Chapter 2 – Regulation of the Securities Industry

Q1. Following the 1929 Stock market crash, Congress passed a series of Acts to regulate the securities industries. Name four of these Acts and briefly describe their purpose.

A. The four Acts are:

i. Securities Act of 1933 – mandated all securities to be properly documented and disclosed to the investing public.

ii. Securities Act of 1934 – created the Securities and Exchange Commission (SEC) to oversee the trading practices of the securities industry.

iii. Investment Company Act of 1940 –regulated investment companies such as mutual funds. The Act mandated that open-end mutual funds could not take on debt and closed-end funds had restrictions on their leveraging capacity.

iv. Glass Steagall Act: separated deposit taking and loan making "commercial banking" from underwriting "investment banking."

Q2. A goal of many parts of U.S. regulatory legislation has been to eliminate/minimize conflicts of interest between issuers, investment banks, and investors. Provide examples of conflicts of interest in the U.S. investment banking industry and the corresponding regulations that attempted to resolve those issues.

A. Sell-side research vs.banking division: global research settlement; spinning: global research settlement; insider trading: '34 Act; independence of outside auditors: Sarbanes-Oxley; commercial banks vs.investment banks: Glass-Steagall; bankers' involvement in bankruptcies: Chandler Act; investment bank/mutual fund cross holdings/mgmt: ICA 1940.

Q3. Disclosure of information to investors is another recurring theme in U.S. regulation of the securities industry. Provide examples of disclosure required by U.S. regulations.

A. Securities Act of 1933: investors must receive financial and other significant information about a company offering securities for public sale; '34 Act: periodic reporting of information by companies with publicly traded securities; ICA 1940: investment companies must disclose financial condition and investment policies to investors; Sarbanes-Oxley: greater disclosure of off-balance sheet transactions, disclosure and reconciliation of non-GAAP financial measures; global research settlement: disclosure of potential conflicts of interest between the research department and the investment banking department.

Q4. What is the role of states in the U.S. in regulating investment banks?

A. Only anti-fraud matters.

Q5. What type of U.S. securities offerings do not need to be registered with the SEC?

A. Private offerings to limited number of persons or institutions; offerings of limited size; intrastate offerings; securities of municipal, state and federal governments

Q6. What is a "Red Herring"?

A. A "Red Herring" is a preliminary registration statement that has been filed with the SEC and which carries a front-page statement (written with red ink) which cautions prospective investors that the SEC has not approved the registration and sales cannot be completed until a "final" registration statement is declared effective by the SEC and is delivered to investors. Red Herrings are provided by sales people to their prospective clients to educate, rather than to be used as a final sales document.

Q7. Before an SEC registration statement is declared effective, companies (or their underwriters) that sell stock or are deemed to be promoting the sale of stock have a securities law problem. What is this problem called and what are its consequences?

A. Gun jumping. The company must withdraw the issuance until the SEC is satisfied that no fraud or manipulation has occurred. The company may also be required to pay a fine.

Q8. What are the "Risk Factors" in a prospectus? Why are they important to the issuer and to the investor?

A. Risk Factors are disclosures about potential problems the company may encounter, including possible losses, unpredictable revenue, capacity constraints, reliance on suppliers, technological change, competition, litigation regulation, customer mix, etc.

i. Issuer: The issuer must list every reasonable risk in order to meet full disclosure requirements of securities laws and to therefore have a defense in case they are sued by shareholders if the company's share price drops.

ii. Investors: Investors should read these disclosures to ensure that they understand all relevant risks before making decisions regarding purchase of securities.

Q9. What is the significance of the Gramm-Leach-Bliley Act of 1999 in relation to the securities industry?

A. The Gramm-Leach-Bliley Act, in essence, repealed the Glass Steagall Act of 1933 and allowed the creation of financial holding companies that could participate in both commercial and investment banking, a practice formerly separated by the Glass-Steagall Act. This act paved the way for

conglomerate, multi-service providers such as Citigroup and JP Morgan and permitted the convergence of banking, insurance and securities businesses.

Q10. What are some securities regulations in place in the U.K., Japan and China that mirror U.S. regulations?

A. Japan and China: Originally separated the functions of commercial and investment banks (these changes happened within a much shorter time frame for China). Later, like the U.S., those restrictions were eliminated. Also, various Japanese laws requiring disclosure and internal controls in public companies were similar to those in the U.S. The U.K. also has an SRO system like the U.S. Chinainstituted anti-fraud and insider trading rules in 2005 similar to those in the U.S.

Q11. What are some major differences between the regulatory frameworks of the four countries covered in this chapter?

A. One main difference is the U.S. has somewhat fragmented and decentralized securities regulatory bodies, whereas in the other three countries, securities regulation is centralized.

Q12. Compare the regulatory bodies of the four countries covered in this chapter.

A. The Financial Supervisory Agency in Japan, the Financial Services Authority in U.K., and the China Securities Regulatory Commission are the sole financial regulators in those countries. In the U.S., the two main regulators are the Fed and the SEC. In addition, entities such as the Commodity Futures Trading Commission and the FDIC also have regulatory powers.

Q13. What does the Dodd-Frank Act of 2010 mainly focus on?

A. This Act mainly focused on protecting consumers, ending “too big to fail” bailouts, improving coordination between various regulatory agencies, identifying systemic risk early, creating greater transparency for complex financial instruments and providing greater transparency for executive compensation.