

# SELECT OVERVIEW OF U.S. COMPANY AND SECURITIES LAWS

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November 17, 2004

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# THIS PRESENTATION WILL COVER:

- The basic legal framework of U.S. securities and company laws with emphasis on the role of the Securities and Exchange Commission (SEC)
- An outline of the disclosure and reporting requirements applicable to publicly-owned companies under the Securities Exchange Act of 1934 (Exchange Act), including:
  - Changes made as a result of the Sarbanes-Oxley Act of 2002 (SOX)
  - Recent corporate governance changes under stock exchange listing rules
- Civil, administrative and criminal liability provisions of the U.S. securities laws
- Regulation of U.S. stock exchanges and other self-regulatory organizations (SROs)
- Recent proposed changes in the U.S. model for self-regulation of exchanges and other self-regulatory organizations (SROs)

# U.S. SECURITIES LAWS

- The U.S. has federal and state securities laws
  - State laws are not relevant for purposes of this presentation
- Federal securities laws regulate, among other things:
  - Public offerings securities
  - Disclosure and reporting obligations of publicly-traded companies
  - Stock exchanges, other trading markets and market participants, including brokers, dealers, clearing and settlement agencies, transfer agents and registered securities associations (the NASD)
  - Investment funds and investment advisers
- Federal securities laws are administered by the SEC, among other ways, by rulemaking, review of disclosure documents and inspections and examinations of market participants
- Federal securities laws are enforced:
  - By the SEC in civil and administrative provisions
  - By private parties in civil litigation
  - By U.S. criminal authorities (less than 5% of all cases)
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# KEY CHARACTERISTICS OF THE U.S. SECURITIES REGULATION MODEL

- SEC has broad rulemaking authority to implement the laws
- A full disclosure model is used, as distinguished from merit regulation
- Self-regulation whereby stock exchanges, the NASD and other SROs are delegated much of the day-to-day responsibility for market regulation, subject to comprehensive SEC oversight
- SEC has very broad investigatory and enforcement powers
- Rights of investors to sue in private civil actions strengthens the enforcement process and the role of “gatekeepers”
- U.S. court system is efficient and free of corruption
- U.S. has a free and knowledgeable financial press, which fosters accountability by the SEC and market participants

# THE SEC IS AN INDEPENDENT REGULATORY COMMISSION

- Created by Congress in 1934
- Not part of the legislative, executive or judicial branches
- Performs all three of these functions in regulating US securities markets:
  - Implements legislation via rulemaking
  - Exercises executive functions by registering market participants
  - Adjudicates administrative proceedings and reviews self-regulatory organization (SRO) disciplinary proceedings

# APPOINTMENT PROCESS FOR COMMISSIONERS

- President appoints commissioners; Senate must ratify appointments
- Terms are five years and staggered to provide continuity
- No more than three commissioners from the same political party
- Once appointed, commissioners may only be removed for cause by Congressional impeachment
- Political changes in the presidency or the Congress do not require resignation or changes in the Commission, although each President may select his own Chairman
- Commissioners serve full-time, do not represent other government interests and must sever any private sector ties

# THE SEC IS ACCOUNTABLE:

- To Congress
  - Annual Report
  - Congressional oversight subcommittees
  - Budgetary Process
- To the courts with respect to their authority to hear appeals of many Commission decisions
- To the public, including the financial press, because its actions must be transparent and based upon a written record

# THE SEC'S BUDGET

- Based upon an annual legislative appropriation
- Budget Authority: Over \$900 million in 2005, mostly to cover salaries of employees
- The Commission collects fees based upon securities transactions and filings, and fines for violations, but these are turned over to the general treasury

# SEC ORGANIZATION

- Consists of a Washington DC headquarters, five regional offices and six district offices
- Regional and district offices employ persons primarily in examination, inspection, investigatory and enforcement capacities
- Total staff is being increased to approximately 3800 persons
- Over 1200 employees work in the regional and district offices; the remaining employees are at Washington headquarters
- Most important categories of professional staff are lawyers and accountants
- Substantial information about the SEC is available on its web site, [www.sec.gov](http://www.sec.gov)

