



UNITED STATES

FINANCIAL SECTOR ASSESSMENT PROGRAM

April 2015

DETAILED ASSESSMENT OF IMPLEMENTATION OF THE IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

This Detailed Assessment of Implementation of the IOSCO Objectives and Principles of Securities Regulation on the United States was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed in March 2015.

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March 2015

DETAILED ASSESSMENT OF IMPLEMENTATION

IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

Prepared By
**Monetary and Capital
Markets Department**

This Detailed Assessment Report was prepared in the context of an IMF Financial Sector Assessment Program (FSAP) mission in the United States during October–November 2014, led by Aditya Narain, IMF and overseen by the Monetary and Capital Markets Department, IMF. Further information on the FSAP program can be found at <http://www.imf.org/external/np/fsap/fssa.aspx>.

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Glossary

| | |
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| ABS | Asset-Backed Security |
| AICPA | American Institute of Certified Public Accountants |
| ALJ | Administrative Law Judge |
| AML | Anti-Money Laundering |
| ANC | Alternative Net Capital |
| AP | Associated Person |
| APA | Administrative Procedure Act |
| ARP | Automation Review Policy |
| ASB | Auditing Standards Board |
| ATS | Alternative Trading System |
| AUM | Assets under Management |
| BCP | Business Continuity Plan |
| BD | Broker-Dealer |
| CAT | Consolidated Audit Trail |
| CBOE | Chicago Board Options Exchange |
| CCO | Chief Compliance Officer |
| CCP | Central Counterparty |
| CD&A | Compensation Disclosure and Analysis |
| CDO | Collateralized Debt Obligation |
| CDS | Credit Default Swap |
| CEA | Commodity Exchange Act |
| CF | SEC's Corporation Finance Division |
| CFMA | Commodity Futures Modernization Act of 2000 |
| CFTC | Commodity Futures Trading Commission |
| CHX | Chicago Stock Exchange |
| CIP | Customer Identification Program |
| CIS | Collective Investment Scheme |
| CMBS | Commercial Mortgage-Backed Security |
| CME | Chicago Mercantile Exchange |
| CP | Commodity Pool |
| CPA | Certified Public Accountant |
| CP&P | Compliance Policies and Procedures |
| CPO | Commodity Pool Operator |
| CRA | Credit Rating Agency |
| CRARA | Congressional Review of Agency Rulemaking Act |
| CSD | Central Securities Depository |
| CTA | Commodity Trading Advisor |
| DCM | Designated Contract Market |
| DCO | Derivatives Clearing Organization |

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|--------|--|
| DCR | Division of Clearing and Risk |
| DEA | Designated Examining Authority |
| DERA | SEC's Division of Economic and Risk Analysis |
| DFMU | Designated Financial Market Utility |
| DGCL | Delaware General Corporation Law |
| DMO | Division of Market Oversight |
| DOE | Division of Enforcement |
| DOJ | Department of Justice |
| DSIO | Division of Swap Dealer and Intermediary Oversight |
| DSRO | Designated Self-regulatory Organization |
| DTC | The Depository Trust Company |
| ECN | Electronic Communications Network |
| ECP | Eligible Contract Participant |
| EDGAR | Electronic Data Gathering, Analysis, and Retrieval System |
| ERA | Exempt Reporting Adviser |
| ETF | Exchange Traded Fund |
| FAF | Financial Accounting Foundation |
| FASB | Financial Accounting Standards Board |
| FATF | Financial Action Task Force |
| FBI | Federal Bureau of Investigation |
| FBOT | Foreign Board of Trade |
| FCM | Futures Commission Merchant |
| FDIC | Federal Deposit Insurance Corporation |
| FERC | Federal Energy Regulatory Commission |
| FESC | Front End Systemic Capture |
| FHFA | Federal Housing Finance Agency |
| FHFOB | Federal Housing Finance Oversight Board |
| FICC | Fixed Income Clearing Corporation |
| FinCEN | Financial Crimes Enforcement Network |
| FINRA | Financial Industry Regulatory Authority |
| FMU | Financial Market Utility |
| FOIA | Freedom of Information Act |
| FSB | Financial Stability Board |
| FSOC | Financial Stability Oversight Council |
| FTC | Federal Trade Commission |
| FTCA | Federal Employees Liability Reform and Tort Compensation Act of 1988 |
| GAAP | Generally Accepted Accounting Principles |
| GAAS | Generally Acceptable Auditing Standards |
| GAO | Government Accountability Office |
| GLBA | Gramm-Leach-Bliley Act of 1999 |
| HF | Hedge Fund |

| | |
|----------|---|
| IA | Investment Adviser |
| IAC | Investor Advisory Committee |
| IASB | International Accounting Standards Board |
| IB | Introducing Broker |
| ICA | Investment Company Act of 1940 |
| ICE | Intercontinental Exchange |
| ICEEU | ICE Clear Europe |
| IFRS | International Financial Reporting Standards |
| IM | SEC's Division of Investment Management |
| IOPA | (Office of) Independent Oversight and Performance Assurance |
| IOSCO | International Organization of Securities Commissions |
| IPO | Initial Public Offering |
| IRS | Internal Revenue Service |
| ISG | Intermarket Surveillance Group |
| ISV | Independent Software Vendor |
| JAC | Joint Advisory Committee |
| JOBS Act | Jumpstart Our Business Startups Act |
| LLC | Limited Liability Company |
| LULD | Limit-Up Limit-Down |
| MD&A | Management's Discussion and Analysis |
| MIDAS | Market Information Data and Analytics System |
| MLWG | Money Laundering Working Group |
| MMF | Money Market Fund |
| MMOU | Multilateral Memorandum of Understanding |
| MOU | Memorandum of Understanding |
| MRAC | Market Risk Advisory Committee |
| MSBSP | Major Security-Based Swap Participants |
| MSP | Major Swap Participant |
| MSPPU | Municipal Securities and Public Pensions Unit |
| MSRB | Municipal Securities Rulemaking Board |
| NASD | National Association of Securities Dealers |
| NAV | Net Asset Value |
| NBB | National Best Bid |
| NBBO | National Best Bid and Offer |
| NEP | National Examination Program |
| NFA | National Futures Association |
| NMS | National Market System |
| NRSRO | Nationally Recognized Statistical Rating Organization |
| NSCC | National Securities Clearing Corporation |
| NSMIA | National Securities Markets Improvement Act of 1996 |
| NYSE | New York Stock Exchange |
| OATS | Order Audit Trail System |

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| OCA | SEC's Office of the Chief Accountant |
| OCC | Office of the Comptroller of the Currency |
| OCE | Office of the Chief Economist |
| OCIE | SEC's Office of Compliance Inspections and Examinations |
| OCR | SEC's Office of Credit Ratings |
| OEC | SEC's Office of the Ethics Counsel |
| OFR | Office of Financial Research |
| OGC | Office of the General Counsel |
| OGE | Office of Government Ethics |
| OIA | Office of International Affairs |
| OIG | Office of the Inspector General |
| OMB | Office of Management and Budget |
| OTC | Over-the-counter |
| PCAOB | Public Company Accounting Oversight Board |
| PRA | Paperwork Reduction Act |
| RAUM | Regulatory Assets Under Management |
| RER | Rule Enforcement Review |
| RFA | Registered Futures Association |
| RFPA | Right to Financial Privacy Act |
| RMBS | Residential Mortgage-Backed Security |
| ROOR | Risk Oversight and Operational Regulation |
| RSA | Regulatory Service Agreement |
| RSD | Regulatory Services Division |
| RSG | CFTC's Risk Surveillance Group |
| SAI | Statement of Additional Information |
| SAR | Suspicious Activity Report |
| SB SEF | Security-Based Swap Execution Facility |
| SBS | Security-Based Swap |
| SBSD | Security-Based Swap Dealer |
| SCI | Systems Compliance and Integrity |
| SD | Swap Dealer |
| SDR | Swap Data Repository |
| SEC | Securities and Exchange Commission |
| SEF | Swap Execution Facility |
| SFP | Securities Futures Product |
| SIDCO | Systemically Important Derivatives Clearing Organization |
| SIP | Securities Information Processor |
| SIPA | Securities Investor Protection Act |
| SIPC | Securities Investor Protection Corporation |
| SRO | Self-Regulatory Organization |
| SOX | Sarbanes-Oxley Act of 2002 |
| TCP | Technology Control Program |
| TCR | Tip, Complaint, or Referral |

| | |
|-------|---|
| TFCE | Trading and Financial Compliance Examinations |
| TM | SEC's Division of Trading and Markets |
| TRO | Temporary Restraining Order |
| UIT | Unit Investment Trust |
| UNTOC | U.N. Convention Against Transnational Organized Crime |
| VAR | Value at Risk |
| XBRL | eXtensible Business Reporting Language |

EXECUTIVE SUMMARY

1. The United States has large, well-developed and complex securities and derivatives markets. These provide widespread benefits not only to the U.S. economy, but globally. The crisis and recent high profile failures have provided important lessons that have significantly impacted the regulation and supervision of these markets.

2. Post crisis, the legal mandates of the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) have significantly expanded. The agencies now share the responsibility for swaps markets, while hedge fund (HF) managers and municipal advisors are now under the SEC's jurisdiction. The CFTC has already adopted the large majority of rules needed for swaps markets, and final registration of swap dealers is underway. The same applies to the SEC in connection with HF managers and municipal advisors, while its rulemaking related to swaps is less advanced. Enhancements have been made to prudential requirements applicable to some key regulated entities, in particular in connection with internal controls, risk management, and protection of client assets. The agencies are taking an increasingly forward looking risk-based approach to supervision and enhancing their risk identification processes. This includes improving data collection, developing automated tools for data analysis, and recruiting staff with diverse skill sets. The agencies have also worked on improving the use of the enforcement function. Many of these improvements can also be observed at the SROs. All are welcome changes and efforts in all these areas should continue as appropriate.

3. The level of funding of both the SEC and CFTC is a key challenge affecting their ability to deliver on their mandates in a way that provides confidence to markets and investors. Funding limitations have impacted the timely delivery of new rules and the implementation of registration programs for the new categories of participants. These are transitory challenges. However, the markets under the agencies' supervision have become larger and more complex. In this context, the number of expert staff in the SEC and CFTC does not appear to be sufficient to ensure a robust level of hands-on supervision, which has become clear in the case of investment advisers (IAs). Leveraging on technology can mitigate but not replace the need for additional human resources. Therefore consideration should be given to making both agencies self-funded and allowing for multiyear budgeting.

4. The fragmented structure of equity markets remains a key challenge for the SEC. The framework developed by the SEC has served its purpose of enhancing competition and providing a framework for best execution. However, the markets have evolved and the framework needs to be updated accordingly to ensure sufficient operational transparency for all types of trading venues as well as fair and objective access. At the same time, the SEC needs to remain vigilant about the impact dark trading may have on overall price formation. The recently announced Equity Market Structure Advisory Committee is an important step.

5. It is important that both agencies continue to strengthen their ability to identify emerging and systemic risks. This is critical for the effective discharge of their respective

mandates, but also to enhance their contributions to the mandate of the Financial Stability Oversight Council (FSOC). Enhancing mechanisms to ensure a holistic view of risks is recommended, in particular by the respective Commission (as a whole) of each agency becoming more involved in the process of assessing and monitoring responses to risks.

6. The regulatory and supervisory arrangements remain quite complex, involving two agencies and a number of important self-regulatory organizations (SROs). Effective supervision of the SROs and, given its gatekeeping role, the Public Company Accounting Oversight Board (PCAOB), remains a priority. The SEC and CFTC have made efforts to ensure effective communication and, where possible, coordination on rulemaking and supervision. Those efforts should continue, in particular because a significant portion of regulated entities conduct activities in both the securities and derivatives markets. More generally, effective coordination needs to extend to all regulatory authorities—including banking regulators and SROs—with mandates that impact securities and derivatives markets.

INTRODUCTION

7. An assessment of the level of implementation of the IOSCO Objectives and Principles of Securities Regulation (IOSCO Principles) was conducted in the United States from October 27 to November 19, 2014. The assessment was made as part of the IMF FSAP by Ana Carvajal, IMF (currently seconded to the World Bank Group), Eija Holttinen, IMF, and Malcolm Rodgers, external expert working for the IMF. The previous IOSCO assessment of the United States was conducted in 2009.

INFORMATION AND METHODOLOGY USED FOR ASSESSMENT

8. The assessment was made on the basis of the IOSCO Principles approved in 2010 and the Assessment Methodology adopted in 2011. As has been the standard practice, Principle 38 was not assessed due to the existence of separate standards for securities settlement systems and central counterparties. A review of the regulatory and supervisory framework in place at the state level was outside of the scope of this assessment. Given the relatively limited role played by state regulation and supervision (as described below), the assessors do not consider that this limitation in the scope of the assessment has materially affected the overall judgment of the U.S. regime.

9. The IOSCO Assessment Methodology requires that assessors not only look at the legal and regulatory framework in place, but also at how it has been implemented in practice. The ongoing global financial crisis has reinforced the need for assessors to make a judgment about supervisory and other operational practices and to determine whether they are sufficiently effective. Among other things, such a judgment involves a review of the inspection programs for different types of supervised entities, the cycle, scope and quality of inspections, as well as how the relevant authorities follow up on findings, including by using enforcement actions. Given that the IOSCO Principles and Methodology do not specifically address OTC derivatives, the adoption and implementation status of the U.S. OTC derivatives framework has not impacted the grades given.

10. The assessment was based on several sources. These comprise (i) self-assessments and additional written responses prepared by the CFTC and SEC; (ii) reviews of the relevant legislation and regulations; (iii) meetings with the management and staff of the CFTC, SEC, PCAOB, and the criminal authorities; and (iv) meetings with industry associations and market participants, including exchanges, broker-dealers (BDs), IAs, futures commission merchants (FCMs), commodity pool operators (CPOs), audit firms, and credit rating agencies (CRAs).

11. The assessors want to thank the U.S. authorities and market participants for their cooperation and willingness to share information. The views of authorities and market participants on the current status and the best way forward for the regulation and supervision of the U.S. securities and derivatives markets provided an essential input to the conclusions of the mission.

INSTITUTIONAL AND MARKET STRUCTURE— OVERVIEW

A. Regulatory Structure

12. Two federal agencies, the SEC and the CFTC, share the primary responsibility for the regulation and supervision of the U.S. securities and derivatives markets. Broadly speaking, the SEC is in charge of the regulation and supervision of securities markets and single security based options, futures and swaps markets. Its functions and powers are based on several Federal Acts, most importantly the Securities Exchange Act of 1934 (Exchange Act), the Securities Act of 1933 (Securities Act), the Investment Company Act of 1940 (ICA), and the Investment Advisers Act of 1940 (Advisers Act). The CFTC is responsible for the regulation and supervision of futures, options and swaps markets (except for narrow-based security indices), exercising its authority primarily under the Commodity Exchange Act (CEA).

13. The SEC's and CFTC's mandates were significantly expanded as a result of the enactment of the Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The Act provided the SEC and CFTC with shared responsibility over the swaps markets and brought HF managers and municipal advisors under the jurisdiction of the SEC. The CFTC has already adopted the large majority of rules needed for swaps markets, and final registration of swap dealers is underway. The mandatory clearing and trade execution requirements already apply to certain swaps, and several swap execution facilities (SEFs) have been temporarily registered. Swaps have to be reported to swap data repositories (SDRs). Rulemaking by the SEC in relation to HF managers and municipal advisors has been completed, while the SEC's securities-based swaps rulemaking is less advanced. The authorities' progress in proposing and adopting their respective regulations is further described throughout this assessment, but as noted above, has not impacted the grades.

14. State securities regulators coexist with the federal regulators; however their role is limited. The registration of securities for issuance to the public and of intermediaries, along with the monitoring and supervision of these activities, are mainly carried out by the federal regulators. State regulators maintain responsibility for issuances that are conducted at the state level only. Both state and federal legislation provide a regulatory framework for BDs and IAs, but not for futures and derivatives intermediaries. The role of state regulators has recently increased for smaller IAs. Pursuant to the thresholds established in the Dodd-Frank Act, the registration and supervision of IAs with portfolios of \$100 million or less (increased from \$25 million) is generally now the responsibility of the state regulators.

15. The CFTC and SEC rely to a significant degree on SROs for the regulation of the markets and their participants. The SROs include exchanges, clearing organizations, and securities and futures associations. Given the focus of the IOSCO assessment, the emphasis has been on the exchanges and associations. In general exchanges have a role in market surveillance and some of them also in member supervision. There are two registered associations with SRO functions: the

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Financial Industry Regulatory Authority (FINRA) and the National Futures Association (NFA). FINRA has authority over BDs, while the NFA has authority over all intermediaries in the futures and swaps markets. Membership in an SRO is mandatory for the corresponding intermediaries.¹ In addition to member registration and supervision, FINRA also has a role in market surveillance due to agreements with different exchanges and for OTC trading. The NFA is developing a similar role for some SEFs.

16. Criminal enforcement is the responsibility of federal, state and local authorities. The SEC and CFTC have significant administrative and civil enforcement powers. In addition, criminal prosecution is available by other U.S. authorities to pursue securities and derivatives market violations. Federal, state and local prosecutorial authorities play an active role in criminal (and in some cases civil) enforcement of securities laws, working both with the regulators and on their own initiative.

B. Market Structure

Issuers

17. The U.S. equity markets continue to be the largest in the world. As of end 2013 there were 5,655 issuers listed on the three largest exchanges (the majority of them either on the New York Stock Exchange (NYSE) or NASDAQ) with a total market capitalization of approximately 150 percent of GDP. The number of new listings remained high, with 614 new issues listed in 2013. (Table 1).

| | 2011 | | | 2012 | | | 2013 | | |
|---|--------|--------|------|--------|--------|------|--------|--------|------|
| | NYSE | NASDAQ | BATS | NYSE | NASDAQ | BATS | NYSE | NASDAQ | BATS |
| Number of issuers | 2,995 | 2,680 | - | 2,989 | 2,577 | 2 | 3,016 | 2,637 | 2 |
| Market capitalization (billion USD) | 11,796 | 4,421 | - | 14,086 | 5,149 | 0.5 | 17,950 | 6,974 | 1.4 |
| Market capitalization as percent of GDP | 70 | 28 | - | 87 | 32 | 0.0 | 107 | 42 | 0.0 |
| Market capitalization of top 10 issuers (billion USD) | 2,210 | 1,544 | - | 2,338 | 1,750 | 36 | 2,683 | 2,151 | 54 |
| Number of new listings | 497 | 151 | - | 376 | 158 | 17 | 369 | 239 | 6 |
| Annual turnover (trillion USD) | 19.3 | NA | - | 14.7 | NA | 1 | 15.3 | NA | 3.5 |
| Average daily turnover (billion USD) | 75.9 | NA | - | 59 | NA | 5.6 | 60.7 | NA | 17.4 |

Source: NYSE, NASDAQ, BATS

¹ Only IAs are not required to be members of any SRO and are therefore exclusively supervised by the SEC. Municipal advisors must be registered with both the MRSB and the SEC.

18. Municipal securities are an important component of the U.S. securities markets. The outstanding amount of municipal securities as of end-2014 was approximately \$ 3.7 trillion (around one third of the size of the corporate and foreign bonds market). There are roughly 45,000 different municipalities issuing debt, and some 12,000 bond issues on an annual basis. Average issue size is \$25 million. Retail investors account for a significant portion of this market. Direct retail holdings are estimated at roughly 45–50 percent of total outstanding debt, and indirect holdings (through mutual funds) at about 25 percent. Historical rates of default have been low (less than 1 percent compared to 11–13 percent for issuers of corporate debt, although the rate of default for non-municipal conduit borrowers has been higher).

19. Almost all asset-backed securities (ABS) markets experienced historic downturns following the crisis, and the recovery of these markets has not been uniform.² Private label (non-U.S. agency) ABS issuers held \$2.6 trillion in assets in 2004, which grew to \$4.5 trillion in 2007, and declined to \$1.6 trillion in 2013. This distinction is most stark in the case of private-label residential mortgage-backed securities (RMBS), including home equity lines of credit. Prior to the crisis the overwhelming majority of these securities were registered issuances. In 2004 new issuances of registered private-label RMBS totaled \$746 billion. This dropped to \$12 billion in 2008 and \$4 billion in 2013, 0.5 percent of the 2004 issuance level. As of the time of the assessment the private-label RMBS market remained weak and consisted almost exclusively of unregistered RMBS offerings. Registered commercial mortgage-backed securities (CMBS) experienced a similar drop. In 2004 new issuances totaled \$74 billion, declining to \$11 billion in 2008, and \$53 billion in 2013. The consumer finance ABS market, including credit card and auto securitizations, also declined drastically both in terms of number of deals and issuance volume after the financial crisis. For example, \$85 billion of Auto ABS were issued in 2005, but after the crisis issuance dropped to \$32 billion in 2008. However, unlike RMBS, issuance of consumer finance ABS, especially Auto ABS, has since 2008 steadily increased to \$62 billion in 2013.

Trading venues

20. Trading in the U.S. equity markets is divided between national securities exchanges, alternative trading systems (ATS), and over-the-counter (OTC). At the end of December 2014, there were 11 national securities exchanges and 39 ATS operating equity trading systems. There are no official statistics on the distribution of trading between exchanges, ATS, and OTC. Some market sources estimate the latter two to amount up to approximately 40 percent of the total value of equity trading in the U.S.³ According to a paper published by SEC staff,⁴ ATSs executed 11.3 percent of the total value of trading in National Market System (NMS) stocks during a one week period in

² See Securities and Exchange Commission. 17 CFR Parts 229, 230, 232, 239, 240, 243, and 249. Release Nos. 33-9638; 34-72982; File No. S7-08-10.

³ See, for example, <http://www.bloombergvew.com/quicktake/dark-pools>.

⁴ Tuttle, Laura, Alternative Trading Systems: Description of ATS Trading in National Market System Stocks, October 2013.

May 2012. Another SEC staff paper⁵ estimates that 17 percent of the total value of trading in NMS stocks was executed OTC (excluding ATS trading) during one week in May 2012. During May 2014–September 2014, ATs accounted for 15 percent of the trading volume for NMS stocks (by number of shares).

21. While futures and options trading volumes continue to increase, the majority of derivatives are traded in the OTC derivatives (swaps) markets. 15 Designated Contract Markets (DCMs) currently organize trading in futures and options, with the number of contracts traded estimated to amount to 3.7 billion at the end of 2014. At the same time, swap trading volumes were estimated to amount to 13.5 billion contracts. The majority of swap trading still takes place OTC rather than on the 24 SEFs.

Collective Investment Schemes

22. The U.S. securities CIS market is the largest in the world. At the end of 2013, there were 4,168 registered collective investment scheme (CIS) funds with more than \$17 trillion assets under management (AUM). The market for securities CIS is dominated by mutual funds, which at end 2013 accounted for 88 percent of all securities CIS assets. ETFs’ share of overall AUM has grown significantly over the last five years, while closed end funds and unit investment trusts (UITs) account for only a small proportion of total assets. At the end of 2013, retail investors held over 65 percent of assets in mutual funds.

| Table 2. Investment Company Total Net Assets by Type | | | | | |
|---|---------------------|-------------------------|-------------|-------------|--------------|
| \$ billions | | | | | |
| | Mutual Funds | Closed-end funds | ETFs | UITs | Total |
| 2009 | 11,113 | 223 | 777 | 38 | 12,152 |
| 2010 | 11,831 | 238 | 992 | 51 | 13,112 |
| 2011 | 11,626 | 243 | 1,048 | 60 | 12,978 |
| 2012 | 13,044 | 264 | 1,337 | 72 | 14,717 |
| 2013 | 15,018 | 279 | 1,675 | 87 | 17,058 |

Source: 2014 Investment Company Fact Book

⁵ Tuttle, Laura, OTC Trading: Description of Non-ATS OTC Trading in National Market System Stocks, March 2014.

| \$ billions | Retail Investors | | | Institutional Investors | | | Total | | | |
|---------------------|------------------|---------------|---------------|-------------------------|--------------|--------------|---------------|---------------|---------------|------|
| | End-year | 2011 | 2012 | 2013 | 2011 | 2012 | 2013 | 2011 | 2012 | 2013 |
| <i>Mutual Funds</i> | | | | | | | | | | |
| Equity | 4,713 | 5,351 | 6,988 | 501 | 589 | 776 | 5,214 | 5,940 | 7,764 | |
| Bond | 2,513 | 2,981 | 2,875 | 326 | 398 | 391 | 2,838 | 3,379 | 3,265 | |
| Hybrid | 851 | 996 | 1,220 | 32 | 35 | 50 | 883 | 1,031 | 1,270 | |
| Money Market | 1,805 | 1,795 | 1,775 | 886 | 899 | 944 | 2,691 | 2,694 | 2,718 | |
| Total | 9,882 | 11,123 | 12,857 | 1,745 | 1,921 | 2,161 | 11,627 | 13,044 | 15,018 | |

Source: ICI

23. As of September 2014, 2,691 IAs registered with the SEC advised at least one HF.

Registered IAs to HFs manage approximately \$5.4 trillion in cumulative reported regulatory assets under management (RAUM). As of May 7, 2014 there were 544 IAs classified as large HF managers (i.e., with 1.5 billion HF AUM), with a total of 3,835 HFs under management. In addition to IAs registered with the SEC, there are also exempted reporting advisers (ERAs), which are exempted from registration with the SEC, but are subject to limited reporting on their business and their private fund clients. There are approximately 2,693 ERAs with 875 advisers or 32 percent of them managing HFs that account for approximately \$846 billion in RAUM.

24. Both the number of commodity pool operators (CPOs) and their total AUM has grown dramatically over the past four years. This resulted from the inclusion of swaps in the definition of commodity under the Dodd-Frank Act. Many CIS investing in swaps are therefore now regulated as commodity pools (CPs) for the first time. Retail participation in swaps-based CIS is small and largely confined to traditional CPs, with the CFTC estimating that retail investors hold approximately 10 to 15 percent of total AUM in those pools.

| \$ billions | Total Number of NFA Member CPOs | Number of Foreign CPOs | Number of U.S. CPOs | Total AUM reported |
|---------------------|---------------------------------|------------------------|---------------------|--------------------|
| end-2011 | 1,078 | 83 | 995 | 348 |
| end-2012 | 1,105 | 76 | 1,029 | 493 |
| end-2013 | 1,686 | 255 | 1,431 | 2,809 |
| Aug. 6, 2014 | 1,658 | 267 | 1,391 | 2,928 |

Source: CFTC

Market intermediaries

25. There are separate regimes for securities and derivatives market intermediaries. BDs registered under the Exchange Act and FCMs and introducing brokers (IBs) registered under the CEA trade as principals or agents. Advisers are registered as IAs or commodity trading advisers (CTAs) under the securities or futures legislation. Operators of CIS are registered as IAs under the Advisers Act or CPOs under the CEA. The number of registered BDs has fallen over the last five years. As a result of changes introduced by the Dodd-Frank Act, IAs that previously were not subject to registration (such as IAs to HFs) are now required to register with the SEC, while smaller IAs are now subject to registration by the state regulators only. Overall, these changes resulted in a small decline in the number of IAs registered with the SEC, while the total AUM for SEC registered IAs has increased (the SEC estimates total AUM for IAs, including mutual funds, is approximately \$63 trillion). The number of FCMs is relatively small and many of the larger FCMs are also registered as BDs.

| Table 5. Registered Broker-Dealers | | | | | | | | | | |
|---|------|------|-----|-------|------|--------------|------|-----|-------|-------|
| <i>(by SRO membership)</i> | | | | | | | | | | |
| | ARCA | CBOE | CHX | FINRA | NYSE | NYSE MKT* | PHLX | SEC | UNA** | Total |
| January 1, 2010 | 28 | 237 | 26 | 4,775 | 46 | 46 | 33 | 5 | 57 | 5,253 |
| January 1, 2011 | 21 | 190 | 27 | 4,664 | 0 | 28 | 28 | 5 | 66 | 5,029 |
| January 1, 2012 | 18 | 155 | 26 | 4,515 | 0 | 21 | 20 | 5 | 42 | 4,802 |
| January 1, 2013 | 14 | 132 | 22 | 4,351 | 1 | 21 | 18 | 5 | 48 | 4,612 |
| January 1, 2014 | 14 | 104 | 16 | 4,196 | 0 | 18 | 18 | 5 | 39 | 4,410 |
| July 1, 2014 | 15 | 92 | 17 | 4,097 | 0 | 15 | 18 | 5 | 48 | 4,307 |

Source: SEC

* Formerly AMEX

** UNA - unassigned (not a member of any self-regulatory organization)

| Table 6. SEC Registered Investment Advisers | | | |
|--|-------------|-------------|-------------|
| At January 2 | 2012 | 2013 | 2014 |
| SEC-registered investment advisers | 11,658 | 10,754 | 10,920 |
| SEC exempt reporting advisers | 0 | 2,331 | 2,594 |

Source: SEC

| Table 7. Derivatives Market Intermediaries Registered with the CFTC | |
|--|---|
| Type of Person | Number of Registered Persons |
| | as of July 31, 2014 |
| Futures Commission Merchant | 78 |
| Introducing Broker | 1,354 |
| Commodity Pool Operator | 1,770 |
| Commodity Trading Advisor | 2,539 |
| Retail Foreign Exchange Dealer | 7 |
| Swap Dealer | 102 |
| Major Swap Participant | 2 |
| Floor Broker | 4,495 |
| Floor Trader | 827 |
| Notice-Registered IB | 46 |
| Notice-Registered FCM | 14 |

Source: CFTC

PRECONDITIONS FOR EFFECTIVE SECURITIES REGULATION

26. All the preconditions for effective securities markets regulation appear to be in place in the United States.

- No barriers to entry: Registration requirements for all categories of regulated activities are based on objective criteria, which are clearly set up by laws and regulations. Foreign investors can invest in the securities and derivatives markets under the same conditions as domestic investors.
- Taxation: There do not appear to be distortions in market structure created by the tax regime.
- Company law: Companies are free to determine the state where they want to be incorporated. The majority of companies choose Delaware, as it is considered to provide significant freedom for companies to organize their business. As many aspects of corporate governance rely on state company law, the Delaware company law and the jurisprudence of the Delaware courts are key components of securities markets framework.

- **Insolvency law:** The Bankruptcy Code provides two primary routes for business bankruptcy: (i) Chapter 11, where the 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; and (ii) Chapter 7, where 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 in accordance with the federal bankruptcy rules. Public companies generally file under Chapter 11 rather than Chapter 7 because they can continue to run their business and control the bankruptcy process.
- **Competition law:** The U.S. has strong and vigorously enforced anti-trust legislation, which applies to all economic sectors, including the financial sector.
- **Accounting and auditing standards:** Accounting and auditing standards are globally recognized as of high international quality.
- **Protection of investors' rights:** The judiciary is acknowledged to be independent from political influence. There are private rights of action under company, securities and derivatives laws, which are actively exercised by investors, including through class action suits. The SROs have mechanisms, obligatory for all members, for alternative resolution of disputes between intermediaries and their clients.

MAIN FINDINGS

27. Principles for the regulator. The SEC and the CFTC are independent agencies, with clear mandates stemming from the law. Both have sufficient powers to fulfill their mandates, including rulemaking, registration, examination and enforcement powers. They operate under a high level of accountability, which is supported by public transparency of a wide range of regulatory actions and decisions. Strong ethics rules apply to Commissioners and staff of both the SEC and CFTC. The current level of resources poses challenges for the SEC and CFTC to effectively discharge their functions, particularly in light of their expanded mandates. The agencies are taking an increasingly forward looking risk-based approach to supervision and enhancing their risk identification processes, which in turn is helping them to contribute more effectively to the FSOC. Both have processes to review the perimeter of regulation.

28. Principles for self-regulation. The U.S. system relies strongly on SROs, such as FINRA and the NFA, for supervision of markets and intermediaries. SROs are subject to oversight, including approval or notification of rules, and ongoing monitoring of their self-regulatory activities via reporting and examinations.

29. Principles for enforcement. The SEC and CFTC have broad inspection powers over regulatees and investigative and enforcement powers over regulated entities, regulated individuals, and third parties. Overall, the agencies, along with the SROs, have put in place robust supervisory programs to monitor ongoing compliance by regulated entities and individuals and to monitor

market activity. The programs for regulated entities are risk-based. In most cases, the coverage of the examination program is such that no entity goes without inspection for a long period of time, even if it is low risk. The situation is different for IAs, as the coverage of their examination program is more limited. Market surveillance relies primarily on SROs' automated tools. Both agencies make extensive use of their enforcement powers. The SEC, the CFTC and criminal authorities are active in pursuing securities and derivatives violations.

30. Principles for cooperation. The SEC and CFTC have the ability and capacity to share information and cooperate with other authorities domestically and internationally. They are signatories to many Memoranda of Understanding (MOU), including the IOSCO Multilateral MOU (MMOU) and a number of bilateral MOUs with domestic and foreign authorities, and have records of active cooperation. The SEC and CFTC do not need the permission of any outside authority or an independent interest to share or obtain information. Access to the financial records of individuals and small partnerships requires notifying the customer; delaying such notice is also possible in certain circumstances.

31. Principles for issuers. Generally issuers of public offerings, including ABS, are subject to strong disclosure requirements both at the moment of registration and on a periodic basis, except for municipal securities which are exempt from those registration and reporting requirements. The current framework provides reporting companies with significant freedom to decide on their structure, and the classes of shares to be offered to the public. However, they are subject to strong disclosure obligations, and any limitations to the rights of shareholders must be clearly disclosed in the prospectus. Federal laws allow the acquisition of control without triggering an obligation to make a tender offer. However, a number of features in the legal system, mainly state corporate laws, create disincentives from doing so. The current regime requires reporting of insiders' holdings and substantial holdings, as well as reporting of beneficial ownership. The SEC has developed an active program to monitor and enforce issuers' compliance with their disclosure obligations. High quality accounting standards, the U.S. Generally Accepted Accounting Principles (GAAP), are set through an open and transparent process.

32. Principles for auditors, credit rating agencies, and other information service providers. Auditors of reporting companies must be registered with the PCAOB. The PCAOB has developed a credible examination program for audit firms. Audit standards are considered of high quality. The PCAOB is responsible for the enforcement of compliance with audit standards, and the SEC can also exercise its enforcement powers over auditors and has done so in an active manner. CRAs that wish their credit ratings to be used for regulatory purposes must elect to register with the SEC as Nationally Recognized Statistical Rating Organizations (NRSROs). In practice, ratings are currently used for regulatory purposes by the SEC in very limited cases, mainly in connection with money market funds (MMFs). The registration process subjects NRSROs to appropriate requirements. The SEC conducts NRSRO examinations on an annual basis. BDs on the securities side and FCMs, IBs, swap dealers (SDs) and major swap participants (MSPs) on the derivatives side are subject to obligations in connection with the provision of research analysis that aim at managing potential conflicts of interest.

33. Principles for collective investment schemes. IAs to mutual funds (MFs) and commodity pool operators (CPOs) are subject to registration with the SEC and CFTC, which focuses mainly on their integrity and disclosure to investors. MFs and CPs are subject to disclosure obligations both at the moment of registration and on a periodic basis. Self-custody and related party custody of MF and CP assets is allowed, however additional safeguards apply in the case of MFs. MF and CP assets must be valued according to the U.S. GAAP. MF and CP shares and units must be valued at net asset value (NAV), except MMFs. IAs to HFs are subject to registration requirements that are based on disclosure. Standards of organizational and operational conduct apply to them. The SEC conducts only limited examinations of IAs to MFs, although it has implemented a presence examination program for newly registered IAs, including those that manage HFs.

34. Principles for market intermediaries. The registration regime combined with the relevant SRO's membership regime subjects all categories of participants except IAs and CTAs to comprehensive eligibility criteria that include integrity, capital requirements, and adequacy of internal controls. All categories of intermediaries except IAs and CTAs are subject to capital requirements and periodic reporting of their financial position and capital adequacy. IAs and CTAs' registration regime is based on integrity criteria and disclosure. However, they are not permitted to hold clients assets nor deal on behalf of customers, though they may have discretion to make investment decisions. Early warning systems are in place. There are well-developed processes to deal with the failure of intermediaries that have been applied in practice.

35. Principles for secondary markets. Exchanges and DCMs are subject to detailed registration requirements. ATs are subject to the SEC broker-dealer registration and FINRA membership processes along with SEC disclosure obligations. Limited public information is available on ATS operations, subscribers and market models. The exchanges and FINRA share the responsibility for market surveillance and member supervision in securities markets, and the DCMs and NFA in commodity futures and options markets. The exchanges and DCMs are subject to active SEC and CFTC supervision. Pre- and post-trade transparency requirements apply in both securities and derivatives markets, subject to certain derogations that may lead to less than optimal pre-trade transparency. Market abuse is addressed by the Exchange Act and CEA and subject to administrative, civil and criminal sanctions. Open positions in commodity futures and options markets are closely monitored by the SROs and CFTC, while position information is available in securities markets through a DTCC service. Default procedures apply in both clearing agencies and Derivatives Clearing Organizations (DCOs) and are disclosed through their rules. Short selling is subject to disclosure and "locate" requirements, and the SEC and SROs monitor compliance.

