1. Overview

Jerry W. Markham

THE FEDERAL SECURITIES LAWS—AN OVERVIEW

The federal securities laws that now govern the regulation of securities markets in the U.S. are largely based on legislation that was passed in the wake of the Stock Market Crash of 1929 and in the midst of the Great Depression. The passage of those statutes was preceded by lengthy Congressional investigations that uncovered numerous abusive trading practices and widespread fraud.1

Those congressional investigations resulted in the passage of five statutes that now comprise the legislation that, after many amendments, still regulates the securities markets. The statutes are commonly referred to as the “federal securities laws” and include the Securities Act of 1933 (“1933 Act”),2 the Securities Exchange Act of 1934 (“1934 Act”),3 the Investment Advisers Act of 1940 (“1940 Act”),4 the Investment Company Act of 1940,5 and the little noticed Trust Indenture Act of 1939.6

The 1933 Act

The 1933 Act regulates public offerings of securities. That statute is modeled after earlier English legislation that sought to regulate public companies through the disclosure of their operations and finance. The federal securities laws also embrace the views of Justice Louis Brandeis who stated that “publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants;

1 Ferdinand Pecora, Wall Street Under Oath (1939) (describing those congressional investigations).
5 15 U.S.C. § 80a-1 et seq.
6 15 U.S.C. § 77aaa et seq. Another of these statutes, the Public Utility Holding Company Act of 1935, was largely repealed by the Energy Policy Act of 2005.
electric light the most efficient policeman.” The 1933 Act also added “to the ancient rule of caveat emptor, the further doctrine ‘let the seller also beware.’”

The 1933 Act prohibits the public sale of securities that are not registered with the Securities and Exchange Commission (“SEC”), unless they are exempted from that requirement. In brief, the registration statement required by the 1933 Act must contain information fully disclosing the financial circumstances of the company and all other material information about the company. The 1933 Act and SEC rules specify the information that must be disclosed and the format for such disclosure. The 1933 Act provides for a waiting period before the registration statement becomes effective. That waiting period allows the public to assess the information disclosed in the registration statement. It is intended to avoid the need for hurried, uninformed investment decisions.

The 1933 Act prohibits fraud in connection with the sale of securities, as defined in that statute. The 1933 Act also contains private rights of actions for investors who are injured by violations of the Act or SEC regulations. Such actions may be brought against underwriters, brokers and company insiders who signed the registration statement. There are, however, limitations on the damages that may be claimed and the actions that may be brought.

The 1934 Act

The 1934 Act regulates the secondary market in securities transactions. The 1934 Act thus picks up where the 1933 Act leaves off by requiring public companies to provide current information about their finances and operations. This assures that the information provided during the registration process under the 1933 Act remains up to date and allows

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7 Louis Brandeis, Other People’s Money and How the Brokers Use It, 4 (1932).
10 Section 17 of the 1933 Act is an antifraud provision that allows the SEC to bring civil enforcement cases and which also provides for criminal penalties. 15 U.S.C. § 77q.
investors to make informed decisions about securities traded on exchanges or in the over-the-counter market.

The 1934 Act also governs the proxy process for shareholder voting companies registered under the 1933 Act (public companies). The 1934 Act includes a requirement that securities exchanges register with the SEC as a “national securities exchange.” Those exchanges must fulfill a 1934 Act mandate of a “self-regulatory organization” (“SRO”). They are required to police the conduct of their members in order to insure that they do not harm the public. That SRO role is largely carried out by the Financial Industry Regulatory Authority (“FINRA”).

The 1934 Act also broadly regulates the operations of broker-dealers. Broker-dealers must register with the SEC. Once registered, a broker-dealer is subject to a broad range of regulatory requirements. Broker-dealers must keep customer funds and securities segregated from the broker-dealer’s own funds. To insure financial stability, broker-dealers are subject to a complex net capital requirement, which is designed to shut down failing broker-dealers before they become bankrupt and endanger customer funds insured by the Securities Investor Protection Corporation (“SIPC”).

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”) regulated swaps and other over-the-counter derivative instruments for the first time. That legislation divided regulation of those instruments between the SEC and the Commodity Futures Trading Commission (“CFTC”).