# U. S. COMPANY LAWS

- Each of the 50 states and the District of Columbia has its own company law, normally referred to as a corporation law
- The two leading models of company law are the Delaware General Corporation Law and the Model Business Corporation Act, a model developed by the American Bar Association and American Law Institute, and adopted in several states
- This presentation will draw upon Delaware law since it is the most developed and interpreted because most publicly-owned companies are incorporated under Delaware law
- Delaware law is enforceable as to basic filing and ministerial requirements by the Office of Secretary of State of Delaware. However, most substantive provisions of the law are enforceable in the Delaware courts through shareholder litigation
- The SEC does not have authority to enforce Delaware or other states' company laws

# KEY CHARACTERISTICS OF U.S. COMPANY LAWS

- General default provisions regarding certificate of incorporation, by-law, purpose, quorum, notice, voting and similar requirements give companies significant flexibility to adopt more stringent requirements or to include in their certificate of incorporation and by-laws provisions that are not specifically prohibited by the laws
- Only one level board of directors; primacy of the board of directors re many matters; e.g. shareholders do not vote on declaration of dividends, approval of financial statements or discharge of directors
- Duties of care and loyalty, including the corporate opportunity doctrine are universally recognized
- Business judgment rule is universally recognized
- Relatively broad indemnification provisions; officers and directors' insurance
- Reasonably uniform approach re approval and justification of interested party transactions
- Derivative and class actions permitted
- Substantial flexibility in corporate finance provisions re choice of securities' terms and conditions and capital structure
- Low and no par stock is common and concept of legal capital is rarely important

# FACTORS AFFECTING CORPORATE GOVERNANCE OF PUBLICLY-OWNED COMPANIES IN THE UNITED STATES

- Company law of the state of incorporation
  - Not significantly as to governance process, but more significantly as to directors' and officers' responsibilities
- Stock exchange listing requirements
  - Decision to list is voluntary but once listed, compliance becomes a contractual obligation
- U.S. securities laws
  - Historically, these laws have specified informational disclosure requirements essential to evaluate governance, but with SOX, some substantive provisions, such as prohibitions on most loans to directors and executive officers, have been added
  - Exception, Investment Company Act of 1940 contains corporate governance provisions for registered investment funds
- Private sector initiatives re best practices that have been voluntarily accepted

# EXCHANGE ACT REPORTING PROCESS

- A company that makes a public offering of its securities in the United States is not required to list its securities for trading on an organized market although most companies that are eligible elect to list on Nasdaq or the NYSE
- Under the Exchange Act, any company that makes a public offering is required to file periodic reports with the SEC as long as it has more than 300 holders of record of its securities
- If the company elects to list its securities, it must also register the class of securities under the Exchange Act so that it becomes subject to Exchange Act reporting as well as certain other disclosure provisions, such as the proxy statement rules and the tender offer rules
- Even if an company does not list, or have an IPO, if it has more than \$10 million in total assets and more than 500 holders of record of a class of equity securities, the company must register the class of security under the Exchange Act and it becomes subject to the same disclosure and reporting obligations referred to above.

# DOMESTIC VS. FOREIGN ISSUERS' REPORTING REQUIREMENTS

- Foreign issuers are not subject to SEC quarterly reporting requirements, although NYSE and Nasdaq may require release of quarterly results
- Foreign issuers are not required to file SEC current reports on Form 8-K, although they are required to submit certain information under cover of Form 6-K Reports as such information is made available under their home country requirements
- Foreign issuers are not subject to SEC proxy or information statement rules, to Section 16 insider reporting rules, or to SEC Regulation FD (fair disclosure); they are subject to the same insider trading prohibitions as domestic issuers
- Foreign issuers are subject to the same Exchange and Nasdaq rules regarding timely disclosure of material information as domestic issuers
- Historically, the stock exchanges and Nasdaq have had separate quantitative listing standards for foreign issuers and they have not applied their corporate governance standards for domestic issuers to foreign issuers. This has changed somewhat, as a result of SOX

# OVERVIEW OF PERIODIC REPORTING

- Domestic companies are required to file an Annual Report on Form 10-K within 75 days after their fiscal year; the time period is scheduled to be accelerated to 60 days for most domestic companies; foreign private companies file an Annual Report on Form 20-F, which is due six months after their fiscal year
- Annual reporting essentially requires the company to bring forward by one year the same type of information that it was required to include in its prospectus, including three years' audited financial statements and management's discussion and analysis (MD&A)
- Domestic companies are required to file a Form 10-Q Quarterly Report after the close of a quarter for the first three quarters of the fiscal year; the time period is being accelerated to 35 days for most domestic companies