SUMMARY IMPLEMENTATION OF THE IOSCO PRINCIPLES

Table 8. Summary Implementation of the IOSCO Principles—Detailed Assessments

| Principle | Grade | Findings |
|---|-------|--|
| Principle 1. The responsibilities of the Regulator should be clear and objectively stated. | BI | The mandates of the SEC and CFTC are stated by law. The agencies can and do interpret the laws under their jurisdiction. There is a high level of public transparency on interpretations, guidance and no action letters. In general, like products and entities are treated in a consistent manner. However, the CPO and CTA regimes may lead to different investor protection consequences than that applied to IAs. The legal framework requires the agencies to consult and coordinate in specific areas. In addition, the agencies communicate on a regular basis. In a few areas the SEC and CFTC have been able to streamline obligations of dually registered entities by establishing single reporting or substituted compliance mechanisms. In a few cases, joint inspections in areas of common interest have taken place. |
| Principle 2. The Regulator should be operationally independent and accountable in the exercise of its functions and powers. | BI | The SEC and CFTC have been established as independent agencies separate from any office of the Government. Rules governing the appointment of Commissioners seek to balance political affiliations. As per judicial precedents, Commissioners can be removed only for cause. The Congressional budget approval process has the potential to materially affect the agencies' ability to decide on their priorities, and the annual nature of the budget can affect long term planning. In general, on a day to day basis the agencies do not require approval of or consultation with other authorities to exercise their functions. There is a strong accountability regime to Congress and the public, supported by a high level of transparency of a wide range of regulatory actions and decisions, as well as judicial review of rules and regulatory decisions. |
| Principle 3. The Regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers. | PI | The SEC and CFTC have sufficient powers to fulfill their respective mandates, including rulemaking, registration, examination, investigation and enforcement powers. The agencies have been recruiting staff with diverse skill-sets. However, the current level of funding poses challenges for the proper discharge of their functions, in particular given their expanded mandates. |
| Principle 4. The Regulator should adopt clear and consistent regulatory processes. | FI | Requirements for the provision of regulated activities are available on the agencies' websites. The legal framework requires the rulemaking process to include public consultation and an analysis of costs. In practice the agencies have also used other mechanisms, such as roundtables, to gather views from stakeholders on complex topics. Regulatory decisions are |

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| | | subject to due process, including generally a need for notice of proposed decisions, opportunity for affected parties to be heard, and judicial review. |
| Principle 5. The staff of the Regulator should observe the highest professional standards, including appropriate standards of confidentiality. | FI | The SEC and CFTC are bound by general rules on ethics applicable to government officials. In addition, both agencies have established specific ethics rules that include additional restrictions for staff, in particular in the area of holding and trading securities and commodities. Both agencies are subject to strict rules of confidentiality. There are appropriate mechanisms to monitor potential breaches of ethics and confidentiality obligations. |
| Principle 6. The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate. | BI | The supervisory programs of the different divisions of both agencies to monitor entities, products and markets are the main mechanisms to identify emerging and systemic risks. At the SEC, regular meetings take place between division staff and the SEC Chair, between division staff and individual Commissioners, and between the SEC Chair and individual Commissioners. Through these meetings, the SEC Chair obtains the views of the other Commissioners and informs them on issues of concern, including on emerging and systemic risks. Additionally, through these meetings the Chair and the other Commissioners are informed by the staff, and they share their views with the staff, on these same issues. CFTC staff has informal meetings to discuss risk issues. Weekly closed door surveillance meetings of staff with the Commission are also scheduled; these are used to discuss emerging risks, take decisions on how to tackle them, and follow up. Both agencies have made significant improvements to data collection and analysis, but enhancements are needed, particularly on asset management and swaps data. Through the participation of their chairs as voting members at the FSOC and of staff members in the subcommittees, the SEC and CFTC contribute to the process of identifying emerging and systemic risks in the financial sector. |
| Principle 7. The Regulator should have or contribute to a process to review the perimeter of regulation regularly. | FI | Various processes allow the SEC and CFTC to review the perimeter of regulation, both in regard to a specific sector, entity or product, and in a more holistic manner. Examples of the former are reviews prompted by concerns identified through their supervisory programs, market events, or law. Examples of the latter are the strategic plans the agencies develop on a five year cycle, which require them to take a view on priorities. Types of action taken to address the regulatory perimeter include taking supervisory actions, issuing guidance or new rules, and proposing changes to the legal frameworks. |
| Principle 8. The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed | FI | The regulatory framework to address issuers' conflicts of interest is based on strong disclosure obligations, including on related party transactions. Extensive disclosure obligations apply to the underlying assets of ABS. New disclosure requirements for asset level data and retention requirements |

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| or otherwise managed. | | will become effective over the next two years. The regime for regulated entities relies on a combination of prohibitions and management and disclosure of conflicts of interest. The SEC and CFTC monitor compliance primarily through their supervisory programs. |
| Principle 9. Where the regulatory system makes use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, such SROs should be subject to the oversight of the Regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities. | FI | The current regime relies extensively on the use of SROs for the supervision of the majority of the categories of intermediaries (FCMs, IBs, BDs), as well as for market surveillance. There are two main categories of SROs: the exchanges and DCMs and associations (FINRA and NFA). All SROs are subject to SEC or CFTC ongoing oversight. This includes approval or notification of rules, with appropriate tools to prevent rule implementation in case of non-compliance with the statutes; reporting requirements; and risk-based on-site examinations. |
| Principle 10. The Regulator should have comprehensive inspection, investigation and surveillance powers. | FI | The SEC and CFTC have broad powers to inspect all categories of regulated entities and individuals, require information from them, and conduct investigations into their activities for potential breaches of their statutory and regulatory obligations. They also have the power to conduct market surveillance. The CFTC and NFA conduct front line surveillance for markets under their jurisdiction. For the securities markets, the SEC and the SROs work cooperatively to conduct surveillance of those markets. |
| Principle 11. The Regulator should have comprehensive enforcement powers. | FI | The SEC and CFTC have robust powers to access information from any person, including subpoena powers over records and testimony, where a breach of law is suspected. Both agencies have a wide variety of enforcement tools at their disposal, including the use of administrative and civil proceedings and the ability to refer matters to the criminal authorities. A wide range of sanctions can be sought in administrative and civil proceedings, including monetary penalties and disgorgement and, for the CFTC, restitution. |
| Principle 12. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program. | BI | The agencies and the SROs have put in place robust supervisory programs to monitor markets and the ongoing compliance of registered entities and individuals. The program for regulated entities is risk-based. In most cases, the examination program covers all entities so that none goes without inspection for a long period of time, even if it is low risk. However, the coverage of the IA examination program is limited in spite of the importance of the sector. Market surveillance for derivatives markets is carried out by the DCMs and directly by the CFTC; for securities markets, front line surveillance is largely the responsibility of the exchanges and FINRA. Both agencies make extensive use of their enforcement powers. In recent years, the SEC has made important improvements to its enforcement program, including case |

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| | | management, the use of settlements that include an admission of breaches, and the constitution of specialized units and task forces. The agencies and criminal authorities are active in pursuing securities and derivatives violations. |
| Principle 13. The Regulator should have authority to share both public and non-public information with domestic and foreign counterparts. | FI | Subject to compliance with relevant legal requirements, the SEC and CFTC can share information with other domestic and foreign authorities without the need for external approval. Access to the financial records of individuals and small partnerships covered by the Right to Financial Privacy Act (RFPA) requires notifying the customer; delaying such notice is also possible in certain circumstances. The IOSCO MMOU requirement on prior consultation of the requesting foreign authority before notifying the customer is followed. |
| Principle 14. Regulators should establish information sharing mechanisms that set out when and how they will share both public and nonpublic information with their domestic and foreign counterparts. | FI | The SEC and CFTC have concluded some domestic MOUs and are signatories to the IOSCO MMOU. Ad hoc information sharing arrangements and access request letters are used in the absence of an MOU with sufficient coverage. The agencies also have several bilateral MOUs with foreign authorities. Both have responded to a significant number of information requests from foreign authorities. |
| Principle 15. 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. | FI | The SEC and CFTC have assisted foreign authorities on numerous occasions through their ability to use their extensive powers to obtain and compel documents and testimony. |
| Principle 16. There should be full, accurate and timely disclosure of financial results, risk and other information that is material to investors' decisions. | BI | The regulatory regime generally subjects issuers to strong initial and periodic disclosure obligations, including the submission of annual reports that must contain audited financial statements, quarterly reports, and disclosure of material events. However, municipal securities are exempted from the registration and reporting requirements. Through indirect mechanisms, the SEC has established disclosure obligations applicable to municipal securities. The SEC currently lacks direct authority to ensure issuers' compliance with these obligations, except for enforcement authority based on antifraud provisions. The current statutory thresholds for the suspension of periodic reporting obligations on issuers of publicly offered securities are high. The SEC has an active program to monitor issuers' compliance with their disclosure obligations. |
| Principle 17. Holders of securities in a company should be treated in a fair and equitable manner. | FI | The current legal and regulatory framework generally allows companies significant freedom to decide on their structure, the classes of shares to be offered to the public and the rights associated with the shares. Reporting issuers are subject to strong disclosure obligations, including requiring disclosure of shareholder rights in the prospectus. This is complemented by |

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| | | strong fiduciary duties, and shareholders can (and do) exercise actively their private rights in the courts. Federal laws allow the acquisition of control of a reporting company without triggering tender offer obligations. There are a number of features of the legal system, principally state corporate laws, that create disincentives for parties seeking to acquire control from doing so other than by negotiating with the board of directors or making a tender offer for all shares. The current regime requires reporting of insiders' holdings, substantial holdings (over 10 percent), and holdings of most beneficial owners within stipulated deadlines. |
| Principle 18. Accounting standards used by issuers to prepare financial statements should be of a high and internationally acceptable quality. | FI | Reporting issuers must prepare their financial statements in accordance with the U.S. GAAP, which are considered of high quality. Foreign issuers can use International Financial Reporting Standards (IFRS), and other accounting standards, the latter with reconciliation. The U.S. GAAP are set by the Financial Accounting Standards Board (FASB), which is overseen by the Financial Accounting Foundation (FAF), an independent, non-profit organization run by a Board of Trustees. The FASB is funded by fees assessed against issuers. The standard setting process is open, provides for consultation of stakeholders, and is actively monitored by the SEC. As part of its program to monitor issuers' compliance with their disclosure obligations, the SEC examines financial statements and their compliance with the U.S. GAAP. The SEC enforcement program has renewed its focus on accounting and financial fraud through the creation of a specialized task force. |
| Principle 19. Auditors should be subject to adequate levels of oversight. | FI | Auditors of reporting companies must register with the PCAOB, which was created by law as a non-profit corporation under the oversight of the SEC. The PCAOB is composed of five members selected by the SEC, including two certified public accountants (CPAs). All members serve on a full time basis and must be independent from the audit profession. The PCAOB is funded by fees assessed to issuers, BDs, and other entities that are required to register with it. The PCAOB has established an inspection program for audit firms, where the inspection frequency depends on the number of issuers the audit firm audits. In addition to remediation of deficiencies, the PCAOB can impose enforcement actions on audit firms and individual auditors for breaches of their obligations and has done so in practice. SEC's own enforcement actions have complemented PCAOB efforts. |
| Principle 20. Auditors should be independent of the issuing entity that they audit. | FI | There are specific SEC rules on auditor independence that impose restrictions on financial relations, and address issues such as self-interest, advocacy, familiarity, intimidation, provision of non-audit services, and rotation of the lead auditor every five years. The PCAOB requires audit firms to have a system of quality controls that provides reasonable assurance that personnel maintain independence in fact and |

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| | | appearance. Audit committees of listed companies are required to oversee the selection and work of audit firms. The PCAOB inspection program, along with its enforcement actions, is the key external mechanism to monitor compliance with the independence obligations. SEC enforcement actions over auditors have complemented PCAOB efforts. |
| Principle 21. Audit standards should be of a high and internationally acceptable quality. | FI | Audit standards are set by the PCAOB and are considered of high quality. The standard setting process involves public consultation with stakeholders. The PCAOB inspection program, along with its enforcement actions, is the main mechanism to monitor audit firms' compliance with the audit standards. SEC enforcement actions have complemented PCAOB efforts. |
| Principle 22. Credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision. | FI | A U.S. or foreign CRA that wishes its credit ratings to be used for regulatory purposes in the U.S. must elect to register with the SEC. In practice, credit ratings are currently used for limited regulatory purposes by the SEC, most notably in connection with MMFs. The registration process and the ongoing examinations of NRSROs address the relevant integrity, transparency, timeliness, confidentiality and conflict of interest management aspects. The SEC conducts examinations of each NRSRO at least annually. If needed, it can recommend remedial action or bring enforcement actions against an NRSRO. Sanctions may range from fines to suspension or revocation of registration as an NRSRO. In practice the SEC has sanctioned at least one CRA. |
| Principle 23. Other entities that offer investors analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them. | FI | The provision of equity research by BDs is subject to comprehensive SRO rules designed to increase an analyst's independence and manage conflicts of interest. The large BDs were subject to a settlement in 2003-2004 that required them to strengthen the independence of their research analysis, including by establishing information barriers. The settlement covers BDs accounting for approximately 80 to 90 percent of the U.S. equity underwriting business and is still in effect. Both equity and debt research are subject to SEC rules that require analysts to certify that their reports accurately reflect their views and disclose certain conflicts; in addition antifraud provisions apply. On the commodities side, CFTC rules impose information barriers and disclosure requirements in connection with research analysis conducted by FCMs, IBs, SDs and MSPs. |
| Principle 24. The regulatory system should set standards for the eligibility, governance, organization and operational conduct of those who wish to market or operate a CIS. | PI | IAs to MFs and CPOs are subject to registration by the SEC and the CFTC respectively; the latter has delegated this function to the NFA. Both registration requirements focus on statutory disqualifications and extensive disclosure requirements to the regulator and investors. On an ongoing basis, IAs to MFs and CPOs are subject to certain organizational and operational conduct obligations, in particular the implementation of a compliance program. Monitoring of CPOs' ongoing compliance is conducted by the NFA on the basis of a risk- |

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| | | based supervisory program. MF boards have the responsibility of selecting and overseeing the IAs and in practice exercise this role in a proactive manner both at the moment of the initial selection and on an on-going basis through reporting and meetings. The SEC has in place a risk-based supervisory program for ongoing monitoring of IAs to MFs. However, its coverage is limited despite the importance of the sector. |
| Principle 25. 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. | BI | MFs and CPs can adopt different legal structures; these structures and the rights of investors must be disclosed in the prospectus. MF assets must be segregated. Custody by an IA or related entity is allowed, but in both cases additional safeguards apply, in particular the requirement for additional inspections by an auditor (two unannounced). In practice few MFs have self-custody by the IA or its related entity. The CFTC's current regime requires CP assets to be segregated, but does not require the use of a custodian or depository. There are no additional safeguards in place when assets are held by the CPO or a related custodian. In practice most CPs do have separate custodians, which however are often related entities. |
| Principle 26. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a CIS for a particular investor and the value of the investor's interest in the scheme. | FI | MFs and CPs that are offered to the public are subject to the Securities Act prospectus obligations (MFs are also subject to the ICA). MFs and CPs that issue prospectuses are required to provide periodic information to investors including both annual and semiannual reports. The CEA framework requires CPOs to provide a detailed disclosure document to prospective participants. In addition, the CPOs must provide annual audited financial statements and an annual report to their participants and the regulator. Quarterly or monthly reporting is also required. Delegation of activities by IAs and CPOs is permitted, but must be entrusted to entities that are also registered with the SEC and/or CFTC. |
| Principle 27. Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a CIS. | BI | MFs and CPs are required to value their portfolios according to the U.S. GAAP. The MF prospectus and the CP disclosure document require disclosure of the frequency, timing and manner in which a participant may redeem its units. Sales and redemptions must be effected at the current net asset value (NAV). MMFs are not required to price their units at market value and may use fixed prices; however strict rules apply on eligible assets and duration of the portfolio. Federal laws do not require disclosure of NAV to investors on a periodic basis, but the price of MFs and CPs offered to the public is generally available through financial publications and websites. There are no specific requirements that govern pricing errors, but market practices on the securities side address compensation of losses to investors in certain circumstances. Suspensions and deferrals of redemptions are dealt with via disclosure (and pursuant to specific rules under the ICA with respect to MFs and MMFs); however, the SEC and CFTC have the authority to take action if necessary. |

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| <p>Principle 28. Regulation should ensure that hedge funds and/or hedge funds managers/advisers are subject to appropriate oversight.</p> | <p>FI</p> | <p>Federal laws do not define HFs, but HF managers that operate HFs are required to register with the SEC and/or the CFTC as IAs or CPOs depending on the type of assets that the HF invests in. Similar to any other IA or CPO, current registration requirements focus on statutory disqualifications and disclosure to investors of extensive information about the manager, which must be kept up-to-date. Standards of organization and operational conduct apply to both IAs and CPOs of HFs on an ongoing basis. HF managers with RAUM above a certain threshold are subject to additional periodic reporting obligations to the SEC and CFTC on the funds they manage, including their assets, exposures and leverage. These reports can be shared with domestic authorities, including the FSOC, as well as with foreign regulators under the frameworks described in Principles 13-15. Capital requirements and other prudential requirements could be established on IAs and CPOs that manage HFs, if FSOC designated any such entity as systemically important.</p> |
| <p>Principle 29. Regulation should provide for minimum entry standards for market intermediaries.</p> | <p>FI</p> | <p>The statutory registration regime combined with the SRO membership regime subjects all categories of participants except IAs and CTAs to a comprehensive set of eligibility criteria that includes integrity, capital requirements, and adequacy of internal controls. IAs and CTAs are not permitted to hold customer assets or deal for customers, though they may have discretion to make investment decisions. As a result, the registration regime focuses on statutory disqualifications and disclosure to the regulators and investors of extensive information about the IAs or CTAs. Organizational and conduct obligations, including the obligation to implement a compliance program, apply on an ongoing basis to IAs and CTAs.</p> |
| <p>Principle 30. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.</p> | <p>FI</p> | <p>All categories of intermediaries except IAs and CTAs are subject to capital requirements based on a net capital formula. Assets are subject to deductions for liquidity and market risks, and additional charges apply to concentration risk. Some large BDs apply an alternative net capital (ANC) framework that allows them to use models to calculate their haircuts, but ANC firms have higher minimum capital requirements, and their use of models is approved by the SEC. The ANC framework does not include separate concentration charges, but uses value-at-risk to measure concentration risk. Intermediaries must report their financial position including net capital on a periodic basis, with frequency varying depending on the activities of the intermediary. They are also required to notify the authorities, if their capital falls below certain thresholds established in the regulatory framework. The SEC, CFTC and the SROs have mechanisms in place for ongoing monitoring of the financial position of firms.</p> |
| <p>Principle 31. Market</p> | <p>BI</p> | <p>With the exception of IAs and CTAs, intermediaries are</p> |

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| intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters. | | explicitly required to have adequate internal controls and risk management systems. Segregation obligations apply to all types of intermediaries. Both in the securities and commodity futures side, intermediaries are required to know their customers. Intermediaries are required to manage conflicts of interest, although in the commodity futures side the framework relies more extensively on disclosure. The coverage of the examination program for IAs is limited, in spite of the importance of the sector. |
| Principle 32. 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. | FI | The CFTC has a plan to deal with market disruption events, including the failure of a firm. The SEC has a clearly defined process to deal with failures of regulated entities. In both cases there are early warning systems for intermediaries with a minimum capital requirement, which includes reporting requirements when their capital falls below certain thresholds. Active monitoring of the firms' financial positions is conducted by both agencies and the SROs. To the extent a BD is in or approaching financial difficulty, SEC staff informs the Securities Investor Protection Corporation (SIPC), so that the SIPC can assess whether it should initiate a Securities Investor Protection Act (SIPA) proceeding. If a SIPA proceeding is initiated, a SIPA trustee is appointed with power to transfer clients' accounts. If the BD's assets are not sufficient to cover customers' claims, the SIPC Fund compensates up to a limit. If a failed FCM's assets are not sufficient to cover all losses, customers are compensated on a pro rata basis. There is no equivalent to a SIPC fund. Under the Dodd-Frank Act, systemically important intermediaries may be placed into a Title II receivership with the Federal Deposit Insurance Corporation (FDIC) as receiver. |
| Principle 33. The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight. | BI | Exchanges and boards of trade are required to be registered, and the registration criteria and processes are set out in the Exchange Act, CEA, and related rules and regulations. Before commencing operations, an ATS must register as a broker-dealer, become a member of an SRO (in practice FINRA), and file an initial Form ATS with the SEC. Form ATS provides the SEC with information on the ATS' subscribers, access to its services, and operations. Fair access requirements apply after an ATS's market share exceeds a five percent threshold; currently there are no such ATS. Limited public information is available on ATSs' order execution rules and procedures, subscribers, and market models on the basis of voluntary disclosures. |
| Principle 34. There should be ongoing regulatory supervision of exchanges and trading | FI | The national securities exchanges and FINRA share the responsibility for market surveillance and member supervision in securities markets, while the DCMs and NFA carry out these |

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| <p>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.</p> | | <p>functions for commodity futures and options markets. Most SEFs have outsourced their market surveillance to the NFA. The SEC and CFTC can investigate improper market conduct referred by the SROs or at their own initiative. They supervise exchanges primarily through rule approval/review and on-site examinations of exchanges' self-regulatory functions. Examining the exchanges' technological systems and system safeguards has become an increased focus of both the SEC and CFTC.</p> |
| <p>Principle 35. Regulation should promote transparency of trading.</p> | <p>BI</p> | <p>The statutory pre- and post-trade transparency requirements in equity markets are based on Regulation National Market System (NMS). In practice, exchanges' proprietary feeds are also available to subscribers. Pre-trade transparency is not available in case of exchanges' dark order types and trading on dark pool ATS. Post-trade transparency information has to be disclosed as soon as practicable, but within a maximum delay of 10/90 seconds; in practice information is disclosed within milliseconds of trades. In commodity futures and options markets, block trades and bona fide exchanges of futures for related positions are exempted from pre-trade transparency through DCM rules. The block trade thresholds set by DCM rules have decreased over the past years. The CFTC regulation on harmonized block trade requirements has not been finalized.</p> |
| <p>Principle 36. Regulation should be designed to detect and deter manipulation and other unfair trading practices.</p> | <p>FI</p> | <p>Fraudulent and manipulative practices are prohibited in the Exchange Act, CEA and SRO rules. Insider trading prohibition applies on securities markets. Trading in commodity futures and options on the basis of material nonpublic information in breach of a pre-existing duty to disclose may be a violation of the CEA. Market abuse is subject to administrative, civil and criminal sanctions. The potential for market abuse is monitored by the SROs that may take action under their rules or refer cases to the SEC, CFTC and criminal authorities. A range of administrative, civil and criminal sanctions has been imposed.</p> |
| <p>Principle 37. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.</p> | <p>FI</p> | <p>DCMs and DCOs closely monitor open positions in commodity futures and options markets. This is complemented by CFTC monitoring. Action can be taken, if a clearing member is not able to meet its obligations or post required margin. Individual clearing agencies monitor member exposures in securities markets. Cross-market post-trade monitoring is facilitated through the DTCC Limit Monitoring system. Default procedures are in place in both clearing agencies and DCOs and disclosed through their rules. Short selling is subject to disclosure and locate requirements. Both the SEC and SROs monitor compliance with the regulatory requirements on short selling.</p> |
| <p>Principle 38. Securities settlement systems and central counterparties should be</p> | | <p>Not assessed.</p> |

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| subject to regulatory and supervisory requirements that are designed to ensure that they are fair, effective and efficient and that they reduce systemic risk. | | |
| Fully Implemented (FI), Broadly Implemented (BI), Partly Implemented (PI), Not Implemented (NI), Not Applicable (NA) | | |

RECOMMENDED ACTION PLAN AND AUTHORITIES' RESPONSE

| Table 9. Recommended Action Plan to Improve Implementation of the IOSCO Principles | |
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| Principle | Recommended Action |
| Principle 1 | <ul style="list-style-type: none"> • The SEC and CFTC should continue their efforts to coordinate via joint regulations, unified reporting and/or use of substituted compliance as appropriate. • All regulatory authorities with mandates impacting securities and derivatives markets should continue to enhance coordination. • The CFTC is encouraged to review whether legal changes should be pursued in order to subject CPOs and CTAs to a similar standard of care as IAs and to a more comprehensive framework to address conflicts of interest. |
| Principle 2 | <ul style="list-style-type: none"> • Consideration should be given to mechanisms to make both the SEC and CFTC's funding more stable, for example by the agencies' becoming self-funded and/or providing for multiyear budgeting. |
| Principle 3 | <ul style="list-style-type: none"> • Additional resources should be provided for the SEC and CFTC commensurate to their expanded mandates. |
| Principle 6 | <ul style="list-style-type: none"> • The SEC should continue to work on improving data availability and automated tools to identify risks, in particular in connection with asset managers. • The SEC should consider enhancing mechanisms to ensure a holistic view of emerging and systemic risk, for example by making more formal arrangements for discussions on risk, ensuring participation of the Commission as a whole, and establishing a more formal accountability framework. • The CFTC should continue to work on improving the quality of swaps data and expanding current mechanisms to monitor the swaps markets. |
| Principle 8 | <ul style="list-style-type: none"> • The SEC is encouraged to review conflicts of interest arising from the participation of BD affiliates in an ATS managed by the BD. • The SEC is encouraged to review the impact of order types, order routing, and related fee structures in equity markets on conflicts of interest. • The SEC is encouraged to continue its review of the BD and IA models to determine whether harmonization of the standards of care is needed, and whether |

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| | <p>additional actions are needed in connection with conflicts of interest, including those arising from compensation arrangements for different types of accounts, products or services.</p> |
| Principles 12, 24 and 31 | <ul style="list-style-type: none"> • The SEC should increase the intensity of its examination coverage of IAs. |
| Principle 16 | <ul style="list-style-type: none"> • Consideration should be given to making amendments to the federal securities laws to grant the SEC direct authority to impose disclosure requirements on issuers of municipal securities and to remove the exemption available to non-municipal conduit borrowers. • Consideration should be given to reviewing the thresholds that trigger a suspension in reporting obligations, in particular for banks and bank holding companies. |
| Principle 17 | <ul style="list-style-type: none"> • The SEC is encouraged to consider reducing the deadline for beneficial ownership disclosure as well as for the first report that insiders need to file. |
| Principle 19 | <ul style="list-style-type: none"> • The PCAOB should take forward the implementation of actions to ensure the timeliness of its enforcement proceedings. • The SEC and PCAOB are encouraged to further analyze whether PCAOB proceedings should be made public. |
| Principle 21 | <ul style="list-style-type: none"> • The PCAOB should work on ensuring timely advancement of its standard setting agenda. |
| Principle 23 | <ul style="list-style-type: none"> • FINRA is encouraged to finalize its rules for research analysis in debt securities, as well as rules for research analysis in equity securities to eliminate, where appropriate, potential asymmetries between the regime applicable to the firms covered by the Global Settlement and the regime applicable to the rest of the industry. |
| Principle 24 | <ul style="list-style-type: none"> • The authorities should consider to explicitly require IAs to MFs and CPOs to implement internal controls and risk management. |
| Principle 25 | <ul style="list-style-type: none"> • Consideration should be given to amending the CEA to enable the CFTC to require additional safeguards where a CPO or a related entity has possession of pool assets. |
| Principle 27 | <ul style="list-style-type: none"> • The CFTC or the NFA should adopt a rule providing for the way investors are to be treated, if adversely affected by errors in the pricing of interests in a CP. |
| Principle 28 | <ul style="list-style-type: none"> • As the authorities continue to analyze the risks posed by HFs, they are encouraged to review whether a comprehensive risk management framework is warranted. |
| Principle 29 | <ul style="list-style-type: none"> • The authorities are encouraged to consider whether to explicitly require internal controls and risk management for IAs and CTAs that conduct portfolio management. |
| Principle 30 | <ul style="list-style-type: none"> • The SEC is encouraged to continue its review of the capital and liquidity framework for ANC firms. More broadly, the SEC is encouraged to continue reviewing the adequacy of liquidity requirements for the larger BDs. |
| Principle 33 | <ul style="list-style-type: none"> • The SEC should continue to follow the development of bilateral trading systems and, if needed, adjust the regulatory framework as appropriate. |

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| | <ul style="list-style-type: none"> • The SEC should require the ATSS to disclose their order execution rules and procedures. • The SEC should ensure that the regulatory framework enhances the requirement for fair access to ATS, including by removing or at least lowering the current five percent threshold. • The SEC and FINRA are encouraged to further ensure that their respective processes provide a sufficiently in-depth analysis of the order execution procedures of a new ATS, in particular for fairness, and provide specific evidence of a BD's operational and other competence to operate an ATS. • The SEC is encouraged to consider whether additional requirements could be applied to exchanges themselves to further enhance their ability to manage the risks arising from direct electronic access. |
| Principle 35 | <ul style="list-style-type: none"> • The SEC is encouraged to continue to deepen its analysis of the pre-trade transparency impact of various order types and the reference prices dark order types are permitted to use to ensure that current derogations do not adversely impact the price discovery process. • The CFTC should promptly finalize its block trade rules to provide a regulatory basis for assessing pre-trade transparency waivers for block trades. |
| Principle 37 | <ul style="list-style-type: none"> • The authorities are encouraged to review whether the current mechanisms are sufficient to provide them with a comprehensive view of the total exposures of market participants that are active across various markets (equity, fixed income, commodity futures and options). |

C. Authorities' Response to the Assessment

36. The Chairs of the SEC and the CFTC appreciate the IMF's commitment of time and resources to the Financial Sector Assessment Program. We would like to express our gratitude to the IMF for fielding such a highly professional, hard working, and knowledgeable team of assessors to prepare the Detailed Assessment Report.

37. As the United States has the largest and most complex financial markets in the world, we recognize and welcome the fact that the United States is held to the highest and most stringent grading standard. We value the objective assessment conducted of our Commissions' regulatory regimes.

38. In the aftermath of the financial crisis, our agencies were given new powers and broad new responsibilities to make our financial regulatory system stronger, more resilient and more effective. We are pleased to see that the Report reflects a recognition that over the past five years the SEC and CFTC have harnessed these new powers and seized upon these new responsibilities to implement more robust and comprehensive rulemaking, supervision and enforcement programs. As just one example, the Report noted that our agencies have introduced comprehensive regulatory reform of the OTC derivatives marketplace, improved supervisory programs to monitor compliance by registered entities, and made extensive use of our enforcement powers.

39. The overall ratings in the Report reflect the SEC's and CFTC's regulatory successes, while at the same time noting that there is room for improvement. Although staff disagrees with certain of the conclusions, recommendations, ratings and interpretations of the IOSCO Principles, we found the assessment process to be comprehensive and fair. SEC and CFTC staffs will continue to evaluate the Report as a tool for our respective Commissions to enhance their regulatory programs and to improve cooperation and coordination in rulemaking and regulatory oversight.

40. We look forward to a continuing dialogue with the IMF to advance our shared goal of strengthening the U.S. financial regulatory system.

DETAILED ASSESSMENT

41. **The purpose of the assessment is primarily to ascertain whether the legal and regulatory securities markets requirements of the country and the operations of the securities regulatory authorities in implementing and enforcing these requirements in practice meet the standards set out in the IOSCO Principles.** The assessment is to be a means of identifying potential gaps, inconsistencies, weaknesses and areas where further powers and/or better implementation of the existing framework may be necessary and used as a basis for establishing priorities for improvements to the current regulatory scheme.

42. **The assessment of the country's observance of each individual Principle is made by assigning to it one of the following assessment categories: fully implemented, broadly implemented, partly implemented, not implemented and not applicable.** The IOSCO assessment methodology provides a set of assessment criteria to be met in respect of each Principle to achieve the designated benchmarks. The methodology recognizes that the means of implementation may vary depending on the domestic context, structure, and stage of development of the country's capital market and acknowledges that regulatory authorities may implement the Principles in many different ways.

- A Principle is considered **fully implemented** when all assessment criteria specified for that Principle are generally met without any significant deficiencies.
- A Principle is considered **broadly implemented** when the exceptions to meeting the assessment criteria specified for that Principle are limited to those specified under the broadly implemented benchmark for that Principle and do not substantially affect the overall adequacy of the regulation that the Principle is intended to address.
- A Principle is considered **partly implemented** when the assessment criteria specified under the partly implemented benchmark for that Principle are generally met without any significant deficiencies.
- A Principle is considered **not implemented** when major shortcomings (as specified in the not implemented benchmark for that Principle) are found in adhering to the assessment criteria specified for that Principle.

- A Principle is considered **not applicable** when it does not apply because of the nature of the country's securities market and relevant structural, legal and institutional considerations.

| Table 10. Detailed Assessment of Implementation of the IOSCO Principles | |
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| Principles for the Regulator | |
| Principle 1. | The responsibilities of the regulator should be clear and objectively stated. |
| Description | <p>Regulatory structure</p> <p><i>Federal regulation</i></p> <p>At the federal level, regulation of securities and derivatives markets is divided between the SEC and the CFTC. In broad terms, the SEC is responsible for the securities markets and related derivatives markets (such as options on securities), and the CFTC for futures and other derivatives markets.</p> <p>The Dodd-Frank Act expanded the coverage of the federal legislation, notably by:</p> <p>Bringing swaps within the federal legislation, and allocating responsibility for swaps markets between the CFTC and the SEC;</p> <p>Requiring the registration of municipal advisors with the SEC and providing for their regulation. The offering of municipal securities continues to be exempted from the registration and reporting requirements of the federal securities laws;</p> <p>Requiring the registration with the SEC of previously exempt advisers to HFs and private equity funds;</p> <p>Expanding the authority of the CFTC over off-exchange transactions in foreign currency with members of the retail public; and</p> <p>Removing exemptions from regulation provided for under the Commodity Futures Modernization Act of 2000 (CFMA) for foreign and other exempt boards of trade</p> <p><i>State-based securities regulation</i></p> <p>State authorities continue to play some role in the regulation of the securities markets. For example, smaller IAs (those with less than US\$100 million in assets under management) are generally not required to register with the SEC as IAs, but are subject to state regulation. Some offerings of securities must be registered under both the Securities Act and applicable state securities laws, unless an exemption from registration is available. The National Securities Markets Improvement Act of 1996 (NSMIA) provided that the offer and sale of certain "covered securities" (such as securities listed on NYSE or NASDAQ) are no longer subject to state securities law registration requirements. NSMIA preserves the right of the states to investigate and prosecute fraud. Certain other securities offerings (such as those made solely within a single state) are not required to be registered under the Securities Act, but are subject to state regulation. Securities market intermediaries are typically required to register at the state as well as the federal level.</p> <p><i>SROs</i></p> <p>The U.S. regulatory system makes extensive use of SROs, including exchanges that have SRO roles and specialist SROs such as FINRA and the NFA. These SROs are subject to the authorization and oversight of the relevant regulator (see further under Principle 9).</p> |

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| | <p><u>CFTC</u></p> <p>Responsibilities, powers and authority</p> <p>The CFTC is an operationally independent federal agency established under the CEA. Its responsibilities, powers and authority are set out in the CEA and related CFTC Regulations. (For example, see Section 2(a) of the CEA for the CFTC’s jurisdiction and Section 8a for its powers). The CFTC’s mission is to protect market users and the public from fraud, manipulation, other abusive practices, and systemic risk related to derivatives that are subject to the CEA and to foster open, transparent, competitive and financially sound markets (Section 3(b) CEA).</p> <p><i>Discretion to interpret authority</i></p> <p>The CFTC can interpret the authority granted to it by the CEA. It largely interprets the CEA based on the plain meaning of the statute and available legislative history. Interpretation is done mainly via guidance as well as more informal means such as frequently ask questions.</p> <p>In addition, the CEA gives the CFTC broad exemptive authority (Section 4(c)) and broad rulemaking authority (Section 8a(5)). Exemptive authority has been used to exempt classes of participants from particular provisions of a regulation, but also to allow a particular firm or product (or type of firm or product) not to comply with a specific provision in a law or regulation. The latter is usually done via no action letters.</p> <p>The rulemaking process is governed by Section 553 of the Administrative Procedure Act (APA) and other statutes that prescribe the manner in which the CFTC may adopt rules and regulations (see Principle 4). In general, rules are subject to consultation and cost-benefit analysis. This process is fully transparent with CFTC rule proposals, adoptions, and concept releases published in the Federal Register and on the CFTC’s website.</p> <p>Concerns have been expressed about the degree to which the CFTC has relied on guidance and no action letter relief to implement some provisions of the Dodd-Frank Act. The former because guidance is not subject to the formal consultation and cost-benefit analysis that is required for the adoption of rules under the APA. The latter mainly because it has added uncertainty to the regulatory framework, in particular since many no action letters have been time limited and some of them have been extended only shortly before their original expiry date.</p> <p><u>SEC</u></p> <p>Responsibilities, powers and authority</p> <p>The SEC is an operationally independent federal agency established under the Exchange Act. Its responsibilities, powers and authority are set out in the legislation it administers, including the Securities Act, the Exchange Act, the Trust Indenture Act, the ICA, the Advisers Act, the Sarbanes-Oxley Act (SOX), the Dodd-Frank Act and the Jumpstart Our Business Startups Act (JOBS Act). The SEC’s mission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.</p> <p><i>Discretion to interpret authority</i></p> <p>The SEC can interpret its authority and the process for interpretation is clear and transparent. The SEC provides guidance by issuing interpretive releases, interpretive letters, legal or accounting bulletins, or less formal guidance such as frequently asked questions. These interpretations are posted on the SEC website and published in the Federal Register.</p> <p>Similar to the CFTC, the SEC has broad exemptive authority and rulemaking authority pursuant</p> |
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to the federal securities laws.

As in the case of the CFTC, 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 (see Principle 4). In general, rules are subject to consultation and cost-benefit analysis. This process is also fully transparent with SEC rule proposals, adoptions and concept releases published in the Federal Register and on the SEC's website.

Multi-authority issues (gaps and overlaps)

As a general rule, the SEC and the CFTC have exclusive jurisdiction for the regulation of activities and products within the scope of their statutory mandates. There are, however, a number of exceptions. In addition to the authority state authorities have in relation to certain securities market activities (see above), there are some areas of the market where the CFTC's and SEC's authority overlaps, or is shared with one another or with other authorities.

Swaps

Title VII of the Dodd-Frank Act provides for a comprehensive new regulatory framework for the OTC derivatives market (referred to as swaps in the U.S.). Under this framework, the CFTC regulates "swaps"; the SEC regulates security-based swaps (SBS); and the SEC and CFTC jointly regulate "mixed swaps." The new framework covers the registration and regulation of dealers and major participants, as well as requirements related to clearing, trade execution, regulatory reporting, and public dissemination of trade data. While the CFTC has primary regulatory responsibility for certain security based swap agreements (e.g., a swap over a broad based index such as the S&P 500), the SEC has authority in relation to the anti-fraud provisions of federal securities legislation. The prudential authorities also play a part in aspects of the regulation of the swaps market, especially in relation to clearing.

Municipal brokers, dealers and advisors

Banks transacting business in municipal securities are not required to register as BDs, but they are included in the definition of municipal securities dealer and must register with the SEC and the Municipal Securities Rulemaking Board (MSRB) in that capacity. In the municipal market, responsibility for ensuring compliance with MSRB rules is divided between the SEC, FINRA and federal bank regulators. The SEC has broad inspection and enforcement authority over broker-dealers and non-bank municipal securities dealers with respect to MSRB rules, SEC rules, and the federal securities laws. FINRA has inspection and enforcement responsibility over its BD members. Federal bank regulators have inspection and enforcement authority for municipal securities dealers that are banks. In addition to the SEC and FINRA, the FDIC, the Federal Reserve, and the Office of the Comptroller of the Currency (OCC) all play a role in the enforcement of MSRB rules.

Banks' broker activity

Some activities conducted by banks that would be regulated by the SEC if conducted by another type of market participant are either excluded or exempt from SEC regulation and subject only to regulation by the banking regulators. The Gramm-Leach-Bliley Act of 1999 (GLBA) provided certain exceptions from SEC oversight for specified securities activities. The Exchange Act provides conditional exceptions from the definition of "broker" for banks that engage in specified 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 transactions.

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| | <p>The federal banking statutes generally do not limit the SEC's authority over affiliates of banks such as their securities subsidiaries.</p> <p><i>Commodity pools</i></p> <p>The solicitation of funds for investment in a CP constitutes the offer of a security and is subject to obligations under the Securities Act and the Exchange Act. As a practical matter, public offers for CPs are generally made by one prospectus that complies with both the securities laws and the CFTC's CP regulations. The majority of CPs are private placements, and therefore subject primarily to CFTC substantive regulation, but exchange traded products traded on national securities exchanges are subject to dual regulation by both the CFTC and SEC consisting of CP registration and regulation and disclosure requirements under both the CEA and federal securities laws. The SEC's anti-fraud authority applies.</p> <p><i>Broker margin rules</i></p> <p>The Federal Reserve has legislative responsibility for setting margin requirements for both securities and futures intermediaries. It delegated this power to the CFTC in 1993, subject to annual reporting requirements, in relation to the futures industry but the Federal Reserve's Regulation T applies directly to securities market intermediaries.</p> <p><i>Clearing houses and systemically important financial institutions</i></p> <p>Title VIII of the Dodd-Frank Act created a new framework for assessing the systemic risk associated with financial institutions and financial market utilities involved in clearing financial transactions. The Title grants authority to the Federal Reserve, the CFTC, the SEC, and the FDIC to work together to promulgate rules and standards of operation, enforce those rules, and generally manage the systemic risk of clearing houses and other financial market utilities. FSO is responsible for designating financial institutions that are, or are likely to become, systemically important.</p> <p><i>Dual registration</i></p> <p>BDs registered with the SEC may also dually register with the CFTC, and many of the largest FCMs are also registered with the SEC as BDs. The SEC and CFTC have harmonized regulations where possible, for example in relation to uniform capital and financial reporting requirements. Because swaps are now included in the definition of commodity, HF managers that use them may be required to register as CPOs under the CEA as well as IAs under the Advisers Act.</p> <p>Consistent regulation of like services and products</p> <p><i>Insurance products</i></p> <p>Insurance products whose performance is based on underlying investments that are securities (such as unit linked products) are regulated as securities and issuers must comply with securities legislation disclosure obligations.</p> <p><i>Other activities</i></p> <p>CIS are regulated either as MFs under the securities laws or CPs under the CEA. There are some differences in the obligations that apply to their operators depending on the applicable regime (whether securities or derivatives). For example, IAs are subject to a strict fiduciary obligation, but such a duty does not apply to CPOs under the CEA—although this type of duty may stem from state law. Similarly, BDs that provide advice to clients incidental to their broker-dealer business are not bound by the same fiduciary standard as IAs.</p> |
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| | <p>Coordination and cooperation between regulators</p> <p>The chairs of both the CFTC and SEC are members of FSOC, which is responsible for facilitating coordination among financial regulators to monitor systemic risk and promote financial stability across the U.S. financial system. For further details on the composition and operation of FSOC, see Principle 6.</p> <p>Both organizations also participate in a variety of cross government forums, such as the Financial Fraud Enforcement Taskforce, and in regular meetings between the SEC, the CFTC, the Federal Reserve, the FDIC and the OCC to discuss implementation of the Volcker rule.</p> <p>Because of the intersections between the securities regime and the regime in the CEA, the SEC and the CFTC have worked together over many years on matters of joint interest. The chairs of the SEC and CFTC are in regular contact. In some cases, coordination between the SEC and CFTC (and in some cases with other agencies) is required by statutes such as the Dodd-Frank Act. There are a number of MOUs in place to support these collaborative efforts, including MOUs dealing with:</p> <p>Ongoing regulatory liaison between the two agencies, including information sharing and key principles for dealing with novel derivatives products that may reflect elements of both securities and commodity futures and options;</p> <p>The oversight of and sharing of information about securities futures products, including provisions for example that the agencies will notify each other of planned examinations and share examination information; and</p> <p>A framework for consultation and information sharing on issues related to CDS central counterparties (the Federal Reserve is also a party to this MOU).</p> <p>According to market participants, the level of communication between the two agencies has increased over time. However, participants expressed concern that this enhanced communication has had a more limited impact on ensuring consistency of regulations, and reducing duplicative reporting and inspections.</p> <p>Other MOUs are in place with other government agencies, such as an MOU between the SEC and the Federal Reserve which deals with information sharing and cooperation including on AML, bank brokerage activities under the GLBA, clearing and settlement in the banking and securities industries, and the regulation of transfer agents.</p> <p>Both agencies have a close working relationship with federal law enforcement authorities.</p> |
| Assessment | Broadly Implemented |
| Comments | <p>The SEC and CFTC have clear mandates set out in the legislation they administer. Both have considerable discretion to interpret the legislation, especially in their rulemaking functions. The process for making formal rules is governed by legislation and is fully transparent and well understood by market participants and others. In less formal areas, especially guidance, there are concerns that in some cases the processes used are less rigorous. This is particularly the case in areas subject to recent rulemaking, such as the new swaps jurisdiction, where there has been extensive use of no action letters. While they have often been necessary to address unanticipated effects of the rules, some market participants considered that in some cases they should have been issued at an earlier stage.</p> <p>The sweeping changes made by the Dodd-Frank Act have eliminated many gaps in coverage in the regulatory system, notably in relation to swaps activity, municipal advisors, advisers to HFs and private equity funds, and retail foreign exchange activity. The legislation also removed exemptions previously applying to futures trading on exempt markets. Virtually all</p> |

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| | <p>market activity is now covered by the regulatory regime. One exception is that offerings of municipal securities remain exempt from the registration and reporting requirements of the Securities Act and Exchange Act, although the anti-fraud provisions of both Acts apply to such offerings and the SEC has taken enforcement action against municipal issuers and other municipal market participants by using those provisions. This potential gap in the regime has not affected the grade under the Principle and is dealt with under Principle 16.</p> <p>Two issues contribute to the grade for this Principle:</p> <p>Consistent treatment of like conduct and products (Key Question 2(b) of the IOSCO Assessment Methodology);</p> <p>Arrangements for cooperation between responsible regulators (Key Question 2(d)).</p> <p>Consistent treatment of like conduct and products</p> <p>For the most part, like regulation is applied to like products and services. In some areas, however, there are differences between the regulatory regimes for what is, in essence, the same activity, especially from the perspective of retail investors. For example, in the securities area, IAs are subject to a fiduciary obligation to their customers and, at least in the case of IAs to mutual funds, conflicts of interest regulation contains an extensive list of prohibitions. In the derivatives area, CPOs and CTAs do not have fiduciary obligations stemming from the CEA, and the relationship between them and CP participants and CTA customers is governed largely by disclosure obligations and by some specified rules of conduct.</p> <p>The assessors recognize that in some cases an obligation akin to a fiduciary duty may arise under state law. They also acknowledge that there are differences between securities and derivatives products (including futures) that can justify differences in the way these products are regulated. Nonetheless, conduct in the form of the provision of advice to retail investors is substantially the same type of conduct, regardless of whether the products that are the subject of the advice are securities or derivatives. Yet, current differences in the areas identified could have a significant impact on the degree of protection afforded to retail investors in CPs and customers of CTAs. The CFTC may wish to look more closely to determine whether legal changes should be pursued to subject CPOs and CTAs to a similar standard of care as IAs and to a more comprehensive framework to address conflicts of interest.</p> <p>Cooperation between regulators</p> <p>In a system as large and complex as the U.S. one, with multiple authorities having sometimes overlapping jurisdiction, effective coordination between authorities is critical. This applies to coordination in both the rulemaking and the supervision processes and in the latter case also applies to coordination between the statutory regulators (the SEC and the CFTC) and the SROs (notably FINRA and NFA). The authorities, in particular the SEC and the CFTC, have made efforts to ensure effective communication and where possible coordination on rulemaking and supervision. For example, there has been extensive communication and coordination between the CFTC and the SEC in rulemaking under the Dodd-Frank Act and in the development of common standards for data collection from CPOs and private funds. The Chairs of the SEC and CFTC have regular discussions. Nonetheless, market participants pointed to examples where in both rulemaking and supervision there appears on occasion to be less coordination than may be optimal.</p> <p>Many market participants are subject to supervision by both the SEC and the CFTC, by the SROs, and also in some cases by the banking regulators. For example, many of the largest FCMs are also BDs, and potentially subject to examinations by the CFTC, SEC, FINRA and NFA.</p> |
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| | <p>Market participants recognized the different mandates and areas of focus of the regulators, but expressed a need for increased coordination, cooperation and mutual reliance between the regulators and SROs in relation to reporting, examinations and other supervisory activities. Effective coordination of supervision efforts on the part of all regulators is especially important where, as is increasingly the case, supervision and examinations are focusing more on areas that are common across regulatory regimes, such as the adequacy of governance arrangements, internal control and risk management. These are areas where market participants suggest the need for enhanced communication and coordination between the regulators, especially in the planning and carrying out of examinations, and in the sharing of information both ex ante and post. The assessors agree there would seem to be opportunities for further coordination in the planning, implementation and sharing of information about these areas of activity.</p> |
| <p>Principle 2.</p> | <p>The regulator should be operationally independent and accountable in the exercise of its functions and powers.</p> |
| <p>Description</p> | <p>CFTC</p> <p>Independence</p> <p>The CFTC is an independent regulatory commission of the U.S. government and does not operate as a division of any Executive Branch department or other agency. It is accountable directly to Congress rather than to the Executive Branch of government.</p> <p><i>Governance</i></p> <p>The CFTC is governed by a Commission consisting of five Commissioners appointed by the President with the advice and consent of the Senate. Each Commissioner holds office for five years, with appointments staggered so that one Commissioner’s term expires each year. No more than three Commissioners may be members of the same political party.</p> <p>The President appoints, with the advice and consent of the Senate, a member of the CFTC as Chairman. The Chairman serves at the pleasure of the President and the President may at any time appoint a different Chairman subject to the advice and consent of the Senate. The CFTC Chairman replaced through this process may complete his or her term as a Commissioner.</p> <p>There are no statutory criteria for the removal from office of a Commissioner, but case law has established that the President can exercise the power to remove a Commissioner only for cause such as neglect of duty or malfeasance in office. The CEA prohibits CFTC Commissioners from accepting employment or compensation from any entity regulated by the CFTC and from participating, directly or indirectly, in any transactions subject to CFTC regulation.</p> <p><i>Interaction with government and other agencies</i></p> <p>In general, the CFTC can discharge its functions without the need for approval from or consultation with any other governmental authority.</p> <p>Various pieces of legislation require the CFTC to consult with and coordinate with other regulatory authorities in specific cases. For example, Section 712(a)(1) of the Dodd-Frank Act requires the CFTC to consult and coordinate with the SEC and the prudential regulators on rule making relating to the swaps market. The CFTC must also consult on a number of other matters with other authorities such as the Treasury Department and Federal Reserve before the registration of a DCM planning to trade futures based on any security issued or guaranteed by the U.S. government or any U.S. agency. The CFTC also has obligations to coordinate with other federal regulators (such as the Federal Trade Commission (FTC) and the</p> |

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| | <p>Federal Energy Regulatory Commission (FERC)) on matters relating to the cash markets underlying derivatives products.</p> <p>The Congressional Review of Agency Rulemaking Act (CRARA) requires agencies to submit proposed rules to Congress with specified details about the rules. A non-major rule becomes effective as proposed by an agency, if Congress receives the required report. A major rule generally becomes effective 60 days after Congressional receipt of an agency's report. This process is an information channel rather than an approval channel (and there may be a constitutional question as to Congress's power to overturn a rule without legislative action). In practice, Congress has not sought to exercise a power of disapproval.</p> <p><i>Interaction with commercial and other sectoral interests</i></p> <p>There are explicit conflict of interest provisions that seek to address potential conflicts of interest of Commissioners and CFTC staff arising from previous relationships as well as from their holdings of financial products. These provisions are further described in Principle 4.</p> <p>The CFTC interacts with industry in particular in connection with the rulemaking process. Such interactions are conducted under an open process prescribed by the APA. In addition, the CFTC has adopted the practice of making a public record of a summary of any <i>ex parte</i> communications made to Commission members or staff in the course of rulemaking, and written submissions on proposed rules are placed on the public record.</p> <p><i>Funding stability</i></p> <p>The CFTC is funded through an annual appropriations process. It submits a budget request to the President or the Office of Management and Budget (OMB), which provides advice to the President on budget matters. The request must also be copied to relevant Congressional Committees. Authorization of the CFTC's budget is through the adoption by the Congress of a specific bill authorizing and funding the CFTC's operations (as part of the President's budget). The appropriate House and Senate committees may hold hearings, request additional testimony by CFTC Commissioners or staff, or request additional documentation.</p> <p>On many occasions, the budget approved by Congress has been lower than the one requested by the CFTC. For example, for fiscal year 2015 the President recommended \$280 million for the CFTC (an increase of \$65 million and 253 staff persons over the 2014 levels), but the 2015 Agriculture Appropriations Bill provides the CFTC with a budget of \$218 million. This budget represents an increase of \$3 million over the 2014 enacted level, but is \$62 million below the President's request. The Bill allocates over \$52 million for the purchase of information technology until September 30, 2016.</p> <p>The budget of the CFTC has been subject to sequestration three times during the last five years. However, CFTC staff indicated that in practice it has not had material consequences for the budget of the agency, although the furlough had to be applied on one occasion.</p> <p><i>Reauthorization process</i></p> <p>In common with a number of other federal agencies, the CFTC is subject to periodic reauthorization, typically at five year intervals. But even if a reauthorization decision is not made within the specified period (as is currently the case), as long as Congress continues to make budget appropriations to the agency, it is taken to have continuing authorization. For this reason CFTC senior officials did not consider that the requirement for reauthorization hinders the agency's ability to discharge its functions effectively; rather they consider that it provides a point of accountability.</p> |
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Legal protection

Principles of sovereign immunity apply to the CFTC as an agency of the federal government. The Federal Employees Liability Reform and Tort Compensation Act of 1988 (FTCA) provides federal employees with immunity from individual liability for torts committed in the scope of their employment. The CFTC has also adopted indemnification rules, covering Commissioners and staff, to provide protection for individual liability for possible violation of constitutional or statutory duties that are not covered by the FTCA.

