CHAPTER 1

Federal Law Review

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INTRODUCTION

Although the Series 63 exam is a state-based exam, a full understanding of federal securities laws is required. All federal securities laws have a year attached to them that corresponds with the year the law was enacted.

THE SECURITIES ACT OF 1933

The Securities Act of 1933 was the first major piece of securities industry regulation, which was brought about largely as a result of the stock market crash of 1929. Other laws were also enacted to help prevent another meltdown of the nation's financial system, such as the Securities Exchange Act of 1934, which will be discussed later.

The Securities Act of 1933 regulates the primary market. The primary market consists exclusively of transactions between issuers of securities and investors. In a primary market transaction, the issuer of the securities receives the proceeds from the sale of the securities. The Securities Act of 1933 requires nonexempt issuers, typically corporate issuers, to file a registration statement with the Securities and Exchange Commission (SEC). The SEC will review the registration statement for a minimum of 20 days. During this time, known as the cooling-off period, no sales of securities may take place. If the SEC requires additional information regarding the offering, the SEC may issue a deficiency letter or a stop order that will extend the cooling-off period beyond the original 20 days. The cooling-off period will continue until

the SEC has received all of the information it has requested. The registration statement, formally known as an S1, is the issuer's full disclosure document for the registration of the securities with the SEC.

THE PROSPECTUS

While the SEC is reviewing the securities' registration statement, registered representatives are very limited as to what they may do with regard to the new issue. During the cooling-off period, the only thing a registered representative may do is obtain indications on interest from clients by providing them with a preliminary prospectus, also known as a red herring. The term "red herring" originated from the fact that all preliminary prospectuses must have a statement printed in red ink on the front cover stating, "These securities have not yet become registered with the SEC and therefore may not be sold." An indication of interest is an investor's or broker dealer's statement that it may be interested in purchasing the securities being offered. The preliminary prospectus contains most of the same information that will be contained in the final prospectus except for the offering price and the proceeds to the issuer. All information contained in a preliminary prospectus is subject to change or revision.

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THE FINAL PROSPECTUS

All purchasers of new issues must be given a final prospectus before any sales may be allowed. The final prospectus serves as the issuer's full-disclosure document for the purchaser of the securities. If the issuer has filed a prospectus with the SEC and the prospectus can be viewed on the SEC's website, a prospectus will be deemed to have been provided to the investor through the "access equals delivery" rule. Once the issuer's registration statement becomes effective, the final prospectus must include the following:

- Type and description of the securities
- Price of the securities
- Use of the proceeds
- Underwriter's discount
- Date of offering
- Type and description of underwriting
- Business history of issuer

- Biographical data for company officers and directors
- Information regarding large stockholders
- Company financial data
- Risks to purchaser
- Legal matters concerning the company
- SEC disclaimer

SEC DISCLAIMER

The SEC reviews the issuer's registration statement and the prospectus but does not guarantee the accuracy or adequacy of the information. The following SEC disclaimer must appear on the cover of all prospectuses: "These securities have not been approved or disapproved by the SEC nor have any representations been made about the accuracy or the adequacy of the information."

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MISREPRESENTATIONS

Financial relief for misrepresentations made under the Securities Act of 1933 is available for purchasers of any security that is sold under a prospectus that is found to contain false or misleading statements. Purchasers of the security may be entitled to seek financial relief from any or all of the following:

- The issuer
- The underwriters
- Officers and directors
- All parties who signed the registration statement
- Accountants and attorneys who helped prepare the registration statement

THE SECURITIES EXCHANGE ACT OF 1934

The Securities Exchange Act of 1934 was the second major piece of legislation that resulted from the market crash of 1929. The Securities Exchange Act of 1934 regulates the secondary market, which consists of investor-to-investor transactions. All transactions between two investors that are executed on any of the exchanges or in the over-the-counter (OTC) market are secondary market transactions. In a secondary market transaction, the selling security holder

receives the money, not the issuing corporation. The Securities Exchange Act of 1934 also regulates all individuals and firms that conduct business in the securities industry. The Securities Exchange Act of 1934:

- Created the SEC
- Requires registration of broker dealers and agents
- Regulates the exchanges and the National Association of Securities Dealers (the NASD is now part of FINRA)
- Requires net capital for broker dealers
- Regulates short sales
- Regulates insider transactions
- Requires public companies to solicit proxies
- Requires segregation of customer and firm assets
- Authorizes the Federal Reserve Board to regulate the extension of credit for securities purchases under Regulation T
- Regulates the handling of client accounts

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THE SECURITIES AND EXCHANGE COMMISSION (SEC)

One of the biggest components of the Securities Exchange Act of 1934 was the creation of the SEC. The SEC is the ultimate securities industry authority, and it is a government body. Five commissioners are appointed to five-year terms by the president, and each must be approved by the Senate. The SEC is neither a self-regulatory organization (SRO) nor a designated examining authority (DEA). A self-regulatory organization regulates its own members, such as the New York Stock Exchange (NYSE) or FINRA. A DEA inspects a broker dealer's books and records; it can also be the NYSE or FINRA. All broker dealers, exchanges, agents, and securities must register with the SEC. All exchanges are required to file a registration statement with the SEC that includes the articles of incorporation, bylaws, and constitution. All new rules and regulations adopted by the exchanges must be disclosed to the SEC as soon as they are enacted. Issuers of securities with more than 500 shareholders and with assets exceeding $5,000,000 must register with the SEC, file quarterly and annual reports, and solicit proxies from stockholders. A broker dealer that conducts business with the public must register with the SEC and maintain a certain level of financial solvency, known as net capital. All broker dealers are required to forward a financial statement to all customers of the firm. Additionally, all employees

of the broker dealer involved in securities sales who have access to cash and securities or who supervise employees must be fingerprinted.

EXTENSION OF CREDIT

The Securities Act of 1934 gave the authority to the Federal Reserve Board to regulate the extension of credit by broker dealers for the purchase of securities by their customers. The following is a list of the regulations of the different lenders and the regulation that gave the Federal Reserve Board the authority to govern their activities:

- Regulation T: Broker dealers
- Regulation U: Banks
- Regulation G: All other financial institutions

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PUBLIC UTILITIES HOLDING COMPANY ACT OF 1935

The Public Utilities Holding Company Act of 1935 regulates all companies that are in business to provide retail distribution of gas and electric power. Because the companies are regulated by this act, their securities are exempt from state registration requirements.

THE MALONEY ACT OF 1938 /NASD

The Maloney Act of 1938 was an amendment to the Securities Exchange Act of 1934 that allowed the creation of the NASD. The NASD is the SRO for the OTC market. Its purpose is to regulate the broker dealers that conduct business in the OTC market. The NASD (now part of FINRA) is organized into four major bylaws. They are:

- The Rules of Fair Practice
- The Uniform Practice Code
- The Code of Procedure
- The Code of Arbitration

THE TRUST INDENTURE ACT OF 1939

The Trust Indenture Act of 1939 requires that corporate bond issues in excess of $5,000,000 that are to be repaid during a term in excess of one

year issue a trust indenture for the issue. The trust indenture is a contract between the issuer and the trustee. The trustee acts on behalf of all of the bondholders and ensures that the issuer is in compliance with all of the promises and covenants made to the bondholders. The trustee is appointed by the corporation and is usually a bank or a trust company. The Trust Indenture Act of 1939 only applies to corporate issuers. Both federal and municipal issuers are exempt.

INVESTMENT ADVISERS ACT OF 1940

The Investment Advisers Act of 1940 regulates industry professionals who charge a fee for the advice they offer to clients. The Investment Advisers Act sets forth registration requirements for advisers as well as disclosure requirements relating to the adviser's:

- Methods of recommendations
- Types of securities recommended
- Professional background and qualifications
- Fees to be charged
- Method for computing and charging fees
- Types of clients

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INVESTMENT COMPANY ACT OF 1940

The Investment Company Act of 1940 regulates companies that are in business to invest or reinvest money for the benefit of its investors. The Investment Company Act sets forth registration requirements for the three types of investment companies. They are:

- Management investment companies
- Unit investment trusts (UITs)
- Face-amount companies (FACs)

SECURITIES INVESTOR PROTECTION CORPORATION ACT OF 1970 (SIPC)

The Securities Investor Protection Corporation (SIPC) is a government-sponsored corporation that provides protection to customers in the event of a broker dealer's failure. All broker dealers that are registered with the SEC are

required to be SIPC members. All broker dealers are required to pay annual dues to SIPC's insurance fund to cover losses due to broker dealer failure. If a broker dealer fails to pay its SIPC assessment, it may not transact business until it is paid.