# REPORTING - CONTINUED

- Principal Form 10-Q unaudited financial statement requirements are:
  - A summary balance sheet as of the close of the quarter compared to the balance sheet as of the end of the company's last fiscal year;
  - Summary, comparative statements of operations and changes in stockholders' equity for both the most recent quarter and the year to date;
  - Summary, comparative statements of cash flow for the year to date
  - Footnotes as necessary to update certain Form 10-K financial statement footnotes
- MD&A is required
- Form 20-F, 10-K and 10-Q Reports must be signed by company's principal executive, financial and accounting officers and certified as to content, disclosure and accounting controls by the CEO and CFO  
Form 10-K and 20-F Reports also must be signed by a majority of the company's directors
- Even though Form 10-Q financial statements are unaudited, companies that are listed on an exchange or Nasdaq are required to have their independent accountants perform a review of the Form 10-Q financial statements before filing

# REPORTING - CONTINUED

- Form 8-K Current reports are required to be filed when certain events take place

Examples:

- Changes in control
- Acquisition or disposition of significant assets
- Change in independent accountants
- Bankruptcy of receivership
- Resignation of directors if they wish to make a statement
- Unregistered sales of equity securities
- Other material important events at the issuer's option
- Reg. FD disclosures

# REPORTING - CONTINUED

- In a step toward more real-time reporting the SEC has recently added to the list of reportable items on Form 8-K and accelerated the filing dates for most items
  - Entry into a Material Definitive Agreement
  - Termination of a Material Definitive Agreement
  - Results of Operations and Financial Condition
  - Creation of a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement
  - Triggering Events That Accelerate or Increase a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement
  - Costs Associated with Exit or Disposal Activities
  - Material Impairments
  - Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing
  - Material Modifications to Rights of Security Holders
  - Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review
  - Departure of Directors or Principal Officers; Election of Directors; Appointment of Principal Officers
  - Disclosure when certain officers retire, resign or are terminated and disclosure when a director retires, resigns, is removed or refuses to stand for re-election
  - Disclosure when the company appoints certain new officers or a new director is elected
  - Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year

# SARBANES-OXLEY OVERVIEW

- SOX is the most important securities legislation affecting public companies and accounting oversight since the SEC was established in 1934
- While the new law was prompted by problems encountered in the U.S., these problems are global in dimension
- Sox's provisions generally make no distinction between U.S. and foreign issuers who seek to access U.S. capital markets
  - The terms “issuer” and “public company” as used in many places throughout SOX mean an issuer the securities of which are registered under the Exchange Act, which is required to file reports under the Exchange Act, or that has filed a registration statement for a public offering of its securities that has not become effective and that has not been withdrawn

# SOX AUDIT COMMITTEE REQUIREMENTS

- SOX defines “audit committee” for purposes of the Act and the Exchange Act as:
  - “a committee (or equivalent body) established by and amongst the board of directors of an issuer for purposes 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”
- For certain purposes, however, SOX imposes additional requirements regarding the composition and responsibilities of an “audit committee”

# SOX AUDIT COMMITTEE REQUIREMENTS

- SOX required that the SEC, by rule, direct the national securities exchanges and NASD to prohibit the listing of securities of any company, including foreign companies, that do not meet the following requirements:
  - Each member of the company’s audit committee must be a director and must otherwise be independent; :
  - The audit committee must be responsible for hiring and discharging the independent auditors
  - The audit committee shall be responsible for approval or all audit and non-audit services
  - The audit committee shall receive reports from the independent auditors regarding critical accounting polices and practices, discussions that have taken place with management regarding alternative treatments of financial information under GAAP, and any accounting disagreements and other material written communications between the auditors and management
  - The audit committee must establish procedures to receive and address complaints regarding accounting, internal control and audit issues, and to provide company employees an opportunity to make confidential, anonymous submissions regarding accounting and auditing matters