Accountability

The CFTC is accountable to Congress. The House Committee on Agriculture and its Subcommittee on Risk Management and Specialty Crops, and the Senate Agriculture, Nutrition and Forestry Committee and its Subcommittee on Research, Nutrition and General Legislation have the principal responsibility for oversight of the CFTC. These Committees handle, in the first instance, the reauthorization, budget and funding decisions for the CFTC, as well as bills affecting the CEA.

Transparency

Section 8(h) of the CEA requires the CFTC to submit to Congress a written report within 120 days after the end of each fiscal year detailing the operations of the CFTC during that fiscal year. The CFTC is required to include in this annual report any information, data and legislative recommendations it deems advisable with respect to the administration of the CEA and its powers and functions under the CEA. Section 18(b) of the CEA requires that the annual report contain plans and findings regarding implementation of Section 18(a) of the CEA, which mandates certain research and information programs.

The APA governs CFTC rulemaking and requires interested persons be given an opportunity to comment on proposed rulemaking. The Sunshine Act generally provides that meetings of the Commission must be open to the public and requires the CFTC to provide advance notice of such meetings (see Principle 4).

Use of funds

Section 8(i) of the CEA requires the Comptroller General (Government Accountability Office, GAO) to conduct reviews and audits of the CFTC and make reports on them. The CFTC must make available to the GAO any required information about its powers, duties, organization, transactions, operations and activities, as well as access to any books and records (subject to confidentiality requirements).

In addition, the operations of the CFTC are subject to ongoing review by the CFTC's independent Office of the Inspector General (OIG). OIG conducts and supervises audits and investigations of CFTC programs and operations and reviews existing and proposed legislation and regulations. OIG recommends policies to promote economy, efficiency and effectiveness in CFTC programs and operations, and to prevent and detect fraud and abuse. OIG keeps the Chairman of the CFTC and Congress informed about any problems, deficiencies, and progress of corrective action in programs and operations. OIG reports may be made public.

Review of decisions

Under the APA, a person aggrieved by a decision or action of the CFTC can challenge that decision in a U.S. Federal District Court. This applies to decisions to adopt rules, and decisions such as the denial of applications for registration or sanctions decisions.

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| | <p>Confidentiality</p> <p>Section 8(a)(1) of the CEA provides that, except as otherwise specified in the CEA, the CFTC must not publish data and information that would separately disclose market positions, business transactions, trade secrets or names of customers, and the CFTC must not make public any data or information concerning or obtained in connection with any pending investigation of any person. Confidentiality of information is preserved through the accountability process by the code of ethics that applies to members of Congress and their staff, and by negotiation between the CFTC and Congress and its members.</p> <p><u>SEC</u></p> <p>Independence</p> <p>The SEC is an independent federal agency of the U.S. government and operates independently of the Executive Branch of government. It is accountable directly to Congress rather than to the Executive Branch of government.</p> <p><i>Governance</i></p> <p>The SEC is governed by a Commission consisting of five Commissioners appointed by the President with the advice and consent of the Senate. Their terms last five years and are staggered so that one Commissioner's term ends on June 5 of each year. No more than three Commissioners may belong to the same political party. The President also designates one of the Commissioners as Chairman. Some chairs of the SEC have not been affiliated with a political party.</p> <p>The laws governing the SEC do not provide express criteria for removal of Commissioners, but as noted above, judicial precedent establishes that they can only be removed for cause.</p> <p>Commissioners must be full time and not engage in any other form of employment other than as Commissioner. The SEC's Supplemental Standards of Ethical Conduct include prohibitions for Commissioners and staff on transactions involving an issuer directly regulated by the SEC or under investigation by it. These Standards also require Commissioners and staff to clear in advance any securities transactions or holdings.</p> <p><i>Interaction with government and other authorities</i></p> <p>As a general matter, 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 laws.</p> <p>Various provisions of the securities laws require consultation or cooperation with other agencies in specific cases. For example, under the Exchange Act, the SEC consults and cooperates with the OCC, the Federal Reserve and the FDIC on bank transfer agents and clearing agencies; Title VII of the Dodd-Frank Act requires the SEC to engage in joint rulemaking with the CFTC on aspects of the swaps market; and Title VIII of the Dodd-Frank Act authorizes the SEC, in consultation with the Federal Reserve and the FSOC, to prescribe new risk management standards for example for clearing agencies. The situations in which consultation or cooperation is required are set out in legislation and transparent.</p> <p>The SEC is also subject to general administrative statutes that require it to undertake consultations with respect to its rulemaking or other operations (see Principle 4). As with the CFTC, all final SEC rules must be submitted to Congress before they can take effect.</p> <p><i>Interaction with commercial and other sectoral interests</i></p> <p>Similar to the CFTC, there are explicit conflict of interest provisions that seek to address</p> |
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potential conflicts of interest of Commissioners and SEC staff arising from previous relationships as well as from their holdings of financial products. These provisions are further described in Principle 5.

As with the CFTC, the SEC interacts with industry particularly in connection with its rulemaking function. It does so through a transparent process further described in Principle 4. It also has adopted the practice of making a public record of a summary of any ex parte communications made to Commission members or staff in the course of rulemaking

Funding stability

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 budget request outlines the major program areas of the SEC and estimates the resources (including staff and expenses such as salary, facilities and supplies) needed to operate them.

Funding for the SEC is made through an annual appropriation from Congress. This appropriation is deficit-neutral, because it is offset by securities transaction fees assessed on SROs in accordance with Section 31 of the Exchange Act. The current fee rate is approximately \$0.02 per every \$1,000 transacted.

The SEC also has a reserve fund, which can, under certain circumstances, be used for the agency's expenses, and the SEC has dedicated this to technology. The SEC can use up to \$100 million from this fund each year. The funding is provided by deposits of \$50 million per year in securities registration fees (with the remainder of registration fees being remitted to Treasury).

The level of funding approved by Congress has been significantly lower than that requested by the SEC. Similar to the CFTC, SEC budget has been affected by the sequestration process in three occasions during the last five years. SEC staff indicated that in one occasion the sequestration process had a material effect in the final budget of the agency.

Legal protection

Similar to the CFTC, the principle of sovereign immunity provides protection to the SEC as a whole and to individuals (the Chair, Commissioners, and staff). While there are exceptions to the principle of sovereign immunity, the SEC and its members and staff are generally protected from frivolous or unwarranted litigation or claims.

Staff acting in a prosecutorial fashion are entitled to absolute immunity from constitutional torts (civil rights actions), so long as the actions are taken within the scope of their authority. The FTCA provides immunity for torts committed by employees of the federal government within the scope of their employment.

Accountability

The SEC is subject to Congressional oversight. The two Congressional committees with primary authorizing and oversight responsibilities over the SEC are the Senate Committee on Banking, Housing and Urban Affairs (Senate Banking Committee) and the House of Representatives Committee on Financial Services (House Financial Services Committee). Each of those committees contains a subcommittee with jurisdiction specific to securities issues. Various other Congressional committees also have oversight or other responsibilities related to the SEC.

Section 961 of the Dodd-Frank Act requires the SEC to report to Congress on the supervisory controls over the conduct of the SEC over its examinations of registered entities, enforcement investigations, and review of corporate financial securities filings. The Act also mandates a number of other periodic reports from the GAO on aspects of the SEC's performance.

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| | <p>The SEC is also accountable to Congress through its relationship with the GAO. 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:</p> <ul style="list-style-type: none"> Auditing agency operations to determine whether federal funds are being spent efficiently and effectively; Investigating allegations of illegal and improper activities; Reporting on how government programs and policies are meeting their objectives; Performing policy analyses and outlining options for congressional consideration; and Issuing legal decisions and opinions. <p>During the last 5 years GAO has delivered reports to Congress on topics such as municipal securities, credit rating agencies, the definition of accredited investors and regulation of research analysts.</p> <p><i>Transparency</i></p> <p>The SEC's operations and use of resources are transparent. For example, the SEC publishes annually an Agency Financial Report, which describes the SEC's activities and financial operations for a given fiscal year. The SEC also makes publicly available a copy of its current Rules of Practice and Rules on Fair Fund and Disgorgement Plans; and the Staff's Enforcement Manual.</p> <p>The SEC is required to report to the Senate Banking Committee and the House Financial Services Committee not later than 90 days after the end of each fiscal year on the supervisory controls over the conduct by the SEC of examinations of registered entities, enforcement investigations, and review of corporate financial securities filings.</p> <p>The APA governs SEC rulemaking and generally requires that interested persons are given an opportunity to comment on proposed rulemaking. The SEC posts its rulemaking releases, public comment letters filed with the SEC, as well as other data or information that is important to the SEC's consideration of the rulemaking on the SEC's website. The Sunshine Act generally provides that meetings of the Commission must be open to the public and requires the SEC to provide advance notice of such meetings. The SEC videocasts all open SEC meetings on the Internet.</p> <p><i>Use of funds</i></p> <p>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). The GAO conducts annual audit of the SEC's financial statements and internal controls over financial reporting. 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 OMB, and are generally made public on the Internet.</p> <p>Review of decisions</p> <p>A person aggrieved by a final order of the Commission may seek judicial review in a federal court. Judicial review can be sought by those adversely affected by agency rulemaking, by registration decisions and sanctions decisions.</p> <p>The APA requires the SEC to prepare a written decision setting out the SEC's findings of fact and conclusions of law and the underlying reasons. The federal securities laws also require the SEC to issue orders in its administrative proceedings. The SEC has extensive published rules of</p> |
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| | <p>procedure aimed at ensuring fairness in the conduct of hearings and other administrative activities.</p> <p>Confidentiality</p> <p>The Exchange Act and Advisers Act contain statutory provisions designed to safeguard the confidentiality of information obtained in the course of examinations or investigations. Rule 24c-1 under the Exchange Act provides that the SEC may provide nonpublic information in its possession to certain entities, including other domestic and foreign governmental entities, but only if it receives appropriate assurances of confidentiality.</p> <p>The Freedom of Information Act (FOIA) governs public access to certain types of documents. FOIA requires that the SEC make certain information available to the public, but also provides certain exceptions for, among other things, commercially sensitive material.</p> <p>The confidentiality of information provided through the accountability process is preserved, as with the CFTC, through a combination of the ethical obligations of members of Congress and their staff, and by negotiation between the SEC and Congress.</p> |
| Assessment | Broadly Implemented |
| Comments | <p>Both the SEC and the CFTC are operationally independent on a day-to-day basis and fully accountable to the legislature.</p> <p>The reason for the grade in this Principle is that the annual budget process to which both agencies are subject makes planning for medium and long term priorities subject to considerable uncertainties. In addition, in recent years there have been significant gaps between both agencies' budget requests (which have been supported by the President) and the funding they have received. This means that new responsibilities, especially those resulting from the Dodd-Frank Act, have largely been met by reallocating resources internally, including away from other regulatory and supervision areas. This has, notably, impacted the frequency of examinations. The sequestration process has added uncertainty about budgets.</p> <p>Congress, through legislation, creates mandates that affect both aspects of supervisory activity and the structure of the agencies, for example by mandating that the SEC conduct annual examinations of CRAs (see Principle 22), and create a separate Office of Credit Ratings. While some types of legislative mandate given to the SEC and the CFTC can potentially limit their ability to manage resources effectively to meet emerging needs as market circumstances change, the assessors consider that the current legislative mandates have been fairly well aligned with the SEC's and CFTC's own priorities. In the same vein, while in the case of the SEC certain structures have been mandated, the impact of those on the agencies' organizational structure has so far been relatively limited.</p> <p>The assessors recognize that there is a delicate balance between independence and accountability, and that the funding process does not appear to have had any impact on the independence of the SEC's and CFTC's regulatory and supervisory decision making processes. Nonetheless, in recent years the Congressional budget process, on which funding decisions for the CFTC and the SEC depends, has been politically complex and subject to considerable uncertainties; there have been significant delays in the approval of proposed budgets; and, as noted above, there are major gaps between budget requests and final allocations. This adds to the uncertainties inherent in an annual budget process, and potentially limits the ability of the agencies to make forward plans for multi-year investments (such as in technology) and supervisory activities spanning more than the current budget cycle.</p> <p>The assessors believe that, within the existing accountability framework, consideration should be given to mechanisms that would allow the agencies to make longer term plans for the use</p> |

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| | <p>of resources than is possible under an annual budget process. Examples of such mechanisms include multi-year budgets, or a move toward some or all of the agencies' budgets being self-funded.</p> <p>Composition of both Commissions is subject to a requirement as to the political affiliation of Commissioners, and legislation requires that no more than three commissioners may belong to the same political party. This is an unusual requirement by international standards and reflects particular U.S. traditions. In practice it protects the agencies from a perception that agency thinking is dominated by the views of one political party; but it also risks creating a perception that decision making at Commission level is in some sense a political process. This potentially may lead to a further perception that the agency is not fully independent from political influence. The Sunshine Act provisions, which mandate an unusually high level of transparency in Commission decision making, are intended to mitigate this risk.</p> |
| Principle 3. | The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers. |

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| Description | <p>CFTC</p> <p>The CFTC has four Divisions (Clearing and Risk (DCR); Enforcement (DOE); Market Oversight (DMO) and Swap Dealer and Intermediary Oversight (DSIO)) and eight Offices (including an Office of the Chief Economist, an Office of Data and Technology, an Office of international Affairs) and an Office of the Inspector General). It also has 3 regional offices.</p> <p>Power and authorities</p> <p>The CEA gives the CFTC extensive powers to supervise the markets, financial institutions, market participants and SROs within its jurisdiction. These powers include the power to seek information from regulated persons and others, to conduct surveillance of markets, to monitor compliance by regulated entities, to investigate suspected breaches of the legislation it administers, to impose sanctions and to refer matters to the criminal authorities. See further under Principles 10 and 11.</p> <p>The Dodd-Frank Act significantly enhanced the CFTC's regulatory authority including by:</p> <ul style="list-style-type: none"> Giving it new authorities over SDs, major swap participants (MSPs), DCMs, DCOs, SEFs and SDRs; Significantly enhancing the CFTC's enforcement anti-manipulation authority (see DEA Section 753); Expanding the CFTC's authority to bring new types of enforcement actions alleging false statements to the CFTC (see CEA Section 6(c)(2)); Expressly prohibiting certain trading practices that are disruptive of fair and equitable trading (see Section 747 of the Dodd-Frank Act and Section 4c(a) of the CEA); Removing a number of previous exemptions from regulation; and Including detailed Core Principles for DCOs to enhance the CEA regulatory regime for central counterparties. <p>The CFTC has undertaken extensive rulemaking to implement the requirements of the Dodd-Frank Act. Most mandated rulemaking is now complete.</p> <p>Allocation of resources and sufficiency of funding</p> <p>The CFTC's ability to affect the operational allocation of resources is impacted by the way the budget is approved. The budget submitted to Congress must include an allocation request that</p> |
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contains a specific breakdown of the proposed resource allocation within the CFTC. This allocation may be revised as part of discussions between the Congress and the CFTC. The final allocation is established when the Congress adopts the bill funding the CFTC's operations. Significant changes in allocation of funds once appropriated require a reprogramming request to the relevant Committee of Congress.

Senior officials from the CFTC acknowledge that the current level of funding poses challenges particularly in light of the expansion of the CFTC mandate brought by the Dodd-Frank Act, but that they will continue to use resources as effectively as possible. However, market participants expressed concerns about the impact that Congress' approved budget has on the CFTC's ability to deliver timely high quality regulations as well as effective supervision of the new population under the CFTC's jurisdiction.

Staff resources

As of May 31, 2014, the CFTC had 646 employees that comprised 435 regulatory and supervision staff (attorneys, economists, auditors, risk and trade analysts, and other financial specialists); 163 management and support staff; and 48 executives.

Section 2(a)(7) of the CEA permits the CFTC to maintain comparative compensation and benefits in relation to other federal financial regulators for the purpose of retaining and attracting employees. Current salaries are comparable to those paid by other federal financial regulators –although some of them can offer better benefits given their self-funded nature.

Staff turnover has ranged from 8 to 12 percent, and has remained in this range for the last five years.

Training

The CFTC's Human Resources Branch provides a series of educational/training seminars keyed to the primary mission of the CFTC through its Talent Management and Leadership Development Section. The Section employs a full-time Chief Learning Officer to ensure that the training needs of all employees are met. Training seminars are focused on the financial and legal aspects of the futures, options and swaps markets. The Commission recently announced that it has entered into a multi-year contract to allow all CFTC employees to take technical training related to financial management, financial marketplaces and business skill enhancement.

Technological resources

CFTC senior staff highlighted the investments that the agency has made to develop robust automated mechanisms for market surveillance. Current efforts focus on extending such tools to the swaps market as described in Principle 6.

Investor education

The CFTC has an Office of Consumer Outreach which creates and distributes financial education messages to help consumers avoid fraud and deception in the commodities markets. It has a section on its website devoted to consumer protection. The consumer protection section of the website educates consumers about the U.S. futures markets; notifies the public about the types of fraud in the marketplace; offers guidance on how to file complaints or send in tips regarding suspicious activities; and provides updates on disciplinary actions.

SEC

The SEC has five Divisions (Corporation Finance (CF); Enforcement, Investment Management (IM); Trading and Markets (TM); and Economic and Risk Analysis (DERA)); and 22 Offices, including the Office of Compliance Inspections and Examinations (OCIE), the Office of the Chief

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| | <p>Accountant (OCA), the Office of Credit Ratings (OCR), the Office of Municipal Securities, and the Office of the Inspector General (OIG). It also has 11 regional offices.</p> <p>Power and authorities</p> <p>The legislation administered by the SEC (outlined under Principle 1) gives it extensive powers to supervise the markets, financial institutions, market participants and SROs within its jurisdiction. These powers include the power to seek information from regulated persons and others, to conduct surveillance of markets, to monitor compliance by regulated entities, to investigate suspected breaches of the legislation it administers, to impose sanctions and to refer matters to the criminal authorities. See further under Principles 10 and 11.</p> <p>The Dodd-Frank Act expanded the authority of the SEC in a number of areas, giving it new authority over:</p> <ul style="list-style-type: none"> Previously exempt IAs to HFs and private equity funds with over US\$100 million assets under management; Municipal advisors; and Security based swaps. <p>Allocation of resources and sufficiency of funding</p> <p>As is the case for the CFTC, the SEC's ability to make operational changes to the budget approved by Congress is affected by the way the budget is approved. When the agency submits its budget proposal to Congress, the proposal must be accompanied by an allocation request which establishes the way resources will be spent. In this regard the budget allocates the funds for categories of spending called "object classes". The SEC's largest budget object class, for instance, is for personnel compensation and benefits, which was approximately \$927 million for fiscal year 2014. The budget approval bill usually includes provisions that authorize the SEC to transfer funds among object classes or programs within certain limits (in recent years, for instance, the SEC has been allowed to reallocate the lesser of \$5 million or 10 percent of a category). Outside these limits, the SEC needs to seek the permission of the House and Senate Appropriations Committees to reallocate funds from one category to another by submitting a formal reprogramming request.</p> <p>The SEC budget has not increased in line with the expansion of its mandate as a result of the Dodd-Frank Act. According to SEC senior staff, this has among other challenges affected the SEC's ability to implement a robust examination program for IAs.</p> <p>Staff resources</p> <p>The SEC has a staff of more than 4,000 people. While the majority of the SEC staff is composed of lawyers and accountants, the agency has increased the number of economists and quantitative analysts as part of its effort to enhance its risk-based supervisory approach. Like the CFTC, the SEC is exempted from the general salary scale applicable to government employees. Current salaries are comparable to those paid by other financial regulators – although some of them can offer better benefits given their self-funded nature. The SEC continues to implement enhanced employee benefits, market-based pay structure, multiple day telework, flexible work schedules, and pay-for-performance, all of which are designed to encourage skilled staff members to remain.</p> <p>The SEC aims to keep its turnover rate relatively low, below 8 percent per year. During fiscal years 2010 through 2013, the SEC experienced a turnover rate that averaged less than 6 percent, which was consistent with the overall federal sector turnover rate.</p> |
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| | <p><i>Training</i></p> <p>The SEC has created SEC University to provide training and development opportunities to all staff. The mission of SEC University is to develop SEC employees and managers to ensure high performance and productivity and a collaborative, effective, and engaged workplace. SEC University plans and delivers internally held in-person courses, assists employees who need to take a class offered by an outside organization, and provides a variety of web based training.</p> <p>Every new employee and Commissioner receives ethics education and training. Regulatory requirements regarding ethics training are set forth in the Government-wide ethics regulations. OEC has an internal website on the SEC’s intranet that provides additional guidance on all of these topics and links to the Office of Government Ethics (OGE) regulations and disclosure forms.</p> <p>Technological resources</p> <p>The SEC is increasingly making more use of quantitative data to support both its rulemaking as well as its supervisory activities. Technology is a key component of this effort and sophisticated tools have been developed by the agency as described in Principle 6.</p> <p>Investor education</p> <p>The SEC’s Office of Investor Education and Advocacy leads the SEC’s investor education initiatives by communicating with investors, responding to complaints and inquiries, and providing educational programs and materials. It does so by:</p> <ul style="list-style-type: none"> Handling investment-related complaints; Providing responses to investor requests for information and assistance; Raising awareness about the SEC’s online educational resources, including the SEC’s investor.gov website; Implementing investor education programs; and Participating in in-person events for investors. |
| Assessment | Partly Implemented |
| Comments | <p>Both the CFTC and the SEC have stated in testimonies on their budgets that their levels of funding need to be increased to enable them to effectively fulfill their mandates. The SEC in particular has stated that its supervision of IAs, including the new population of advisers to HFs and private equity funds, is affected by budget constraints. For the CFTC, rulemaking for swaps has meant more limited resources are available for areas within its established jurisdiction. The CFTC has stated that this has affected its ability to carry out examinations of intermediaries; to make full use of swaps data; to conduct effective daily surveillance of market activity; and to investigate and prosecute violations. This resource constraint will likely become increasingly important with the implementation of new rules.</p> <p>The CFTC has also been subject to specific requirements to allocate part of its budget to IT investments and activities, which, while important, face implementation challenges due to lack of sufficient funding for staff resources.</p> <p>In practice, in recent years the budget appropriations of both agencies have not kept pace with the expanded mandates and increasingly complex markets.</p> |

| | <table border="1" style="margin-left: auto; margin-right: auto;"> <thead> <tr> <th colspan="6" style="text-align: center;">CFTC and SEC appropriations</th> </tr> <tr> <th colspan="6" style="text-align: center;">Fiscal years 2010-2014</th> </tr> <tr> <th colspan="6" style="text-align: center;">(\$ million)</th> </tr> <tr> <th></th> <th style="text-align: center;">FY 2010</th> <th style="text-align: center;">FY 2011</th> <th style="text-align: center;">FY 2012</th> <th style="text-align: center;">FY 2013</th> <th style="text-align: center;">FY 2014</th> </tr> </thead> <tbody> <tr> <td style="text-align: center;">CFTC</td> <td style="text-align: center;">169</td> <td style="text-align: center;">203</td> <td style="text-align: center;">205</td> <td style="text-align: center;">205</td> <td style="text-align: center;">215</td> </tr> <tr> <td style="text-align: center;">SEC</td> <td style="text-align: center;">1,111</td> <td style="text-align: center;">1,185</td> <td style="text-align: center;">1,346</td> <td style="text-align: center;">1,302</td> <td style="text-align: center;">1,372</td> </tr> </tbody> </table> <p style="text-align: center; margin-top: 5px;">Source: CFTC and SEC.</p> | CFTC and SEC appropriations | | | | | | Fiscal years 2010-2014 | | | | | | (\$ million) | | | | | | | FY 2010 | FY 2011 | FY 2012 | FY 2013 | FY 2014 | CFTC | 169 | 203 | 205 | 205 | 215 | SEC | 1,111 | 1,185 | 1,346 | 1,302 | 1,372 |
|------------------------------------|---|------------------------------------|----------------|----------------|----------------|--|--|-------------------------------|--|--|--|--|--|---------------------|--|--|--|--|--|--|----------------|----------------|----------------|----------------|----------------|------|-----|-----|-----|-----|-----|-----|-------|-------|-------|-------|-------|
| CFTC and SEC appropriations | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Fiscal years 2010-2014 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| (\$ million) | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | FY 2010 | FY 2011 | FY 2012 | FY 2013 | FY 2014 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| CFTC | 169 | 203 | 205 | 205 | 215 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| SEC | 1,111 | 1,185 | 1,346 | 1,302 | 1,372 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Principle 4. | The regulator should adopt clear and consistent regulatory processes. | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Description | <p>Clear and equitable procedures</p> <p><i>Procedural rules and regulations</i></p> <p>Both the CFTC and the SEC operate in a highly transparent way. Registration requirements are transparent and published on the CFTC and SEC’s websites, and so are interpretations, guidance and (subject to requests for confidentiality for a specified time) no action letters. In particular in the enforcement area, manuals and guidance available on the agencies’ websites set out the agencies’ approach to investigations and the imposition of sanctions. For critical processes the agencies require staff to work under the four eye principle, which helps to ensure consistency of decisions.</p> <p>As a general matter, the U.S. Constitution requires administrative agencies to conduct their proceedings with due process. Legislation that applies to most federal agencies applies to the CFTC and the SEC. The most important of these statutes are:</p> <p><u>The APA</u>: there are detailed provisions in the APA dealing with processes for agency decision making, including rulemaking (for example requirements for notice and an opportunity to participate in rulemaking through submission of written data, views or argument) and other decisions such as registration and sanctions decisions. It generally requires that affected parties be given notice of reasons for decisions and an opportunity to be heard before final decisions are made. The APA also provides for judicial review of final agency decisions.</p> <p><u>The Sunshine Act</u>: this Act requires transparent procedures in the discharge of agency business. Among other things, it provides that meetings of the Commissions must be open to the public unless an exemption applies, and requires advance notice of meetings.</p> <p><u>The Paperwork Reduction Act (PRA)</u>: this Act requires review and analysis of reporting and record-keeping issues and burdens in agency rulemaking;</p> <p><u>The Regulatory Flexibility Act (RFA)</u>: this Act requires the agencies to consider the needs of small entities in evaluating proposed rules and rule changes;</p> <p><u>The Freedom of Information Act (FOIA)</u>: this Act requires agencies to make publicly available information that is not subject to specified restrictions on disclosure;</p> <p><u>The Privacy Act</u>: this Act sets out procedures for agencies when they obtain, maintain and disseminate information about members of the public; and</p> <p><u>The Right to Financial Privacy Act (RFPA)</u>: this Act requires agencies to follow specified procedures when they seek to subpoena certain financial records from financial institutions or transfer these records to other government agencies.</p> <p>Both the CFTC and the SEC are also bound by procedural rules in the legislation they administer. For example, Section 23(a)(2) of the Exchange Act requires the SEC to consider the</p> | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |

impact proposed rules would have on competition; and Section 15(a) of the CEA requires the CFTC to consider the costs and benefits of its actions before issuing a new regulation.

The CFTC and the SEC have also promulgated extensive rules and regulations that establish procedural and transparency standards for agency actions. For example, both agencies have specific regulations setting out rules of procedure for specific aspects of their operations, such as adjudicatory proceedings and investigatory proceedings.

Consultation and transparency

Both agencies' rulemaking processes are governed by the APA. The APA generally requires the agencies to publish a notice of proposed and final rulemaking in the Federal Register and to provide interested persons an opportunity to participate in the rulemaking through submission of written data, views or arguments with or without an opportunity for oral presentations. The SEC and the CFTC also from time to time use public forums to enable discussion of proposed rules.

The SEC has created a number of advisory committees pursuant to the Federal Advisory Committee Act (FACA), which regulates the formation and operation of advisory committees by federal agencies. These consultative committees include an Investor Advisory Committee (which has been made permanent by the Dodd-Frank Act) and an Advisory Committee on Small and Emerging Companies.

The CFTC also has a number of advisory committees, including an Agricultural Advisory Committee, a Global Markets Advisory Committee, a Technology Advisory Committee and an Energy and Environmental Markets Advisory Committee.

The SEC and CFTC websites provide access to all rules, regulations and policies adopted by the agencies, as well as other material such as staff interpretive letters and no action letters.

Cost of compliance

The consultation processes used by the CFTC and the SEC in their rulemaking enable them to consider the costs and benefits of proposed rules. Specific legislation, such as the PRA and RFA, also require consideration of regulatory burdens imposed by proposed rules.

Section 15(a) of the CEA requires the CFTC to consider the costs and benefits of its action from five perspectives: protection of market participants and the public; efficiency, competitiveness and financial integrity of futures markets; price discovery; sound risk management practices; and other public interest considerations.

Procedural fairness

As described above, the SEC and the CFTC are bound by statutory provisions and their own rules to provide procedural fairness. As a general rule, these provisions require the agency to provide a statement of reasons for decisions, and an opportunity for an affected party to be heard before a final decision is made.

Section 557 of the APA requires that the agency decisions (including initial, recommended, and tentative 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. In this context decisions include decisions to deny or revoke a license.

Review of decisions

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

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| | <p>agency action is entitled to judicial review.</p> <p>Decisions of an Administrative Law Judge can be appealed to each Commission, and the Commissions' decisions can be appealed to a court.</p> <p>Confidentiality</p> <p>Section 8(a)(1) of the CEA provides that, except as otherwise specified in the CEA, the CFTC may not publish data and information that would separately disclose market positions, business transactions, trade secrets or names of customers, and the CFTC may withhold from public disclosure any data or information concerning or obtained in connection with any pending investigation of any person.</p> <p>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. Rule 24c-1 under the Exchange Act provides that the SEC may provide nonpublic information in its possession to certain entities, including other domestic and foreign governmental entities, but only if it receives appropriate assurances of confidentiality.</p> <p>Both agencies have a policy of not commenting publicly on ongoing investigations.</p> |
| Assessment | Fully Implemented |
| Comments | Both the CFTC and the SEC are subject to transparent and comprehensive procedural rules and regulations, imposed by government-wide legislation and by their own rules. The issue of the use of guidance and no action letters, rather than rulemaking, to adjust the parameters of the regulatory regime is dealt with in the comments under Principle 1. |
| Principle 5. | The staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality. |
| Description | <p>The Commissioners and staff of the CFTC and SEC are subject to codes of ethics and professional conduct standards that cover integrity, procedural fairness, prevention of conflict and confidentiality.</p> <p>Regulations issued by the U.S. Office of Government Ethics (OGE) apply to the SEC and the CFTC and cover: basic obligations of public trust; gifts from outside sources; gifts between employees; conflicting financial interests; impartiality in performing official duties; seeking other employment; misuse of position; and outside activities. In addition both agencies have supplemented these government-wide rules by adopting detailed rules and regulations governing the conduct of Commissioners and staff.</p> <p><u>CFTC</u></p> <p>Conflicts of interest</p> <p>Subpart C of Part 140 of the CFTC Regulations establishes general ethical standards of conduct for CFTC employees and CFTC Commissioners. CFTC Regulations restrict business and financial transactions and interests; non-governmental employment and outside activities; and the receipt and disposition of foreign gifts and decorations. Other Regulations prohibit the disclosure of non-public commercial, economic or official information to any unauthorized person; and require reporting by and an ethics review of all former employees who intend to practice or otherwise represent a party before the CFTC for two years after terminating employment with the CFTC.</p> |

Trading

CFTC Regulations prohibit, subject to some narrow exceptions, CFTC Commissioners and staff from trading in products regulated by the CFTC.

Use of information

Section 9(d) of the CEA makes it a punishable felony for a CFTC employee or CFTC Commissioner to share or otherwise benefit from information the employee or Commissioner receives in the course of employment which may affect or tend to affect the price of commodities. Section 9(c) of the CEA makes it a felony for a CFTC employee or CFTC Commissioner to trade commodity futures and options or to participate directly or indirectly in any investment transaction in an actual commodity, if nonpublic information is used in the transaction or if prohibited by CFTC regulations.

Confidentiality and secrecy

Except as otherwise provided in the CEA, Section 8(a) of the CEA prohibits the CFTC from disclosing publicly data and information that would separately disclose the business transactions, or market positions of any person and trade secrets or names of customers. Section 9(a)(5) makes it a felony punishable by a fine of up to \$500,000 and/or imprisonment up to five years if any person willfully violates any other provision of the CEA.

Procedural fairness

CFTC Commissioners and staff are bound by the procedural fairness rules described under Principle 4.

Monitoring compliance

Most CFTC staff are required to complete annual financial declarations, with more comprehensive information mandated for senior staff. Approximately 170 staff members must also report financial transactions.

Compliance is monitored by the Office of General Counsel, which reviews disclosures. If non-compliance is detected, the OIG is asked if it wishes to investigate. If not, the matter is handled through management. Serious violations potentially involving criminal breaches are referred to the Office of Public Integrity within the DOJ, which makes a decision on whether to commence a criminal action.

SEC**Conflicts of interest**

SEC Commissioners and staff are bound by the government wide rules described above that prohibit them from participating personally in particular matters that would have a direct and predictable effect on their own or imputed financial interests.

These standards also regulate non-financial conflicts that could create the appearance that the individual would lack impartiality. Commissioners and staff cannot participate in a matter involving a person with whom they have a "covered relationship" or if the circumstances would cause a reasonable person with knowledge of the relevant facts to question their impartiality in the matter unless an SEC ethics official issues an authorization to participate.