The 1940 Act

In brief, the 1940 Act applies to investment advisers, i.e., persons who provide investment advice to customers and who manage customer funds. Among other things, the 1940 Act has an anti-fraud provision that prohibits investment advisers from even negligently defrauding their clients. The SEC has adopted a number of rules under that provision that seek to assure that investment adviser activities do not conflict with those

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of their customers. SEC rules also impose custody requirements for customer assets held by registered investment advisers.

An SEC rule requiring hedge funds to register as investment advisers under the 1940 Act was stricken by a court of appeals. However, the Dodd-Frank Act included a provision overturning that decision.

The Investment Company Act of 1940

The Investment Company Act of 1940 ("Investment Company Act") regulates mutual funds and other investment companies. "It regulates virtually every aspect of the operations of investment companies; their valuation of assets, their governance and structure, their issuance of debt and other senior securities, their investments, sales and redemptions of their shares, and, perhaps most importantly, their dealings with service providers and other affiliates."  

The Investment Company Act classifies investment companies into the following categories: "face amount certificates" and "unit investment trusts," which are not actively managed, and "management companies," which are actively managed. Management companies are further classified into "closed" and "open-end" investment companies.

Trust Indenture Act of 1939

The Trust Indenture Act of 1939 regulates the public offering of debt securities in excess of $1 million. The title of this legislation is a reference to "trust indentures," which are master agreements that govern the terms and conditions of the issuance and payment of interest and principal on corporate bonds, a.k.a., "debentures." The Trust Indenture

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19 See SEC v. Mount Vernon Mem’l Park, 664 F.2d 1358 (9th Cir. 1982) (describing these instruments).
Act sets forth requirements of independence and the responsibilities of indenture trustees. It provides for certain protections for investors when there has been a bond default.

THE SECURITIES AND EXCHANGE COMMISSION

Created by the 1934 Act, the SEC is an independent federal agency that is responsible for the enforcement of the federal securities laws. The SEC has responsibility for regulating the securities exchanges and the over-the-counter market. It also regulates approximately 35,000 regulated entities including some 12,000 investment advisers, 10,000 mutual funds and exchange traded funds ("ETFs"), 4,500 broker-dealers and 9,100 public companies.\(^\text{23}\)

The SEC is composed of five commissioners who are appointed by the President with the advice and consent of the Senate for five-year terms. No more than three members may be members of the same political party. The SEC is headquartered in Washington, D.C., but it also has several regional offices across the country.

The SEC’s work is largely carried out by its staff, which is divided into various divisions and offices. The SEC’s Division of Enforcement is staffed by some 1,500 employees and is responsible for investigating potential violations and recommending to the SEC whether an enforcement action should be brought.\(^\text{24}\) If approved by the Commission, the Enforcement Division will prosecute the case as a civil matter in federal court or before an SEC administrative law judge. It may also make criminal references to the Justice Department if deemed warranted.

The SEC’s Division of Trading and Markets is responsible for the oversight of the securities exchanges. The SEC Division of Economic and Risk Analysis is responsible for integrating risk and data analysis into the SEC’s processes. The SEC Division of Corporate Finance is responsible for reviewing disclosure documents and financial statements filed with the SEC by public companies. The SEC Division of Investment Management oversees the regulation of investment companies and investment advisers.

The SEC also has several other offices, including the Office of General Counsel, which defends the SEC in court, handles appeals and advises


\(^{24}\) Id.
6 Research handbook on securities regulation in the United States

the SEC as its lawyer. The SEC’s Office of Compliance and Inspections is responsible for conducting compliance inspections of investment advisers and broker-dealers. Other offices include an Office of Municipal Securities, Office of International Affairs, Office of Credit Ratings and the Office of Chief Accountant.

THE DODD-FRANK ACT

Adopted in the wake of the Financial Crisis in 2008, the Dodd-Frank Act made several changes to the SEC’s regulatory duties. Among other things, the SEC was subjected to oversight by the Office of the Comptroller General, who must report on the SEC’s effectiveness every three years.25 That change reflected a concern that the SEC had not been an effective regulator during and before the Financial Crisis in 2008.