# SOX AUDIT COMMITTEE REQUIREMENTS

- Independence, for these purposes, means that an audit committee member is not an affiliate of the issuer or any subsidiary and that the member receives no consulting, advisory or compensatory fee from the issuer except in his capacity as a member of the audit committee, another board committee or the board of directors
- On April 1, 2003, the SEC adopted a final audit committee rule for listed companies, which will not apply until 2005 to foreign issuers and recognizes certain exemptions from the independence requirement:
  - Non-management employees may serve on audit committees consistent with co-determination and similar requirements in certain countries
  - Permitting principal (more than 50%) shareholders to have non-voting observer status on the audit committee, provided such persons are not management representatives
  - Permitting a foreign government shareholder representative on the audit committee
  - Recognizing that in certain countries, statutory auditors or boards of auditors may perform audit committee functions, provided that the persons on these boards are not management employees or persons selected by management and they are involved to extent permitted by law in the oversight of the independent audit process
- The final rule clarifies that it is not intended to distinguish between management and audit committee oversight of the independent audit process and it is not intended to prohibit shareholders from voting for or ratifying the selection of auditors, which is the practice in many countries

# CEO AND CFO CERTIFICATION OF FINANCIAL REPORTS

- SOX requires two types of certifications by the CEOs and CFOs of all SEC reporting companies – one administered by the SEC and one by the Dept. of Justice
- The SEC rules require a company's CEO and CFO to certify the contents of the company's quarterly and annual reports.
- The CEO and CFO must certify that:
  - he or she has reviewed the report;
  - based on his or her knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;
  - based on his or her knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;

# CEO AND CFO CERTIFICATION

## The CEO and CFO

- are responsible for establishing and maintaining "disclosure controls and procedures" (a newly-defined term reflecting the concept of controls and procedures related to disclosure) for the issuer;
- have designed such disclosure controls and procedures to ensure that material information is made known to them, particularly during the period in which the periodic report is being prepared;
- have evaluated the effectiveness of the issuer's disclosure controls and procedures within 90 days of the date of the report; and
- have presented in the report their conclusions about the effectiveness of the disclosure controls and procedures based on the required evaluation

## CERTIFICATION - CONT.

- The CEO and CFO also must certify that they have disclosed to the company's auditors and to the audit committee of the board of directors (or persons fulfilling the equivalent function):
  - All significant deficiencies in the design or operation of internal controls (a pre-existing term relating to internal controls regarding financial reporting) which could adversely affect the issuer's ability to record, process, summarize and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and
  - Any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and
  - Whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

# MANAGEMENT REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

- On May 27, 2003, the SEC implemented Section 404 of SOX by requiring domestic and foreign issuers to include in their annual reports a management report on internal control over financial reporting signed by the issuer's principal executive and principal financial officers. The report must include:
  - A statement regarding management's responsibility for establishing and maintaining a system of internal control over financial reporting
  - A statement identifying the framework used by management to evaluate the effectiveness of this internal control
  - Management's assessment of the effectiveness of the internal control as of the end of the last fiscal year (any material weaknesses must be disclosed and if they exist, management cannot conclude that internal control is effective)
  - A statement that the issuer's independent accountants have issued an attestation report on management's assessment (an attestation report is different from an audit report under US GAAS)

# OTHER CHANGES IN INTERNAL ACCOUNTING CONTROL REQUIREMENTS

- SOX requires the new Public Company Accounting Oversight Board (PCAOB) to adopt rules that will require the independent auditor to describe in its audit report the scope of its testing of the internal control structure and procedures of the company, and to present (in such report or in a separate report):
  - The findings of the auditor from such testing
  - An evaluation whether the internal control structure and procedures achieve substantially the principal internal accounting control requirements of the Exchange Act
- This requirement differs from the independent auditor's current obligation under GAAS to evaluate internal controls of the company for purposes of planning the scope of the audit. See PCAOB Statement No. 2 available on [www.pcaobus.org](http://www.pcaobus.org)
- This requirement is in addition to the independent auditor's obligation under SOX to attest to management's report and assessment of the internal control structure and procedures for financial reporting

# DEFERRAL OF ACCELERATED REPORTING

Because many companies claim the new internal control requirements are burdensome, the SEC has deferred for one year the acceleration of annual reporting deadlines for US companies from 75 to 60 days

The effective dates of the internal control requirements remain fiscal years ending on or after November 15, 2004 for US companies, and July 15, 2005 for foreign issuers

Foreign issuers still have six months to file their annual reports with the SEC

# EVOLUTION OF U.S. INDEPENDENT DIRECTOR REQUIREMENTS

Before SOX, no federal securities law (and no state corporate law) required independent directors, except for registered investment funds under the Investment Company Act of 1940. However, stock exchange listing rules required a majority of independent directors on audit committees and many companies voluntarily chose to have a significant number of independent directors.