The SEC has adopted Supplemental Standards of Ethical Conduct for its Commissioners and employees. Among other things, these standards include comprehensive rules in connection with securities holdings and transactions in securities. They also include more strict provisions in connection with post-employment restrictions. As per the general framework (supplemented by

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| | <p>SEC standards) positions at certain salary levels are subject to a one year cooling off period.</p> <p>Securities trading and financial interests</p> <p>The SEC’s Conduct Regulation includes comprehensive rules regarding the securities holdings and transactions of all staff, including Commissioners, as well as any employee’s spouse, minor children, or any person the employee serves as legal guardian. The SEC’s regulations require the reporting of securities transactions, with certain exceptions, within five days of the receipt of confirmation. The SEC’s Supplemental Standards of Ethical Conduct include prohibitions for Commissioners and staff on transactions involving an issuer directly regulated by the SEC or under investigation by it. These Standards also require SEC staff to clear in advance any securities transactions or holdings.</p> <p>Commissioners and some 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 confidential financial disclosure forms.</p> <p>Use of information</p> <p>The OGE Standards of Conduct prohibit the misuse of one’s official position, including the use of (or allowing others to use) confidential or nonpublic information. The SEC’s own regulation also prohibits the misuse of confidential and nonpublic information.</p> <p>Confidentiality and secrecy</p> <p>SEC Commissioners and staff are bound by confidentiality provisions imposed by the statutes they administer (see for example Section 24(b) of the Exchange Act).</p> <p>Procedural fairness</p> <p>SEC Commissioners and staff are bound by the procedural fairness rules described under Principle 4. Statutory provisions are supplemented by detailed procedural rules such as those governing administrative hearings and enforcement and rulemaking activities.</p> <p>Monitoring compliance</p> <p>The SEC’s OEC was established in 2011 as an independent office reporting directly to the SEC’s Chair. The OEC is responsible for administering the Commission’s ethics program and for interpreting the SEC’s supplemental ethics rules as well as federal government-wide ethics laws, rules, and regulations. The OEC does not have investigative or disciplinary powers. If it finds a potential breach, it refers it to management. If the conduct were criminal, it would be referred to OIG.</p> <p>OIG has investigative powers. It is responsible for notification to the DOJ and OGE for referrals of potential violations of the federal government-wide criminal conflict of interest statutes. If the OIG finds evidence of non-criminal misconduct under either government-wide or SEC regulations, it forwards a report of investigation to the appropriate management officials for consideration of disciplinary or remedial action.</p> <p>According to the SEC staff, one staff member has been criminally prosecuted for false disclosure.</p> <p>Sanctions</p> <p>Violations of the federal government-wide conflict of interest statutes may be enforced either civilly or criminally. Violations of the SEC’s administrative rules can result in disciplinary action. Willful disclosure of nonpublic information under the Exchange Act is also a criminal offense. Depending on the circumstances and the legal authority at issue, an SEC employee may be</p> |
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| | imprisoned, fined, demoted, or terminated for violating an ethics provision. |
| Assessment | Fully Implemented |
| Comments | |
| Principle 6. | The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate. |
| Descriptions | <p>SEC</p> <p><i>Process to identify risks</i></p> <p>The statutory mandate of the SEC does not explicitly refer to financial stability or systemic risk. Nevertheless, SEC staff commented that contributing to the identification of emerging and systemic risk is seen by the agency as an important function which is inextricably linked to its statutory objectives of protecting investors, maintaining fair markets and facilitating capital formation.</p> <p>Current supervisory programs developed to fulfill its core mandate are the main channels through which the agency identifies emerging and systemic risks in the U.S. securities markets. Those supervisory programs are developed by the divisions in charge of monitoring the corresponding entities/sector. Senior staff indicated that in setting up their priorities each division has interaction with other relevant parts of the organization including, as appropriate, with the Commission to ensure that such priorities take into consideration relevant information.</p> <p>The supervisory program for monitoring of issuers is described in detail in Principle 16; for mutual funds it appears mainly in Principle 24; for securities intermediaries mainly in Principles 30 and 31; and for market supervision and surveillance mainly in Principles 34 and 37.</p> <p>In recent years such programs have been strengthened to more effectively contribute to risk identification, in three different ways:</p> <p><i>Data availability</i></p> <p>As part of its ongoing supervision of issuers, mutual funds, and intermediaries, the SEC already receives periodic reports (as described in the respective principles) that allow it to identify issues of concern in specific firms as well as potential areas of concern across an industry. This information is received electronically, and in the case of domestic corporate issuers already in a mark-up language that facilitates its use. Mark-up language is also being implemented for certain data that securitization issuers and NRSROs will have to provide.</p> <p>Through legal and regulatory reforms implemented in recent years the information available to the SEC has been expanded. Key examples of data that the SEC already receives and uses as a result of these reforms are (i) MMFs' holdings; and (ii) private funds (including HFs).</p> <p><i>Addition of staff with different skill profiles and corresponding organizational changes</i></p> <p>In recent years the SEC has increased staff with different skill profiles (economists, quantitative analysts) and made organizational changes to strengthen its ability to identify risks, including for policy-making purposes. For example, organizational changes include:</p> <p>The creation of several offices in OCIE, such as the (i) Office of Risk Analysis and Surveillance (ORAS) to enhance OCIE's ability to perform more sophisticated data analytics, (ii) the Risk Analysis Examination (RAE) team to develop a more consistent, risk-based approach to the selection of firms for examination; and (iii) the Quantitative Analytics Unit (QAU) which provides support in the field to the SEC's examination teams by creating and deploying customized data</p> |

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| | <p>analytic tools.</p> <p>The creation of the Risk and Examinations Office (REO) in the Investment Management Division to coordinate with OCIE and contribute to the SEC's efforts to monitor risk in the asset management industry including through ongoing monitoring of a select number of the largest asset managers selected for monitoring based on certain risk characteristics.</p> <p>The creation of the Office of Risk Supervision in TM, which participates in a variety of ongoing monitoring reviews focused on clearing agency risk frameworks and processes.</p> <p><i>Development of sophisticated tools to allow for increased use of data</i></p> <p>In tandem, the SEC has developed more sophisticated tools that allow different divisions to have more robust processes of risk identification. For example:</p> <p>In connection with issuers' monitoring: ENF has developed a tool for corporate issuer risk assessment that creates a consistent methodology for quantifying earnings management and other abnormal behaviors through the use of regression models and statistical analysis.</p> <p>In connection with BDs and IAs: ORAS has constructed risk models that attempt to identify potential areas of risk at all of these intermediaries based on information contained in regulatory filings.</p> <p>In connection with private funds: DERA has developed HF performance models (Aberrational Performance Inquiry or API models).</p> <p>In connection with markets: the SEC launched a new analytical tool called MIDAS that enables the SEC to analyze, almost instantaneously, large amounts of trading data across markets. Currently MIDAS comprises only data of exchanges. Through another initiative (CAT described in Principle 36) the SEC would have available a consolidated audit trail.</p> <p>In addition, a risk analytics committee was created in 2013 to facilitate cross departmental discussions on risk analytics tools used by different divisions, to avoid duplication and ensure cross-fertilization. The committee is coordinated by DERA.</p> <p><i>Internal coordination</i></p> <p>SEC staff indicated that discussions between departments where issues of concern, including emerging risks, are discussed take place on a regular basis. Feedback from these discussions feeds into SEC's broader risk assessment process. In addition, the directors hold weekly meetings with the SEC Chair. These meetings can deal with a variety of issues, including discussions on emerging risk brought by the directors. The meetings do not have a predefined agenda. Staff from the Chair's office attends these meetings and helps to ensure follow up.</p> <p>The SEC Chair in turn has weekly (one on one) meetings with each Commissioner, discussing a variety of issues, including emerging risks and potential follow up actions, and receiving feedback from Commissioners. In addition, staff from the divisions meets with Commissioners, both on an ad-hoc and on a routine basis, to discuss topics of interest including emerging risks. More informally Commissioners may ask staff for further briefings and responses to their questions regarding risks. Based on all this input, the Chair directs staff to undertake specific actions to address identified risks; i.e. whether by rule-making, study or change in supervisory approach. For each identified risk, particular staff is selected, who remains accountable to formulate, if necessary, a recommendation for an agency response to address the risk consistent with the Chair's direction. In the case of rulemaking, counsels to each Commissioner are briefed on an ad-hoc and routine basis by the staff and the Chair's office on rulemaking. Finally OCIE coordinates an inter-disciplinary and cross divisional task force called the Market Event Response Team, a mechanism through which OCIE, Enforcement, Trading and Markets,</p> |
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other SEC divisions and offices, and self-regulatory organizations work collaboratively to respond real-time to rapidly evolving market events.

CFTC

Process to identify risks

The CEA includes CFTC objectives “to deter and prevent price manipulation or any other disruptions to market integrity; to ensure the financial integrity of all transactions ... and the avoidance of systemic risk; to protect all market participants from fraudulent or other abusive sales practices and misuses of customer assets; and to promote responsible innovation and fair competition among boards of trade, other markets and market participants.” Similar to the SEC, the supervisory processes developed by the CFTC to fulfill its core mandate are the main channels through which the agency identifies emerging and systemic risks in commodities markets. Those supervisory processes include (i) market surveillance (described mainly in Principles 34, 36 and 37); and (ii) monitoring of financial risk posed by regulated entities (described mainly in Principles 30 and 37).

CFTC staff indicated that such processes are well developed and rely on robust access to data based on reporting obligations (such as the large traders report submitted by the FCMs and information on margins submitted by the DCOs) and automated tools for market surveillance.

Each day, for all active futures and options contract markets, the CFTC's market surveillance staff monitors the activities of large traders, and examines all price spikes, scheduled news release periods of market-sensitive data, all daily settlements in the major commodities and all option and final settlements in all major futures and options contracts. Staff also tracks key price relationships, and relevant supply and demand factors in a review for potential market problems. With the addition of swaps, staff now monitors credit events for effects on credit default indices and evaluates if the CDS settlement, after a credit event, was potentially manipulated.

The CFTC risk surveillance staff monitors the financial risk posed to and by DCOs, clearing members, and market participants, including market risk, liquidity risk, credit risk, and concentration risk. Relevant margin and financial resources are included within this monitoring program. CFTC staff regularly conducts back-testing to review margin coverage at the product level and follows up with the relevant clearing house regarding exceptional results. Independent stress testing of portfolios is conducted regularly. The independent stress tests may lead to individual trader reviews and/or FCM risk reviews. Traders and FCMs that have a higher risk profile are then reviewed during the CFTC's on-site review of a clearing house's risk management procedures. In addition, examinations of DCOs involve an analysis of a broad range of topics including, but not limited to, the adequacy of a DCO's financial, operational and managerial resources; the DCO's ability to manage all risks associated with clearing and settlement, including whether the DCO uses appropriate tools and procedures to monitor such risks; whether the DCO's risk analysis and oversight program is able to accurately identify and minimize sources of operational risk; and a DCO's ability to resist, and to minimize, any potential damage from cyber security threats.

CFTC staff indicated that the current focus lies in expanding these processes to monitor swaps markets. This requires enhancing the expertise of the agency, the technology available to it, and a significant effort to improve the quality of swaps data. On the latter, CFTC staff indicated that since the passage of the Dodd-Frank Act it has actively engaged its new authority, and has registered four SDRs, implemented regulations requiring real time public reporting of swaps transaction data by the SDRs on their websites and began publishing a weekly swaps report on the CFTC website. CFTC staff continues to evaluate and engage in dialogue regarding the

policies and procedures employed by registered SDRs to ensure accuracy of swap data received. In addition, the Division of Market Oversight recently created a new Data and Reporting Branch. The CFTC is also pursuing data quality metrics. Additionally in January 2014 the CFTC constituted an interdivisional staff working group to complement ongoing efforts to improve swap transaction data quality and the CFTC ability to use the data for analysis and regulatory purposes. Finally the CFTC signed an MOU with the OFR in 2014 which establishes a framework for assessing the quality of the data. This framework will form the basis of the subsequent development of a project plan for understanding swaps and OTC derivatives transactions and their impact on financial stability

Internal coordination

CFTC staff indicated that a significant amount of coordination among the different divisions takes place on a regular basis, under informal mechanisms. In addition, there are meetings of staff with the Chair on a weekly basis where concerns on potential risks can be raised. There are also informal meetings between staff and individual Commissioners on issues of their interest. Through meetings with market participants, the staff and individual Commissioners also maintain direct contact with the market which allows them to have a better understanding of risks.

Finally closed door surveillance meetings are held at Commission level every Friday, which are permitted under an exception in the Sunshine Act. The meetings have three parts: surveillance, examination and enforcement. An agenda is set up seven days in advance of a meeting. Briefs are prepared and presented by staff as necessary. In general, the surveillance part of the meeting is used by staff to discuss with the Commission emerging issues, take decisions on how to tackle them, as well as decide on the need for any follow up. Meetings are recorded: the record includes a list of participants, a brief outline of the topics discussed and a statement that the General Counsel certified that the meeting was properly closed.

In addition, staff indicated that the CFTC has formed a Market Risk Advisory Committee (MRAC) with a mandate to conduct public meetings and submit reports and recommendations to the CFTC regarding systemic risk issues that could potentially threaten the stability of the derivatives and other financial markets. The membership of MRAC will consist of 20-25 members from a variety of different type of industry members and its charter will indicate that the MRAC "will make recommendations to the Commission's mission of ensuring integrity of the derivatives markets and monitoring and managing system risk".

Coordination among the agencies

SEC and CFTC staff meet on a frequent basis, in regard to specific firms or issues of common interest. The Chairs also meet on a regular basis to discuss issues of common interest.

Participation of SEC and CFTC in the FSOC

The FSOC is a key channel by which the SEC and CFTC contribute to a process of emerging and systemic risk identification across the financial sector. As per the Dodd-Frank Act, the FSOC is in charge of the identification of risks to the financial stability of the U.S. that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace; and responding to threats to financial stability.

Pursuant to the Dodd-Frank Act, the FSOC consists of ten voting members and five non-voting members. The Chairs of the SEC and CFTC are voting members of the FSOC. Under the current framework there is no requirement that the Commission vote ahead of the Chair expressing opinions in the FSOC. This enables more expeditious contribution and voting. However, at the

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| | <p>same time it means that the positions the heads take in the FSOC meetings do not have to reflect the views of the Commission as a whole.</p> <p>The FSOC works under a committee structure. The FSOC’s systemic risk committee is the key structure for FSOC’s analysis of emerging threats to financial stability. The systemic risk committee includes senior staff of all the relevant agencies comprising the FSOC and reports to a Deputies Committee. The Deputies Committee coordinates and oversees the work of the interagency staff committees. The members of the Deputies Committee include a senior official from each member agency. The Deputies Committee convenes approximately every two weeks to discuss the Council’s agenda and to direct the work of the Systemic Risk Committee and the five other functional committees.</p> <p>The systemic risk committee plays a key role in prioritizing the review of sources of systemic risk and guiding the work of staff and the systemic risk subcommittees. If there is agreement at the systemic risk committee that an issue warrants further examination, the issue is usually assigned for its further development to the agency with the most expertise in the area, whereby such agency would further explore risks and vulnerabilities and potential responses/actions to address vulnerabilities identified and present them to the committee. When the committee determines that the issue is sufficiently developed, it presents the issue to the Deputies Committee. Examples of issues discussed by FSOC under the jurisdictions of the SEC or the CFTC include MMFs and asset managers. In both cases the SEC has taken a lead role in the analysis of risks as well as in developing a regulatory response, as appropriate. The FSOC has also used its designation powers and designated eight financial market utilities and three non-bank financial companies as systemically important.</p> <p>Staff of both the SEC and CFTC concurred that the creation of the FSOC has strengthened coordination between all the agencies and provided a structured forum for discussions on risks. They agreed that FSOC structure and tools are still evolving. Pursuant to the Dodd-Frank Act the GAO has made a number of recommendations to the FSOC, including on the development of a more robust framework for identification of emerging and systemic risks. Senior officials from the agencies highlighted also the importance that the FSOC develops robust frameworks for designation of non-bank SIFIs. Market participants highlighted that there would be benefits in increased transparency vis-à-vis the industry.</p> <p>International cooperation and coordination</p> <p>In addition, SEC and CFTC staff also participate in supervisory arrangements for certain complex global financial institutions. These arrangements create a framework for ongoing dialogue and cooperation among multiple financial authorities with a view to enhancing the risk assessment of internationally active entities and to supporting effective supervision of such entities. For example, the SEC participates in colleges for CRAs and the CFTC in arrangements of CCPs. The SEC and CFTC also cooperate with counterparts on supervisory matters on an ad hoc basis and engage in bilateral and multilateral consultations with counterpart regulators to discuss issues of general regulatory concern that exist at a higher, more market-wide level.</p> |
| Assessment | Broadly Implemented |
| Comments | <p>The main reason for the grade relates to the robustness of current processes to identify emerging and systemic risks in connection with Key Question 1 of the Assessment Methodology.</p> <p>The first assessments of Principle 6 conducted by the IMF after the introduction of the new Assessment Methodology focused on three high level issues in assessing the existence of a process to identify systemic risk, which is required pursuant to Key Question 1: (i) whether the arrangements in place allow for a holistic (across products, entities, and markets) view of risk;</p> |

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| | <p>(ii) whether they allow for a periodic reassessment of risk; and (iii) whether they allow for proper follow-up actions. The experience gained has enabled an enhancement of the assessment criteria for Key Question 1, to include the following two additional criteria: (iv) a review of the type of data and analysis that the authorities use as part of the process to identify such risks; and (v) the degree to which the process implemented allows for proper accountability. This is in line with the recommendations included in the recent report of the Assessment Committee of IOSCO. These enhanced assessment criteria have been applied since the assessments conducted from summer 2013 onwards.</p> <p>The assessors note the increased attention that both the SEC and CFTC are giving to proper risk identification and its impact on the identification of systemic risk.</p> <p>As described above, the SEC has been working on improving data availability, tools to leverage such data and, ensuring that the agency has staff with the right set of skills. While these improvements are still work in progress, they have already led to significant enhancements in the risk identification processes of the different divisions through which the SEC discharges its functions. However, in the assessors' opinion there is room to enhance mechanisms that allow the agency to ensure a holistic view of risks (across markets/products/entities), such as via more formal/structured and regular discussions/meetings on emerging and systemic risks. The assessors acknowledge that there are avenues that are currently being used for risk discussions. However, they seem to require enhancements to ensure that discussions on emerging and systemic risks are conducted in a systematic way, under a framework that formalizes accountability. Further, a stronger involvement of the Commission as a whole appears necessary. The SEC cited the Sunshine Act as inhibiting the ability of the Commission (as a whole) to hold periodic meetings on risk. Instead the Chair does hold regular meetings with individual Commissioners. However, this limitation has the potential of detracting from the quality of discussions, and may also have an impact on the accountability of the Commission as a whole.</p> <p>In addition, efforts to enhance data availability should continue, in particular in connection with the asset management industry. As the SEC Chair has stated, "while funds and advisers currently report significant information about their portfolios and operations to the Commission, these reporting obligations have not adequately kept pace with emerging products and strategies being used in the asset management industry". For example, SEC rules do not require standardized reporting for many types of derivatives used by funds today. Similarly, the SEC does not currently receive complete information about securities lending by funds. Collecting more data on separately managed accounts is also needed. In this regard, the assessors note that the SEC staff is currently developing recommendations for the Commission to modernize and enhance data reporting for both funds and advisers.</p> <p>In the case of the CFTC, the assessors agree that the processes for risk identification in the futures markets are at a mature stage, and on an ongoing basis the CFTC has made necessary enhancements, such as in the case of the large traders report. The challenges it now faces relate to ensuring that it can develop similarly robust mechanisms to monitor the swaps markets. Work on the latter is at an early stage. The assessors acknowledge that this is a global challenge, given that in most markets swaps have just recently become regulated. They also acknowledge initiatives in place that seek to improve the quality of data reporting for swaps.</p> <p>Finally, the assessors take note of the fact that the agency has developed mechanisms for the Commission as a whole to hold periodic discussions on emerging and systemic risks via its closed door surveillance meetings. Given the more focused mandate of the CFTC and the size of the organization, current mechanisms can be an effective channel for the agency to have broad discussions on risk.</p> |
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| | <p>Finally, the creation of the FSOC and the participation of the chairs of the SEC and CFTC in the FSOC have contributed to enhancing the agencies’ role in systemic risk identification. However, the positions the heads take in the FSOC meetings do not have to reflect the views of the Commission as a whole (i.e., there is no requirement that the Commission vote ahead of the Chair expressing opinions in the FSOC).</p> <p>The operation of the FSOC itself is outside of the scope of this assessment (as the requirement of the methodology is to assess the agencies’ own process to identify risk and/or contribute to a process to identify systemic risk of other agencies).</p> |
| <p>Principle 7.</p> | <p>The Regulator should have or contribute to a process to review the perimeter of regulation regularly.</p> |
| <p>Description</p> | <p>Different processes lead to reviews of the perimeter of regulation by both agencies. Such reviews in turn can prompt changes in (i) regulations which the agencies themselves can undertake as they both have rulemaking authority; (ii) proposals for legislative changes; or (iii) the adoption of other types of measures to address risks identified in products, entities or markets –whether regulated or unregulated.</p> <p>Supervisory processes of both agencies</p> <p>The supervisory processes established by both agencies to fulfill their mandates (as described in Principle 6) are key channels that allow the agencies to identify risks posed by products, entities and markets—whether regulated or unregulated.</p> <p>In turn, the identification of areas of risks is a key factor that shapes the examination programs of both agencies. For example,</p> <p>The SEC has instituted a “presence examination program”, for new categories of registrants brought under its jurisdiction by the Dodd-Frank Act, such as IAs of private and HFs, whereby staff holds meetings with senior staff of the firms to better understand the business model and risk associated to these new categories of registrants.</p> <p>The CFTC has increased its presence in the FCM community and pays particular attention to liquidity risks via horizontal examinations.</p> <p>The identification of risks also impacts regulatory proposals and may lead to changes in regulations or the issuance of guidance. In both agencies their economic analysis units (DERA and OCE) play an important role in rule-making by conducting research as well as cost/benefit analysis in connection with rule proposals. For example, the findings from the examination program of BDs have led the SEC to issue guidance in connection with liquidity management. Further, its program for large BDs has resulted in proposals to review the capital and liquidity framework for ANC firms.</p> <p>The agencies have also made requests to Congress for reviews of their legal authority as a result of risks identified through their supervisory programs.</p> <p>For example, in the 2000s the CFTC requested Congress expand the CFTC’s authority over retail foreign exchange products. This issue was largely addressed in the reauthorization of the CFTC in 2008, and its authority further expanded in the Dodd-Frank Act.</p> <p>During the summer of 2009, the Director of IM testified on behalf of the SEC that the incomplete information that the SEC had regarding advisers to private funds was a “significant regulatory gap in need of closing.” Also that summer, the SEC Chair sent Congress a list of other suggested ideas identified by the SEC staff as possible provisions for securities law improvements to help the SEC better protect investors, and many of these proposals became</p> |

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| | <p>part of the Dodd-Frank Act.</p> <p>Other types of measures adopted by both agencies to address risks identified through their supervisory processes include investor education and the use of alerts, such as alerts on fraud and risks stemming from unregulated products. In fiscal year 2013, the SEC OIEA published 26 investor alerts and bulletins. OIEA's alerts and bulletins have covered a range of topics including Bitcoin and Other Virtual Currency-Related Investments and Advertising for Unregistered Securities Offerings. Staff also works with other regulators to issue joint alerts and bulletins. Recent examples include: an SEC-CFTC investor alert on binary options, an SEC-FINRA alert on pump-and-dump stock schemes, and an SEC-FINRA bulletin on pension and settlement income streams.</p> <p>FSOC</p> <p>Reviews of the perimeter of regulation can also be prompted by discussions at FSOC level. For example, internal concerns, as well as discussions at FSOC led the SEC to make significant reforms to the MMF regulatory framework, including the removal of an exemptive relief for a subset of such funds that will after a transitional period be required to value their portfolios at fair value. The SEC is currently conducting a review of specific aspects of the asset management industry also as a result of internal concerns as well as discussions at FSOC in connection with asset managers and systemic risk.</p> <p>Review of past events</p> <p>Both agencies have made changes to the perimeter of regulation as a result of lessons from market events, and have sought legislative changes as necessary. For example,</p> <p>The SEC implemented a series of reforms to its regulatory framework to strengthen the reliability of the equity markets, following the 2010 flash crash. Such measures (along with others that are currently at a proposal stage) were part of the recommendations of the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues established on May 11, 2010 to analyze the flash crash.</p> <p>The CFTC significantly strengthened the financial responsibility rules for FCMs as a result of the failures of Peregrine and MF Global in 2011 and 2012.</p> <p>Specific reviews required by law or decree</p> <p>The Dodd-Frank Act required the GAO to conduct a review of the municipal securities markets. This review coincided with a series of recommendations by the SEC to enhance disclosure and transparency in the municipal markets, as further described in Principle 16. Those disclosure recommendations include legislative changes (to provide the SEC with additional authority to impose requirements in connection with the disclosure that municipal issuers must make to investors) as well as actions within the authority of the SEC (including issuing updated interpretative guidance regarding disclosure obligations of municipal securities issuers or amending Exchange Act Rule 15c2-12 to further improve disclosure);</p> <p>The JOBS Act mandated the SEC staff to undertake a review of Regulation S-K to determine how SEC requirements could be updated and modernized to simplify the securities registration process. The SEC staff completed this mandated review and is currently developing specific recommendations for updating disclosure requirements.</p> <p>Executive Order 13563, Improving Regulation and Regulatory Review (issued January 18, 2011), included calls on agencies to undertake an annual retrospective review of agency regulations. This Order does not apply to independent agencies; however the CFTC has voluntarily abided by it. In determining the extent to which these existing regulations needed to be modified to</p> |
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conform to the Dodd-Frank Act's new requirements, the CFTC has subjected many of its rules to scrutiny in accordance with the Executive Order. The CFTC staff intends to begin the process of the periodic, retrospective examination of the remainder of its regulations after completion of rules required by Dodd Frank. A Regulatory Review Group consisting of senior agency staff will be formed to implement this review.

Advisory committees

Both agencies have also made use of advisory committees to identify areas of risk where a regulatory response might be needed.

The SEC's Investor Advisory Committee (IAC) was established by the Dodd-Frank Act as a permanent committee to advise the SEC on regulatory priorities, regulation of securities products, trading strategies, fee structures, effectiveness of disclosure, and initiatives that protect investor interests and promote investor confidence and the integrity of the securities marketplace. The Dodd-Frank Act authorizes the committee to submit findings and recommendations for review and consideration by the SEC. In fiscal year 2013, the IAC submitted its initial recommendations for review and consideration by the SEC. Among the emerging issues the IAC addressed were recommendations for the SEC to review universal proxy ballots, data tagging, target date mutual funds, and implementation of the JOBS Act rulemaking mandate to remove the ban on general solicitation in private offerings. The SEC also utilizes an Advisory Committee on Small and Emerging Companies; and more recently, it formed a new Equity Market Structure Advisory Committee.

The CFTC's Advisory Committees provide input and make recommendations on a variety of regulatory and market issues that affect the integrity and competitiveness of U.S. markets. The committees, governed by the provisions of the FACA, currently include: Agricultural Advisory Committee, Global Markets Advisory Committee, Energy and Environmental Markets Advisory Committee, and Technology Advisory Committee. These committees provide recommendations as well as guidance to regulated entities in the specific issues under their jurisdictions, thus contributing to ensuring that the regulatory perimeter and framework remains up-to-date (see for example the recommendations of the Technology Committee on pre-trade practices issued in 2011).

Internal reviews as part of the Strategic Plans

Both agencies develop strategic plans, which identify the strategic priorities for the agencies as well as specific regulatory and supervisory actions to meet such priorities. Such identification is supported by formal structured discussions within the organizations. The approved Strategic Plan forms the basis for each fiscal year's operating plan and associated activities. At the end of each fiscal year or the conclusion of individual activities, staff evaluates performance and resource utilization against performance measures that have been identified in the Strategic Plan and in the SEC and CFTC's budget submissions to Congress.

For example the SEC Strategic Plan for 2014-2018 identifies the review of the structure of the equity markets as an area for review. As part of the implementation of this priority the current Chair has announced the creation of a committee, with both internal and external membership, that will assess the current market structure and come up with recommendations.

In the case of the CFTC, the Strategic Plan 2011-2015 identified the review and update of the content requirements of the large traders report as a key priority for the agency as it would enable it to better monitor the markets. These improvements were implemented this year.

International

SEC and CFTC staff also participates in a number of international and multilateral processes to

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| | <p>review various types of risks associated with market products and participants. For example, SEC DERA staff participates in IOSCO’s Committee on Emerging Risks (CER). A key objective of the CER is to develop and maintain a detailed research methodology for the identification, monitoring and mitigation of systemic risk that can be used by securities regulators around the globe. DERA staff is also engaged in the Financial Innovation Network of the Financial Stability Board’s Analytical Group on Vulnerabilities, which examines new financial products and services with a view towards spotting emerging risks and regulatory gaps.</p> |
| Assessment | Fully Implemented |
| Comments | <p>Several different processes contribute to the review of perimeter of regulation by the SEC and CFTC both on a sectoral/issue specific basis as well as on a more holistic basis. Examples of the former are reviews as a result of the supervisory programs for each type of entities, specific events, recommendations from advisory committees, or reviews required by Congress on specific provisions of a law. An example of the latter is the strategic planning process, which requires the agencies to set priorities and to define areas where changes to regulations (or supervisory practices) are needed. In the case of the CFTC, voluntary adherence to the Executive Order on Improving Regulation is another example of a broader process, as it requires the agency to conduct retrospective reviews of its rules on an annual basis to ensure that they remain relevant.</p> <p>The assessors note however that the robustness of the reviews of the perimeter of regulation is dependent of the agencies’ processes for risk identification. In this regard, the assessors refer to the comments made on Principle 6.</p> |
| Principle 8. | The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed. |
| Description | <p>Regulation of conflict of interest</p> <p>The SEC and CFTC administer a regulatory framework that is designed to address conflicts of interest and misalignment of incentives through requirements that prohibit conflicts, mandate disclosure, or require appropriate steps to manage or mitigate conflicts of interest and misalignment of incentives.</p> <p><i>Issuers</i></p> <p>The framework for issuers mainly relies on disclosure of conflicts of interest in the prospectus and subsequent filings (as further explained in Principle 16). This obligation is complemented by fiduciary duties owed by company directors to the company and its shareholders (see Principle 17).</p> <p>In particular, the SEC recently adopted rules that will increase the transparency of ABS (Regulation AB II). Among others, these rules will require disclosure of asset-level data (ALD) that will need to be provided for several types of securitizations at the time of the offering and on an ongoing basis; enhanced disclosure about transaction parties and loss mitigation practices; and for shelf offerings of ABS, certification by the CEO of the depositor about the disclosure contained in the prospectus and the structure of the securitization. Compliance with the new rules is required by November 23, 2015 except for compliance with new ALD requirements which is, required by November 23, 2016.</p> <p>In addition, the final rule recently jointly adopted by six federal agencies, including the SEC, implemented risk retention requirements included in the Dodd-Frank Act. The rule requires sponsors of ABS to retain no less than five percent of the credit risk of the assets collateralizing the ABS issuance. The rule prohibits hedging or transferring of the credit risk that the sponsor is required to retain. As required by the Dodd-Frank Act the final rule defines qualified residential</p> |

mortgages (QRM) and exempt securitizations of QRMs from the retention requirements. In defining QRM, the agencies refer to the definition of qualified mortgage developed by the Consumer Financial Protection Bureau the key features of which exclude interest-only loans, negative amortization loans, loans beyond 30 years, balloon loans, and loans with excessive up front points and fees, and require limits on debt to income ratio (not higher than 43 percent). The final rule requires the agencies to review the QRM definition not later than 4 years after the effective date of the rule (and every five years after that date). The rule also exempts from the retention requirements commercial loans, commercial mortgages or automobile loans if they meet specific standards of high quality underwriting. The rule is effective one year after publication in the Federal Register for RMBS and 2 years after publication for all other securitizations.

Finally the Dodd-Frank Act requires the SEC to implement rules to address potential conflicts of interest in the SBS markets. Two sets of rules are currently under consultation, one would limit certain concentrations in the ownership of, and exercise of voting rights with respect to SBS clearing agencies, security-based SEFs and national securities exchanges that post or make available for trading SBS. The other would require SBSDs and MSBSPs to disclose to the relevant counterparty material information about the SBS, including material incentives and conflicts of interest.

Securities Intermediaries

Intermediaries registered with the SEC and CFTC are also subject to conflict of interest provisions. Depending on the type of registrant the specific regime applicable to conflicts relies on disclosures, prohibitions and/or information barriers. These frameworks are described in more detail in other Principles: CIS operators (Principle 24); and other securities intermediaries (Principle 31).

In general, the U.S. regime relies heavily on disclosure to the party affected by the conflict via a document made available to that party as a key mechanism to deal with conflict of interest. This reliance on disclosure (as opposed to management or prohibition) is much more predominant in the commodities side.

Other entities

Frameworks for addressing conflicts of interest exist also for SROs (Principle 9), auditors (Principle 20) and NRSRO (Principle 22).

Monitoring of conflicts of interest

The SEC monitors issuers' compliance of disclosure obligations through the CF program of file review described in Principle 16.

Review of registrants' compliance with their obligations in relation to conflicts of interest is a key component of the examination program instituted by both the SEC and CFTC as well as by FINRA and the NFA. These programs are described in more detail in other Principles: SROs (Principle 9), NRSRO (Principle 22); CIS operators (Principle 24); and securities intermediaries (Principle 31). Monitoring compliance by auditors with their independence obligations is a key component of the inspection program developed by the PCAOB.

When breaches are found, both agencies (and the SROs) require remediation actions and, when appropriate, take enforcement actions. For example, in a recent action the SEC instituted proceedings against an IA, its chief executive officer, chief compliance officer (CCO), and another employee for allegedly misleading investors and breaching their fiduciary duties to clients. More specifically, Enforcement alleged, among other things, that the firm and its CEO entered into revenue sharing arrangements in which they paid themselves kickbacks and failed

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| | to disclose the conflicts of interest created by these agreements as they recommended investments to clients. The CCO and an IA representative are also alleged to have breached their fiduciary duties and defrauded clients by failing to disclose conflicts of interest and concealing the kickbacks they received from the investments that they recommended. |
| Assessment | Fully Implemented |
| Comments | <p>Overall, discussions with market participants led to conclude that conflicts of interest have been an important component of the examination programs of the agencies and SROs. However, there are a few important areas where participants expressed concerns about the existence of conflicts of interest that require further action by the SEC. Those include: (i) the participation of affiliates of brokers that operate ATS in their platforms; (ii) the impact of order types, order routing and related fee structures in equity markets; and (iii) the degree of flexibility in the choice of registration either as a BD or IA, and in that context, the different standard of care that legally applies to each type of intermediary, different compensation arrangements for the sale of products, and how they impact customer protection, including in connection with the types of accounts, products and/or transactions that are recommended to customers.</p> <p>The recently announced recommendation to establish an advisory committee to analyze the current equity market structure is an important step. Short term changes are intended to be considered, together with a more holistic review of the market. In addition, the SEC has put out a request for data to allow the agency to gain deeper understanding on the different regimes applicable to BDs and IAs.</p> |
| Principles for Self-Regulation | |
| Principle 9. | Where the regulatory system makes use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, such SROs should be subject to the oversight of the Regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities. |
| Description | <p>The U.S. system makes extensive use of SROs in both securities and derivatives markets. The overall regulatory effectiveness depends on effective supervision by SROs, and on effective supervision by the CFTC and the SEC of SROs within their jurisdiction. SROs have two broad areas of responsibility: supervision of markets and supervision of market intermediaries. SRO functions are recognized by the CEA and CFTC regulations, and by the Exchange Act and related SEC rules.</p> <p>CEA SROs</p> <p>Several categories of organizations authorized by the CEA have self-regulatory responsibilities: futures exchanges (DCMs), SEFs, DCOs, and RFAs. CFTC Regulations define the term SRO as a contract market, SEF or RFA. DCOs are not formally recognized as SROs in the CFTC Regulations but they do have some self-regulatory obligations.</p> <p>There are currently 16 registered DCMs of which 15 are active; 24 SEFs temporarily registered or with pending temporary registration; 14 DCOs; and one RFA (NFA).</p> <p>Since many FCMs are members of more than one DCM, the CFTC has allowed the SROs to agree among themselves which of the SROs will be the designated self-regulatory organization (DSRO) for the purpose of maintaining ongoing financial and sales practice surveillance over member FCMs. The SROs have entered into agreements among themselves and have established the Joint Advisory Committee (JAC) to coordinate their oversight activities. All current DCM SROs and the NFA participate in these arrangements. In practice, there are two DSROs: CME is the DSRO for all FCMs that are clearing firms; and NFA is the DSRO for a</p> |

number of non-clearing FCMs, for swap dealers, independent IBs, CTAs and CPOs.

In addition, some smaller DCMs have contracted with NFA to conduct market surveillance and trade practice surveillance on their behalf, and most SEFs have contracted with NFA to conduct market surveillance on their behalf.

SROs that participate in these arrangements remain responsible for their SRO obligations under the CEA.

NFA

The NFA is the only RFA. All firms and individuals that wish to act as futures market intermediaries must apply for NFA membership or associate status.

NFA has incorporated into its rules, by reference, the CFTC's segregation, recordkeeping, and related reporting requirements for SDs, MSPs, FCMs, IBs, CPOs, and CTAs.

The CFTC has delegated to NFA registration processing functions and the authority to take adverse action, such as to revoke or to deny registration, against registrants and applicants for registration based upon disqualifying conduct set out in Sections 8a(2) and (3) of the CEA. The CFTC retains authority to take actions of this kind.

The CFTC has also delegated other functions to NFA, including the responsibility to review CPO and CTA disclosure documents.

The CFTC has general oversight responsibility for all NFA functions and has full access to the information NFA obtains in the course of its regulatory activities. The CFTC also monitors NFA for enforcement of NFA's own rules and by-laws.

Market operators and clearing organizations

The CEA contains sets of "core principles" for DCMs (23 Core Principles), SEFs (15) and DCOs (18). These core principles recognize the SRO functions performed, and set out requirements to be met in carrying out these functions. CFTC Regulations elaborate on these requirements.

Admission of participants

Core Principle 2 requires a DCM to establish, monitor and enforce compliance with access requirement rules. CFTC regulations require access criteria that are impartial, transparent and applied in a non-discriminatory way. Rules to the same effect apply to SEFs (SEF Core Principle 2 and related CFTC Regulations). DCO Core Principle C requires a DCO to have objective, publicly disclosed, fair and open access requirements.

Section 17(b)(2) of the CEA requires an RFA's rules to provide that any person or entity registered under the CEA, a registered entity, or any other person designated under CFTC Regulations as eligible for membership may become a member of the RFA.

Rules of conduct

DCM Core Principle 12 requires DCMs to establish and enforce rules to:

Protect market participants from abusive practices committed by any party, including abusive practices committed by a party acting as an agent for a participant; and

Promote fair and equitable trading on the contract market.

Section 17(p) of the CEA requires an RFA to establish rules that require the RFA, among other things, to establish training standards and proficiency testing for persons involved in futures industry, and to establish minimum standards governing sales practices of its members and Associated Persons (APs).

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| | <p><i>Disciplinary rules and proceedings</i></p> <p>The CEA and CFTC Regulations require SROs to monitor and enforce compliance with rules and standards. In addition, NFA and DCMs must monitor and enforce compliance with CFTC Regulations establishing standards for intermediaries, such as CFTC minimum financial and reporting requirements, requirements for the protection of customer funds and communications with customers.</p> <p><i>Division of responsibilities between the CFTC and SROs</i></p> <p>Although much of the day-to-day supervision of markets and industry participants is carried out by the SROs, the CFTC retains authority to inquire into any matters covered by SRO supervision.</p> <p>Where an SRO does not have the ability to obtain necessary information (for example, where the investigation requires subpoenaing third party records) or impose sanctions (for example, in the case of a recidivist), CFTC enforcement staff can support the SRO responsibilities.</p> <p>Authorization</p> <p><i>Capacity</i></p> <p>To become registered, each DCM, SEF and DCO applicant must show compliance with the Core Principles and maintain compliance with them to retain registration. An applicant for RFA status must show that it complies with the requirements for an RFA to be registered under Section 17 of the CEA.</p> <p><i>Rules</i></p> <p>Section 5c(c) of the CEA requires DCMs, SEFs, and DCOs to file with the CFTC new products, new rules, and rule amendments. These entities can choose either to self-certify that the rule complies with the CEA or request the CFTC's approval of the rule. A rule subject to self-certification can be implemented 10 days after it has been filed. In practice, almost all rules and rule amendments come through the self-certification process. The CFTC can make a decision to stay the certification of a rule for up to 90 days if the rule raises novel or complex issues, inadequate explanation was provided, or the rule is potentially inconsistent with the CEA. For rules where the CFTC's approval is sought, the CFTC has 45 days to consider the rule (this may be extended if the rule raises novel or complex issues).</p> <p>Special provisions apply to new products (see Principle 33). Section 8a(7) of the CEA authorizes the CFTC to alter or supplement the rules of a registered entity (such as a DCM, SEF or DCO) under certain circumstances and provided it follows specified procedural steps.</p> <p>Section 17 of the CEA requires an applicant for RFA status to provide the CFTC with copies of its constitution, charter or articles of incorporation or association, and all bylaws. An RFA must file with the CFTC copies of any changes or additions to its rules. The RFA may make any proposed change or addition effective 10 days after the receipt of a filing by the CFTC, unless it requests that the CFTC review and approve the submission or the CFTC informs the RFA of its intention to do so.</p> <p>The CFTC has power to abrogate, alter or supplement the rules of an RFA if it appears necessary or appropriate to assure fair dealing by the members of the association, to assure a fair representation of its members in the administration of its affairs, or to effectuate the purposes of the CEA.</p> <p>To deny certification of a rule made by an SRO, the CFTC must make a determination that the rule would be inconsistent with the CEA or regulations made under it.</p> <p><i>Co-operation with the CFTC</i></p> |
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The CEA and CFTC Regulations directly oblige SROs to cooperate with the CFTC and with other SROs to investigate and enforce applicable laws and regulations. In view of the statutory obligations, MOUs between the CFTC and SROs are not used.

Governance

Acceptable Practices under DCM rules state that a board be composed of least 35 percent public (independent) directors, and executive committees must also have 35 percent public membership. In addition, the Acceptable Practices state that DCM boards must have a Regulatory Oversight Committee, consisting of only public directors, which monitors and oversees the DCM's regulatory program and a DCM's disciplinary panel be composed to minimize conflicts of interest.

Section 17 of the CEA requires that an RFA's rules assure a fair representation of its members in the adoption of any rule of the association, the selection of its officers and directors, and in all other phases of the administration of its affairs. An RFA must provide for meaningful representation on the governing board of a diversity of membership interests and that no less than 20 percent of the regular voting members of the board are comprised of qualified non-members who are not regulated by the RFA. An RFA must provide on all major disciplinary committees for a diversity of membership sufficient to ensure fairness and to prevent special treatment or preference for any person in the conduct of disciplinary proceedings and the assessment of penalties.

Avoiding anti-competitive situations and misuse of oversight role

Section 15 of the CEA requires the CFTC to take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives of the CEA in issuing any order or in approving any rule of a DCM or an RFA. CFTC Regulation 170.9 requires that an applicant to become an RFA must demonstrate that it will promote fair and open competition among its members and will conduct its affairs consistent with the public interest to be protected by the antitrust laws. DCM Core Principle 19 provides that, unless necessary or appropriate to achieve the purposes of the CEA, the DCM must not adopt any rule or take any action that results in any unreasonable restraint of trade, or impose any material anticompetitive burden on trading on the contract market. SEFs (Core Principle 11) and DCOs (Core Principle N) must not adopt any rule or take any action that results in any unreasonable restraint of trade, or impose any material anticompetitive burden.

Supervision

All current SROs (DCMs and NFA) participate in a joint audit program under the auspices of the JAC, which must meet the requirements of CFTC Regulation 1.52. This audit program focuses on the SROs' supervision of FCMs' financial and reporting requirements. Recent amendments require that the program be separately evaluated by an "examination expert" at least once every three years, and that a report containing the content and any related responses to the findings of the examination be provided to the CFTC. The first evaluation has not yet taken place.

The CFTC requires that DSROs to ensure that each FCM is subject to an on-site examination within nine to 18 months of the date of the previous examination by the DSRO.

DCMs

The CFTC's rule enforcement program for DCMs covers review of market surveillance, audit trail, trade practice surveillance, disciplinary and dispute resolution programs. DMO's Compliance Branch conducts rule enforcement reviews (RERs) of each DCM's ongoing compliance with the Core Principles through their self-regulatory programs. For the largest DCMs, the CFTC aims to conduct an RER each year focusing on at least one of the above topics, and generally cover market surveillance and trade practice surveillance at least every two years.