Dodd-Frank subjected hedge funds to regulation by the SEC.26 That legislation also addressed the regulation of rating agencies because the ill-advised high ratings given to securitized subprime loans was thought to have contributed to the intensity of the Financial Crisis. The SEC was ordered to establish an Office of Credit Ratings and the SEC was to conduct examinations of credit rating agencies at least once a year. Disclosure of rating methodologies was also required. At least 50 percent of the directors of the rating agencies were required to be independent directors.27

In response to the massive Madoff Ponzi scheme,28 the Dodd-Frank Act directed the SEC to conduct a study of how it could enhance its examinations of investment advisers.29 A new Office of Investor Advocate was created at the SEC and it was to be assisted by the appointment of an ombudsman to act as an investor advocate.30 The SEC was authorized to restrict mandatory arbitration of retail customer claims.31 Whistleblower bounties were addressed for persons reporting violations of the federal securities laws.32

25 Dodd-Frank § 962.
26 Dodd-Frank § 401 et seq.
27 Dodd-Frank § 931 et seq.
29 Dodd-Frank § 914.
30 Dodd-Frank § 915.
31 Dodd-Frank § 921.
32 Dodd-Frank § 922.
Dodd-Frank gave shareholders a say on executive pay in the form of the right to vote approval or disapproval on executive pay and golden parachutes. The SEC was given authority to allow shareholders proxy access to nominate directors. Compensation committees were required to include only independent directors who would have authority to hire compensation consultants in order to strengthen their independence. Public companies are now required to adopt claw-back provisions for executive compensation that was based on inaccurate financial information. Regulators were required to adopt rules prohibiting compensation practices in the form of excessive compensation that encourages excessive risk taking. Broker voting restrictions on board votes were adopted. Public companies are also required to disclose why they have or have not decided to split the role of chairman and CEO.

Advisers on municipal securities are now required to register with the SEC and are subject to regulation and fiduciary duties. The industry is also required to fund the Governmental Accounting Standards Board, which is tasked with establishing standards of financial accounting and reporting recognized as generally accepted accounting principles applicable to State and local governments. The SEC was directed to conduct a study of whether customers of broker-dealers should be given the same protections of fiduciary duties as those of investment advisers. The SEC was authorized to impose such a requirement, but there was to be no continuing fiduciary duty after personalized advice is given.

The Dodd-Frank Act directed the SEC substantively to regulate the previously unregulated market in securities-based swaps and security-based swap dealers. Dodd-Frank gave the SEC broad and exclusive jurisdiction over “security-based swaps,” while the CFTC was given jurisdiction over other swaps, and joint jurisdiction was declared for the SEC and CFTC over “mixed swaps.” The goal of that legislation was to move swaps from the over-the-counter market to central exchanges where

33 Dodd-Frank § 951.
34 Dodd-Frank § 952.
35 Dodd-Frank § 954.
36 Dodd-Frank § 956.
37 Dodd-Frank § 957.
38 Dodd-Frank § 972.
40 Dodd-Frank § 913.
41 Dodd-Frank § 762.
42 Dodd-Frank § 712.
they would be cleared like futures and options contracts. That regulation reversed a decision by Congress in legislation enacted in 1992 and 2000 to allow these instruments to trade without substantive regulation. However, concerns over energy price manipulations and losses from credit default swaps led to their regulation. The bankruptcy of the American International Group, which the federal government had to bail out as the result of losses from credit default swaps, was a key factor in the demand for legislation that led to the passage of Dodd-Frank.

SEC ENFORCEMENT PROCEEDINGS

As described above, the SEC Division of Enforcement (“DOE”) is responsible for investigating potential violations of the federal securities laws and SEC regulations. These investigations are conducted privately and may be “informal” or “formal.” An informal investigation involves a request for information by the DOE that is voluntary on the part of the person receiving the request. A formal investigation is conducted pursuant to an order of investigation. A formal investigation carries with it the power to subpoena witnesses and documents. A court may enforce those subpoenas.