As required by SOX, the SEC, by rule, directed the stock exchanges and NASD to prohibit the listing of securities of any company, including a foreign company, that does not have an audit committee comprised entirely of independent directors.

Independence, for these purposes, means that an audit committee member is not an affiliate of the issuer or any subsidiary and that the member receives no consulting, advisory or compensatory fee from the issuer except in his capacity as a member of the audit committee, another board committee or the board of directors.

As noted above, certain accommodations were made for foreign issuers.

The stock exchanges and NASD have adopted additional requirements for audit committees, including the requirements that members be financially sophisticated and at least one member must be an expert in accounting/auditing matters.

# NYSE AND NASDAQ GOVERNANCE CHANGES

A majority of the board of directors must be independent directors

- More stringent definitions of “independent director” than used in SOX

A compensation committee of the board and a nominating/corporate governance committee of the board must be comprised entirely of independent directors

Except for the audit committee requirements mandated by SOX, the above requirements are not necessarily mandatory for foreign companies.

NYSE will require disclosure of how a foreign issuer’s governance differs from these requirements

Nasdaq will permit foreign issuers to be exempted from its requirements if they are contrary to home country requirements or business practices

# ADDITIONAL NYSE AND NASDAQ CHANGES

## NYSE

Corporate governance guidelines  
Separate meetings of non-management directors  
Audit committee charter  
Internal audit function  
Code of business conduct and ethics  
CEO certification of compliance with governance requirements  
Public reprimand letter  
Shareholder approval of equity compensation plans

## NASDAQ

Separate meetings of independent directors  
Audit committee charter  
Code of business conduct and ethics  
Notification of noncompliance  
Public announcement of audit opinions with going concern qualifications  
Review and approval of related party transactions by audit committee or other independent board-level body  
Shareholder approval of equity compensation plans

# CORPORATE GOVERNANCE CHANGES AFFECTING INVESTMENT FUNDS

The Investment Company Act of 1940 differs from other disclosure-oriented securities laws administered by the SEC in that the Act includes certain governance requirements and prohibits certain conflicts of interest. For example:

The Act requires at least 40% of the directors of a registered investment fund to be independent.

The SEC has used its rulemaking authority to grant exemptions from certain provisions of the Act to further strengthen governance requirements

On July 27, 2004 the Commission by 3-2 vote required as a condition of availability of certain exemptions under the Act that:

1. At least 75% of the fund's board must be independent directors, or if the fund has only three directors, all but one of the directors must be independent.
2. The Chairman of the Board must be an independent director.
3. The Board must perform a self-assessment at least once annually.
4. The independent directors must meet separately at least once per quarter.
5. Independent directors must be affirmatively authorized to hire their own staff.

The U.S. Chamber of Commerce has challenged the SEC's authority to adopt these requirements.

# SEC PROPOSALS FOR SHAREHOLDER NOMINATION OF DIRECTOR CANDIDATES

Current Practice: Shareholders generally may nominate candidates for election as directors, but if they wish to solicit proxies from other shareholders, they must do so separately at their own expense.

On October 14, 2003, the SEC proposed rules that would, under certain circumstances, require companies to include in their proxy materials security holder nominees for election as director. Proposed triggering events:

- More than 35% of votes are withheld for a company nominee at a prior year's election.

- Prior passage by 50% of the votes cast of a shareholder proposal for direct shareholder access to the proxy machinery.

The rules would not apply to contests for control or where the nominee has a financial relationship with the nominating shareholder.

These proposals, which are still pending, have received both substantial support and substantial opposition from public commentators.

On November 24, 2003, the SEC adopted amendments to its proxy rules that require companies to make more transparent disclosures regarding the operations of board nominating committees, including consideration of shareholder nominees.