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| | <p>For smaller DCMs, RERs are carried out less frequently (in practice every 3 to 4 years) and often look at a number of these topics.</p> <p>Typically, the DMO's Compliance Branch selects a 12 month target period and examines a DCM's audit trail reviews, trade practice and market surveillance investigations, investigation logs, hedge exemptions, surveillance systems, compliance manuals, summary fine schedules, disciplinary files, settlement agreements, and arbitration files. CFTC staff also conduct on-the-record interviews with a DCM's compliance officials. The Compliance Branch's findings, any deficiencies identified, or recommendations for improvement are included in a report presented to the Commission, which votes on whether to accept the report. The report is published on the CFTC's website.</p> <p>Other periodic RERs usually examine a DCM's market surveillance program for compliance with DCM Core Principle 4 (Prevention of Market Disruption), and DCM Core Principle 5 (Position Limitations or Accountability). The Compliance Branch also from time to time conducts horizontal RERs of the compliance of multiple exchanges in regard to particular Core Principles.</p> <p>DMO also carries out systems safeguards examinations of DCMs, reviewing one or more of seven topics, including enterprise risk management and governance, systems operations, business continuity planning and disaster recovery. For the critical exchanges such as CME and ICE, these are carried out every 12 to 18 months; for others, these reviews take place every 3 to 4 years.</p> <p>The CFTC also has a market surveillance program designed to prevent market manipulation in futures and options markets and monitor compliance with the CFTC rules and regulations (see Principle 34).</p> <p><i>SEFs</i></p> <p>It is anticipated that the DMO's Compliance Branch will conduct RERs for a SEF after it obtains permanent registration.</p> <p><i>NFA</i></p> <p>In addition to the FCMs for which it is responsible under the joint audit program, NFA is responsible for regulatory compliance matters with respect to its member IBs, except for IBs guaranteed by an FCM that does not have NFA as its DSRO. NFA is also responsible for sales practice surveillance over all member CPOs and CTAs. NFA's oversight of CPOs and CTAs includes review of annual reports and disclosure documents, and the conduct of examinations of these firms on a periodic basis.</p> <p>The CFTC monitors compliance by NFA with its self-regulatory obligations by conducting periodic reviews of NFA's compliance programs. NFA oversight reviews focus on the NFA responsibilities, including review of the financial and sales practice compliance programs for registered intermediaries, as well as review of NFA's programs for arbitration, registration and fitness, and disciplinary actions.</p> <p>CFTC staff members meet with NFA and review program materials and databases, evaluate procedures, and perform reviews of samples of NFA's files to determine whether its procedures are consistent with its regulatory obligations, whether it has properly executed its program, and that the files contain sufficient documentation. The results of these reviews are presented to the CFTC and reported back to NFA. Consecutive reviews of the same program may focus on a particular aspect of the program in question, including following up on recommendations made in prior reviews.</p> <p>The CFTC conducted a review of NFA's registration program in 2010, and within the past ten</p> |
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years has conducted reviews of NFA's programs for CPO and CTA compliance, telemarketing supervision, FCM and IB financial reports, disciplinary actions, and arbitration. In the past year, the CFTC has conducted 3 different reviews, with a focus on disclosure document processes, the financial disclosure process, and NFA examinations of registrants.

Professional standards

The CEA and CFTC Regulations impose conduct standards on SROs and their employees. These include:

Obligations to keep confidential material non-public information (CFTC Regulation 1.59(d)(ii) and information supplied to an SRO by the CFTC); and

Prohibitions on the misuse of information acquired as a result of carrying out SRO duties (Section 9(e)(1) CEA and CFTC Regulation 1.59(d)(ii)).

Conflicts of interest

As well as the governance arrangements described above, Core Principles applying to DCMs, SEFs and DCOs all contain provisions (elaborated on in the CFTC rules) expressly requiring them to minimize and resolve conflicts of interest. The Core Principles are supplemented by more detailed rules such as CFTC Regulation 1.69, which requires that a member of an SRO's governing board, disciplinary committee or oversight panel must abstain from voting on any matter and from deliberating on the same where that member is a named party or otherwise has an interest.

Exchange Act SROs

Background

Two main SRO functions are performed by registered exchanges and FINRA: supervision of market activity (market surveillance) and supervision of market intermediaries. All exchanges have SRO responsibilities under the Exchange Act but they can "outsource" some or all of their market surveillance responsibilities by contracting with another SRO through a regulatory service agreement (RSA). The outsourcing exchange remains liable for its market surveillance obligations under the legislation. In practice, many exchanges have entered into market surveillance RSAs with FINRA (see Principle 34 for further details).

BDs 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. To deal with the situation where BDs are members of more than one SRO, the Exchange Act (Section 17(d)) and SEC Rules) permit SROs to enter into a plan (which must be approved by the SEC) for one SRO to become the designated examining authority (DEA) for common members. SEC approval of a plan filed pursuant to Rule 17d-2 relieves an SRO of the regulatory responsibilities allocated by the plan to another SRO.

FINRA

FINRA is currently the only SRO that is a registered securities association. BDs that have a public customer business must be members of a registered securities association and therefore FINRA unless they limit their transactions to securities traded on an exchange of which they are a member. BDs that limit their activity to government securities or municipal securities are subject to special registration.

Natural persons "associated with" a registered BD do not have to register themselves as BDs, but, unless their activities are strictly clerical and ministerial, they must register with the appropriate SRO (generally, FINRA), and take the appropriate qualifying examinations. There

are about 630,000 individuals registered in this way. All BD staff with client facing responsibilities must be registered.

Exchanges

To trade directly on a particular exchange, a BD must become a member of that exchange.

MSRB

Firms that engage in transactions in municipal securities must also comply with the rules of the MSRB, an SRO that, subject to SEC review, makes rules governing transactions in municipal securities. Unlike other SROs, the MSRB generally does not enforce compliance with its rules. Compliance with MSRB rules is monitored and enforced by FINRA and/or the SEC (in the case of BDs and municipal advisors), and the federal bank regulators and the SEC (in the case of banks).

Admission of participants

Under the Exchange Act, a national securities exchange, registered securities association, or clearing agency must have rules that permit any registered BD or natural person associated with a BD to become a member of the exchange or association. Under the Exchange Act, the rules of an SRO must not be designed to permit unfair discrimination between customers, issuers, brokers or dealers regulated by virtue of the Exchange Act on the basis of matters not related to the purposes of the Exchange Act or the administration of the SRO.

If an exchange or FINRA denies membership or participation to an applicant, it must notify the SEC. A denial of membership or participation by an exchange or FINRA is reviewable by the SEC.

Rules of conduct

Exchange and FINRA members are required to comply with trading and business conduct rules. The Exchange Act provides that an exchange and FINRA must be able to enforce members' compliance with their rules. The Exchange Act sets out the requirements for rules, which include rules designed to prevent fraudulent and manipulative acts and practices and to protect investors and the public interest.

Disciplinary rules and proceedings

The exchanges and FINRA must have rules that provide that their members will be appropriately disciplined for violation of the provisions of the Exchange Act and SEC rules and regulations, and their own rules. Sanctions must include expulsion, suspension, limitation of activities, functions and operations, fines, censure, and being suspended or barred from being associated with a member of any other fitting sanction. Parallel provisions apply to clearing agencies.

Once an SRO has imposed a final disciplinary sanction against a member or person associated with a member, it must promptly file notice with the SEC of its action. A final disciplinary sanction imposed by a SRO is reviewable by the SEC.

Division of responsibilities between the SEC and SROs

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 SEC has authority to take disciplinary actions directly against a BD and associated persons.

Registration*Capacity*

Sections 6(b)(1) and 15A(b)(2) of the Exchange Act provide that an exchange or association shall not be registered unless it is so organized and has the capacity to carry out the purposes of the Exchange Act. The exchange or association must also be able to enforce compliance by its members and persons associated with its members with the Exchange Act, the rules and regulations thereunder, and its own rules. Further details on exchange registration are included in Principle 33.

Rules

As part of the registration process for SROs, the SEC reviews their proposed rules to ensure they comply with the standards required by the Exchange Act.

Under Section 19(b)(1) of the Exchange Act, an SRO must file any proposed change in, addition to, or deletion from its rules. Once filed, the SEC must publish a notice of the filing in the Federal Register, which must include specified details and give the public an opportunity to submit comments. Thereafter, within 45 days after the publication date, the SEC must approve, disapprove, or institute proceedings to determine whether to approve or disapprove the rule change, subject to an extension of time from the SRO or on the SEC's own motion up to a maximum of 90 days from the publication date.

The SEC must approve a proposed rule change, if it finds it consistent with the requirements of the Exchange Act and the rules and regulations thereunder. Otherwise it must disapprove it. In making this determination, the SEC must consider whether the proposed rule change will promote efficiency, competition and capital formation. The SEC has disapproved exchanges' rule changes in the past.

Rules generally do not take effect until approved by the SEC, but some proposed rule changes filed under Section 19(b)(3)(A) of the Exchange Act take effect upon filing, without need for SEC approval. The proposed rule changes that may take effect upon filing include rules that: constitute a stated, policy, practice or interpretation with respect to the enforcement of an existing rule; establish or change a due, fee, or other charge imposed by the exchange; or are concerned solely with the administration of the exchange. The SEC has by rule extended the categories of rules that become effective on filing to include rules that do not significantly affect the protection of investors or the public interest or rules that do not impose a significant burden on competition (see SEC Rule 19b-4(f)).

Section 19(c) of the Exchange Act gives the SEC authority to abrogate, add to, and delete from the rules of an SRO (other than a registered clearing agency).

Co-operation with the SEC and other SROs

All SROs are defined as SROs under the Exchange Act and have obligations imposed directly on them by the legislation and are subject to oversight by the SEC. MOUs are therefore not used.

Some SROs have entered into agreements under Exchange Act Section 17(d) and SEC Rule 17d-2 to coordinate among themselves the allocation of regulatory responsibility regarding the receipt of regulatory reports from participants, the examination of participants for compliance, and the enforcement of compliance. All agreements must be filed with the SEC and, after public notice and comment, may be declared effective by the SEC.

Governance

The Exchange Act requires that the rules of an SRO must assure a fair representation of its members in the selection of its directors and the administration of the affairs of the SRO.

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.

The SEC has generally approved for SROs other than clearing agencies up to 20 percent member representation on SRO boards of directors and on SRO committees dealing with trading rules and member discipline. For clearing agencies, the SEC evaluates the procedures of each clearing agency for meeting the fair representation requirement on a case-by-case basis.

Section 15B(b)(2)(B) of the Exchange Act was amended by the Dodd-Frank Act to require that the number of public representatives on the MSRB at all times exceed the number of regulated representatives.

Avoiding anti-competitive situations and misuse of oversight role

The Exchange Act requires that the rules of SROs (including MSRB) 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, among other things, the rule's burden on competition.

Oversight

Supervision programs

The SEC has an examination and enforcement program to oversee the activities of the SROs, including exchanges, FINRA, and clearing agencies.

Section 19(g)(1) mandates that every SRO comply with and enforce compliance with the provisions of the Exchange Act and the SEC rules and regulations and the SRO's own rules, "absent reasonable justification or excuse." The SEC assesses an SRO's continuing compliance with these obligations by carrying out examinations of SROs as part of OCIE's examination and inspection program.

During these inspections, OCIE can review, among other things, the SROs' examination and surveillance programs for member financial responsibility and operational compliance, regulatory programs for monitoring trading activity, disciplinary and enforcement programs, exchange listing programs, membership programs and arbitration programs.

In the past three fiscal years, OCIE has conducted a total of 140 examinations of SROs.

SEC examinations of the national securities exchanges and FINRA are not done on a fixed cycle, and generally a risk based approach is used. In 2012 and 2013, the SEC did an assessment of all national securities exchanges and FINRA to establish a baseline for governance, internal controls, and enterprise risk management programs at each SRO. Other inputs into the risk assessment process include TCRs and information from DERA and Trading and Markets. Among recent risk areas identified for examination of exchange SROs are: the internal controls and governance around their rule making process; their supervision of RSAs; order types used by the options exchanges and the related governance; systems outages, errors and integrity; and, exchanges' business continuity planning.

In the past year, OCIE conducted examinations across most of the national securities exchanges (and FINRA, SIPC, MSRB and 2 clearing organizations) focusing on, among other areas, the listings processes, order types and governance and the collection of securities transaction fees.

The SEC also has a program for review of the SROs' information technology systems to evaluate whether the systems have sufficient capacity and resiliency to accommodate conditions of increased volume and disruptions to normal operations. This program is now carried out by OCIE and is staffed by information technology experts who regularly confer and meet with

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| | <p>members of the SROs' information technology staff (for exchanges, see also Principle 34).</p> <p><i>FINRA</i></p> <p>Dodd-Frank Act Section 964 requires that, on a regular basis, the GAO submit a report to Congress on the SEC's oversight of FINRA with respect to ten specified areas. The areas include governance (including management of conflicts of interest), examinations, arbitration services, and funding of FINRA's operations. In 2013, OCIE completed an inspection of FINRA focusing on these ten areas to assist in its risk scoping efforts. For future risk scoping purposes, OCIE has developed a process to evaluate risks and prioritize areas of focus in inspections of FINRA.</p> <p>FINRA is subject to periodic reviews and at any time a number of reviews may be taking place. A technology review (see above) is generally done annually. Reviews of FINRA's supervision of the sales practices of its BD members are also carried out annually. These involve a review of the sales practice supervision programs conducted by three district offices of FINRA. In 2013, the SEC reviewed FINRA's enforcement program. Other reviews include examination of the market surveillance activities carried out by FINRA under RSAs.</p> <p>Professional standards</p> <p>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 prohibit 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, nonpublic information in a duty of trust or confidence from breaching that duty, causing the trading of securities on the basis on nonpublic information (insider trading).</p> <p>Sections 6(b)(7), 15A(b)(8), and 17A(b)(3)(H) of the Exchange Act require 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. SROs are required, for example, to notify members of the specific charge against them, give them an opportunity to defend themselves and to keep a record of the proceeding.</p> <p>Conflicts of interest</p> <p>The SEC reviews SRO proposals and examines SRO operations to evaluate any potential impact conflicts of interest may have on the effective oversight of the securities markets. In particular, the SEC reviews proposed changes to an SRO's ownership and regulatory structure, and has a focus in that review of addressing conflicts of interest at the SRO.</p> |
| Assessment | Fully Implemented |
| Comments | <p>In the U.S. regulatory system, SROs, including FINRA, NFA, and the exchanges and clearing organizations, play a critical role as front line supervisors of markets and intermediaries. SRO responsibilities are set out in the legislation. This results in a complex set of arrangements, but the legislation gives the regulators full authority to oversee the conduct of SROs, for example through the rule approval process, the power to intervene and require changes to rules or supervision practices, and by their powers to conduct examinations that test whether SROs are complying with their regulatory and supervision obligations.</p> <p>Both the CFTC and the SEC have robust programs to monitor compliance by SROs, and carry out regular examinations. In addition, there are regular interactions with the SROs, often on a daily basis. For the SROs' market surveillance obligations, these examinations cover, among</p> |

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| | <p>other things, the exchanges’ governance, compliance with record keeping and audit trail obligations, and the functioning of trade practice and market surveillance processes including the investigation of suspected misconduct. For member supervision, examinations cover the membership application processes used by the SROs, and their ongoing supervision of issues such as sales practices, discipline and arbitration.</p> <p>The timeframe for the regulators’ review of SRO rule amendments is limited, especially for the CFTC. The self-certification process allows the CFTC limited time to review rules, especially for new products, and relies on the accuracy of the certification of the SROs. In this regard, however, the assessors note:</p> <p>The practice of SROs to consult informally with the CFTC prior to formal lodgment of rules, including rules relating to new products, where the rule is potentially controversial. This gives the CFTC opportunity to influence the final content of the rule prior to formal registration;</p> <p>The fact that the regulators can extend the time to enable more scrutiny, including public consultation.</p> <p>The fact that, although most rules use the self- certification process, the CFTC has used the stay procedure on a number of occasions in the past year, in rules relating to SEFs;</p> <p>The fact that the CFTC (and the SEC) have the power to mandate or impose changes to SRO rules.</p> <p>Taking into account these factors, the assessors conclude that the requirements of Key Question 2(d) are met.</p> |
| <p>Principles for the Enforcement of Securities Regulation</p> | |
| <p>Principle 10.</p> | <p>The regulator should have comprehensive inspection, investigation and surveillance powers.</p> |
| <p>Description</p> | <p><u>CFTC</u></p> <p>Information gathering and inspection powers</p> <p><i>General powers</i></p> <p>The CFTC’s power to examine documents and inspect regulated entities and individuals is based on the entities’ record-keeping obligations and the requirement that all books and records be retained for five years and be “readily accessible” to the CFTC and the DOJ during the first two years of that period (Regulation 1.31(a)). The CFTC can require records of regulated persons to be produced without judicial process or notice.</p> <p><i>Surveillance powers</i></p> <p>DCMs and SEFs have responsibility for the conduct of surveillance for trading activity. In addition, CFTC staff conducts front line surveillance on a broader base of information than individual DCMs and SEFs possess. CFTC has direct access to participant information. In addition to information submitted to the CFTC regularly, CFTC staff has authority to request data directly from market participants and from DCMs and other regulated entities.(see Principle 34). CFTC staff carry out periodic routine inspections and audits of DCMs to ensure that they are carrying out their obligations. Staff will conduct these routine audits and inspections on SEFs once they have obtained permanent registration status.</p> <p>Record keeping requirements</p> <p><i>Customer identity</i></p> |

FCMs, IBs and members of a contract market (such as floor brokers) must keep a record which shows for each commodity futures or options account the identity of the person for whom such account is carried or introduced and their principal occupation or business. They also must keep a record showing the identity of any other person guaranteeing such an account or exercising any trading control over the account (CFTC Regulation 1.37(a)). Know-your-client and AML record keeping requirements also apply (see under Principle 31). SDs and MSPs are subject to similar requirements with respect to counterparties whose identity is known to the SD or MSP prior to the execution of a swap transaction.

A Customer Identification Program (CIP) Regulation issued jointly by the CFTC and FinCEN pursuant to the Bank Secrecy Act (BSA) requires that certain registrants obtain identification and verification information on their customers. An FCM's or IB's CIP procedures must enable it to form a reasonable belief that it knows the true identity of each customer.

Bank and brokerage accounts

CFTC Regulations require that there be a complete record, or audit trail, of the entry and execution of all orders for transactions in commodity interest and related cash or forward transactions. Comprehensive record creation, retention and reporting requirements ensure that all transactions in futures and options can be documented and reconstructed. These obligations are supplemented by BSA requirements, under which the CFTC has authority to obtain the identification and verification information collected under the CIP Regulation.

Record retention

CFTC Regulation 1.31 requires all books and records required by the CEA and CFTC regulations to be kept for a period of five years and to be readily accessible during the first 2 years of the 5-year period. All books and records must be open to inspection by any representative of the CFTC or DOJ.

Outsourcing to SROs and third parties

As described under Principle 9, the U.S. system makes extensive use of SROs (notably DCMs and the NFA) to supervise the conduct of SRO members. SROs performing these roles have member inspection programs. SROs' compliance with their supervision obligations is supervised by the CFTC through RERs for DCMs and through its program for the supervision of the NFA. The CFTC has access to information about the SRO and can cause improvements to be made in SRO processes. SROs themselves may only delegate supervision functions to the NFA or another SRO.

CFTC Regulation 38.154(a) permits a DCM to use a NFA or another registered entity to provide services to assist in complying with the Core Principles. A DCM that uses a regulatory service provider must ensure that its regulatory service provider has the capacity and resources necessary to provide timely and effective regulatory services, including adequate staff and automated surveillance systems. A DCM remains responsible for the performance of any regulatory services received from a third party, and for the regulatory service provider's performance on its behalf. A DCM must also conduct periodic reviews of the adequacy and effectiveness of the services provided.

Under Commission Regulation 37.204(a), analogous provisions apply to SEFs that delegate supervision responsibilities to the NFA, another registered entity, or FINRA.

SEC

Information gathering and inspection powers

General powers

The SEC has the power under the Exchange Act, the Advisers Act, and the ICA to inspect all

regulated entities' business operations, including books and records, at any time without giving notice and without judicial action, even in the absence of suspected misconduct. The SEC has the power to supervise registered exchanges and ATS pursuant to its authority to conduct SRO inspections and broker-dealer examinations. It has access to all books and records of registered exchanges and other trading venues.

Trading activity

Subject to the SEC's oversight, SROs have legislatively mandated market surveillance responsibilities and have the frontline responsibility for overseeing daily trading activities and regulatory compliance on the exchanges.

Record-keeping requirements

Statutory record-keeping and record retention requirements applying to entities regulated by the SEC are contained in the Exchange Act, the ICA and the Advisers Act.

Exchange Act Rules set out record-keeping rules for securities exchanges, registered securities associations (i.e., FINRA), clearing agencies and the MSRB, and for brokers and dealers. Rule 17a-4 governs the retention of these records, which vary by record type, as well as other records such as information supporting a firm's financial reports and communications sent or received by the firm that relate to the firm's business.

ICA Rules set out record keeping and retention rules for investment companies. The required retention periods vary according to the record type. Advisers Act Rules set out record keeping and retention rules for advisers and, in general, records 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).

The SEC is in the process of developing record keeping and retention rules for regulated entities in the swap industry for which it has jurisdiction.

Customer identity

Registrants are required to maintain specified records concerning client identity under regulations promulgated under the Exchange Act, the Advisers Act, the BSA, and the PATRIOT Act. Mutual funds are treated as "financial institutions" for certain purposes and thus specific BSA rules apply to mutual funds, including client identification obligations. Under this legislative scheme, broker-dealers and mutual funds must maintain a CIP appropriate to their size and type of business.

Through use of its powers to require access to books and records and to compel information, the SEC has access to the identity of all customers of registrants, including those of broker-dealers, investment companies and IAs.

IAs cannot be compelled to disclose the identity of clients (Section 210(c) of the Advisers Act) except when disclosure may be necessary or appropriate in an enforcement investigation or proceeding. In practice, this provision has not posed difficulties for the SEC in obtaining information about clients of IAs.

Bank and brokerage accounts

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, BSA rules require BDs, mutual funds and IAs to obtain and keep certain records relating to the transfer of funds to or from the entity.

Outsourcing to SROs and third parties

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| | <p>The SEC does not outsource any of its own inspection or other regulatory enforcement authority to SROs or third parties. But as noted under Principle 9 and above, the system administered by the SEC makes extensive use of SROs, notably national securities exchanges and FINRA.</p> <p>An SRO may enter into a regulatory service agreement (RSA) with a registered third-party SRO under which the third-party SRO agrees to perform certain regulatory obligations of the procuring SRO. The procuring SRO remains responsible for meeting its regulatory obligations under the Exchange Act. Under Exchange Act Rule 17d-2, any two or more SROs may file with the SEC a plan to allocate regulatory responsibilities among themselves. If the SEC declares the plan effective, any SRO that is a party to the plan is relieved of its regulatory responsibility to the extent that its responsibility is allocated under the plan to another SRO.</p> <p>The SEC has full access to information maintained or obtained by SROs. It can bring an enforcement action against an SRO for failure to act or adequately perform required functions. It can also cause changes and improvements to be made to an SRO's processes, for example by requiring changes to its rules (including by directly imposing rule changes); or taking administrative or court action to impose remedies that result in changes or improvements.</p> |
| Assessment | Fully Implemented |
| Comments | |
| Principle 11. | The regulator should have comprehensive enforcement powers. |
| Description | <p>CFTC</p> <p>Powers of investigation</p> <p>Section 8(a)(1) of the CEA gives the CFTC comprehensive power to conduct investigations to ensure compliance with laws and regulations. Section 6(c) gives the CFTC 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 that the CFTC deems material to the inquiry. These powers can be used to seek information from any person, whether regulated or not. If an individual or firm named in a subpoena refuses to comply with its terms, the CFTC may apply to a federal district court to enforce the subpoena.</p> <p>Enforcement powers</p> <p>The CFTC has the authority under the CEA to file a civil enforcement action in federal district court or an administrative enforcement proceeding in an administrative tribunal to ensure compliance with the CEA. It has extensive rules relating to enforcement activity such as Part 11 of its rules (Investigations).</p> <p>The Dodd-Frank Act strengthened the CFTC's enforcement powers by adding or amending certain provisions, including:</p> <p>Section 6(c) (and CFTC Regulation 180.1) to prohibit any manipulative device, scheme or artifice in the swaps, futures and cash markets and explicitly prohibit false or misleading statements;</p> <p>Section 4c(a) to prohibit disruptive trading practices, including violations of bids and offers, intentional or reckless disregard for the orderly execution of transactions during the close, and spoofing;</p> <p>Section 4s (and CFTC Regulations 23.400-451), setting out business conduct standards for SDs and MSPs;</p> |

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| | <p>Sections 2(c)(2)(B) and 2(c)(2)(D), strengthening the CFTC’s enforcement authority over retail Forex and retail commodity transactions (e.g., precious metals); and</p> <p>Section 23 (and Regulation 165), creating whistleblower incentives and protection; and Section 4c(a)(4), prohibiting trading on confidential information emanating from government departments or agencies that may affect or tend to affect the price of any commodity in interstate commerce or swap.</p> <p><i>Civil proceedings</i></p> <p>Remedies available in a federal district court include injunctions, ex parte orders to preserve records and freeze assets, civil monetary penalties, disgorgement, restitution, and contract rescission, and any other equitable relief needed. Civil monetary penalties of up to the greater of \$140,000 or triple the monetary gain to the person can be imposed for each violation other than manipulation (plus post-judgment interest). In the case of manipulation or attempted manipulation, a civil monetary penalty of up to the greater of \$1 million or triple the monetary gain to the person can be imposed for each violation (plus post-judgment interest).</p> <p><i>Administrative proceedings</i></p> <p>Complaints initiating an administrative action under Sections 6(c) and 6(d) of the CEA are conducted under the CFTC’s Rules of Practice in Part 10 of the CFTC Regulations. Sanctions that can be imposed by administrative action include orders:</p> <p>Prohibiting a respondent from trading on or subject to the rules of any contract market and requiring all contract markets to refuse such person all trading privileges for any period specified in the order;</p> <p>Suspending (for a period of not more than six months), revoking or restricting a respondent’s registration with the CFTC;</p> <p>Assessing civil monetary penalties against a respondent, up to \$140,000 or triple the monetary gain to the person for each violation; not more than the greater of \$1 million or triple the monetary gain to the person for each violation for manipulation; plus post-judgment interest;</p> <p>Directing that a respondent make restitution to customers of damages proximately caused by the respondent’s violations; and</p> <p>Directing a respondent to cease and desist from violating the CEA or CFTC Regulations in an administrative action brought pursuant to Section 6(d).</p> <p><i>Criminal prosecutions</i></p> <p>The CFTC has the power to refer matters for criminal prosecution to DOJ and state criminal authorities, but it cannot independently initiate criminal actions. The CFTC routinely works in parallel with criminal law enforcement authorities to investigate potential violations of the CEA. Alleged criminal violations of the CEA pursuant to Section 9 of the CEA or violations of other federal laws that involve commodity futures trading are referred to DOJ for prosecution. Likewise, conduct that may violate state laws is referred to the appropriate state authority. A criminal prosecution does not preclude the CFTC from taking civil action for the same conduct, and similarly, CFTC action does not preclude a subsequent criminal prosecution.</p> <p>Power to require information</p> <p><i>Power to compel a person to provide information</i></p> <p>The CFTC has broad subpoena powers and may obtain information from any individual or entity, whether registered or not, in connection with possible violations of the CEA and</p> |
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Commission regulations. Section 6(c) of the CEA authorizes the CFTC to subpoena the production of documentary and testimonial evidence from any place in the United States, any State, or any foreign country or jurisdiction.

Telecommunications data

The CFTC has power to access electronic communications from regulated entities, but a judicial decision based on internet privacy legislation has ruled that it cannot require access to the content of communications from an internet service provider without seeking judicial approval.

Bank records

The RFPA creates a procedure that must be followed in an investigation before the CFTC can access bank records relating to individuals or partnerships of less than six people. The Act generally requires prior notice to be given to the account holder, but it also permits delayed notice in specified circumstances, such as where there is a risk of the destruction of evidence, or where notice would seriously jeopardize an investigation. These provisions do not apply to civil proceedings, where discovery rules apply. In practice, the CFTC has not had difficulty in using the delayed notice provisions where circumstances warrant. (See also Principle 13).

Private rights of action

Section 22 of the CEA permits private rights of action under certain circumstances. Section 22(a) permits private damage actions against anyone other than a SRO who violates, or willfully aids and abets a violation, of the CEA. Section 22(b) establishes a private damage remedy against SROs and their officials, which in bad faith refuse to enforce their own rules, or enforce their own rules in violation of the CEA, and cause monetary loss to the plaintiff. The CFTC's enforcement powers do not compromise a private person's right of action to seek remedies under the CEA.

Section 14 of the CEA permits anyone complaining of a violation of the CEA or the CFTC's rules to apply to the CFTC for an order awarding damages caused by the violation. These reparations procedures provide a variety of methods to resolve claims, including a voluntary procedure based on the submission of written documents, a summary procedure for claims of less than \$30,000 and a formal procedure before an Administrative Law Judge.

Information sharing

If information is available from another federal or state agency, such as a state securities regulator or the SEC, the CFTC can obtain this information by seeking access to the public and non-public information in that agency's files. The CFTC cooperates with other domestic enforcement authorities through explicit statutory authorization, formal MOUs and informal arrangements.

SEC

Powers of investigation

General investigation power

The Securities Act, the Exchange Act, the Advisers Act, and the ICA give the SEC broad authority to investigate actual or potential violations of the federal securities laws, including the SEC's rules and regulations and the rules of SROs, and give it broad powers to gather evidence from any person, whether regulated or not. For example, Section 21(b) of the Exchange Act gives the SEC authority to subpoena witnesses to compel their testimony, and require the production of books and records. It also permits the SEC to administer oaths and affirmations, which require witnesses to be truthful in their testimony.

Enforcement powers*Civil proceedings*

The SEC can bring civil proceedings in a federal district court seeking remedies that include injunctions, temporary restraining orders to halt ongoing fraud and freeze assets, disgorgement, civil money penalties and any other equitable relief deemed necessary. The range of civil money penalties varies in accordance with the application of the facts of the case to the structure for penalties available under the federal securities laws. Statutory amounts are adjusted periodically for inflation. Under the Exchange Act for example, the current maximum amount of civil penalty per violation in a civil action for fraud is the greater of \$160,000 for a natural person, \$775,000 for an entity or, as to a natural person or entity, the gross amount of pecuniary gain (Section 21(d)(3) of the Exchange Act).

In insider trading cases, for example, the Exchange Act provides that a person who committed the violation may be subject to a penalty amount as much as three times the amount of profit gained or losses avoided by the unlawful trading or communication of information (Section 21A of the Exchange Act).

Administrative proceedings

The SEC has the authority to institute administrative actions against a person or an entity alleged to have violated the law. Administrative actions are instituted by the SEC and litigated by Enforcement before an SEC ALJ. The ALJ's decision is subject to review by the SEC, and the SEC's decision is in turn subject to appeal before a U.S. Court of Appeals.

Sanctions and remedies available through administrative proceedings include:

- Securities industry suspensions of up to twelve months;
- Bars as to regulated individuals;
- Limitations on activities;
- Civil penalties;
- Disgorgement;
- Revocation of the registration of an entity; and
- For professionals, such as attorneys and accountants, an order that the professional be suspended from or denied the privilege of practicing before the SEC.

Criminal prosecutions

The SEC has the authority to refer cases to federal and state criminal law enforcement authorities. It routinely works in parallel with criminal law enforcement authorities to investigate potential violations of the securities laws. 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.

Suspension of trading

The SEC can summarily suspend trading in a security for up to ten business days under Exchange Act Section 12(k), if it determines that the public interest and protection of investors require such a suspension. Also, pursuant to Section 8(d) of the Securities Act, the SEC can issue a stop order suspending the effectiveness of a registration statement that contains incomplete, inaccurate, false or misleading information. Under Section 12(j) of the Exchange Act, the SEC can also deny, suspend for up to twelve months, or revoke the registration of a security if the issuer is

found to have failed to comply with the Exchange Act and rules made under it.

Dodd-Frank Act

- The Dodd-Frank Act gave the SEC additional enforcement powers in a number of areas, including by, for example:
- Authorizing the SEC to impose civil money penalties in cease-and-desist proceedings;
- Authorizing the SEC to impose industry wide collateral bars on individuals found to have violated the securities laws;
- Providing authority for charging aiding and abetting liability under the Securities Act and the ICA (this liability already existed under the Exchange Act and the Advisers Act);
- Authorizing the SEC to obtain penalties against aiders and abettors in civil actions under the Advisers Act; and
- Specifying that manipulative short sales are unlawful.

Power to require information

The SEC can use the supervisory powers described under Principle 10 to access information and records held by regulated entities. In addition, under its subpoena authority, the SEC can compel the production of documents or testimony from any person or entity (whether regulated or not) anywhere within the U.S., including from banking entities.

Electronics data

As is the case with the CFTC, U.S. federal law imposes restrictions on the SEC's ability to obtain certain information regarding electronic communications.

Bank records

The SEC must follow the procedures set out in the RFPA when it seeks financial records of an individual customer or small partnership from a financial institution. The process is the same as that applied to the CFTC (see also Principle 13).

Private rights of action

Private persons can 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. In addition, the federal securities laws provide for express remedies in favor of private parties who claim damages as a result of specific violations of the federal securities laws. For example, Section 11 of the Securities Act imposes liability for misstatements or omissions in registration statements; and Section 9 of the Exchange Act imposes liability for specified manipulations of exchange-traded securities.

Federal courts have implied private rights of action under some statutory provisions, notably under Exchange Act Section 10(b) for securities fraud.

Information sharing

The SEC is authorized by law to share information with certain other authorities. Under Section 24(c) of the Exchange Act, the SEC can make nonpublic 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. Generally, the SEC is not reliant on other authorities to obtain evidence necessary for its investigations.

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|----------------------|---|
| Assessment | Fully Implemented |
| Comments | |
| Principle 12. | The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program. |
| Description | <p>CFTC</p> <p>Inspection, surveillance and compliance monitoring</p> <p>In 2014, the CFTC has 95 staff positions dedicated to examinations of registrants.</p> <p><i>DCM and DCO supervision</i></p> <p>The CFTC has a direct examination program for DCMs and DCOs, and will commence direct examinations of SEFs and SDRs in the near future. This work is undertaken by DMO and DCR, which in fiscal year 2014 have a total of 47 examination positions to carry out this function.</p> <p>The operational integrity of exchanges is addressed through the CFTC’s periodic RERs that broadly address audit trail, market surveillance, trade practice surveillance, and disciplinary programs. RERs are typically carried out every year for the larger exchanges and about every three to four years for the smaller exchanges. These reviews test each DCM’s ongoing compliance with the Core Principles through the self-regulatory programs operated by the exchange to enforce its rules, prevent market manipulation and customer and market abuses, and ensure the recording and safe storage of trade information. The Compliance Section of DMO also carries out horizontal RERs, testing across a number of exchanges compliance with particular Core Principles. See also Principles 9 and 34.</p> <p><i>Licensed intermediaries</i></p> <p>For intermediaries generally, the CFTC itself does not conduct routine on-site direct inspections of intermediaries. The CFTC’s regulatory scheme relies on the supervision activities of the SROs (DCMs and NFA) and continuing oversight by the CFTC of the exercise of those responsibilities. To test the work performed by DSROs, CFTC staff conduct risk-based reviews that focus on five areas of an SRO’s supervisory program: financial stability, customer protection, risk management, market moves and operational capabilities. The CFTC conducts examinations of intermediaries for cause or to test the quality of the DSROs’ work. In FY 2014, DSIO carried out 11 limited scope examinations of FCMs and one for cause examination of a swap dealer.</p> <p>For detail on the intermediary inspection programs carried out by the SROs, see further under Principle 24 (for CPOs) and Principle 31 (for other intermediaries).</p> <p>The CFTC requires DSROs to ensure that each FCM is subject to an on-site examination within nine to 18 months of the date of the previous examination by the DSRO.</p> <p><i>Unusual market transactions</i></p> <p>On a daily basis, DMO’s Surveillance staff reviews details of transactions at each exchange by using the CFTC’s surveillance system. Analysts identify potential abuses from data analysis conducted using tools developed by the staff. The CFTC is currently in the process of upgrading this system to enhance its ability to detect trade practice violations, including wash trading and trading ahead. DMO staff also periodically observe trading activity on the floor of each exchange for the exchanges that still have open outcry trading and discuss potential issues of concern with compliance staff at the exchange.</p> <p>Compliance systems</p> <p>The Core Principles applying to DCMs and SEFs oblige them to have in place arrangements to</p> |

monitor and enforce compliance with the legislation and with their rules. CFTC Regulations require them to have adequate staff to fulfil their obligations as SROs.

All categories of intermediaries, including FCM, IBs, CPOs and CTAs are required to develop and maintain compliance policies and procedures. CFTC Regulation 166.3 requires all CFTC registrants to diligently supervise the handling of all commodity interest accounts by partners, officers, employees and agents. Any violation of the CEA by a supervised person creates a liability on the supervisor for failure to supervise. Section 2(a)(1)(B) of the CEA imposes *respondeat superior* liability on the principal for the acts of its agents.

Mechanisms to detect and investigate insider trading and other forms of market abuse

DCM Core Principles require a DCM to monitor and enforce compliance with rules of the contract market, including rules relating to abusive trading practices. CFTC Regulation 38.156 requires DCMs to have an automated trade surveillance system capable of detecting potential trade practices violations. The automated system must, among other things, process daily orders and trades no later than 24 hours after the completion of the trading day; and be capable of detecting and flagging specific trade execution patterns and trade anomalies. Regulation 38.157 requires a DCM to conduct real-time market monitoring of all trading activity on its electronic trading platform(s) to identify disorderly trading and any market or system anomalies. SEFs are subject to analogous requirements. The CFTC conducts oversight of the exchanges' programs to ensure effectiveness. In addition to the exchange surveillance program, the CFTC independently conducts an extensive market surveillance program, utilizing large trader reports and analysis of trading data, which it receives on a daily basis.

Intelligence and investor complaints

CFTC investigations often come from customer tips, complaints, or referrals (TCRs). Over 200 TCRs were received from whistleblowers in the fiscal year 2014. The Dodd-Frank Act amended the CEA by adding a new Section 23 (Commodity Whistleblower Incentives and Protection) under which the CFTC established a whistleblower program. The CFTC can pay awards, based on collected monetary sanctions, to eligible whistleblowers who voluntarily provide the CFTC with original information about violations of the CEA that lead either to a judicial or administrative action. The CFTC made its first payment to a whistleblower in May 2014.

Other CFTC enforcement cases come from a variety of sources, including internal referrals from the supervisory areas of the CFTC and referrals from SROs, state and federal authorities or foreign regulators. CFTC enforcement staff also monitors press reports and websites the information from which may form the basis of enforcement cases.

Reconstruction of execution and trading

CFTC Regulation 38.551 requires a DCM to capture and retain all audit trail data necessary to detect, investigate, and prevent customer and market abuses. This data must be able to be used to reconstruct all transactions within a reasonable period of time. Regulation 37.205 makes analogous provisions in relation to SEFs.

Enforcement

The CFTC's Division of Enforcement (DOE) has a total staff of just over 150 people, the majority of whom are attorneys, but also include over 20 investigators and 3 economists.

At the time of the assessment mission, the CFTC had approximately 99 litigation matters pending in United States District Courts throughout the U.S., approximately 433 pending investigations, and 77 preliminary inquiries. These matters target specific program areas including:

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| | <ul style="list-style-type: none"> • Allegations of manipulation, attempted manipulation, and false reporting; • Trade practice violations; • Fraud and other misconduct involving CPs, HF, CPOs, and CTAs; and • Financial, supervision, recordkeeping and other violations committed by registered entities and individuals. <p>In addition, the DOE program focuses on pervasive fraud involving retail forex futures, forex options, and off-exchange precious metal and retail forex transactions.</p> <p>The CFTC has tended to bring cases in the federal courts rather than through administrative proceedings before an ALJ. There are no permanent ALJs attached to the CFTC and where used they are sourced from outside the agency. Some matters, such as revocation of registration or statutory disqualification, must be done administratively.</p> <p>DOE works actively with federal and state criminal and civil law enforcement authorities. Over 90 percent of the CFTC’s major fraud cases (those with customer losses over \$1 million) filed during fiscal year 2013 involved a parallel criminal proceeding. During fiscal years 2010 to 2013, the CFTC referred an average of approximately 50 matters to domestic criminal and civil authorities annually, of which an average of 40 matters were referred to criminal authorities. As a result of these criminal referrals, an average of 45 indictments were filed annually alleging a range of criminal misconduct arising out of activity in the futures and swaps markets. Criminal sanctions in those cases included prison sentences, fines, and restitution. Defendants received prison sentences of up to 50 years, others received fines of over \$100 million, and still others were ordered to pay restitution of more than \$250 million.</p> <p>The CFTC has obtained the following monetary relief in its civil and administrative enforcement actions over the last 3 fiscal years:</p> |
|--|---|

| CFTC Enforcement Actions Type of Violation and Actions Filed (by Fiscal Year)¹ | | | | |
|--|--------------------|--------------------|--------------------|--------------------|
| Type of Violation | FY 2011 | FY 2012 | FY 2013 | FY 2014 |
| Fraud | 55 | 57 | 29 | 26 |
| Illegal Offering of Off-Exchange Transactions | 1 | 0 | 8 | 13 |
| Trade Practice | 6 | 15 | 7 ² | 6 |
| Financial Integrity and Controls | 3 | 12 | 23 | 7 |
| Recordkeeping and Reporting | 1 | 2 | 0 | 2 |
| Manipulation, Attempted Manipulation and False Reporting of Market Information | 3 | 2 | 4 | 6 |
| Disclosure of Non-Public Material Information | 0 | 0 | 1 | 0 |
| Statutory Disqualification | 1 | 9 | 5 | 4 |
| False Statements and Omissions of Material Facts to the Commission/NFA/Exchanges | 2 | 2 | 1 ³ | 2 |
| Violation of a Commission Order | 0 | 0 | 1 | 1 |
| Registration Violations | 25 | 3 | 1 | 0 |
| Audit Failures | 2 | 0 | 2 | 0 |

Source: CFTC

¹ Many of these cases involved multiple, significant charges including various combinations of fraud, illegal off-exchange transactions, registration violations, false statements to the CFTC/NFA/exchanges, recordkeeping violations, etc. Placement of a case with a particular category was where it was deemed the best fit.

² In Fiscal Year 2013, the CFTC brought its first action using its anti-spoofing/disruptive trading authority enacted under the Dodd-Frank Act.

³ In Fiscal Year 2013, the CFTC brought its first case for false statements to the CFTC using its new Dodd-Frank Act authority. In fiscal year 2014, the CFTC brought two other actions for false statements.

| CFTC Monetary Relief | | |
|-----------------------------|-------------------------------------|---|
| Fiscal Year | Civil Monetary Penalties | Restitution and Disgorgement |
| FY11 | \$316,682,679 | \$181,844,807 |
| FY12 | \$475,360,925 | \$456,581,900 |
| FY13 | \$1,570,700,568 | \$201,409,408 |
| FY14 (to Apr 30) | \$961,072,836 | \$1,330,365,570 |
| Total | \$4,831,648,447 | \$3,686,210,358 |

Source: CFTC

SEC**Inspection, surveillance and compliance monitoring***Intermediaries supervision*

OCIE carries out the SEC's examination authority through its National Examination Program (NEP). OCIE:

Examines or inspects securities firms registered with the SEC, including BDs, municipal securities dealers, clearing agencies, transfer agents, IAs, investment companies, and municipal advisors; and:

Examines and oversees the SROs, which monitor trading activity on the exchanges for which the SROs provide additional regulatory oversight.