If the DOE concludes that a violation has occurred and that enforcement action is appropriate, notice of that conclusion is given to the targeted party. That party is then normally provided the opportunity to submit a “Wells Submission” to the SEC to explain why such an enforcement action should not be undertaken. Such notices frequently result in settlements in which the party neither admits nor denies the SEC’s findings of violations. However, in recent months, the SEC has

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43 See, e.g., 15 U.S.C. § 78(a) for the SEC’s authority to conduct such investigations.


45 See SEC v. Sands, 902 F. Supp. 1149, 1167 (C.D. Cal. 1995), aff’d sub nom.; SEC v. First Pacific Bancorp, 142 F.3d 1186 (9th Cir. 1998), cert. denied, 525 U.S. 1121 (1999) (“A Wells submission is a document filed with the SEC in which a defendant presents the evidence and legal theories he believes the SEC should consider in deciding whether to file an enforcement action.”).
begun a campaign of requiring at least some parties to admit wrongdoing.46

If settlement cannot be reached, and if the SEC concludes that such an action should be taken over the objections of the targeted party, the DOE will be authorized to bring enforcement proceedings. Such a proceeding may take the form of an injunctive action in federal court47 or an administrative proceeding before an SEC administrative law judge.

As one author notes:

First, the SEC has the power to bring actions in federal court to seek temporary and permanent injunctive relief against possible violators, to request that a court prohibit persons from serving as officers or directors of registered companies, to seek civil monetary penalties for securities law violations, and to request equitable relief. Second, the SEC can bring administrative action against alleged violators. In these administrative proceedings, the SEC may impose monetary penalties after notice and opportunity for a hearing. An administrative law judge (ALJ), who is independent of the SEC, presides over these hearings. The ALJ issues an initial decision, which can be appealed to the Commission. The Commission’s decision can be appealed to federal circuit courts. Third, the SEC can refer cases to the Department of Justice for criminal prosecution.48

In order to establish that injunctive relief is appropriate, the DOE need not show irreparable injury or the inadequacy of other remedies, as is the case for private injunctive relief. Instead, the DOE must show that there is a “realistic likelihood” of future violations. As one court held:

Several factors are to be considered in determining the probability of future violations: “(1) the degree of scienter involved, (2) the isolated or recurring nature of the fraudulent activity, (3) the defendant’s appreciation of his wrongdoing, and (4) the defendant’s opportunities to commit future violations.” Where the defendant’s misconduct involves “systematic wrongdoing”

rather than an isolated incident, courts have found that there is a greater probability that the defendant will commit future violations of the securities laws.49

The SEC often seeks “ancillary” equitable relief in its enforcement actions, including disgorgement from defendants of their ill-gotten gains and civil penalties may be imposed.50 As one court noted:

Although injunctive relief is the only relief that the statutes expressly authorize, we have held that federal courts have “inherent equitable authority to issue a variety of ‘ancillary relief’ measures in actions brought by the SEC to enforce the federal securities laws.” In particular, a court may impose a receivership, freeze assets, and order the disgorgement of the proceeds of fraud held by defendants, and by third-party nominal defendants.51

A receiver may be appointed in SEC injunctive actions to take control of a company found to have defrauded investors.52 Alternatively, a “corporate monitor” may also be appointed to assure future compliance.53 The SEC may also seek to bar individuals from serving as an officer or director of a public company if they are shown to be unfit to serve in such a capacity.54

The maximum amount of civil penalties that may be imposed in SEC enforcement proceedings may vary based on the level of seriousness of the violations found. Those penalties range from $7,500 to $150,000 for each violation committed by an individual and from $75,000 to $725,000 for corporate entities.55 In actions for insider trading, the civil penalty may not exceed three times the insider’s trading benefits.56

In administrative proceedings, a respondent may be subject to a cease and desist order, revocation of registration, monetary penalties and bars

50 The 1934 Act states that: “In any action or proceeding brought or instituted by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors.” 15 U.S.C. § 78u.
51 Sherman v. SEC, 491 F.3d 948, 959 (9th Cir. 2007).
52 See generally Warfield v. Byron, 436 F.3d 551 (5th Cir. 2006).
from the securities industry. The decision of an SEC administrative law judge is appealable to the SEC and from there to a federal court of appeals.