a broker-dealer that has customer accounts is administered by the SIPC pursuant to the framework in SIPA. In the event of a participant default, the clearing agency will work with the receiver appointed by SIPC to distribute customer cash and securities (SIPC provides some insurance coverage if there is a shortfall). *See* the responses to RCCP Recommendation 6, Default Procedures (Key Question 1(c)) and SSS Recommendation 1, Legal Risk (Key Question 2).

The rules and procedures of a clearing agency are designed to assure the safeguarding of securities and funds—including customer securities and funds-- under its control or for which it is responsible. *See* Section 17A(b)(3)(F) of the Securities Exchange Act of 1934.

⁸⁰¹ An exception to this is The Options Clearing Corporation, which clears options and futures and follows a futures customer segregation regime.

29.5

Is there a mechanism by which market authorities for related products can consult with each other in order to minimize the adverse effects of market disruptions?

The SEC has Memorandums of Understanding with several federal regulators. For example, an MOU with the CFTC on general regulatory cooperation states that the SEC and CFTC recognize that enhanced coordination and cooperation concerning issues of common regulatory interest is necessary in order to foster market innovation and fair competition and to promote efficiency in regulatory oversight.

As another example, the SEC has entered into an MOU with the CFTC and the Federal Reserve relating to credit default swaps which states that it reflects the agencies' intent to cooperate, coordinate and share information, including by establishing regulatory liaisons, in carrying out their respective responsibilities and exercising their respective authorities with regard to Central Counterparties for credit default swaps.

In the case of broker-dealers experiencing financial or operational distress, there is a sharing of information on a real-time basis between SROs and exchanges so that the implications of ones actions can be understood by all and the impact assessed to the respective marketplaces.

See response to Principle 12.

Annex A

List of bilateral and multilateral MOUs⁸⁰² the SEC has entered into with foreign authorities

For Enforcement Cooperation:

- Comisión Nacional de Valores, Argentina, signed December 9, 1991
- Australian Securities and Investments Commission, signed August 25, 2008
- Comissão de Valores Mobiliários, Brazil, signed July 1, 1988
- Ontario Securities Commission, Commission des valeurs mobilières du Québec, British Columbia Securities Commission, Canada, signed January 7, 1988
- Superintendencia de Valores y Seguros, Chile, signed June 3, 1993
- Commission des Opérations de Bourse, France, signed December 14, 1989
- Bundesanstalt für Finanzdienstleistungsaufsicht, Germany, signed October 17, 1997
- Securities and Futures Commission, Hong Kong, signed October 5, 1995
- IOSCO, signed May 2002
- Israel Securities Authority, signed February 13, 1996
- Commissione Nazionale per le Società e la Borsa, Italy, signed May 3 & 5, 1993
- Financial Services Agency, Japan, signed May 17, 2002
- Jersey Financial Services Commission, signed May 22, 2002
- Comisión Nacional de Valores, Mexico, signed October 18, 1990
- Ministry of Finance, the Netherlands, signed December 11, 1989
- Banking, Insurance and Securities Commission, Norway, signed December 11, 1989
- Comissão do Mercado de Valores Mobiliários, Portugal, signed October 10, 1997
- Monetary Authority of Singapore, signed May 16, 2000
- Comisión Nacional del Mercado de Valores, Spain, signed July 8, 1992
- Government of Switzerland, signed August 31, 1982
- Department of Trade and Industry, Securities and Investments Board, UK, signed September 25, 1991

For Supervisory Cooperation:

Market Participants and Markets

- College of Euronext Regulators, signed January 2007
- Australian Securities and Investments Commission, signed August 25, 2008
- Commission Bancaire Financière et des Assurances, Belgium, signed June 29, 2006
- Bundesanstalt für Finanzdienstleistungsaufsicht, Germany, signed April 26, 2007
- Securities and Futures Commission, Hong Kong, signed October 5, 1995

⁸⁰²

The MOUs are available at: http://www.sec.gov/about/offices/oia/oia_cooparrangements.htm.

- Federal Banking Commission, Switzerland, signed December 2007
- Financial Services Authority, UK, signed March 14, 2006
- Bank of England, UK, signed October 27, 1997

Issuers and Financial Reporting

- Commission Bancaire Financière et des Assurances, Belgium, signed May 2008
- Financial Supervision Commission, Bulgaria, signed May 2008
- Kredittilsynet, Norway, signed May 2008
- Comissão do Mercado de Valores Mobiliários, Portugal, signed May 2008
- Financial Services Authority and Financial Reporting Council, UK, signed April 2007