In carrying out these responsibilities, OCIE uses a risk-based approach for selecting which firms, areas, and issues to examine, and draws on a variety of resources, including its staff's specialized knowledge, risk analytics, and advanced technology, to target its resources on the areas that pose the highest risk.

As of early 2014, OCIE had approximately 805 examiners, many of whom are accountants, attorneys, and former industry professionals, devoted to examinations of registrants. A number of specialist units and programs within OCIE provide support to the examinations process, as discussed under Principle 6.

In 2013, OCIE began publishing its annual examination priorities to educate and inform registrants of particular areas of examination focus and to provide entities an opportunity to evaluate their compliance systems and remediate any issues identified before they might be selected for examination.

OCIE conducts inspections in all categories of securities intermediaries. However, FINRA is considered the front line supervisor for BDs. Details of the examination programs are included in Principle 24 for mutual funds and their operators and Principle 31 for securities intermediaries. In addition, the Risk and Examinations Office in IM has a risk monitoring program that includes targeted, risk-based examinations to obtain information and evaluate potential financial or operational risks in the asset management industry. See further under Principle 24.

SRO supervision

OCIE conducts comprehensive risk-based examinations of SROs' regulatory programs, including reviews of SROs' examination and surveillance programs and their disciplinary and enforcement programs. See further under Principle 9 and Principle 34.

NRSROs

Office of Credit Ratings (OCR) conducts examinations of NRSROs. The Office had 44 staff for fiscal year 2014. Pursuant to the Dodd-Frank Act examinations must be conducted on an annual basis. (See Principle 22).

| OCIE and OCR Examinations and Monitoring | | | |
|--|----------------|----------------|----------------|
| Type/firm | FY 2011 | FY 2012 | FY 2013 |
| Broker-dealers | 390 | 443 | 438 |
| Large firm monitoring | | 11 | 11 |
| Investment advisers | 1,004 | 974 | 964 |
| Investment companies (including administrators) | 112 | 104 | 99 |
| Transfer agents | 46 | 42 | 42 |
| Clearing agencies | 2 | 5 | 17 |
| Municipal advisors | | | 5 |
| NRSROs | 10 | 9 | 10 |
| SROs | 52 | 38 | 50 |
| Technology control program | 11 | 13 | 13 |

Source: SEC

Compliance systems

SEC and SRO rules specifically require regulated entities to have in place supervisory and compliance procedures reasonably designed to prevent securities laws violations. For example, Rule 206(4)-7 of the Advisers Act requires registered advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the legislation and rules made under it; similar provisions apply to investment companies (ICA Rule 38a-1); and FINRA rules, NASD Rules and NYSE rules require written compliance policies and supervisory procedures reasonably designed to achieve compliance with their rules and federal securities laws. FINRA Rules require annual CEO certification of BDs' compliance and supervisory procedures.

OCIE examination staff and the SROs conduct reviews of the adequacy of firms' written supervisory procedures and test whether the procedures are being implemented, including whether employees are given the written supervisory procedures.

As well as taking action against individual employees of regulated entities, the SEC can sanction broker-dealers and IAs and their associated persons for failure reasonably to supervise individuals subject to their supervision who commit violations of the federal securities laws. A BD or IA can be charged with failure to supervise when it fails to have or to implement supervisory and compliance policies reasonably designed to detect and prevent violations of the federal securities laws by subordinate personnel.

Mechanisms to detect and investigate insider trading and other forms of market abuse

The mechanisms to detect market abuse are described in Principles 34 and 36.

When inspecting an SRO's surveillance program, the SEC staff's objectives are to determine

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| | <p>whether:</p> <p>The parameters of SRO automated surveillance systems are appropriately designed to generate alerts that identify potential instances of noncompliance with SRO rules and federal securities laws; and</p> <p>The systems are effectively detecting such activity.</p> <p>Intelligence and investor complaints</p> <p>OCIE reviews and evaluates TCRs from a variety of external sources in accordance with the SEC-wide TCR system and related policies. Particular attention is given to TCRs alleging or indicating fraud. This process helps inform the selection of registrants for examination and the scope of examinations.</p> <p>The Office of the Whistleblower (OWB), established in response to the new whistleblower provisions in the Dodd-Frank Act, administers the SEC's whistleblower program. It gathers intelligence from whistleblowers, and refers matter to other Enforcement staff for further investigation where appropriate. The SEC has made a number of payments under this program.</p> <p>The SEC also has direct electronic access to suspicious activity reports (SARs) and other reports financial institutions are required to file under the BSA.</p> <p>Reconstruction of execution and trading</p> <p>Section 19(g) of the Exchange Act requires each SRO to enforce compliance with the SRO's rules by its members, including by having mechanisms for conducting surveillance of the markets and establishing an audit trail. FINRA has taken over the Order Audit Trail System (OATS) established by NASD and later expanded to include OTC equity securities. Several options exchanges use the Consolidated Options Audit Trail System (COATS).</p> <p>The SEC in 2012 adopted Rule 613 to require the national securities exchanges and FINRA to submit a national market system (NMS) plan to create, implement, and maintain a consolidated order tracking system, or consolidated audit trail, with respect to the trading of NMS securities. This plan was recently submitted to the SEC (see Principle 36).</p> <p>Enforcement</p> <p><i>Background</i></p> <p>The SEC has approximately 1,300 employees in Enforcement, including attorneys, accountants, and other professionals, who investigate and prosecute violations of the federal securities laws. Enforcement staff are located in each of the regional offices and in Washington D.C. The SEC has devoted increasing resources to its enforcement program and in fiscal year 2013, Enforcement had a budget of \$449.35 million.</p> <p>The SEC in recent years has enhanced its enforcement activities, including by:</p> <p>Establishing a cooperation program to provide incentives for individuals and entities to cooperate and assist with SEC investigations and enforcement actions;</p> <p>Adopting a new settlement protocol to require admission of wrongdoing in cases where there is a need for public accountability, such as in cases involving egregious conduct, significant investor harm, significant market risk and obstruction of an SEC investigation (14 cases have so far been settled in this way);</p> <p>Establishing five new national specialized units to target Enforcement staff and other resources to areas of significant concern: an Asset Management Unit; a Municipal Securities and Public Pensions Unit; a Foreign Corrupt Practices Act Unit; a Complex Financial Instruments Unit; and a</p> |
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Market Abuse Unit. Each of these units have taken significant enforcement actions since their establishment in 2010; and

Establishing a number of task forces to focus on high priority areas, including task forces on: financial reporting and audit; microcap fraud; broker-dealers; and the JOBS Act.

Enforcement activities

SEC enforcement cases come from a number of sources. These include:

Referrals from the supervisory areas. Each Regional Office has a referral Committee which brings together Enforcement and supervisory staff to discuss possible enforcement cases. Around 10-15 percent of OCIE examinations result in referrals to Enforcement;

Review by Enforcement’s Office of Market Intelligence of TCRs (around 16,000 TCRS are reviewed each year):

Tips from whistleblowers to the Office of the Whistleblower (in fiscal year 2013, there were about 3,200 tips); and

Referrals from the SROs and other external sources.

Enforcement also commences investigations on its own initiative. For example, the specialized units and task forces carry out monitoring and surveillance of the market and either initiate their own cases or refer them to other parts of Enforcement.

Administrative and civil cases

Enforcement brings cases as administrative proceedings before an ALJ and/or as civil cases in a District Court. The decision as to which route to take depends on the facts and circumstances of each case. Some remedies, such as the freezing of assets, are available only through a court process; and some remedies such as barring individuals from securities industry activity are expressly provided for only in administrative proceedings. Enforcement has about 130 litigation lawyers who, along with staff attorneys, handle these cases.

At the end of fiscal year 2013, Enforcement had over 1,444 ongoing investigations, excluding litigation and other post investigative activities. In that year, the SEC brought 676 enforcement actions, 15 percent of which were high impact cases or reflected a national priority. The SEC obtained some form of relief in 93 percent of actions brought in 2013.

The majority of cases are settled, but an increase in the number of cases against individuals is one factor in the increase in cases that go through the full litigation process.

| Total SEC Enforcement Actions | |
|--------------------------------------|----------------------------|
| Fiscal Year | Enforcement Actions |
| 2014 | 755 |
| 2013 | 676 |
| 2012 | 734 |
| 2011 | 735 |
| 2010 | 681 |
| 2009 | 664 |

Source: SEC

| SEC Enforcement Cases—Selected Types Of Action | | | | |
|---|----------------|----------------|----------------|----------------|
| Type of action | FY 2010 | FY 2011 | FY 2012 | FY 2013 |
| Market manipulation | 34 | 35 | 46 | 50 |
| Insider trading | 53 | 57 | 58 | 44 |
| Securities offerings | 144 | 123 | 89 | 103 |
| Issuer reporting and disclosure | 126 | 89 | 79 | 68 |

Source: SEC

| Sanctions Ordered in SEC Enforcement Actions | | | | |
|---|-----------------------------|--------------------------|----------------------------------|----------------------------|
| Fiscal Year | Disgorgement Ordered | Penalties Ordered | Officer and Director Bars | Trading Suspensions |
| 2013 | \$2.257 billion | \$1.167 billion | 81 | 371 |
| 2012 | \$2.083 billion | \$1.021 billion | 120 | 651 |
| 2011 | \$1.878 billion | \$928 million | 82 | 276 |
| 2010 | \$1.82 billion | \$1.03 billion | 71 | 254 |
| 2009 | \$2.09 billion | \$345 million | 90 | 192 |

Source: SEC

Criminal cases

Criminal actions for violations of the securities laws and for fraud involving securities market activity are taken by the criminal authorities at federal, state and local level. At the federal level, the U.S. Attorney's Office has 93 offices nationally and some 5,500 assistant U.S. attorneys. Economic crime is a significant priority. In addition, the Fraud Section of the Criminal Division of the U.S. Department of Justice in Washington, DC has a specialized group of prosecutors who bring criminal securities fraud cases throughout the United States. State and local prosecutor's offices also investigate and prosecute securities market cases, especially in the large market centers. Large, high profile cases are undertaken at all levels but smaller cases tend to be undertaken at state and local level.

The SEC works closely with criminal authorities, referring cases and providing assistance in investigations. Typically, the SEC refers cases to the U.S. Attorney's Offices and to the Fraud Section of the Criminal Division of the U.S. Department of Justice, but it also makes referrals to the other authorities. Cases requiring the additional powers available to criminal authorities (such as wire-tapping and search warrants) are referred at an early stage. Often, cases are investigated in parallel, with the SEC investigating at the same time as the criminal authorities. Frequently, these cases are filed simultaneously. Criminal action was taken in 126 cases in 2013 as a result of SEC referrals.

The criminal authorities receive cases from other sources, such as complaints, referrals from SROs, or media reports. Some state authorities also proactively monitor data such as suspicious

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| | <p>activity reports to identify possible actionable misconduct. This means that securities fraud cases, including smaller ones, are investigated and prosecuted.</p> <p>SEC Enforcement also works closely with other regulators on enforcement issues. In 2013, SEC staff provided assistance and access to files to domestic regulators in 504 investigations and to foreign regulators in 508 investigations.</p> <p>In addition, the U.S. Department of Justice (through both U.S. Attorney’s Offices and the Civil Division of the Department of Justice in Washington, DC) brings civil actions for securities fraud and other financial fraud; this includes circumstances when the higher standard of proof in criminal cases is not met.</p> <p>The U.S. Department of Justice has a Financial Fraud Enforcement Task Force based in Washington, DC, which coordinates certain criminal and civil actions in complex financial crimes cases.</p> |
| Assessment | Broadly Implemented |
| Comments | <p>The supervision and examination programs of the SROs, and of the SEC and the CFTC, for intermediaries and CIS are described in more detail under the relevant sectoral Principles (especially Principles 24 and 31). Overall, these programs provide for regular cycle examinations of most intermediaries so that even lower risk firms are examined on a regular basis. For cause examinations are also undertaken, in response to particular information such as tips or complaints. For intermediaries other than IAs, the NFA and FINRA carry out most of these examinations, and based on files reviewed by the assessors the examinations are well focused and thorough, with appropriate follow up actions taken where problems are identified. The SEC, and to a lesser extent the CFTC, also carry out direct risk-based examinations, which are also used to test the effectiveness of the supervision carried out by the SROs.</p> <p>For reasons described under Principles 24 and 31, the SEC’s supervision of IAs, including those that operate mutual funds, is less intensive and examinations cover a relatively small percentage of the population each year. This is the reason for the grade under this Principle. The SEC uses sophisticated systems to profile risk and to identify higher risk IAs for examination, but given the importance of the mutual fund and asset management sectors, more frequent examinations of IAs are warranted.</p> <p>Both the SEC and the CFTC make robust use of their enforcement powers, and devote considerable resources to their enforcement activities. Enforcement actions by the agencies cover all areas within their jurisdictions. In particular, the SEC has significantly enhanced many aspects of its enforcement program. These enhancements enable it to better detect and act on problematic behavior reported to it through tips and complaints. Its new specialized enforcement units and taskforces actively monitor priority areas where misconduct may have an impact on the markets or investors.</p> <p>The criminal authorities act on referrals from the regulators and from other sources, and on their own initiative. There are strong incentives for them to act on high profile cases, but attention is also given to smaller cases especially at the state and district level.</p> |
| Principles for Cooperation in Regulation | |
| Principle 13. | The regulator should have authority to share both public and non-public information with domestic and foreign counterparts. |
| Description | <p>Authority to share information</p> <p>Section 24(c) of the Exchange Act and Rule 24c-1 provide that the SEC may, in its discretion and upon showing that the information is needed, provide any records and information in its</p> |

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| | <p>possession⁶ to a range of domestic and foreign regulators and other authorities,⁷ subject to appropriate assurances of confidentiality. Rule 24c-1 specifically includes foreign financial regulatory authorities⁸ among the persons to whom the SEC may provide information. The SEC staff generally relies on the information provided by the requestor as to the need for the information.</p> <p>Upon request, the CFTC may share information with any domestic⁹ or foreign¹⁰ regulator (or other authority) acting within the scope of its jurisdiction, provided that the requirements in Section 8(e) of the CEA are satisfied. The CFTC staff informed that it generally relies on the information provided by the requesting regulator or authority as to the matter falling within the scope of the requestor's jurisdiction.</p> <p>The information sharing right of both the SEC and CFTC covers that required under Key Questions 13.1(a)-(g) and 13.3(a)-(g). It can also include information concerning the beneficial ownership or control of a bank or brokerage account as well as information necessary to reconstruct a transaction, including bank records. No external approval is needed for the SEC or CFTC to share information.</p> <p>The SEC and CFTC have procedures in place for sharing non-public information designed to ensure that the required assurances of confidentiality and use are obtained either through an MOU or less formal arrangements, such as access request letters.</p> <p><i>Specific information sharing powers under the Dodd-Frank Act</i></p> <p>Sections 112(d)(1)-(2) of the Dodd-Frank Act authorize the FSOC to request and receive, and member agencies to provide, any data or information as necessary to monitor the financial services marketplace to identify potential risks to the financial stability of the United States or to otherwise carry out any of the relevant Dodd-Frank Act provisions. Section 809(e) of the Dodd-Frank Act includes specific information sharing powers on designated financial market utilities (DFMUs) or financial institutions engaged in designated activities (DFMIs) with both domestic and foreign authorities.</p> <p><i>No requirement for the breach of U.S. law</i></p> <p>Section 21(a)(2) of the Exchange Act explicitly authorizes the SEC to provide assistance to a foreign securities authority without regard to whether the facts as stated in the foreign securities authority's request would also constitute a violation under U.S. laws. Similarly, Section 12(f)(1) of the CEA expressly states that the CFTC may provide investigative assistance to a foreign futures authority, including collecting and sharing information, without regard to whether the facts</p> |
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⁶ This also covers information that the SEC gathers as a result of a request for information.

⁷ This includes federal, state, local and foreign governmental authorities; SROs; foreign financial regulatory authorities; SIPC and its trustees; trustees in bankruptcy; court-appointed persons charged with performing functions arising from securities litigation, such as receivers; and professional licensing or oversight authorities that are government-sponsored, such as bar associations that are part of a state court system.

⁸ The term foreign financial regulatory authority includes foreign securities authorities, other foreign governmental bodies, or foreign equivalents of an SRO empowered by a foreign government to administer or enforce its laws related to financial activities.

⁹ A domestic regulator or authority refers to a federal department or agency or any department or agency of any state or any political subdivision thereof.

¹⁰ A foreign regulator or authority refers to any foreign futures authority or any department, central bank, ministry or agency of any foreign government or any political subdivision thereof.

stated in the request would also constitute a violation of the laws of the United States.

Customer financial records

If the SEC or CFTC is seeking financial records of a customer (defined in the Right to Financial Privacy Act (RFPA) as an individual or a partnership of five or fewer individuals) from a covered financial institution (including a bank), it must follow specific procedures. According to these procedures, a government authority may have access to or obtain copies of such customer's financial records, if the customer has either authorized such disclosure or, after notice to the customer, the disclosure takes place in response to an investigative subpoena (Section 3402 RFPA). An SEC or CFTC subpoena has to indicate that it is from the respective agency, and that the records are relevant to a legitimate law enforcement inquiry. A copy of the subpoena must be served on the customer or mailed to the customer's last known address. (Section 3405 RFPA).

Requests from foreign authorities under the IOSCO MMOU for financial records covered by the RFPA require consulting the requesting authority before disclosing the request to the customer (Section 11.a of the MMOU). According to the SEC and CFTC, when the SEC or CFTC is making the request on behalf of a foreign authority, the subpoena would identify the SEC or CFTC as the requester and typically would not reveal the name of the requesting foreign authority, nor detailed information about the investigation. Access to records can be gained, if 10 days have expired from the date of service or 14 days have expired from the time of mailing and the customer has not challenged the inquiry. The customer can try to challenge the disclosure of his/her records only on the basis of very limited grounds, including that the records are not relevant for the law enforcement inquiry in question.

The SEC and CFTC could also in certain circumstances obtain the financial records through a delayed notice provision without first notifying the customer. In the case of the SEC, this approach would involve seeking approval from an appropriate court to delay notice to the customer if (Section 21(h) Exchange Act):

A delay in obtaining access to bank records or providing notice would result in a flight from prosecution, destruction of 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;

A delay is necessary to identify or trace the record or beneficial ownership interest in any security;

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; or

The acts or practices under investigation involve significant financial speculation in securities or endanger the stability of any financial or investment intermediary.

The CFTC is subject to the general RFPA conditions for delaying notice to the customer that enable such delay by order of an appropriate court subject to certain conditions, including that there is reason to believe that a notice would result in endangering life or physical safety of any person; flight from prosecution; destruction of or tampering with evidence; intimidation of potential witnesses; or otherwise seriously jeopardizing an investigation or official proceeding or unduly delaying a trial or ongoing official proceeding.

When the agencies receive requests from foreign authorities that require complying with the RFPA, staff explains the RFPA's requirements and notice provisions, on the basis of which the foreign authority can decide on its preferred course of action. The CFTC has been subject to

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| | <p>fewer information requests from foreign authorities than the SEC. In the most recent case, the foreign authority requested the use of the delayed notification procedure.</p> <p>Similarly, U.S. government agencies are subject to restrictions on obtaining certain information from internet service providers under the Electronic Communications Privacy Act (ECPA).</p> <p>Unsolicited information</p> <p>The SEC may share nonpublic information with appropriate authorities on the basis of Section 24(c) of the Exchange Act upon showing that it is needed and that the authority receiving the information provides assurances of confidentiality as the SEC deems appropriate. In some instances, both of these requirements can be satisfied without a request for assistance, as is the case under various MOUs. For example, Section 13 of the IOSCO MMOU authorizes a signatory to proactively share information without prior request under the conditions specified.</p> <p>Section 8(g) of the CEA provides that the CFTC may provide, on its own initiative, registration information to certain authorities. In other cases, the CFTC can share information subject to the conditions set forth in Section 8(e) of the CEA described above. In practice, if the CFTC knows that the information in its possession may be important to another regulator or authority, it encourages the other regulator or authority to make a request for information (if contemplated by the supervisory arrangements) to comply with the relevant Section 8(e) requirement.</p> |
| Assessment | Fully Implemented |
| Comments | The RFPA requirements to give notice to customers on requests for records require consulting the requesting authority. This is consistent with the IOSCO MMOU. The customer is provided with very limited information on the reasons for the request and the process is relatively streamlined. |
| Principle 14. | 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. |
| Description | <p>Power to enter into information sharing arrangements</p> <p>Both the SEC and CFTC have the power to enter into information-sharing arrangements with other domestic and foreign authorities under Section 24(c) of the Exchange Act and Section 8(e) of the CEA, respectively. Both the SEC and CFTC MOUs are approved by the respective Commissions and signed by the Chair or his/her designee. Both agencies can also use less formal arrangements, such as ad hoc requests for information, to facilitate information sharing. This applies regardless of whether a foreign authority has signed the IOSCO MMOU or a bilateral MOU. No written, confidential information can be shared either with a domestic or foreign regulator or authority without an MOU or another type of arrangement, such as an access request letter which provides the necessary assurances of confidentiality and limitations on the use of the information.</p> <p>The Dodd-Frank Act includes two provisions that explicitly relate to information sharing arrangements with foreign regulatory authorities. Under Section 752(a) of the Dodd-Frank Act, the CFTC, SEC and prudential regulators may agree to any necessary or appropriate information sharing arrangements to promote effective and consistent global regulation of swaps and security-based swaps. Specific reference is also made to the right of the CFTC to agree on information sharing arrangements for the regulation of commodity futures and options on such futures (Section 752(b) Dodd-Frank Act).</p> <p>Existing arrangements</p> |

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| | <p><i>Domestic</i></p> <p>The SEC and/or the CFTC have entered into MOUs to facilitate supervisory cooperation with other domestic regulators, including the following:</p> <p>The SEC and the Federal Reserve MOU (July 2008);</p> <p>The SEC, the Federal Reserve and the CFTC MOU on CDS CCPs (November 2008); and</p> <p>The SEC and CFTC MOU establishing a permanent regulatory liaison between the agencies and providing for enhanced information sharing, including an addendum relating to novel financial products that may reflect elements of both securities and commodity futures or options (March 2008).</p> <p><i>Foreign</i></p> <p>Both the CFTC and the SEC have been signatories to the IOSCO MMOU since 2002. The primary MOU used by the CFTC for enforcement purposes is the IOSCO MMOU. Before the establishment of the IOSCO MMOU, the SEC had signed bilateral information sharing MOUs for enforcement cooperation with the securities authorities of 20 different countries. In light of the IOSCO MMOU, the SEC staff now strongly 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.</p> <p>The SEC has also entered into supervisory MOUs regarding cross-border regulated entities with its counterparts in several jurisdictions. The scope of these MOUs varies depending on the level and type of cross-border activity. In addition, the SEC has entered into protocols that cover the sharing of nonpublic issuer specific information relating to the application of IFRS and U.S. GAAP by dually listed issuers. A list of the SEC's MOUs, including MOUs for supervisory cooperation, is available on the SEC's website.</p> <p>Where a foreign authority is not a signatory to the IOSCO MMOU, the CFTC may use bilateral cooperative arrangements entered into primarily for enforcement purposes or informal letter arrangements. Copies of MOUs and other information sharing arrangements are available on the CFTC website.</p> <p>The CFTC has also entered into a range of cooperative arrangements for supervisory, prudential and risk assessment purposes, financial information sharing, and supervision of CIS and the alternative investment fund industry. The CFTC is also a signatory to the Boca Declaration on Cooperation and Supervision of International Futures Exchanges and Clearing Organizations. The CFTC has also entered into supervisory MOUs with respect to regulated entities operating on a cross-border basis.</p> <p>Confidentiality</p> <p>The confidentiality requirements described in Principle 5 apply to the SEC and CFTC and their staff. In addition, there are specific requirements that relate to confidentiality of information exchanged with other authorities.</p> <p><i>SEC</i></p> <p>The SEC can generally maintain the confidentiality of a request for information received from a foreign regulator. This is ensured primarily through the following:</p> <p>Section 24(d) of the Exchange Act provides a basis for denying a third-party request made under the FOIA for records provided by a foreign securities authority that has informed the SEC that disclosure of such information would violate the domestic laws applicable it;</p> |
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| | <p>Section 24(f) of the Exchange Act provides that the SEC cannot be compelled to disclose privileged information obtained from any foreign securities or law enforcement authority, if the latter has informed the SEC that the information is privileged.</p> <p>Section 24(g) of the Exchange Act provides that the SEC is not authorized to withhold information from the Congress or prevented from complying with a court order in an action commenced by the United States or the SEC. As a result, the Congress is entitled to obtain certain information from the SEC. However, it is the practice of the SEC to undertake to keep information provided by a foreign securities authority non-public with the understanding that disclosure could harm the SEC's relationship with the foreign securities authority and adversely affect the SEC's ability to obtain information from the foreign securities authority in the future. According to the SEC staff, requests for this type of information are infrequent and the Congress has been made aware of the need to preserve confidentiality of non-public information held by the SEC.</p> <p><i>CFTC</i></p> <p>Pursuant to CFTC Regulation 11.3, information and documents obtained by the CFTC in the course of any investigation (including investigations initiated to assist a foreign futures authority) are deemed non-public and confidential, unless made a matter of public record (e.g., as part of a civil or administrative proceeding).</p> <p>The CFTC has additional authority to protect from disclosure information regarding requests made by foreign futures authorities and information received from them:</p> <p>The CFTC can refuse to make public under the FOIA documents, where their disclosure could interfere with the CFTC's or any other authority's enforcement activities or disclose the identity of a confidential source, including a foreign agency or authority (CFTC Regulations 145.5(g)(1) and (4));</p> <p>With the exception of legally enforceable demands, the CFTC cannot be compelled to disclose any information obtained from a foreign futures authority, if the latter has stated that public disclosure of the information would violate its laws and the CFTC has obtained the information pursuant to an MOU or other relevant procedure (Section 8(a)(1) CEA); and</p> <p>The CFTC's DOE may withhold from producing in an administrative enforcement proceeding information obtained from a domestic or foreign governmental entity or from a foreign futures authority that either is not relevant to the resolution of the proceeding or was provided on condition that the information not be disclosed or that it only be disclosed as evidence in an enforcement or other proceeding (CFTC Regulation 10.42(b)(2)(v)).</p> <p>The CFTC follows a similar approach to that of the SEC with regards to information requests from Congress (Section 8(a)(1) CEA).</p> <p>Practice</p> <p><i>Domestic information sharing</i></p> <p>The SEC's and CFTC's practice in sharing information with other domestic authorities is described in Principles 1 (other federal authorities and state authorities), 11 (criminal authorities) and 13.</p> <p><i>Foreign information sharing</i></p> <p>At the SEC, requests for assistance from foreign authorities (or to foreign authorities) are handled centrally by the Office of International Affairs (OIA), in close coordination with Enforcement and the other Divisions and Offices, including OCIE and OCR. In fiscal years 2012,</p> |
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| | <p>2013 and 2014, the SEC responded to, respectively, 450,508, and 548 requests for enforcement assistance from foreign authorities. In addition, the SEC provided assistance and received assistance in cross-border examinations and other supervisory matters.</p> <p>Within the CFTC, the responsibility for foreign information sharing relating to the investigation and prosecution of derivatives laws lies within the DOE's International unit. During fiscal year 2013, the CFTC received 69 requests for assistance from 23 foreign regulators and authorities and provided completed responses to 65 of them by the end of the fiscal year. Over the past three fiscal years, the CFTC responded to 173 requests, with an average response time of 39.6 days. In addition, the CFTC shared information in connection with cross-border examinations and other supervisory matters.</p> |
| Assessment | Fully Implemented |
| Comments | |
| Principle 15. | 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. |
| Description | <p>Obtaining records, documents, statements and testimonies</p> <p><i>SEC</i></p> <p>Under Section 21(a)(2) of the Exchange Act, the SEC has the authority to open a formal investigation to provide assistance to a foreign securities authority to determine whether any person has violated, is violating or is about to violate any laws or rules relating to securities matters that the requesting authority administers or enforces. The SEC may provide such assistance without regard to whether the facts stated in the request would constitute a violation of U.S. laws. In exercising this authority, the SEC has to consider whether the requesting authority has agreed to provide reciprocal assistance to the SEC, and whether compliance with the request would prejudice the public interest of the U.S. While not a prerequisite for sharing information with a foreign counterpart, requests made pursuant to an MOU between the SEC and a foreign authority, including the IOSCO MMOU, generally would be deemed to satisfy the reciprocity requirement.</p> <p>As part of providing assistance to a foreign securities authority, the SEC may use its powers under Section 21(b) of the Exchange Act as it would in its own investigations. This 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 U.S. This power is very broad in scope, authorizing any member of the SEC or any officer designated by it 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 that the SEC deems relevant or material to the inquiry. Such attendance of witnesses and the production of any such records may be required from any place in the U.S. at any designated place of hearing.</p> <p><i>CFTC</i></p> <p>The CFTC's ability to provide assistance to foreign authorities is practically identical to that of the SEC. Section 12(f)(1) of the CEA states that, upon request from a foreign futures authority, the CFTC may, in its discretion, provide assistance in conducting an investigation that the foreign futures authority deems necessary to determine whether any person has violated, is violating, or is about to violate any laws, rules or regulations relating to futures or options matters that the requesting authority administers or enforces. The CFTC may conduct such investigation as it deems necessary to collect information and evidence pertinent to the request for assistance. Section 12(f)(2) of the CEA requires the CFTC, in deciding whether to provide assistance, to</p> |

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| | <p>consider whether the requesting authority has agreed to provide reciprocal assistance to the CFTC in futures and options matters and whether compliance with the request would prejudice the U.S. public interest.¹¹ Assistance may be provided without regard to whether the facts stated in the request would also constitute a violation of the laws of the United States.</p> <p>As in the case of the SEC, the CFTC may compel on behalf of a foreign futures authority the production of documents and the taking of statements.</p> <p><i>Independent interest</i></p> <p>The SEC and CFTC are not restricted from sharing information or obtaining information even if they do not have an independent interest in a matter.</p> <p>Providing other assistance</p> <p>Both the SEC and CFTC are able to offer assistance to foreign regulators in securing compliance with the laws and regulations identified in Key Question 2. They can also provide information on the relevant regulatory processes in the U.S. They do not have the power to use their statutory authority to seek urgent injunctions and asset freezes on behalf of foreign regulators. However, they can assist in advising foreign regulators on how to initiate a proceeding in civil court or request the assistance of the DOJ.</p> <p>Foreign regulators may also pursue assistance in obtaining court orders through a mutual legal assistance treaty or a multilateral instrument such as the U.N. Convention against Transnational Organized Crime (UNTOC). DOJ has the ability to assist foreign regulators and foreign criminal authorities in obtaining court orders to issue search warrants, obtain asset freezes, summon witnesses, and compel the production of documents and other evidence. The ability to assist a foreign regulator depends on the specific language of the mutual legal assistance treaty between the U.S. and the foreign country or the terms of UNTOC; typically the remedies offered are only available to prosecutors for criminal violations.</p> <p><i>Providing information on financial conglomerates</i></p> <p>The SEC can provide supervisory assistance under Section 24(c) of the Exchange Act. Similarly, the CFTC can share supervisory information under Section 8(e) of the CEA and obtain information under Section 12(f)(1) of the CEA. Such supervisory information sharing is based on information that the SEC and CFTC already have in their possession or that they can receive from the books and records of supervised entities. This can include information covered by Key Question 7.</p> <p>Supervisory MOUs provide a mechanism by which the SEC, CFTC and their counterparts can consult, cooperate, and share information on a confidential basis about regulated entities that operate across borders. These supervisory MOUs facilitate the easier sharing of supervisory information, including on financial conglomerates.</p> |
| Assessment | Fully Implemented |
| Comments | |
| Principles for Issuers | |

¹¹ This provision also applies to swaps (Section 723(a)(2) of the Dodd-Frank Act added Section 2(d) to the CEA to provide that several enumerated provisions, including Section 12(f), apply to swaps).

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| Principle 16. | There should be full, accurate and timely disclosure of financial results, risk and other information that is material to investors' decisions. |
| Description | <p>Background</p> <p>Disclosure obligations associated with the public offering of securities stem from federal securities laws. Monitoring issuers' compliance with such obligations is a function entrusted to the SEC. In addition, each exchange's listing requirements impose a set of disclosure obligations on issuers, which in general replicate federal requirements, although in a few areas they supplement them. Therefore this assessment focuses on the federal framework—although where appropriate complementary requirements of the exchanges are mentioned. Monitoring compliance with such listing requirements is the exchanges' responsibility.</p> <p>Public offering of securities</p> <p>Under the Securities Act (Sections 3-5), every offer or sale of a security must be registered with the SEC unless an exemption is available. The Securities Act provides exemptions from registration for (i) specific types of securities (such as any security issued or guaranteed by the government (other than foreign governments) or a bank but not a bank holding company, offerings of short-term commercial paper and municipal securities) or (ii) certain types of transactions (in general such exemptions include limitations on the amount that can be raised and/or the type of investors to which the offer can be addressed). The JOBS Act expanded some of the transactional exemptions currently available by (i) allowing general solicitation of certain offers provided that the securities are only sold to accredited investors or qualified institutional buyers depending on the exemption; (ii) exempting from registration offerings up to \$50 million, subject to certain conditions including SEC review and the SEC qualifying the offering statement; and (iii) permitting offerings through crowdfunding up to \$1 million annually without registration. The SEC has already approved regulations for (i) and issued proposals for consultation for (ii) and (iii).</p> <p>Registration statement and prospectus</p> <p>To register a securities offering under the Securities Act, an issuer must file a registration statement with the SEC. The registration statement includes a prospectus.</p> <p>SEC regulations require a prospectus to include disclosure in specific items: (i) information with respect to the issuer, including financial statements (3 years), subject to scaling for smaller reporting companies and emerging growth companies, and selected financial data; the management's discussion and analysis of financial condition and results of operations; description of the issuer and its business; material legal proceedings; description of properties; identification of directors and executive officers; executive compensation and corporate governance; security ownership of certain beneficial owners and management; and transactions with related persons, promoters, and certain control persons; (ii) description of the securities to be registered; (iii) risk factors relating to the issuer and the offering; (iv) dilution; (v) use of proceeds; (vi) a plan of distribution; (vii) the manner of determining the offering price; and (viii) the interests of named experts and counsel. In addition to the specific line items, 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."</p> <p>A registration statement must also 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. In addition, the exhibits must include various documents such as the underwriting agreement,</p> |

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| | <p>the issuer's certificate of incorporation and bylaws, legal opinions, and material contracts.</p> <p><i>Presentation of information</i></p> <p>The SEC's rules under the Securities Act allow for different methods to present 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.</p> <p><i>Shelf registration</i></p> <p>Shelf registration is available to eligible issuers, whereby they can register their securities up to three years in advance of the offering. They initially file a short registration statement that may be reviewed by the SEC staff unless the issuer files an automatically effective shelf registration statement which is available to certain larger issuers. Once it becomes effective, the issuer files a prospectus supplement for each offering with no additional action required by the SEC for the offering to become effective.</p> <p><i>Distribution of prospectus</i></p> <p>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. Under current rules (updated in 2005) which are based on an "access equals delivery" model, 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. In an IPO, Rule 15c2-8 under the Exchange Act requires a broker or dealer to deliver a preliminary prospectus to investors at least 48 hours before the confirmation of the sale of the securities is sent.</p> <p>Periodic requirements</p> <p>The following issuers are subject to the periodic reporting requirements of the Exchange Act:</p> <p><i>Issuers that want to list on a national securities exchange</i> (Section 12(b) of the Exchange Act).</p> <p><i>Issuers with registered offerings</i> unless they satisfy one of the following "thresholds," in which case their filing obligations are suspended after the initial filing year: (i) the company has fewer than 300 shareholders of record of the class of shares offered (1,200 shareholders of record if the company is a bank or bank holding company). SEC staff indicated that in the case of banks and bank holding companies, 96 bank holding companies elected to suspend obligations. Currently there are roughly 500 reporting banks, but approximately 150 meet the criteria to suspend reporting.</p> <p><i>Non-Listed Companies:</i> U.S. issuers which, on the last day of their fiscal year, have more than \$10 million in total assets and a class of equity securities held by either (i) 2,000 or more record holders; or (ii) 500 or more record holders who are not accredited investors must register that class of securities. For banks or bank holding companies, the requirement applies if the company has more than \$10 million in total assets and a class of equity securities held by 2,000 or more record holders (Section 12(g) Exchange Act). These are generally smaller issuers that trade in the OTC markets. According to market participants, the majority of trading is from retail investors.</p> <p><i>Annual reports</i></p> <p>Reporting issuers must file annual reports on Form 10-K. The annual report requires disclosure about the company in all of the same areas, and addresses the same topics, as is required in a prospectus for an IPO under the Securities Act, other than offering-related information.</p> <p>The financial statements required to be included in the annual report include three years of</p> |
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statements of income, cash flow, and changes in shareholders' equity, two years of balance sheets, and a discussion of subsequent events. 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. In addition, pursuant to SOX 404 the annual audited financial statements for issuers with a public float of \$75 million or more must be accompanied by an attestation of the auditor regarding the effectiveness of the internal controls for financial reporting.

The MD&A must accompany the financial statements. The MD&A addresses the financial condition, results of operations, liquidity and capital resources 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. This disclosure also includes off-balance sheet disclosures and contractual obligations.

Large accelerated filers must file annual reports within 60 days, accelerated filers within 75 days and all other U.S. filers within 90 days of the fiscal year-end covered by the report.

Quarterly reports

Issuers must also file quarterly reports for the first three fiscal quarters on Form 10-Q. They 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.

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. Financial statements in quarterly reports also are required to be accompanied by an MD&A.

The requirements for quarterly reports with respect to non-financial statement and related information are not as extensive and do not require updating of all information required in the annual report.

Large accelerated filers and accelerated filers must file a quarterly report within 40 days and all other domestic filers within 45 days after the end of the fiscal quarter covered by the report.

SOX reports

Section 302 of the Sarbanes-Oxley Act (SOX) and corresponding SEC Rules 13a-14(a) and 15d-14(a) require issuers' principal executive officer(s) and principal financial officer(s) to certify in each quarterly and annual report that the reports fairly represent the financial condition and results of operation of the issuer, as well as certify on the effectiveness of financial reporting controls. Section 906 of SOX requires that each periodic report be also accompanied by a certification by the same officers that the report fairly presents, in all material respects, the financial condition and results of operations of the issuer. A person who certifies any statement knowing that the report does not comply with the requirements set forth in SOX is subject to criminal sanctions ranging from fines to imprisonment.

Material events

Domestic issuers must file current reports on Form 8-K upon the occurrence of a set of enumerated events. This is an "exhaustive" list of events (expanded by the SEC in 2004 as a result of SOX). These reports must be filed within 4 business days. In addition, each registered

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| | <p>securities exchange generally requires its listed companies to (i) timely disclose information that may affect security values or influence investment decisions; and (ii) timely provide the exchange with other information in order to maintain an orderly market in the company's securities. (See for example 202.05 of the Listed Company Manual of the NYSE and Nasdaq Rule 5250(b)(1)). As a result of these obligations, in practice the communication of material events by listed issuers usually takes place on shorter deadlines than the 4 business days required under the SEC framework.</p> <p><i>Selective disclosure</i></p> <p>Regulation FD 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.</p> <p><i>Shareholder's voting decisions</i></p> <p>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 of the Exchange Act. 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.</p> <p>Scaled disclosure</p> <p>The SEC rules allow certain type of companies to "scale" their disclosure. These companies fall under two categories:</p> <p>Smaller reporting companies, which are companies with public equity float of less than \$75 million or less than \$50 million in annual revenue, and</p> <p>Emerging growth companies (created under the JOBS Act), which are companies with gross revenues of less than \$1 billion during their most recently completed fiscal year.</p> <p>Overall, under the current framework such companies are allowed to include less extensive narrative in their disclosure documents, in particular in connection with compensation, include financial statements for two years only, and are not subject to the auditor attestation of internal control over financial reporting required by SOX.</p> <p>Asset-backed securities</p> <p>Disclosure requirements for ABS, both arising from the Securities Act and the Exchange Act, are contained in Regulation AB, which the SEC initially adopted in 2004. In August 2014, the SEC adopted significant revisions to Regulation AB and other rules regarding the offering process, disclosure, and reporting for ABS as described in Principle 8. In addition, in 2011, the SEC adopted several rules to implement provisions of the Dodd-Frank Act governing the disclosure for ABS, including requiring disclosure of fulfilled and unfulfilled repurchase requests, requiring issuers to review the assets underlying the ABS, and providing for the suspension of the duty to file reports under Section 15(d) of the Exchange Act.</p> <p><i>Prospectus requirements</i></p> <p>The prospectus for ABS must include information on the following areas: (i) disclosure about the transaction parties; (ii) static pool information (to the extent material); (iii) pool assets; (iv) review</p> |
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of assets (the review must be designed and effected to provide reasonable assurance that the prospectus disclosure about the assets is accurate in all material respects. Disclosure about the nature of the review and the findings and conclusions of the review is required to be provided in the prospectus. ABS issuers must also provide disclosure in the prospectus about any assets in the pool that deviate from the disclosed underwriting criteria, including data on the amount and characteristics of those assets that did not meet the disclosed underwriting criteria); (v) information on significant obligors; (vi) description of the securities and structure of the transaction; (vii) credit enhancements; (viii) use of derivative instruments; (ix) reports and additional information; and (x) other disclosure items. In addition to the disclosure items discussed above, the SEC's rules also require disclosure of, among other things, the most significant risk factors that make the ABS offering speculative and risky and how those risks affect investors, including tailored disclosure if certain risks affect only certain classes of investors.

Periodic reporting

ABS are subject to periodic reporting under the Exchange Act in two circumstances:

If ABS are to be listed on a national securities exchange (registered under Section 12 of the Exchange Act); and

If ABS are not going to be listed on a national securities exchange, an offering of ABS that has been registered under the Securities Act triggers a reporting obligation until the securities registered are no longer held by non-affiliates of the depositor (i.e. the issuer is subject to ongoing periodic obligations as long as the securities are held by non-affiliates) (pursuant to Section 15(d) of the Exchange Act).