# BENEFICIAL OWNERSHIP DISCLOSURE

- Exchange Act Rule 13d-3 defines “beneficial ownership” as the power to vote or the power to dispose of securities, which may be sole or shared and held directly or indirectly
  - More than one person may be the beneficial owner of the same securities
  - Beneficial ownership includes a right to acquire securities exercisable within 60 days
- A person or several persons acting in concert (a group) must report acquisition of more than 5% beneficial ownership of a domestic or foreign SEC reporting company’s equity securities within 10 days of the acquisition to the SEC, the company and the market where the company’s securities are traded
- If the acquirer is not seeking control and owns less than 20% of the company’s outstanding securities it may report such beneficial ownership on Schedule 13G, which requires less background information regarding the acquirer and the acquisition terms
- If the acquirer is seeking control or acquires more than 20% of the company’s outstanding securities it must file a Schedule 13D

# BENEFICIAL OWNERSHIP DISCLOSURE

- Schedule 13D. requires detailed background information regarding the acquirer, the terms under which the securities were acquired, the financing and any plans the acquirer has to cause the issuer to enter into transactions or to change the issuer's management
- Schedule 13D must be amended promptly to report any material changes in the information required; a change of beneficial ownership of more than 2% of the outstanding securities during a twelve-months period is considered material
- After the initial filing, Schedule 13G is only required to be filed annually within 45 days after the calendar year, unless a person filing Schedule 13G decides to seek control of the issuer in which case a Schedule 13D must be filed promptly
- Under U.S. federal securities laws, a person acquiring more than a specified percentage of a company's outstanding shares is not required to make an offer for the other outstanding shares, although such an obligation may arise under state law anti-takeover laws

# BENEFICIAL OWNERSHIP DISCLOSURE

- Institutional investors who acquire more than 5% of a company and are not seeking control file Schedule 13G
- Institutional investors with more than \$100 million of assets under management report their beneficial ownership of SEC reporting companies quarterly pursuant to Exchange Act Section 13(f)
- Beneficial ownership of a company's officers, directors, all officers and directors as a group and more than 5% holders is required disclosure in prospectuses, annual reports and proxy/information statements filed with the SEC
- Officers, directors and more than 10% beneficial owners also are required to report their initial beneficial ownership and any changes in such ownership on a monthly basis pursuant to Exchange Act Section 16(a) (not applicable to foreign issuers)

# SEC ENFORCEMENT AUTHORITY

- Administrative cease and desist proceedings and injunctive actions in federal district court
  - May be used against any person and may include disgorgement of ill-gotten gains and monetary penalties
  - Injunctive actions in federal court may include the above and additional ancillary relief; e.g, an asset freeze
- Administrative proceedings decided by an Administrative Law Judge are appealable to the Commission and eventually to the courts
- Rule 102(e) administrative proceedings against professionals, such as lawyers or accountants
- Criminal reference to the U.S. Department of Justice
  - Willful violation of any section of the federal securities laws or rules or regulations may also result in criminal prosecution
  - Higher standards of proof in criminal vs. civil and administrative actions
- Civil, administrative and criminal actions are not mutually exclusive

# RULE 10b-5 IS VERY BROAD

“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,

- a. to employ any device, scheme, or artifice to defraud,
  - b. 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
  - c. 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.”

Note that the rule applies to any person. SEC may also sanction persons who aid and abet (materially assist) violations of this rule.

# CIVIL LIABILITY PROVISIONS

## Express Section 11 liability re registered public offerings

Lists specific persons who may be held liable

Ordinary negligence standard

One year statute of limitations

Joint and several liability for actual damages, except for non-management directors subject to a scienter standard.

Liability determined as of the effective date

## Express Section 12(a)(2) liability re sale of securities

The seller is liable as of the sale date

Ordinary negligence standards

Actual damages

## Implied civil liability under antifraud Rule 10b-5

Applies to any person who acts with scienter or recklessly in connection with the purchase or sale of a security

## Civil liability provisions may apply to control persons

# FINANCIAL FRAUD CASES

## Financial fraud cases

- most often involve violations of the general antifraud provisions, but
- may also be based upon violations of auditing and accounting standards or SEC reporting requirements, and post-SOX may also involve false CEO/CFO certifications
- may be based upon violation of internal accounting control requirements by SEC reporting issuers
- usually require corrective filings by the issuer
- may result in barring individuals from serving as officers or directors of public companies
- may result in administrative proceedings denying the right of accountants to practice before the SEC