NET CAPITAL REQUIREMENT

All broker dealers are required to maintain a certain level of net capital in order to ensure that they are financially solvent. A broker dealer's capital requirement is contingent on the type of business that it conducts. The larger and more complex the firm's business, the greater the net capital requirement. Should a firm fall below its net capital requirement, it is deemed to be insolvent, and SIPC will petition in court to have a trustee appointed to liquidate the firm and protect the customers. The trustee must be a disinterested party; once the trustee is appointed, the firm may not conduct business or try to conceal any assets.

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CUSTOMER COVERAGE

SIPC protects customers of a brokerage firm in much the same way that the Federal Deposit Insurance Corporation (FDIC) protects customers of banks. SIPC covers customer losses that result from broker dealer failure, not market losses. SIPC covers customers for up to $500,000 per separate customer. Of the $500,000, up to $250,000 may be in cash. Most broker dealers carry additional private insurance to cover larger accounts, but SIPC is the industry-funded insurance and is required by all broker dealers. The following are examples of separate customers:

Customer	Securities Market Value	Cash	SIPC Coverage
Mr. Jones	$320,000	$75,000	All
Mr. & Mrs. Jones	$290,000	$90,000	All
Mrs. Jones	$397,000	$82,000	All

All of the accounts shown would be considered separate customers, and SIPC would cover the entire value of the accounts. If an account has in excess of $250,000 in cash, the individual would not be covered for any amount exceeding $250,000 in cash and would become a general creditor for the rest. SIPC does not consider a margin account and a cash account as

separate customers, and the customer would be covered for the maximum of $500,000. SIPC does not offer coverage for commodities contracts, and all member firms must display the SIPC sign in the lobby of the firm.

FIDELITY BOND

All SIPC members are required to obtain a fidelity bond to protect customers in the event of employee dishonesty. Some things that a fidelity bond will insure against are check forgery and fraudulent trading. The minimum amount of the fidelity bond is $25,000; however, large firms are often required to carry a higher amount.

THE INSIDER TRADING AND SECURITIES FRAUD ENFORCEMENT ACT OF 1988

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The Insider Trading and Securities Fraud Enforcement Act of 1988 set forth guidelines and controls for the use and dissemination of nonpublic material information. Nonpublic information is information that is not known by people outside of the company. Material information is information regarding a situation or development that will materially affect the company in the present or future. It is not only just for insiders to have this type of information, but it is required for them to do their jobs effectively. It is, however, unlawful for an insider to use this information to profit from a forthcoming move in the stock price. An insider is defined as any officer, director, 10% stockholder, or anyone who is in possession of nonpublic material information, as well as the spouse of any such person. Additionally, it is unlawful for the insider to divulge any of this information to any outside party.

Trading on inside information has always been a violation of the Securities Exchange Act of 1934, but the Insider Trading Act prescribed penalties for violators, which include:

- A fine of the greater of 300% of the amount of the gain or 300% of the amount of the loss avoided, or $1,000,000 for the person who acts on the information.
- A fine of up to $1,000,000 for the person who divulges the information.
- Insider traders may be sued by the affected parties.
- Criminal prosecutions.

Information becomes public information once it has been disseminated over public media. The SEC will pay a reward of up to 10% to informants who turn in individuals who trade on inside information. In addition to the insiders already listed, the following are also considered insiders:

- Accountants
- Attorneys
- Investment bankers

FIREWALL

Broker dealers who act as underwriters and investment bankers for corporate clients must have access to information regarding the company in order to advise the company properly. The broker dealer must ensure that no inside information is passed between its investment banking department and its retail trading department. The broker dealer is required to physically separate these divisions by a firewall. The broker dealer must maintain written supervisory procedures to adequately guard against the wrongful use or dissemination of inside information.