Annual reports

ABS issuers must file an annual report on Form 10-K with modified requirements. In lieu of audited financial statements, the issuing entity must file as exhibits to the Form 10-K: (i) a report on assessment of compliance with the required servicing criteria from each party participating in the servicing function; and (ii) an attestation report from a registered public accounting firm about the servicer's assessment of compliance with the required servicing criteria. A servicer compliance statement must also be filed as an exhibit to the Form 10-K, which addresses the servicer's compliance with its obligations under the servicing agreement for that particular ABS transaction. Similar to operating companies, ABS issuers must include a certification pursuant to Section 302 of SOX with their annual report on Form 10-K. The annual report for asset-backed transactions must be filed within 90 days after the end of the fiscal year covered by the report.

Quarterly reports

In lieu of quarterly reports, an ABS issuer is required to file reports on Form 10-D containing periodic distribution and pool performance information for each distribution period.

Additionally, certain non-financial disclosures, such as legal proceedings and matters submitted to a vote of security holders that occurred during the period are also required to be included in the Form 10-D. The Form 10-D must be filed within 15 days after each required distribution date of the ABS.

Material events

ABS issuers must file current reports on Form 8-K upon the occurrence of enumerated events as set forth for other reporting issuers.

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| | <p>Foreign issuers</p> <p>There are approximately 940 foreign private issuers that have registered a class of securities or a transaction and file reports with the SEC under the Exchange Act.</p> <p>The SEC has in place a separate disclosure regime specifically tailored to foreign private issuers which differ from those for U.S. issuers in the following ways:</p> <p>Foreign private issuers may present their financial statements 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 without reconciliation to U.S. GAAP.</p> <p>Foreign private issuers are permitted to follow home country requirements for disclosure of executive compensation.</p> <p>Foreign private issuers are required to file annual reports within four months of the fiscal year end</p> <p>Foreign private issuers are not subject to the quarterly reporting requirements of the Exchange Act</p> <p>Foreign private issuers are not subject to Regulation FD;</p> <p>Foreign private issuers are exempt from the requirements to file proxy or information statements under the Exchange Act; and</p> <p>Foreign private issuers' securities are exempt from Section 16 of the Exchange Act, which requires insiders and substantial holdings disclosure.</p> <p>SEC staff indicated that the majority of foreign registered issuers are also listed on a national securities exchange. As a result they are subject to additional disclosure requirements as imposed by the listing requirements of the respective exchange. For example, the exchanges require at least semiannual reporting. An interim balance sheet and income statement must be provided as of the end of the company's second quarter not later than six months following the end of the second quarter, in English, but they do not have to be reconciled to U.S. GAAP. Further, as the U.S. market practice dictates quarterly statements, foreign issuers also routinely provide them.</p> <p>Advertisements</p> <p>Since 2005 when the corresponding rules were amended, SEC rules allow issuers to communicate more openly and freely with investors and the marketplace. Under SEC rules:</p> <p>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);</p> <p>All reporting issuers are permitted, at any time, to continue to publish regularly released factual business information and forward-looking information;</p> <p>Communications by issuers more than 30 days before filing a registration statement are permitted so long as they do not reference a securities offering that is or will be the subject of a registration statement;</p> <p>All eligible issuers and offering participants in eligible issuer offerings are permitted to use "free writing prospectuses" (written offering materials that may not contain all of the information contained or required in a statutory prospectus) generally after the filing of the registration</p> |
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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

Exemptions for research reports were expanded.

Most of these rules are not available to blank check companies, penny stock issuers, or shell companies.

Sufficiency of information

There are several measures available to the SEC that support and promote robust issuers' disclosure, including:

Staff's filing review process: The Securities Act does not specifically provide for the SEC staff to review or clear prospectuses in connection with public offerings of securities. However, the staff has assumed a selective review function for registration statements and prospectuses under the Securities Act as a result of the statutory framework under the Securities Act; in particular due to provisions that require that the registration statement be in effect (Section 5); that state that a registration statement becomes effective 20 days after filing but allows the SEC to accelerate the effectiveness date (Section 8), and stop order suspending the effectiveness (Section 8);

Required certifications relating to the content of disclosure (such as the SOX certifications explained above) or to the eligibility to use scaled disclosure;

Loss of certain benefits if disclosure obligations are not met in a consistent and timely manner: Certain rules and benefits only apply to specific categories of issuers (such as scaled disclosure or use of shelf registration). Breach of obligations would prompt the loss of such benefits;

A registration statement stop order, investigation, or enforcement action concerning violations of the disclosure requirements. 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(j) of the Exchange Act, the SEC is authorized to deny, to suspend the effective date of, to suspend for a period not exceeding 12 months, or to revoke the registration of a security, if the SEC finds that the issuer 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.

Liability

The Securities Act provides for rights of action against persons who sold or are involved in the sale of securities in an offering.

Section 11 of the Securities Act: a private action in connection with material misstatements or omissions in a registration statement against (i) the issuer; (ii) each of its directors; (iii) each underwriter; (iv) each person signing the registration statement, which includes the issuer's principal executive officer, its principal financial officer, and its principal accounting officer; (v) the independent accountant with respect to audited financial statements; and (vi) each expert with respect to information included in the registration statement in reliance upon the expert. All

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| | <p>persons other than the issuer are entitled to certain due diligence defenses;</p> <p>Section 12 of the Securities Act: private action against any person who offers or sells a security by means of a prospectus or oral communication in connection with material misstatements or omissions. 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;</p> <p>Section 17(a) of the Securities Act: general anti-fraud provision, enforceable by the SEC that imposes liability upon any person who commits fraud in connection with the offer or sale of securities; and</p> <p>Since Exchange Act filings are often incorporated by reference into Securities Act filings, issuers may also be liable under Section 10(b), Rule 10b-5, and Section 18 of the Exchange Act.</p> <p>Market participants commented that there is an active exercise of private rights of action and the resulting market discipline effects are significant.</p> <p>Derogations from full disclosure</p> <p>The SEC may grant an issuer's request for confidential treatment of information included in a document file as an exhibit provided the subject information is filed with the SEC for review on a nonpublic basis and the information meets the legal test for exclusion under the FOIA. Often, issuers applying for confidential treatment in connection with filings rely on the FOIA exemption that covers "trade secrets and commercial or financial information obtained from a person and that is privileged or confidential". In practice, these requests usually relate to limited information in the material contracts that the issuer must file. Similar to the selective review process for registration statements, the SEC staff will undertake a preliminary review of a confidential treatment application to determine whether it will receive a full review, a targeted issue review, or a no review. Following the resolution of any comments and the completion of the staff's review, the staff will publicly grant an order for the confidential treatment of the redacted information, if appropriate.</p> <p>The SEC has 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 have adopted rules relating to the temporary suspension of trading of listed securities in certain circumstances relating to the pending announcement of material information (See for example Rules 202.06(B) and 202.07 of the NYSE Listed Company Manual).</p> <p>Availability of information</p> <p>The SEC's website provides public access to the EDGAR system. EDGAR provides free electronic access to the information that companies that have offerings or securities registered with the SEC file in disclosure documents.</p> <p>Practice</p> <p><i>Monitoring program</i></p> <p>Monitoring of issuers' disclosure obligations under the Securities Act and the Exchange Act is a responsibility of SEC's CF, which is comprised of roughly 500 staff. CF performs its review responsibilities through 12 offices organized by industry. These offices comprise approximately 80 percent of CF's employees. Each office is staffed with 25 to 35 professionals, primarily accountants and lawyers. These offices are complemented by three specialized offices (created in 2010) that focus on large financial institutions, asset-backed securities and other structured products, and securities offering trends (mainly innovative products). CF assigns filings by</p> |
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companies to the review office responsible for the company's particular industry.

As required by Section 408 of SOX, CF undertakes some level of review of the periodic reports made under Section 13(a) of the Exchange Act of each reporting company at least once every three years. In addition, CF selectively reviews transactional filings – documents companies file when they engage in public offerings, business combination transactions, and proxy solicitations. CF staff indicated that in its filing reviews, CF concentrates its review resources on critical disclosures that appear to conflict with the SEC's rules or the applicable accounting standards and on disclosure that appears to be materially deficient in explanation or clarity.

The level of review varies from (i) a full cover-to-cover review to review compliance; (ii) a financial statement review in which the staff will examine the financial statements and related disclosure, such as the MD&A of Financial Condition and Results of Operations, for compliance with the applicable accounting standards and the disclosure requirements of the U.S. federal securities laws and regulations; or (iii) 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 U.S. federal securities laws and regulations.

CF establishes review goals for each year. In general, the CF review focuses on the companies that comprise the majority of market capitalization (roughly 2,500 companies account for 98 percent of market capitalization), but other criteria might also trigger a review. In the past fiscal years, CF reviewed the following percentage of companies: (i) FY 2013 52 percent; (ii) FY 2012 48 percent; (iii) FY 2011 48 percent; (iv) FY 2010 44 percent; and (v) FY 2009 40 percent.

In general, reviews require that four people review the filing. In issuing comments to an issuer, the staff may request that a company provide 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. 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.

Comment letters and company responses to those comment letters are published on the SEC's EDGAR system no earlier than 20 business days after CF 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. CF staff indicated that accounting and law firms prepare summaries of SEC comment letters.

For Securities Act transactional filings, the staff seeks to provide initial comments on filings selected for review within 30 days of the filing date. The target of 30 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.

The Office of Disclosure Standards was created in 2013 to evaluate the outcomes of CF's filing review program and create a self-assessment structure. This office has roughly 15 staff. The office provides comments and recommendations to CF in connection with its reviews (for example highlighting inconsistencies).

CF staff also indicated that the SEC is currently engaged in a comprehensive review of disclosure requirements with a view to assessing the effectiveness of current requirements, and eliminating potential duplications.

Enforcement

The SEC has instituted a Delinquent Filings Program, whereby the SEC's Division of Enforcement

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| | <p>conducts investigations into possible violations of the U.S. federal securities laws for failing to make required filings with the SEC, as well as corporate insiders who fail to file the appropriate forms with the SEC regarding their personal securities trades, and prosecutes civil actions and administrative proceedings in this area.</p> <p>In addition, several initiatives within the enforcement division contribute to SEC’s program to monitor issuers’ compliance with their disclosure obligations. In particular, the Enforcement Division has recently created the Financial Reporting and Audit Task Force, which focuses on financial reporting and accounting fraud (further explained in Principle 18).</p> <p>The SEC has also constituted a Microcap Fraud Task Force which closely monitors and pursues misconduct related to microcap securities. Abuses in this area frequently involve entities that use false or misleading marketing campaigns and manipulative trading strategies, largely at the expense of less sophisticated, retail investors. The Task Force engages in initiatives that target executives, gatekeepers, and other repeat players who help facilitate these schemes. The Task Force also aims to identify and shut down schemes in their early stages in order to halt misconduct and mitigate investor harm.</p> <p>Finally the Cross-Border Working Group continues to focus on companies with substantial foreign operations that are publicly traded in the U.S. To date, the SEC has filed fraud cases against more than 65 foreign issuers or executives and deregistered the securities of more than 50 companies.</p> <p>Municipal securities</p> <p>Municipal securities are an important component of the U.S. securities markets. The outstanding amount of municipal securities as of 2014 was roughly US\$ 3.7 trillion, with roughly 45,000 different municipalities issuing debt, and approximately 12,000 bond issues on an annual basis with an issue size of an average of US\$25 million. Retail investors account for a significant portion of this market. Direct retail holdings are estimated at roughly 45-50 percent of total outstanding debt, and indirect holdings (through CIS) at about 25 percent. Historical rates of default have been low (less than 1 percent compared to 11-13 percent for issuers of corporate debt, although the rate of default for non-municipal conduit issuers has been higher).</p> <p>Municipal securities (which definition includes obligations of non-municipal conduit borrowers) are exempted from the registration and reporting requirements established by the Securities Act and the Exchange Act. In addition, the “Tower Amendment” to the Exchange Act prohibits the SEC and the MSRB from requiring state and local government issuers of municipal securities, either directly or indirectly through their underwriters, to make any specific disclosure filing with the SEC or MSRB prior to the sale of these securities. However, the antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder apply to transactions in municipal securities.</p> <p>While federal regulators are prohibited from directly requiring issuers to file presale information on municipal securities, the SEC has adopted rules—applicable to BDs acting as underwriters—that relate to primary market and continuing disclosures. Using its authority over BDs and its broad authority to prevent fraud in connection with the offer, purchase, or sale of securities, the SEC adopted Rule 15c2-12 in 1989. This rule and its accompanying guidance require underwriters of municipal securities to obtain and review issuers’ official statements and provide them to investors. In addition, the rule was amended in 1995 to require underwriters to reasonably determine that issuers have entered into a written continuing disclosure agreement for the benefit of municipal securities holders to provide (i) annual financial information and operating data of the type included in the official statement and, if available, audited financial statements; and (ii) notices of certain material events. Beginning in 2009, issuers have been</p> |
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| | <p>required by the agreements to provide the continuing disclosure information and data to the Electronic Municipal Market Access (EMMA) database held by the MSRB (either directly or by engaging a third-party dissemination agent to submit such information and data on their behalf).</p> <p>The GAO issued reports on the municipal market in 2011 and 2012 and the SEC issued a report on the municipal market in 2012. These reports found significant challenges in the quality, consistency and timeliness of disclosure by municipal issuers as well as with the mechanisms available to participants to enforce compliance with contractual obligations related to disclosure. The SEC report provided a number of recommendations for consideration. Such recommendations included legislative proposals to provide the SEC with additional authority to impose disclosure requirements on municipal issuers, as well as proposals for actions within the current scope of the authority of the SEC.</p> <p>The SEC recently created the Office of Municipal Securities to coordinate its municipal securities activities. The Office works closely with the municipal securities industry to educate state and local officials and conduit borrowers about risk management issues and foster a thorough understanding of the SEC's policies. It also reviews and processes MSRB rule filings and acts as the Commission's liaison with the MSRB, FINRA, and a variety of industry groups on municipal securities issues.</p> <p>On the enforcement side, the Division of Enforcement created the Municipal Securities and Public Pensions Unit (MSPPU) in 2010 to focus on the SEC's enforcement efforts to police misconduct in the municipal securities market and in connection with pension funds for state and local government employees. The MSPPU has brought several high profile enforcement actions including the following recent examples. The SEC brought the first case charging a municipal issuer with falsely stating to bond investors that it had been providing the required annual financial information and notices in its prior bond offerings. The SEC also brought the first case against an underwriter charging it with violations of the MSRB's pay-to-play rule for "in-kind" political donations.</p> <p>Additionally, the MSPPU recently launched a novel cooperation initiative - the Municipalities Continuing Disclosure Cooperation Initiative - to encourage issuers and underwriters who have conducted offerings that have included false representations as to prior compliance with Rule 15c2-12 filing requirements to self-report those violations in exchange for favorable settlement terms.</p> |
| Assessment | Broadly Implemented |
| Comments | <p>The main reason for the grade relates to the disclosure regime applicable to the offerings of municipal securities.</p> <p>In general, the U.S. legal and regulatory framework subject issuers of securities that are offered to the public to robust disclosure requirements at the moment of the offering and on an ongoing basis. However, the current framework exempts municipal securities from the registration and reporting requirements of the Securities Act and the Exchange Act. Through indirect mechanisms, municipal issuers that want to offer their securities to the public have been subject to disclosure obligations at the moment of the offering as well as on an ongoing basis. However, on the basis of the GAO and SEC reports and conversations with market participants and SEC senior staff, the assessors concluded that these indirect mechanisms have been insufficient to ensure the consistency and quality of the information provided (including the accounting principles used) or consistency in the timeliness with which such information is provided to investors.</p> <p>The assessors acknowledge that the SEC has made municipal securities a key area of focus of its</p> |

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| | <p>enforcement program through the creation of the MSPPU. However, the MSPPU is of recent creation and it is therefore too early to assess whether an increased focus on enforcement by itself, without any other direct authority of the SEC, can bring the disclosure by issuers of municipal securities to a satisfactory level. The municipal securities market has a significant level of retail participation. Although historical rates of default have been low, these securities are exposed to default risk. This legal gap in statutory authority has therefore affected the grade.</p> <p>In addition, the assessors considered the current thresholds for suspension of reporting obligations. The assessors consider that an approach that links periodic reporting obligations to a minimum level of dispersion of a company's securities seems reasonable; however the current thresholds –established by law—appear high, therefore leaving shareholders of companies with an already high level of dispersion without the benefit of periodic information. This applies especially to banks and bank holding companies.</p> <p>Two more issues deserve comment, although they were not taken into consideration for the grade.</p> <p>First, the assessors note that the obligations to disclose material events imposed by the SEC rules are limited to a list of predefined events. In practice this means that there could potentially be material events that would not be communicated to the market until in the quarterly reports. In addition, the deadline to communicate material events included in the list appears long compared with international best practices. However, the exchanges do impose on listed companies a general obligation to disclose events that can affect the price of securities on a prompt basis, which is understood to mean immediate release. Given that the majority of issuers of registered securities are listed, this issue has not been considered for the grade.</p> <p>Second, foreign issuers are not subject to periodic reporting other than an annual report, and thus the regime does not appear to provide a similar level of disclosure as provided by domestic issuers. Nevertheless, the assessors note that these issuers are generally listed and thus through their listing they are subject to stronger disclosure obligations.</p> |
| Principle 17. | Holders of securities in a company should be treated in a fair and equitable manner. |
| Description | <p>Background</p> <p>Shareholders rights and corporate governance are governed by</p> <p>State corporate law: formation and incorporation of companies, and the terms of governance among shareholders, the board of directors, and management;</p> <p>Corporate chartering documents: State corporate law allows the basic chartering documents of a corporation to provide for different rights than may be set out under the statutory provisions (the Delaware Corporate Law is the most relevant from the securities markets perspective as it is a preferred place of incorporation for the majority of corporations);</p> <p>Federal securities laws: The Securities Act and the Exchange Act regulate offerings and sales of securities and on-going disclosure by public company issuers. The Exchange Act also regulates the process by which public companies solicit proxies in connection with shareholder meetings; and</p> <p>Exchange rules: The corporate governance listing requirements of several stock exchanges, including the NYSE and NASDAQ, the principal markets in the United States, are broadly similar, but they do vary in some respects.</p> <p>Voting</p> <p>State corporate laws cover basic provisions in connection with shareholders' voting rights</p> |

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| | <p>including:</p> <p>The right of shareholders to vote under the principle of one share one vote unless otherwise provided in the certificate of incorporation (DGCL 212(a));</p> <p>The right of the corporation to 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 in the certificate of incorporation (DGCL Section 151);</p> <p>The right of shareholders entitled to vote at a meeting of stockholders or to express consent or dissent to corporate actions in writing without a meeting to authorize another person to act for such stockholder by proxy (DGCL Section 212(b));</p> <p>The need for written notice not less than 10 and not more than 60 days before the day of the meeting (DGCL Section 222); and</p> <p>The way to fix the record date for determining stockholders (Section 213). Further, the record date must not be more than 60 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 60 day/ten day notice provisions required for an initial meeting date are observed.</p> <p>Federal securities laws complement the above framework, in particular in connection with proxy voting. 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 connection with or in lieu of a stockholders' meeting pursuant to Schedule 14C under the Exchange Act.</p> <p>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 or without a vote at a 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.</p> <p>Federal securities laws also contain other requirements relating to the efficient distribution of proxies and information statements to beneficial owners. Domestic issuers have an obligation under the proxy rules to distribute proxy and other soliciting material to banks and brokers on a timely basis to be forwarded to beneficial owners.</p> <p>Exchange rules complement these obligations in several areas, such as:</p> <p>Notice of meetings: 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;</p> <p>Notice to exchanges: 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 stockholders meeting called. Nasdaq does not require the notice if a proxy statement is filed via EDGAR;</p> <p>Time of meetings: 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;</p> |
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| | <p>Proxy voting: Section 402.04 of the Listed Company Manual of the NYSE and Section 5620 of the NASDAQ Listing Rules require companies to solicit proxies for all meetings from all stockholders whether registered or beneficial owners; and</p> <p>Rights of shareholders: Section 313.00 of the Listed Company Manual of the NYSE and Section 5640 of the NASDAQ Listing Rules provide that the voting rights of existing shareholders 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. The restriction against the issuance of super voting stock is primarily intended to apply to the issuance of a new class of stock, and companies with existing dual class capital structures would generally be permitted to issue additional shares of the existing super voting stock without conflict with this policy.</p> <p>Election of directors</p> <p>State corporate laws require an annual meeting of stockholders for the election of directors (DGCL Section 211(b)). Pursuant to DGCL Section 214, cumulative voting is possible if provided for in a company's certificate of incorporation.</p> <p>Corporate changes affecting the terms and conditions of securities</p> <p>There are specific state law requirements concerning changes in the certificate of incorporation that would (i) increase or decrease the authorized capital or reclassify it; (ii) cancel or affect rights of shareholders; or (iii) create new classes of stocks (DGCL Section 242(a)). In general, such changes require the company's board to adopt a resolution setting forth the amendment proposed, declaring its advisability, and either calling a special meeting or directing that the amendment proposed be considered at the next annual meeting. The proposed amendment(s) become effective only if a majority of the outstanding stock entitled to vote and a majority of the outstanding stock of each class entitled to vote thereon as a class, vote in favor of the amendment(s).</p> <p>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 20 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. These changes will require the filing of a listing application. Section 312.03 of the Listed Company Manual of the NYSE requires shareholder approval of (i) issuances that will result in common stock with voting power equal to or in excess of 20 percent; (ii) issuances in a change of control of the issuer; (iii) issuance of securities in an equity compensation plan; or (iv) the issuance of common stock in transaction(s) with related parties if the number of shares to be issued or converted exceeds either 1 percent of the number of shares of common stock or 1 percent of the voting power outstanding before the issuance. Likewise, Section 5635 of the NASDAQ Listing Rules requires shareholder approval under similar circumstances.</p> <p>Other fundamental corporate changes</p> <p><i>Mergers and consolidations</i></p> <p>Under DGCL Section 251, the company's board of directors must adopt a resolution stating their advice regarding the proposed merger or consolidation, 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 at least 20 days prior to the date of the meeting. The notice must contain a copy of the agreement or a brief summary</p> |
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thereof. Adoption of the merger or consolidation generally requires the approval of shareholders holding a majority of the outstanding stock of the corporation entitled to vote upon such matters. There are limited exceptions to the requirement of a vote.

Transfer of assets

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 its board of directors deems it to be expedient and for the best interests of the corporation, shareholders holding 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 20 days' notice, and the notice of such meeting states that such a resolution will be considered.

Appraisal rights

Pursuant to DGCL Section 262(c), any corporation may provide in its certificate of incorporation for appraisal rights¹² 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. Even in the absence of such a provision, DGCL Section 262(b) also confers appraisal rights upon stockholders if they are required in the merger to accept cash or certain other consideration for their shares.

Dissolution

Pursuant to DGCL Section 275(a), a corporation may dissolve if it is deemed advisable in the judgment of the board and shareholders holding a majority of the outstanding stock of the corporation entitled to vote thereon adopt a resolution to such effect at a meeting called for that purpose.

Transactions involving a tender offer

Federal securities laws or the SEC's rules do not contain a specific definition of tender offer. The determination of whether a particular course of conduct is a tender offer is important because transactions that constitute tender offers are subject to the federal securities laws and the SEC's rules, which provide specific protections to investors as described below under the Section on third party tender offers. Judicial decisions have enumerated eight factors to be taken into consideration to determine whether a transaction constitutes a tender offer. The eight tender offer factors, each of which is relevant but not individually determinative, are as follows: (i) The bidder makes an active and widespread solicitation of public shareholders; (ii) The solicitation is for a substantial percentage of the target's stock; (iii) The offer is at a premium above the prevailing market price; (iv) The terms are firm rather than negotiable; (v) The offer is contingent on the tender of a fixed minimum number of shares; (vi) The offer is open for a limited period of time; (vii) Shareholders are subject to pressure from the bidder to sell their stock and (viii) The bidder publicly announces an intention to gain control of the target, and then rapidly accumulates stock. In practice this means for example that an acquisition of control via open market transactions or via a private agreement generally would not trigger the requirements set forth in federal laws and SEC rules for tender offers.

There are a number of features of the legal system, principally state corporate laws, that create disincentives for parties seeking to acquire control from doing so other than by negotiating with the board of directors (in cases of statutory mergers) or making a tender offer for all shares.

¹² An appraisal right is the right to receive fair value for a shareholder's securities. Fair value is determined by a court or independent valuer.

First, directors owe a fiduciary duty to shareholders and that principle guides any negotiations between the company and an acquirer. In change of control transactions, the state courts have applied enhanced scrutiny to the actions of a board of directors. Second, most states have adopted some form of business combination statute which prohibits certain transactions—such as mergers, acquisitions of assets, purchases of securities—between the company and an interested stockholder. For example, in Delaware an acquirer of 15 percent or more of a company's outstanding stock is prohibited from engaging in certain transactions with the company unless either its acquisition of stock has been approved in advance by the board of directors or it owned at least 85 percent of the company's outstanding stock after the transaction in which it became an interested stockholder. To reach that 85 percent level, as a practical matter, an acquiring person would need to make a tender offer to all stockholders. Finally, transactions with a controlling stockholder are subject to strict "entire fairness" review by the courts, unless various procedural safeguards (e.g., independent committee, majority of the minority approval) have been put in place to protect the interest of minority stockholders.

Third party (non-issuer) tender offers

Section 14(d) and corresponding Regulation 14D apply to all tender offers for Exchange Act registered equity securities made by parties other than the issuer provided that upon consummation of the tender offer the offeror would beneficially own more than 5 percent of the class of equity securities subject to the offer. An offeror must include any shares it owns before the commencement of the tender offer in calculating the 5 percent amount. Such offers are subject to a set of disclosure and procedural safeguards summarized below.

Disclosure: Section 14(d) of the Exchange Act requires any person or group intending to make a tender offer to file with the SEC a disclosure document on Schedule TO outlining the terms of the offer. A copy must also be delivered to the target issuer and any competing offerors. This document is immediately available to the public via the EDGAR system. In addition, Rules 14d-4(c) and 14d-6(d) require an offeror to disclose promptly any material change in information previously disseminated. This requirement necessarily includes a requirement that security holders be given adequate time to consider the new information.

Time to consider the offer: Rule 14e-1(a) of Regulation 14E requires that an offer remain open for a minimum offering period of 20 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 the class of securities being sought. If an offeror 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.

Withdrawal rights: 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, an offeror 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).

Proration: Rule 14d-8 provides that where more shares are tendered in a partial tender offer within the first ten calendar days of an offer than the offeror 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.

Best price protections: Rule 14d-10 require that each tendering security holder must receive the highest consideration paid to any security holder during the period of the tender offer.

Prompt payment: Rule 14e-1(c) of Regulation 14E requires that the offeror promptly pay for or return securities when the tender offer expires.

Antifraud: Antifraud provisions apply in connection with a tender offer (mainly through Section 14(e) of the Exchange Act).

Obligations for the target company: Rule 14d-9 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 offeror.

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.

Issuer tender offers

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 in the class of equity that is the subject of the offer and that each tendering security holder must receive the highest consideration paid to any security holder during the period of the tender offer.

Other changes of control transactions

State corporate law generally would not apply to a change of control transaction if the transaction does not involve a business combination or shareholders' vote on a matter. The federal securities laws would not apply to a change of control transaction if the transaction does not involve a tender offer, an offer of securities, or a shareholders' vote. However, depending on the circumstances, disclosure obligations might apply. For example, in change of control transactions in which an ownership or management transition may be carried out without a security holder vote, the issuer may be required to disseminate an information statement complying with Schedule 14C of the Exchange Act. Instances in which Section 14(c) may require the dissemination of an information statement are those where management may control sufficient shares to constitute a quorum and produce a favorable vote (e.g., a majority owned subsidiary), or where a solicitation of proxies is made only to certain security holders or certain security holders act unilaterally by written consent.

Ownership registration and transfer of shares

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. The stockholder list is required to remain accessible to any stockholder during the time of the meeting. Exchange rules may require the use of a qualified registrar (most often a transfer agent) to perform a registrar function.

Receipt of dividends and other distributions

State corporate laws are the primary source of substantive regulation on 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 stockholders of record on the declared record date. The federal securities laws (Regulation S-K) require disclosure relating to dividends in an issuer's registration statements and annual reports. Exchanges also have provisions relating to the payment of dividends as part of their listing requirements. (See for example Section 204.12 of the Listed Company Manual of the NYSE and Section 5250(e)(6) of the Nasdaq Listing Rules which both require an issuer to provide notice to the exchange).

Responsibility of directors

Responsibility of directors is addressed mainly 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. Most states possess similar judicial precedents. Two general fiduciary duties imposed on directors are the duty of care and the duty of loyalty. Delaware courts have also developed jurisprudence relating to subsets of the duty of loyalty, reflecting the related concepts of good faith and candor.

Certain state corporate law remedies are available to shareholders to hold the company, its directors and senior management accountable for their involvement in connection with 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 certain circumstances. Under the DGCL, shareholder derivative lawsuits provide additional means for holding directors and senior managers accountable for their oversight of a company's affairs. In addition, a stockholder who is directly injured retains the right to bring an individual action for injuries affecting his or her legal rights as a stockholder.

Bankruptcy or insolvency of the company

The Bankruptcy Code provides two primary routes through business bankruptcy: (i) Chapter 11, whereby the 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; and (ii) Chapter 7, whereby 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 in accordance with the federal bankruptcy rules.

Public companies generally file under Chapter 11 rather than Chapter 7 because they can continue to run their business and control the bankruptcy process. 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.

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 on four principal areas: (i) ensuring that plans and disclosure statements contain adequate information; (ii) ensuring that public investors are adequately represented by an official committee, if appropriate; (iii) ensuring that Bankruptcy Code exemptions from Securities Act registration are not misused; and (iv) participating in 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, it does not get involved in the economic terms of

plans.

Beneficial ownership reporting

The beneficial ownership reporting system provides investors and the issuer information about accumulation of voting classes that may have the potential to change or influence control of the issuer. This framework is established under Sections 13(d) and 13(g) of the Exchange Act.

The rules require a person who beneficially owns, following an acquisition, more than 5 percent of a voting class of equity security registered under the Exchange Act to file a Schedule 13D filing within ten days after the acquisition, which must contain among other things the percentage owned and the reasons surrounding the acquisition (including whether the shares were acquired with the intention to acquire control). Section 929R of the Dodd-Frank Act authorizes the SEC to shorten the initial filing deadline for Schedules 13D. The SEC has not initiated any formal regulatory action to shorten the current ten-day initial reporting period.

Material changes to the information must be disclosed in an amended filing, which must be filed promptly. Under the rules, the acquisition or disposition of beneficial ownership of securities in an amount equal to 1 percent or more of the class of securities is 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 –including any change in the plans and proposals originally disclosed with respect to acquiring control–must likewise be disclosed.

The rules allow certain investors to file a Schedule 13G, “short-form” disclosure document, to disclose their ownership interest in equity securities. These filers include specified institutional investors holding securities in the ordinary course of business and not with a control purpose. Schedule 13G must be filed by these investors within 45 days after December 31 of the year in which the 5 percent threshold was exceeded. Amendments to Schedule 13G filings must be filed on an annual basis and no later than 45 days following the end of the calendar year in which the information previously reported changes regardless of the materiality of such change. In addition, the rules permit other classes of investors who are not the beneficial owners of 20 percent or more of a class of registered voting securities to file a Schedule 13G, provided the acquisition is not for the purpose of acquiring control. For these investors, the due date for the initial filing is ten days after the acquisition that caused the five percent threshold to be exceeded.

When two or more individuals or entities come together for the purpose of acquiring, holding or disposing of a company’s securities, the group is deemed to be a single “person” for purposes of the filing requirement under Sections 13(d) and 13(g). As a result, a Schedule 13D or Schedule 13G must be filed by the members of the “group” when they collectively beneficially own more than 5 percent of the class of company securities. Application of this “group” notion is based on the facts and circumstances of any particular situation.

Beneficial ownership of directors and executive officers of the issuer as a group and any person who is known to the issuer to be the beneficial owner of more than 5 percent of any class of the issuer’s voting securities must be disclosed in annual reports pursuant to Item 403 of Regulation S-K.

All these reports are immediately available to the public via EDGAR.

Insiders and substantial holdings

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

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| | <p>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” under Section 16 of the Exchange Act.</p> <p><i>Issuer disclosure</i></p> <p>In various disclosure documents 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.</p> <p>This disclosure must be made in a prospectus relating to an offering of the issuer’s shares under the Securities Act and in a registration statement under the Exchange Act. 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.</p> <p><i>Section 16 reporting regime</i></p> <p>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 as well as any person who beneficially owns more than 10 percent of the class of equity securities registered under Section 12.</p> <p>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 within 10 days of becoming a reporting person or on or before the effective date of the Section 12 registration statement. 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 an SBS or SBS agreement involving such equity security, before the end of the second business day following the day on which the subject transaction was executed. The SEC has adopted rules that exempt insiders from reporting some changes in security ownership, 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.</p> <p>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.</p> <p>The SEC’s Delinquent Filings Program 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.</p> |
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| | <p>Foreign issuers</p> <p>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”. In practice, in providing “risk factor” disclosure, a foreign private issuer may frequently disclose differences in shareholder rights between the foreign jurisdiction and the United States, 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.</p> <p>In September 2008, the SEC adopted a disclosure requirement applicable to the annual reports of foreign private issuers. 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.</p> <p>Review of transaction files</p> <p>As stated in Principle 16, CF is the main SEC division responsible for monitoring issuers’ compliance with their obligations vis-à-vis the federal securities laws. In practice this means that CF would review transactional filings, for example those submitted in connection with a tender offer. In addition, CF is also responsible for monitoring compliance with notifications of holdings obligations.</p> <p>Violations of shareholders’ rights (when they do not involve obligations imposed by the federal securities laws) would need to be taken by shareholders to the judiciary. In practice shareholders exercise actively their rights and there is abundance of precedent from the Delaware courts in connection with the fiduciary duties of board members.</p> |
| Assessment | Fully Implemented |
| Comments | <p>The U.S. legal regime allows companies that offer securities to the public a significant degree of freedom in connection with their structure and rights of shareholders. As a result, structures that impact the rights of shareholders, such as companies with dual class shares, are allowed in the United States. At the same time the current framework imposes robust disclosure in the prospectus and related filings of the actual rights provided to shareholders in such structures. Further, directors are subject to strong fiduciary duties which shareholders can (and do) make effective through the judiciary. Therefore the assessors consider that the current framework complies with Principle 17 in respect to the treatment of shareholders.</p> <p>Under the current legal and regulatory regime certain mechanisms to acquire control of a company do not constitute a tender offer and, as a result, do not trigger the obligations set forth in the federal laws and SEC rules, including in particular the equal treatment of all shareholders. The assessors acknowledge however that there are a number of features of the legal system, mainly state corporate laws, that , create disincentives for parties seeking to acquire control from doing so other than by negotiating with the board of directors in the case of statutory mergers or making a tender offer for all shares.</p> <p>The current framework allows foreign issuers to follow their domestic frameworks relating to shareholders’ rights. However, the assessors note the existence of robust disclosure obligations, including a description of the differences between shareholders rights, in the prospectus.</p> <p>Finally, the deadline for submission of the first “insider” report appears long when compared to other jurisdictions. However, the assessors do acknowledge that once this first report has been filed, any changes in “holdings” must be reported within 2 days.</p> |

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| Principle 18. | Accounting standards used by issuers to prepare financial statements should be of a high and internationally acceptable quality. |
| Description | <p>Audited financial statements</p> <p>Pursuant to SEC Regulation S-X the issuers' registration statements must include audited financial statements, including 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 for each year presented be audited by an independent public accountant. The auditor must be registered with the PCAOB.</p> <p>Pursuant to the Exchange Act, annual reports and quarterly reports must also include financial statements as described in Principle 16. Unaudited interim financial statements are required to be reviewed by an independent public accountant registered with the PCAOB.</p> <p>Accounting standards</p> <p>Pursuant to Section 108 of SOX the SEC has the authority to recognize the standards of a standard setting body as "generally accepted" for the purposes of the U.S. federal securities laws. Section 108 of SOX establishes criteria that must be met which encompass provisions related to (i) the nature, governance, and funding of the standard setting body, and its capacity to ensure prompt consideration of changes to accounting principles necessary to reflect emerging accounting issues and changing business practices; as well as (ii) its capacity to assist the SEC in fulfilling the requirements of securities laws, in particular by improving the accuracy and effectiveness of financial reporting and the protection of investors under the securities laws. Section 108, however, ratified the SEC's authority to establish accounting principles or standards for purposes of enforcement of the securities laws.</p> <p>Pursuant to Section 108 authority the SEC has recognized the standards of the FASB as "generally accepted". Accordingly, the financial statements of U.S. public companies whether in the annual or interim reports are required to be prepared and presented in accordance with U.S. GAAP. Pursuant to SEC rules, and as indicated under Principle 16, the financial statements of foreign private issuers 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 without reconciliation to U.S. GAAP. Each company may elect the basis of presentation.</p> <p>U.S. GAAP comprises standards and interpretations established by the FASB and its predecessors, as modified or supplemented by rules and guidance from the SEC and its staff. SEC staff indicated that the SEC has rarely used its authority to supplement the standards (the last substantive time was roughly 35 years ago in connection with oil and gas companies). What is more common is the issuance of guidance on how to interpret them.</p> <p>FASB</p> <p>The FASB's mission is to establish and improve standards of financial accounting and reporting that foster financial reporting by non-governmental entities that provides decision-useful information to investors and other users of financial reports.</p> <p>The FASB follows certain guiding principles in conducting its activities. These principles include: to be objective in its decision making; to actively solicit and carefully weigh the views of stakeholders; to issue standards only when the expected benefits exceed the perceived costs; to issue high-quality standards; to manage the process of improving standards in ways that balance the desire to minimize disruption of accounting and financial reporting processes with the need to improve the decision-usefulness of information in financial reports; to provide clear and timely communications; and to review the effects of past decisions and interpret, amend or</p> |

replace standards in a timely fashion if such action is indicated.

The FASB is overseen by the Financial Accounting Foundation (FAF) which is responsible for selecting the seven 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.

Funding is received through an annual accounting support fee assessed against issuers as provided for under Section 109 of the Sarbanes-Oxley Act.

Standard setting

The FASB describes itself as "committed to following an open, orderly process for setting standards". 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. The comments received are discussed in public meetings and the proposed standard is re-deliberated by the Board in light of the public input received. Market participants expressed positive views about the standard setting process, in particular its transparency and the thoroughness of the consultation.

FASB standards do not require formal approval from the SEC. In practice the SEC staff closely monitors the standards development work of the FASB, so that any input necessary is given as part of the standard setting process.

Enforcement of accounting standards

As indicated in Principle 16, SEC 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, SEC 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. If 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 that sets forth the specific concerns the staff has with the filing. The company has an opportunity to address the staff's comments in a response letter to the staff.

In addition, as indicated in Principle 16, in July of 2013 the SEC created the Financial Reporting and Audit Task Force, to renew its focus on financial reporting and accounting fraud. SEC staff indicated that in the wake of the financial crisis the SEC devoted a significant amount of resources to financial crisis cases while fewer accounting fraud investigations were undertaken. For example, in FY2012, the SEC opened 124 financial fraud/issuer disclosure investigations compared to 304 in FY2006 and 228 in FY2007. As for accounting fraud cases, there was a reduction as well: the SEC filed 79 financial fraud/issuer disclosure actions in FY2012 compared to 219 in FY2007. Post-crisis the SEC has renewed its focus on financial reporting and accounting by establishing this task force. The task force has about 12 staff, both lawyers and accountants. Its objective is to improve the SEC's ability to detect and prevent financial statement and other accounting fraud. The SEC anticipates that the task force will continue to cover a wide variety of issues, for example: (i) the manner in which management and auditors make decisions with respect to reserves; (ii) revenue recognition; (iii) independence violations by auditors; and

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| | <p>(iv) audit committees.</p> <p>In the meantime, the SEC has recently brought several financial reporting cases. For example, the SEC charged three top executives at a publicly-traded fund with overstating the company's assets during the financial crisis by failing to fairly value its debt securities and certain collateralized loan obligations. And it charged a Fortune 200 company for various accounting deficiencies that distorted their financial reporting to investors in the midst of the financial crisis.</p> |
| Assessment | Fully Implemented |
| Comments | |
| Principles for Auditors, Credit Ratings Agencies, and Other Information Service Providers | |
| Principle 19. | Auditors should be subject to adequate levels of oversight. |
| Description | <p>PCAOB</p> <p>Section 101 of the SOX established the PCAOB to oversee the audits of public companies. The Dodd-Frank Act expanded PCAOB jurisdiction to also cover BDs' audits.</p> <p>SOX created the PCAOB as a non-profit corporation, under the oversight of the SEC. Its board is composed of five members, including two CPAs. All members serve on a full time basis and must be independent from the audit profession. The SEC selects the board members.</p> <p>Similar to the FASB, the PCAOB receives funding through an annual accounting support fee, as provided for under Section 109 of SOX. The issuer accounting support fee is allocated between equity issuers and investment company issuers in relation to their market capitalization. As of 2014, 8,217 issuers were subject to fees. The largest 100 issuers pay 42 percent of issuer fees.</p> <p>At the time of the assessment PCAOB had 809 staff, the majority in its Division of Registration and Inspections. According to the PCAOB Chair, a key challenge for the Board is its ability to compete with large firms for talent. However, he indicated that overall the PCAOB is able to offer competitive salaries given its private sector status and funding model.</p> <p>Registration requirement</p> <p>Pursuant to Section 102 and 106 of SOX and PCAOB Rule 2100, each public accounting firm (including foreign firms) must register with the PCAOB if the firm (i) prepares or issues any report with respect to any issuer, broker or dealer or (ii) plays a substantial role in the preparation or furnishing of an audit report with respect to any issuer, broker or dealer. The term issuer is defined as an issuer the securities of which are registered under Section 12 of the Exchange Act (listed issuer) or that is required to file reports under Section 15(d) of the Exchange Act (issuer with a registration statement filed with the SEC or that files or has filed a registration statement that has not yet become effective under the Securities Act and that it has not withdrawn). The term substantial role has been defined as performing material services or performing the majority of the audit with respect to a subsidiary or component that constitutes 20 percent or more of the assets or revenues of the issuer.</p> <p>Under PCAOB rules, the PCAOB will not register a firm unless it finds that registration is consistent with the Board's responsibilities under the SOX to protect the interests of investors and to further the public interest in the preparation of informative, accurate, and independent audit reports. In practice registration requirements are limited. PCAOB staff indicated that the reason for this is not to create barriers to competition. Registration includes the need for the audit firm to be duly licensed in the respective state (or even another country); ; a clean disciplinary record; an adequate description of the firm's systems of quality control; and the</p> |

ability to cooperate with the PCAOB. The last consideration was incorporated in 2010 as a result of challenges that the PCAOB had faced in connection with the auditing of firms located in certain foreign jurisdictions; whereby access to working papers has been prevented by host confidentiality rules.