# CIVIL AND ADMINISTRATIVE PENALTIES

- For both civil and administrative actions, there are three levels:
  - First tier: Maximum \$5,000 for individuals and \$50,000 for others
  - Second tier: If the act or omission involved fraud, deceit, manipulation or reckless disregard of a regulatory requirement, maximum is \$50,000 for individuals and \$250,000 for others
  - Third tier: If 2<sup>nd</sup> tier requirements are met and the act or omission resulted in or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the person who committed the act or omission, maximum is \$100,000 for individuals and \$500,000 for others
- For insider trading violations, the SEC may seek disgorgement of profits or losses avoided plus up to three times the amount of profits or losses avoided

# WHO ARE SROs?

Under the Exchange Act SROs include:

- Registered national securities exchanges
- The National Association of Securities Dealers; all broker-dealers conducting a public securities business are required by law to belong to the NASD
- Registered clearing agencies (includes securities depositories)
- The Municipal Securities Rulemaking Board (MSRB)

Each of these SROs, except MSRB, must satisfy certain structural requirements as conditions of their registration

# STRUCTURAL REQUIREMENTS FOR SROs

The NASD and stock exchange SROs must have:

- Capacity to comply with the securities laws and to enforce compliance by members with the securities laws and the SROs' own rules
- Governing instruments that give all members fair representation in the selection of directors and the administration of affairs
- Rules designed to prevent fraud and to promote just and equitable principles of trade
- Fair procedures for bring disciplinary actions against their members and persons associated with members

In addition, an SRO's rules must not impose any unnecessary burden on competition

# THE SEC OVERSEES EVERY ASPECT OF SELF-REGULATION

- Approval of all SRO rules, including the right to amend, modify, abrogate and adopt rules
- Inspection of SROs and oversight of the SROs' examination of their own members with the authority to conduct examinations directly
- Review of SRO disciplinary proceedings and membership denials
- Ability to enforce SRO rules directly if the SRO is unable or unwilling to take appropriate actions
- Enforcement actions against the SRO
- Record keeping and reporting requirements
- Authority to coordinate responsibilities and information sharing among SROs

# ADVANTAGES AND DISADVANTAGES OF THE SRO MODEL

## Advantages

- Technical expertise
- Flexibility; responsiveness to new developments
- Greater acceptance of rules
- Cost savings to government

## Disadvantages

- Conflicts of interest – Examples - NYSE front running; Nasdaq market collusion on quote spreads, NASD oversight of ATS
- Antitrust implications – e.g., collusion of options exchanges against dual listings
- Due process concerns – ability to take away member's right to do business without all of the procedural rights that would apply in a governmental enforcement proceeding

# DEMUTUALIZATION AND SELF-REGULATION IN THE U.S.

What are the potential effects of demutualization on self-regulation?

Will the SRO be adequately funded to carry out its responsibilities?

Will the SRO understand the markets it regulates?

Will the SRO structure be streamlined to minimize duplicative regulation?

What is the best way to control or minimize conflicts of interest?

# RECENT SEC PROPOSALS RE SELF-REGULATION

- A series of releases, including specific rule proposals and an SRO concept release issued by the SEC on November 9, 2004; not yet on the SEC's web site:
- Among other things, the proposals would require:
  - All SROs except clearing agency SROs to have majority independent boards, fully independent Nominating, Governance, Audit, Compensation, and Regulatory Oversight Committees, and the separation of the SRO's regulatory functions from its business functions
  - All SROs to publicly disclose, and update at least annually, material information about their operation and structure, including their governance processes, regulatory programs, financial condition, and ownership
  - All SROs to submit non-public quarterly and annual reports to the SEC containing specified information on the operation of their regulatory programs, including their examination, investigation, and enforcement activities

# SEC SRO PROPOSALS - CONTINUED

- SROs to (i) restrict ownership and voting levels of individual members to no more than 20% and (ii) report significant accumulations of ownership by any person, and would require SRO members to report significant ownership interest information as well
- would impose reporting and notification requirements on an SRO that lists or trades its own securities or those of its trading facilities or affiliates
- The Concept Release requests public comment on a variety of issues relating to the efficacy of the self-regulatory system, including: (a) the inherent conflicts with members, market operators, issuers, and shareholders; (b) the inefficiencies of multiple SROs; (c) weaknesses in intermarket surveillance; and (d) concerns regarding SRO funding
- The Concept Release also requests comment on the advisability of implementing specified enhancements to the current SRO system or, alternatively, pursuing one of several possible alternative regulatory models

THANK YOU  
QUESTIONS?