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THE TELEPHONE CONSUMER PROTECTION ACT OF 1991

The Telephone Consumer Protection Act of 1991 regulates how telemarketing calls are made by businesses. Telemarketing calls that are designed to have consumers invest in or purchase goods, services, or property must adhere to the strict guidelines of the act. All firms must:

- Call only between the hours of 8 a.m. and 9 p.m. in the customer's time zone.
- Maintain a Do-Not-Call list. Individuals placed on the Do-Not-Call list may not be contacted by anyone at the firm for five years.
- Give the prospect the firm's name, address, and phone number when soliciting.
- Follow adequate policies and procedures to maintain a Do-Not-Call list.
- Train representatives on calling policies and use of the Do-Not-Call list.
- Ensure that any fax solicitations have the firm's name, address, and phone number.

EXEMPTION FROM THE TELEPHONE CONSUMER PROTECTION ACT OF 1991

The following are exempt from the Telephone Consumer Protection Act of 1991:

- Calls to existing customers.
- Calls to a delinquent debtor.
- Calls from a religious or nonprofit organization.

Calls may be made prior to 8 a.m. or after 9 p.m. to places of business. The time regulation only relates to contacting noncustomers at home.

NATIONAL SECURITIES MARKET IMPROVEMENT ACT OF 1996

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The National Securities Market Improvement Act of 1996, also known as the Coordination Act, eliminated the duplication of effort among state and federal regulators. Some of the key points of the act include:

- Federal law supersedes state law.
- Registration of investment advisers.
- Capital requirements.
- Industry competition.

The National Securities Market Improvement Act of 1996 ensured that no action by any state or political subdivision could impose laws or requirements upon any broker dealer that differed from or are in addition to those of the Securities Exchange Act of 1934 relating to:

- Capital requirements
- Recordkeeping
- Financial reporting
- Margin
- Custody

The National Securities Market Improvement Act of 1996 also set forth that the states did not have any authority to regulate investment advisory

firms that are federally registered. However, the states may require an investment advisory representative of a federally registered investment advisor to register with the state.

THE UNIFORM SECURITIES ACT

In the early half of the twentieth century, state securities regulators developed rules and regulations for transacting securities business within their states. The result was regulations that varied widely from state to state. The Uniform Securities Act (USA) laid out model legislation for all states in an effort to make each state's rules and regulations more uniform and easier to address. The USA, or the Act, sets minimum qualification and standards for each state securities administrator. The state securities administrator is the top securities regulator within the state. The state securities administrator may be the attorney general or it may be an individual appointed specifically to that post. The USA also:

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- Prohibits the state securities administrator from using the post for personal benefit or from disclosing information.
- Gives the state securities administrator authority to enforce the rules of the USA within that state.
- Gives the administrator the ability to set certain registration requirements for broker dealers, agents, and investment advisers.
- Allows administrators to set fee and testing requirements.
- Permits administrators to suspend or revoke the state registration of a broker dealer, agent, investment adviser, a security, or a security's exemption from registration.
- Sets civil and criminal penalties for violators.

The state-based laws set forth by the USA are also known as blue sky laws.

THE UNIFORM PRUDENT INVESTORS ACT OF 1994

The Uniform Prudent Investors Act of 1994, or UPIA, sets the basic standards by which all investment professionals acting in a fiduciary capacity must abide. The UPIA updates the requirements and definitions of prudent standards in light of the application of modern portfolio theory and the advancement in

the understanding of the behavior of capital markets. The UPIA laid out five fundamental changes in the approach to prudent investing for investment professionals acting in a fiduciary capacity. Those changes are:

- The main consideration of a fiduciary is the management and trade off between risk and reward.
- The standard of prudence for each investment will be viewed in relationship to the overall portfolio rather than as a standalone investment.
- The rules regarding diversification have become part of the definition of prudent investing.
- The restrictions from investing in various types of investments have been removed, and the trustee may invest in anything that is appropriate in light of the objectives of the trust and that is in line with other requirements of prudent investing.
- The rules against delegating the duties of the trustee have been removed, and the trustee may now delegate investment functions subject to safeguards.

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