Licensing requirements for individual auditors vary by state but PCAOB staff indicated that in general they include the need for an accounting degree and continuing education.

There are currently six staff in charge of firm registration. PCAOB staff indicated that it infrequently denies an application for registration. There are currently about 800 firms that conduct audits of issuers –the majority of them audit fewer than five issuers.

Oversight of audit firms

Section 104 of SOX requires the PCAOB to conduct a continuing program of inspections to assess registered firms with regard to the performance of audits and related matters. Inspections are to be performed annually for firms that provide audit reports for more than 100 issuers and at least once every three years for most other registered firms. The PCAOB is required to provide a written report for each inspection to the SEC, and to make portions of the reports publicly available.

The PCAOB currently has 504 staff dedicated to the inspection programs. This staff is generally comprised of auditors with a minimum of 6 years of experience; inspection team leaders for the large annually inspected firms have an average of 30 years of relevant experience and inspection team members assigned to the global network firms have an average of 16 years of relevant experience.

The inspection program for audit firms is divided into two programs:

The Global Network firms program: this program includes U.S. firms subject to annual examination along with their non U.S. affiliates. Currently 6 global network firms are subject to annual examination. Approximately 170 non U.S. firms affiliated with such firms are subject to triennial examination.

Non affiliate firms program: Three of these firms audit more than 100 issuers and are therefore subject to annual inspections. The remaining firms are inspected on a triennial basis. On average the PCAOB inspects 175 firms per year. However, risk assessments may motivate more frequent inspections for triennially inspected firms.

As indicated above, the PCAOB has inspected non-U.S. registered firms as part of this program since 2005. These inspections have generally been carried out in two ways: (i) PCAOB-only inspections, where the PCAOB conducts the inspection on its own in coordination with the home country regulator; and (ii) inspections conducted jointly with the home country regulator. The PCAOB has entered into formal cooperative arrangements with several countries. Under a cooperative framework for non-U.S. inspections adopted by the Board, the PCAOB may rely on inspection work performed by the home country regulator. The Dodd-Frank Act provided the PCAOB with the authority to share confidential information with foreign audit oversight authorities.

PCAOB staff highlighted that it faces challenges to access the working papers of audit firms located in a number of jurisdictions, including China and some European countries; due to the local confidentiality provisions. PCAOB Chair considers this as a challenge for PCAOB effectiveness. The PCAOB publishes and regularly updates a list identifying each issuer whose PCAOB-registered auditor is located in a jurisdiction where obstacles to PCAOB inspections exist. The PCAOB Chair highlighted, however, that progress has been made with China in connection with the development of a framework for cooperation. The SEC has also taken enforcement

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| | <p>actions against affiliates of the big four for allegedly failing to produce audit work.</p> <p>PCAOB staff noted that the inspection program is designed to promote improvement in audit quality. The process includes fieldwork review of firms' systems of quality control and audit engagements. Audit engagements for review are generally selected based on an assessment of risk factors (including the size of the issuer, the sector that it belongs to, etc.). Preliminary draft reports go through multiple levels of internal PCAOB review and evaluation including by inspection staff, staff in the office of the Chief Auditor and in the Office of the General Counsel. Following that process, staff provides the draft report to the firm. The firm has an opportunity to provide a written response. The inspection staff can make changes to the report based on such response. The final report is sent to the Board for issuance. When the Board is satisfied with the content, it issues a final report and transmits it to the firm.</p> <p>All PCAOB inspection reports have a public portion and most also have a non-public portion. The public portion describes the inspection process and any identified audit deficiencies that the PCAOB's inspection staff judged to have resulted in an audit opinion that was insufficiently supported when issued. The non-public portion of a report may provide additional discussion of those deficiencies; criticisms, if any, of the firms' system of quality control; and potentially other process issues related to the firm, such as the possibility of Board disciplinary actions. If the PCAOB issues a final inspection report that contains criticisms of, or potential defects in, a firm's quality control systems, the firm may avoid having that portion of the report become public by addressing that criticism to the Board's satisfaction within 12 months of the date of the PCAOB report. For the largest firms there is a team assigned to follow up on remediation actions and there is communication throughout the year on the plan for remediation and the status of actions taken. For smaller firms, the PCAOB assigns a staff in charge of follow up, but in those cases the level of contact varies.</p> <p>The PCAOB cannot disclose to an audit committee the non-public portion of an inspection report or other non-public inspection information—including whether the inspection identified deficiencies in the audit that the audit committee oversees—and the PCAOB Board cannot compel an audit firm to disclose such information to an audit committee. The audit committee can request such information to the audit firm and potentially if it refuses to share it, the audit committee could recommend that the firm be fired. The PCAOB has issued guidance in connection with its inspection reports that provides information about the inspection process, and the meaning of reported results, to better equip audit committees to engage in meaningful discussion with audit firms about the results of its inspections (PCAOB Release No. 2012-003).</p> <p>If the PCAOB determines that the remediation of a quality control criticism is satisfactory, it notifies the SEC and any applicable state regulatory authorities. If no evidence of remediation is submitted or if the PCAOB determines the remediation is not sufficient, the PCAOB will make those findings public.</p> <p>PCAOB staff highlighted that deficiencies have been found in roughly 40 percent of the inspections. Common findings relate to weaknesses in auditing (i) internal control over financial reporting; (ii) fair value measurement and disclosures; (iii) revenue recognition; and (iv) management estimates. PCAOB staff noted that in general the majority of the firms have managed to satisfactorily address deficiencies during the 12 month remediation period established. PCAOB staff commented that while improvements have been observed, concerns remain as to the quality of the audits. However, as the engagements for inspections are generally selected based on risk, staff considers difficult to make generalizations. As a result, staff indicated that the PCAOB is currently analyzing the possibility to expand the review of engagements beyond those triggered by the risk-based approach.</p> |
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Enforcement

The PCAOB has authority to investigate and discipline registered public accounting firms and persons associated with those firms for noncompliance with the SOX, the rules of the PCAOB and the SEC, and other laws, rules, and professional standards governing the audits of public companies. If the PCAOB finds evidence of a violation the PCAOB may report it to the SEC or state regulatory body or open an enforcement investigation pursuant to Section 105 of the SOX.

Investigations are conducted by the Division of Enforcement, which is comprised of 28 attorneys, 22 accountants and support staff totaling over 60 staff. Cases are litigated before a hearing officer, who is a PCAOB employee insulated from the investigative function. Decisions of the hearing officer can be appealed to the Board and those in turn to the SEC. Pursuant to the SOX, PCAOB investigations are confidential and nonpublic. The SOX also requires that disciplinary proceedings are confidential and nonpublic, unless both the auditor and the PCAOB consent to public proceedings, or until there is a final decision imposing sanctions.

Pursuant to SOX, the PCAOB can impose appropriate sanctions, including: temporary suspension or permanent revocation of registration; temporary suspension or permanent bar of a person from association with a registered public accounting firm; temporary or permanent limitation on the activities of a firm or person; civil monetary penalties; censure; requiring additional education or training; requiring an independent monitor or consultant; implementation of additional or remedial policies and procedures; and requiring an independent review and report on an engagement. PCAOB staff noted that common types of investigations have referred to (i) violations of professional standards (audit failures not limited to matters involving GAAP departures); (ii) independence violations; and (iii) failure to cooperate with an inspection or investigation.

A total of 69 settled disciplinary orders have been issued since the establishment of the PCAOB in 2002, and another 12 disciplinary orders have been issued in proceedings that were adjudicated to conclusion. In addition, a number of other proceedings are currently in litigation, but they are non-public as required by the SOX.

The key enforcement actions used have been revocation of registration and bars, which the PCAOB considers to be more effective than monetary penalties given the impact that they have in the actual business of the firm and the individuals. In practice the PCAOB has imposed sanctions on 61 registered firms including 42 revocations of firm registrations and sanctions on 79 individuals including 69 suspensions or bars.

A significant portion of the enforcement orders and the corresponding sanctions have been imposed during the last 3-5 years. SEC staff indicated that the number of sanctions and its concentration on the last years is a natural reflection of the fact that the PCAOB is still a relatively new organization and that some time has been necessary for the PCAOB to become a fully functioning supervisory body. In this regard SEC staff also indicated that the quality of the cases brought by the PCAOB has improved overtime.

A recent review of the enforcement division by the Office of Independent Oversight and Performance Assurance (IOPA) (the internal audit function of the PCAOB) concluded that overall the PCAOB has been able to establish a comprehensive enforcement program. However, the review highlighted a number of opportunities to improve internal processes and, potentially, case timeliness. This is an issue that has also been raised by SEC staff. PCAOB staff highlighted that they are currently looking at ways to improve the enforcement process and make it more efficient.

Finally, PCAOB staff considers the confidentiality provisions of the SOX in connection with disciplinary proceedings to be a challenge for effective enforcement. Further the fact that

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| | <p>confidentiality remains through the appeal process (unless the SEC lifts the stay) adds more incentive for firms to litigate as long as possible regardless of whether they believe they will ultimately prevail. SEC staff indicated, however, that the differences in the treatment of PCAOB disciplinary proceedings versus SEC proceedings needs to be analyzed in the context of the different nature of the PCAOB versus the SEC, and the different due process that accompanies SEC proceedings.</p> <p>Enforcement by the SEC</p> <p>Pursuant to its selective review of filings, the SEC staff considers the appropriateness of the form of the auditor’s report on the financial statements. The staff may issue comments with respect to the auditor’s report similar to the process for issuing comments on the content of the financial statements and associated disclosures. The SEC can also use its enforcement powers.</p> <p>During the last 5 years the SEC has taken 99 actions against audit firms: 28 in 2014; 18 in 2013; 17 in 2012; 18 in 2011 and 18 in 2010. Actions taken in 2014 involved both small and large audit firms. The types of sanctions imposed varied depending on the gravity of the cases; but have involved suspensions as well as the imposition of monetary penalties. SEC staff indicated that the number of actions taken in the last year reflects the renewed attention that the SEC is giving to financial reporting and accounting fraud, through the recently created Task Force described in Principles 16 and 18. Staff also highlighted increased effectiveness in coordination of enforcement actions with the PCAOB.</p> <p>Oversight of the PCAOB</p> <p>As indicated above the PCAOB is under the oversight of the SEC. Technical oversight is conducted through the Office of the Chief Accountant.</p> <p>The SEC has a wide range of tools to oversee the PCAOB. In particular, it approves the PCAOB budget and accounting support fees. The budget approval process provides an opportunity for the SEC to provide input in connection with the PCAOB strategic priorities and work program. In addition, through the budget order approval the SEC establishes reporting obligations for the PCAOB. For example, the order approval for the 2014 budget directs the PCAOB during the 2014 budget cycle to continue to include in its quarterly reports to the SEC information about the PCAOB’s inspection program. Such information is to include: (i) statistics relative to the numbers and types of firms budgeted and expected to be inspected in 2014, including by location and by year the inspections that are required to be conducted in accordance with SOX and PCAOB rules; (ii) information about the timing of the issuance of inspection reports for domestic and non-U.S. inspections; and (iii) updates on the PCAOB’s efforts to establish cooperative arrangements with respective non-U.S. authorities for inspections required in those countries.</p> <p>The SEC also approves PCAOB auditing standards and rules. The SEC has made use of onsite inspections of the PCAOB.. The last inspections were conducted around 2009, when the registration and inspection programs were formally reviewed. In addition, as indicated above the SEC receives a copy of all examination reports and is informed of all investigations opened by the PCAOB.</p> <p>SEC and PCAOB staff highlighted that in addition to all these more formal oversight mechanisms in practice there is very close contact between the PCAOB and SEC staff.</p> |
| Assessment | Fully Implemented |
| Comments | The assessment of the effectiveness of the enforcement of audit standards has taken into consideration the fact that both the PCAOB and the SEC can file enforcement cases against audit firms. The information provided shows that PCAOB enforcement actions have increased over time. Further, the SEC has made gatekeepers a focus of its enforcement program, and important |

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| | <p>cases have been filed during the last five years, thus complementing PCAOB efforts.</p> <p>The assessors note, however, recommendations issued by the IOPA in particular on the timeliness of PCAOB cases. Timeliness of procedures can be a challenge for credible deterrence, and thus it is important that the PCAOB works in improving its procedures (as it is currently doing). Finally, the assessors also note the fact that PCAOB proceedings are subject to confidentiality, which could also potentially undermine the deterrent effect of PCAOB enforcement efforts.</p> <p>The assessors note efforts by the PCAOB to address existing challenges in connection with access to audit work in certain foreign jurisdictions. Such efforts have been complemented with disclosure to investors (via the PCAOB website) of the countries where such limitations remain. In addition, the assessors also note recent enforcement actions by the SEC in this area. For new audit firms this access limitation has been addressed via the inclusion of a registration requirement that relates to their ability to cooperate with the PCAOB.</p> <p>Finally, the assessors note the limited use of inspections by the SEC for the oversight of the PCAOB, at least in recent years. However, this appears to be largely offset by the work conducted by IOPA, and other regular interactions between the SEC and the PCAOB.</p> |
| <p>Principle 20.</p> | <p>Auditors should be independent of the issuing entity that they audit.</p> |
| <p>Description</p> | <p>Auditors’ independence</p> <p>Independence of the external auditor both in fact and in appearance is required under the U.S. system. It is addressed by the SEC’s auditor independence rules adopted in 2000 and subsequently strengthened in 2003 after the passage of SOX.</p> <p>Rule 2-01 of Regulation S-X sets forth the general standard of auditor independence which considers whether a relationship or the provision of a service: (i) creates a mutual or conflicting interest between the accountant and the audit client; (ii) places the accountant in the position of auditing his or her own work; (iii) results in the accountant acting as management or an employee of the audit client; or (iv) places the accountant in a position of being an advocate for the audit client. In addition, some of the specific major areas covered include financial interests, employment relationships, business relationships, non-audit services, contingent fees, partner rotation, audit committee administration of the audit engagement, quality controls, definitions and other matters. The PCAOB also has adopted certain auditor independence requirements.</p> <p>Restrictions on financial relations</p> <p>In particular, Rule 2-01(c) of Regulation S-X prohibits financial, business, employment and other relationships with an entity that the firm audits that would threaten an auditor’s independence.</p> <p>Threats to independence</p> <p>The Rule covers also the areas addressed by IOSCO:</p> <p>Self-interest: Rule 2-01(c) sets forth a non-exclusive list of circumstances that are considered inconsistent with the general standard of independence in Rule 2-01(b). Rule 2-01(c) specifies circumstances related to financial relationships, employment relationships, business relationships and non-audit services, as well as prohibitions on contingent fees and compensation paid to an audit partner for procuring engagements for non-audit work, that could result in an auditor’s self-interest being in conflict with the performance of an independent audit.</p> <p>Advocacy: The general standard of independence is intended to prevent the auditor from being an advocate for the client. Additionally, Rule 2-01(c)(4)(x) prohibits an auditor from providing an</p> |

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| | <p>expert opinion or other service for the purpose of advocating a client's interests in litigation or in a regulatory or administrative proceeding or investigation. Also, Rule 2-01(c)(4)(ix) prohibits the auditor from providing legal services to its client. Legal service is defined as any service that "under circumstances in which the service is provided, could be provided only by someone licensed, admitted, or otherwise qualified to practice law in the jurisdiction in which the service is provided."</p> <p>Familiarity: Rule 2-01(c) addresses the threat of familiarity by requiring the rotation of an audit partner who has performed the services of a lead or concurring partner for an issuer for more than five consecutive years and certain other members of the audit team who have worked on the audits of an issuer for more than seven consecutive years. In addition, Rule 2-01(c)(2) provides restrictions on certain employment relationships and provides for a cooling off period for certain participants in the audit. Rule 2-01(c)(4) also prohibits an auditor from providing management or human resource functions for an audit client.</p> <p>Intimidation: SEC rules require that the audit committee (and not management) be responsible for the hiring and retention of the auditor. In addition, the auditor is required under Rule 2-07 of Regulation S-X and PCAOB auditing standards to communicate certain audit-related matters to the audit committee. Administering the relationship with the auditor through the audit committee reduces the possibility of intimidation because the auditor has regular, direct communications with the audit committee, which for listed companies is required to be composed of independent directors. Pursuant to SEC rules, an auditor will not be viewed to be independent when an adversarial relationship has been created between the client and its auditor due to litigation or the possibility of litigation that substantially alters the normal relationship between an auditor and its client. Further, Rule 13b2-2 under the Exchange Act prohibits certain persons from taking any action to coerce, manipulate, mislead or fraudulently influence an auditor engaged in an audit or review of financial statements of an issuer that are required to be filed with the SEC.</p> <p>Non-audit services</p> <p>The general standard of independence is intended to prevent the provision of any non-audit services that would impair the independence of the auditor. In addition, Rule 2-01(c)(4) sets forth a non-exclusive list of non-audit services that would impair the independence of the auditor, including bookkeeping services, financial information systems design and implementation, appraisal or valuation services, actuarial services, internal audit outsourcing services, management functions, human resources, broker-dealer, investment adviser or investment banking services, legal services or expert services unrelated to the audit. Rule 2-01(c)(3) prohibits the auditor from having, directly or indirectly, any business relationship with the client or certain persons associated with the client. The PCAOB also has rules governing the provision of certain tax services to audit clients. Both the SEC and PCAOB also have rules requiring pre-approval by the audit committee of any non-audit service provided by the auditor.</p> <p>Internal systems, governance arrangements and processes for monitoring, identifying and addressing threats to independence</p> <p>The PCAOB requires auditors to have a system of quality controls that provides, among other things, reasonable assurance that personnel maintain independence in fact and appearance in all required circumstances (QC 20.09).</p> <p>Rule 2-01(d) under Regulation S-X provides a safe harbor from certain independence violations so long as the auditor had in place a quality control system that provides reasonable assurance that the accounting firm and its employees do not lack independence. For accounting firms that annually provide audit, review or attest services to more than 500 issuers, their quality control</p> |
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system must include written independence policies and procedures, an automated system that identifies investments of partners and managerial employees, a system that provides timely information about entities requiring independence, an annual or on-going training program, an annual internal inspection and testing program, notification of the member of senior management responsible for compliance with independence requirements, written policies and procedures requiring notice when professionals are engaged in employment negotiations and a disciplinary mechanism.

In addition, Rule 2-01(c)(6) provides that an accountant will not be independent if an audit partner performs the services of a lead partner on an audit engagement for more than five consecutive years or the services of a concurring partner for more than seven consecutive years.

Appointment of auditors by issuers

SOX 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 in both fact and appearance.

Listing standards mandated by SOX require that the audit committee of the board of directors oversee 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 in addition to 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 SOX require that all audit 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. The auditor is also required by the PCAOB standards to communicate information to the audit committee regarding the auditor's independence.

Market participants believe that audit committees are increasingly taking an active role in the

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| | <p>oversight of the accounting firms’ work, although more progress is still necessary. Actions by the PCAOB and the SEC are contributing to this outcome. The former has issued guidance including for example in connection with PCAOB audit reports (as explained in Principle 19). The SEC has recently pursued enforcement actions against members of audit committees of two issuers for alleged failures in their oversight role.</p> <p>Disclosure of information about the resignation, removal or replacement of an external auditor</p> <p>When the auditor has resigned during a current audit, declined to stand for re-election after the completion of the audit, or was dismissed by the company being audited, prompt 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.</p> <p>Supervision and enforcement of independence requirements</p> <p>The PCAOB assesses a firm’s independence as part of its regular inspection program. In addition, the PCAOB can require remedial action by firms that are not appropriately maintaining independence from their clients; and impose enforcement actions. The SEC can also bring enforcement actions against firms that have violated its independence rules. More information on the inspection program of auditors by the PCAOB, and on enforcement efforts by the PCAOB and the SEC are provided in Principle 19.</p> |
| Assessment | Fully Implemented |
| Comments | As indicated under Principle 19, the assessors note current legal limitations that prevent the PCAOB from sharing the confidential portion of its inspection reports with the audit committees. However, the PCAOB has taken steps to encourage audit committees to take a proactive approach and ask relevant questions from the audit firms themselves. |
| Principle 21. | Audit standards should be of a high and internationally acceptable quality. |
| Description | <p>Auditing standards</p> <p>Before the enactment of SOX 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 (ASB) had developed a number of Statements of Auditing Standards (SAS) through a process that included deliberations in public meetings and public exposure of draft statements. Section 103 of SOX 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.</p> <p>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 has been reviewing these standards to determine whether they need to be modified, superseded or adopted as permanent standards. For example, the PCAOB has proposed and adopted auditing standards that address audit documentation (AS No. 3), an audit of internal control over financial reporting that is integrated with an audit of financial statements (AS No. 5), engagement quality review (AS No. 7), risk assessment (AS Nos. 8-15), and communications with</p> |

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| | <p>audit committees (AS No. 16).</p> <p>The PCAOB standard setting agenda includes projects on the auditor’s reporting model, related parties, the auditors’ responsibilities with respect to other accounting firms and specialists, and auditing accounting estimates, including fair value measurements. Both senior staff from the SEC and market participants noted that while these proposals are important, current standards are already of high quality.</p> <p>Standard setting</p> <p>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. 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.</p> <p>PCAOB staff is actively involved in drafting proposed standards. After completing the development process, which ordinarily includes consultation with the Standing Advisory Group and may include other public fora such as roundtable discussions, the PCAOB’s staff recommends a proposed standard to the PCAOB. . Proposed standards approved by the PCAOB are published for public consideration and comment. After the PCAOB and its staff evaluate the comments received, the PCAOB staff recommends to the PCAOB a final standard, revised as necessary based on the evaluation of the comments received. PCAOB meetings at which standards –proposed or final—are considered are open meetings. 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.</p> <p>Enforcement of auditing standards</p> <p>The PCAOB is the main body responsible for enforcing compliance with auditing standards through its inspection program and enforcement proceedings described in Principle 19. In addition, the SEC can use both formal and informal mechanisms to enforce compliance with auditing standards, as described in Principle 19. Through the Financial Reporting and Audit Task Force recently constituted the SEC has increased its enforcement efforts in accounting and auditing.</p> |
| Assessment | Fully Implemented |
| Comments | The assessors note the existence of an important agenda of revision to audit standards that are yet to be approved. While both SEC staff and market participants were of the view that the current standards remain of high quality, they did emphasize the importance of many of the proposals on the table as a mechanism to enhance the quality of auditors’ work, particularly in the context where the PCAOB still finds important deficiencies in auditors’ reports. |
| Principle 22. | Credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision. |
| Description | <p>Definition of credit rating</p> <p>The Exchange Act defines “[c]redit [r]ating” as “an assessment of creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments.” The Exchange Act defines “[c]redit [r]ating [a]gency as “any person (i) engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable</p> |

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| | <p>fee, but does not include a commercial credit reporting company; (ii) employing either a quantitative or qualitative model, or both, to determine credit ratings; and (iii) receiving fees from either issuers, investors, or other market participants, or a combination thereof.”</p> <p>Use for regulatory purposes</p> <p>A CRA, whether located in the U.S. or elsewhere, that wishes its credit ratings to be used for regulatory purposes in the U.S. must elect to register with the SEC. If credit ratings issued by affiliates (including affiliates located outside the United States) are to be used for regulatory purposes in the United States, they would need to be properly identified by the NRSRO in its registration form.</p> <p>The credit ratings of these affiliates are treated as credit ratings issued by the NRSRO, and the affiliates are thus subject to the laws and rules applicable to NRSROs (collectively, the NRSRO Regulations) and to direct oversight by the SEC.</p> <p>Currently credit ratings are used for limited purposes in SEC regulations, most notably in MMF regulation (and reporting forms). CFTC regulations do not make reference to ratings.</p> <p>Registration requirements</p> <p>In 2007, the SEC adopted rules which established the framework for voluntary registration of CRAs as NRSROs. A number of these rules were amended in 2014; the effective dates of these amendments vary but they will generally be effective mid-2015. Pursuant to these rules, a CRA applying to be registered with the SEC as an NRSRO must submit an initial application on Form NRSRO. An application is not eligible for approval unless Form NRSRO has been completed properly, following all applicable instructions.</p> <p>Form NRSRO requires an applicant to provide information about itself and its policies and procedures related to its credit rating business, including the following:</p> <ul style="list-style-type: none"> The class or classes of credit ratings for which the applicant is applying, specifying for each class: the approximate number of credit ratings currently outstanding; the approximate date the applicant began issuing credit ratings for the class; and performance measurement statistics; A description of the procedures and methodologies used in determining credit ratings; Identification of conflicts of interest relating to the issuance of credit ratings; Policies and procedures to address and manage conflicts of interest and to prevent the misuse of material, non-public information; The corporate organizational and managerial structure of the applicant and information about its credit rating analysts, credit rating analyst supervisors, and designated compliance officer; Audited financial statements of the applicant or its parent for each of the three prior fiscal years, unaudited revenue information, including the amount of revenue generated from determining and maintaining credit ratings for the most recently concluded fiscal year, and information regarding the total and median annual compensation of credit analysts; and Information regarding any violations of law or other regulations by the applicant or persons associated with the applicant. <p>An applicant is required to notify the SEC if any information submitted in its application is found to be or becomes materially inaccurate prior to the grant or denial of registration. If such circumstances were to occur, the applicant is also required to submit a supplement to its Form NRSRO application identifying the information.</p> <p>The SEC is required to deny an application for registration if it finds that the applicant does not</p> |
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have adequate financial and managerial resources to: consistently produce credit ratings with integrity; materially comply with the procedures and methodologies that it uses in determining credit ratings; and materially comply with the NRSRO Regulations that are in place to prevent the misuse of non-public information, to manage conflicts of interest, to prohibit certain unfair, coercive or abusive practices, and to require designation of a compliance officer responsible, among other things, for ensuring compliance with the NRSRO Regulations.

The SEC must also deny an application for registration if a condition exists that would subject the applicant, if so registered, to suspension or revocation of its registration. The SEC has the authority to suspend or revoke the registration of an NRSRO, entirely or with respect to one or more classes of credit ratings for which the NRSRO is registered, for any of the following reasons:

Willful misstatements or omissions on Form NRSRO or any other report required to be filed with the SEC;

Willful violation of or inability to comply with federal securities laws, willful assistance of a violation of federal securities laws or a failure to reasonably supervise, with a view to preventing such violations, a person who violates federal securities laws;

Convictions by the NRSRO or associated persons of certain crimes;

The finding by a foreign financial regulatory authority of a violation of foreign securities law and certain related actions;

A final order of certain state or federal authorities finding a violation of law meant to prevent fraudulent, manipulative or deceptive conduct;

Injunction by any court of competent jurisdiction from acting as or being associated with an NRSRO;

Failure to file the annual amendment and certification of Form NRSRO;

Failure to "maintain adequate financial and managerial resources to consistently produce credit ratings with integrity; or

Effective June 15, 2015 a violation of the SEC's conflicts of interest rules that affected a credit rating.

Quality and integrity

Procedures and methodologies designed to ensure the issuance of initial credit ratings based on a fair and thorough analysis of all information

Pursuant to Section 15E(c)(3)(A) of the Exchange Act, NRSROs are required to "establish, maintain, enforce and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings taking into consideration such factors as the Commission may prescribe by rule." In issuing credit ratings, an NRSRO is required to consider information in its possession that it finds "credible and potentially significant to a rating decision," including information it "receives from a source other than the issuer or underwriter." Each NRSRO must also publicly disclose on Form NRSRO a description of the procedures and methodologies that it uses to determine its credit ratings.

Internal records

NRSROs are required to keep certain records. The records required to be retained, to the extent made or received, include internal records, including non-public information and work papers,

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| | <p>used to form the basis of a credit rating, credit analysis reports, credit assessment reports, and private credit rating reports of the NRSRO and internal records, including non-public information and work papers, forming a basis for the opinions in these reports; and both internal and external communications that relate to initiating, determining, maintaining, monitoring, changing or withdrawing a credit rating. In addition, the NRSRO Regulations require NRSROs to make and retain certain records, including “a record documenting the established procedures and methodologies used by the NRSRO to determine credit ratings”. Each NRSRO must make and retain records with respect to each of its current credit ratings showing the identity of the credit analysts who participated in determining the credit rating and any other person that approved the credit rating prior to its issuance.</p> <p>Any written communication received from third parties containing complaints about the performance of a credit rating analyst must be retained by the NRSRO.</p> <p>Finally, the NRSRO Regulations require an NRSRO to retain external and internal communications received and sent by the NRSRO concerning the initiating, determining, maintaining, monitoring, changing, or withdrawing of a credit rating. Additionally, for those structured finance securities where a quantitative model plays a substantial role in the determination of the credit rating, the NRSRO must make and retain a record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued.</p> <p><i>Sufficiency of resources to carry out high-quality credit ratings</i></p> <p>Form NRSRO requires applicants to provide relevant information about their resources including managerial resources. An NRSRO must also disclose the employment history and educational background of its designated compliance officer on Form NRSRO.</p> <p>In addition, an NRSRO must disclose annually the number of credit analysts and credit analyst supervisors and the required qualifications for each such role.</p> <p>Each NRSRO is required to provide audited financial statements for itself or its parent (and, if applicable, unaudited consolidating financial statements) with its initial application for registration and, on an ongoing basis, within 90 days of its fiscal year end. Together with such financial statements, an NRSRO must provide unaudited revenue information that specifies the amount of revenue generated from determining and maintaining credit ratings and the total aggregate and mean annual compensation of the NRSRO’s credit analysts.</p> <p>Conflict of interests</p> <p><i>Prohibition and management of conflicts</i></p> <p>The Exchange Act required the SEC to adopt rules to prohibit or require the management of conflicts of interest related to the issuance of credit ratings. Pursuant to that mandate, the SEC has adopted two categories of rules, one of which prohibits certain conflicts of interest and the other of which requires other conflicts of interest to be identified and managed.</p> <p>Prohibitions: the NRSRO Regulations prohibit NRSROs from having the following conflicts of interest:</p> <p>Issuing or maintaining a credit rating solicited by a person that provided the NRSRO with 10 percent or more of its total net revenue in its most recently ended fiscal year;</p> <p>Issuing or maintaining a credit rating with respect to which the related fee was negotiated, discussed or arranged by a person within the NRSRO who has responsibility for participating in determining credit ratings or developing or approving the related procedures and</p> |
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| | <p>methodologies;</p> <p>Issuing or maintaining a credit rating for an affiliate of the NRSRO;</p> <p>Issuing or maintaining a credit rating with respect to a security where the NRSRO or its affiliate made recommendations about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security;</p> <p>Issuing or maintaining a credit rating for a person where the NRSRO directly owns securities of the person that would be subject to the credit rating;</p> <p>Issuing or maintaining a credit rating for a person where an employee of the NRSRO that participated in determining, or is responsible for approving, the credit rating directly owns securities of the person that would be subject to the credit rating;</p> <p>Issuing or maintaining a credit rating for a person where an employee of the NRSRO that participated in determining, or is responsible for approving, the credit rating is an officer or director of the person that would be subject to the credit rating;</p> <p>Issuing or maintaining a credit rating where an employee of the NRSRO that participated in determining or monitoring the credit rating or is responsible for approving the credit rating received gifts valued over \$25 from the person being rated; and</p> <p>Effective June 15, 2015, issuing or maintaining a credit rating where a person within the NRSRO who participates in determining or monitoring the credit rating, or developing or approving procedures or methodologies used for determining the credit rating, including qualitative and quantitative models, also (i) participates in sales or marketing of a product or service of the NRSRO or a product or service of an affiliate of the NRSRO or (ii) is influenced by sales or marketing considerations.</p> <p>Management of conflicts: The following conflicts of interest are permissible only if the NRSRO has identified and implemented procedures for managing their impact:</p> <p>Being paid by obligors, issuers, sponsors of asset-backed securities, or underwriters to determine credit ratings for such entity or the securities they issue, sponsor, or underwrite or for other services offered by the NRSRO;</p> <p>Being paid for services in addition to determining credit ratings by issuers, underwriters, or obligors that have paid the NRSRO to determine a credit rating;</p> <p>Being paid by subscribers to receive access to credit ratings or other services if such subscribers may use the NRSRO's credit ratings to comply with, and obtain benefits or relief under, statutes or regulations using the term "nationally recognized statistical rating organization" or if such subscribers may own investments or have entered into transactions that could be impacted by a credit rating issued by the NRSRO;</p> <p>Allowing persons within the NRSRO to have an ownership interest in rated obligors or securities or to have business relationships that are other than arm's length, ordinary course relationships with such obligors or the issuers of such securities;</p> <p>Having an affiliate that is a broker or dealer engaged in underwriting activities; and</p> <p>Any other type of conflict of interest relating to the issuance of credit ratings by the NRSRO that is material to its organization and identified in its Form NRSRO disclosures.</p> <p>Each NRSRO is required to disclose on Form NRSRO the written policies and procedures maintained and enforced by the NRSRO to manage the conflicts of interest that apply to it.</p> <p>Finally, the NRSRO Regulations also require each NRSRO to have policies and procedures in</p> |
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| | <p>place to provide for an internal review process in order to determine whether a conflict of interest of a former employee influenced a credit rating action in certain instances. A review is required if a former employee is subsequently employed by an entity rated by the NRSRO (or by an issuer, underwriter or sponsor of a security rated by the NRSRO) and the former employee participated in the determination of a credit rating action during the one-year period preceding the date of such credit rating action.</p> <p>NRSROs are required to retain a record of each person who has paid for a credit rating and who has subscribed for a credit rating or credit rating analysis. The twenty largest issuers, subscribers, obligors, and underwriters by revenue must be identified to the SEC annually.</p> <p>An NRSRO is also required to keep records of the general types of products and services it offers, which can be useful in identifying any potential conflicts of interest that can arise from activities ancillary to an NRSRO's credit rating business.</p> <p>Both internal and external communications related to the rating process, which could potentially identify any influence exerted by clients or otherwise by internal sources (e.g., with respect to sales or marketing considerations) are required to be retained.</p> <p><i>Compensation</i></p> <p>NRSROs are required to disclose actual and potential conflicts of interest on Form NRSRO, including those arising from the nature of compensation arrangements for producing credit ratings. The SEC has identified specific conflicts of interest that generally arise from compensation issues in the business of issuing credit ratings, including conflicts relating to credit ratings paid by the entities being rated (i.e., issuer-paid ratings) or by subscribers who stand to benefit by certain rating actions (i.e., subscriber-paid ratings). In particular, the SEC has specified in the NRSRO Regulations that a conflict of interest exists if an NRSRO is paid by obligors, issuers, sponsors of ABS, or underwriters to determine credit ratings for such entities or the securities they issue, sponsor, or underwrite or for other services offered by the NRSRO, or if an NRSRO is paid by subscribers to receive access to credit ratings or other services if such subscribers obtain benefits from the regulatory use of credit ratings or have entered into transactions that could be impacted by a credit rating issued by the NRSRO.</p> <p>The instructions for Form NRSRO list these potential conflicts of interest and require the NRSRO to disclose such conflicts to the extent they apply to its business. Each NRSRO is also required to disclose on Form NRSRO the written policies and procedures maintained and enforced by the NRSRO to manage the conflicts of interest that apply to it. Each NRSRO must update its Form NRSRO annually and certify that the information therein, as updated, continues to be accurate and must also promptly file an amendment to its Form NRSRO if any information therein becomes materially inaccurate.</p> <p>A NRSRO has to make its Form NRSRO publicly available on its website.</p> <p>Effective June 15, 2015, each NRSRO will also be required to disclose information relating to conflicts of interest of the NRSRO when taking certain credit rating actions. In particular, an NRSRO will be required to disclose the source of payment for its fees, if applicable, with respect to the credit rating and whether the NRSRO was paid for any other services provided during the most recently ended fiscal year to the person paying for the credit rating.</p> <p>Transparency and timeliness</p> <p><i>Dissemination of ratings in a timely manner</i></p> <p>Oversight of NRSROs addresses whether NRSROs disseminate their credit ratings in a timely manner.</p> |
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The Exchange Act requires each NRSRO to maintain and enforce written policies and procedures reasonably designed to prevent the inappropriate dissemination of a pending credit rating action before issuing the credit rating on the Internet or through another readily accessible means. As applicable to the business model of the NRSRO, these policies may include procedures designed to ensure that a credit rating action is issued in a way that makes it readily accessible to the market place, such as posting the credit rating or an announcement of the credit rating action on the NRSRO's website or through a news or information service used by market participants or by making it available to all subscribers simultaneously.

The NRSRO Regulations also require each NRSRO to establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings.

Information on methodologies

NRSROs are required to publish a description of their procedures and methodologies so that outside parties can understand how a credit rating was determined and the attributes and limitations of each NRSRO's credit ratings.

Each NRSRO must publicly disclose on Form NRSRO a description of the procedures and methodologies that it uses to determine its credit ratings. The instructions for Form NRSRO state that this description must be sufficiently detailed to provide users of credit ratings with an understanding of the processes employed by the NRSRO in determining credit ratings.

Specifically, the disclosure must include, among other things:

- A description of the sources of information used in determining credit ratings;
- How information about the verification performed with respect to the collateral backing a structured finance product is relied upon in determining credit ratings;
- How the quality of the originators of assets underlying structured finance products factor into the determination of credit ratings;
- The quantitative and qualitative models and metrics used to determine credit ratings;
- The procedures for interacting with the management of the rated entity;
- The structure and voting process of the NRSRO's credit rating committees;
- The procedures for monitoring, reviewing, and updating credit ratings, including how frequently credit ratings are reviewed; and
- The procedures to withdraw a credit rating or suspend maintenance of a credit rating.

These specific items are designed to provide users of credit ratings with useful information to understand how an NRSRO produces credit ratings and to provide a basis for comparing NRSROs. Certain of the required items allow users of credit ratings to understand any limitations of a given credit rating. For instance, the extent to which an NRSRO verifies information (e.g., value of the property or income of the borrower) about the assets underlying a structured finance product will be useful to users of credit ratings in assessing the potential for an NRSRO's credit ratings to be adversely impacted by inaccurate information about the underlying assets. Additionally, information regarding the process for monitoring and maintaining credit ratings after they are issued allows users of credit ratings to assess any limitations on the accuracy of the credit ratings over time.

As noted above, the instructions to Form NRSRO identify specific items that an NRSRO may address in its procedures, and these must be disclosed to the extent applicable. However, the list of items identified in the instructions is not exhaustive, and each NRSRO is required to disclose a

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| | <p>description that is “sufficiently detailed to provide users of credit ratings with an understanding of the processes employed by the NRSRO in determining credit ratings”. The NRSRO Regulations also require NRSROs to retain certain records supporting various credit rating actions and with respect to the development of its methodologies to ensure that OCR examination staff has adequate information to review whether an NRSRO has sufficiently described its methodologies and procedures on Form NRSRO.</p> <p>Each NRSRO is also required to make additional disclosures regarding the general attributes of its credit ratings, by defining the credit rating categories, notches, grades and rankings it uses. This information is designed to allow users of credit ratings to understand what an NRSRO’s ratings symbols represent.</p> <p>Effective June 15, 2015, each NRSRO will be required to disclose certain information about its procedures, methodologies, and assumptions when taking certain credit rating actions. Such information includes, among other things, the version of the procedure or methodology used to determine the credit rating; the main assumptions and principles used in constructing the procedures and methodologies used to determine credit ratings, including qualitative methodologies and quantitative inputs; the potential limitations of the credit rating, including the types of risks excluded from the credit rating; information regarding the uncertainty of the credit rating, including information on the reliability of the data relied on in determining the credit rating; an explanation or measure of the potential volatility of the credit rating, including any factors that are reasonably likely to lead to a change in the credit rating; and information on the sensitivity of the credit rating to assumptions made by the NRSRO.</p> <p><i>Information on historical default rates</i></p> <p>NRSROs are required to publish on their Forms NRSRO information about the historical default rates of their credit ratings so that interested parties can understand the historical performance of their credit ratings.</p> <p>The NRSRO Regulations require each NRSRO to publicly disclose performance measurement statistics with respect to its credit ratings. These performance measurement statistics must include historical credit ratings transition and default rates, showing the changes in the credit ratings assigned to obligors and securities over 1-, 3-, and 10-year periods through the most recent calendar year end. The data are required to be provided separately for each class and certain subclasses of credit ratings for which the NRSRO is registered so that interested parties can focus on the information relevant to them.</p> <p>Amendments to the instructions for Exhibit 1 to Form NRSRO, effective January 1, 2015, standardize the production and presentation of the performance measurement statistics, in order to allow users of credit ratings to compare the performance of credit ratings across NRSROs and provide a standardized definition of default for purposes of calculating the default statistics. The amendments also require statistics to be produced for subclasses of structured finance products and for credit ratings where the obligation was paid off or the credit rating was withdrawn for reasons other than a default or the obligation being paid off.</p> <p>In addition, under the enhanced credit rating history disclosure requirements effective June 15, 2015, an NRSRO, among other things, will be required to publicly disclose historical information concerning each credit rating, such as information that could be used to generate statistics, including default statistics, about the performance of the NRSRO’s credit ratings.</p> <p>Confidential Information</p> <p><i>Use of private information</i></p> <p>The NRSRO Regulations require NRSROs to take steps to address the protection of nonpublic</p> |
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information provided by issuers and others so that such information is only used for credit rating activity purposes. The NRSRO Regulations require each NRSRO to maintain and enforce written policies and procedures reasonably designed to prevent the “inappropriate dissemination within or outside the NRSRO of material non-public information obtained in connection with the performance of credit rating services” and to prevent NRSRO personnel from trading securities when they are aware of material non-public information obtained in connection with the performance of credit rating services. The NRSRO Regulations also require that each NRSRO publicly disclose those policies and procedures on Form NRSRO.

Pending ratings

The NRSRO Regulations require each NRSRO to maintain and enforce written policies and procedures reasonably designed to prevent the inappropriate dissemination of a pending credit rating action before issuing the credit rating on the Internet or through another readily accessible means. The NRSRO Regulations also require that each NRSRO publicly disclose those policies and procedures on Form NRSRO.

Oversight of the NRSRO

Once a CRA is registered with the SEC as an NRSRO, it is subject to continuing oversight by the SEC to monitor compliance with the federal securities laws, including Section 15E of the Exchange Act and the SEC’s related rules (collectively, the NRSRO Regulations).

SEC authority to require information

The Exchange Act requires all NRSROs to make and keep for prescribed periods such records, furnish such 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, or otherwise in furtherance of the Exchange Act. Pursuant to the NRSRO Regulations all records maintained by an NRSRO are subject to examination by the SEC.

The NRSRO Regulations also require each NRSRO to provide certain information to the SEC on an ongoing basis. Each NRSRO must update its Form NRSRO annually and certify that the information therein, as updated, continues to be accurate. The NRSRO Regulations also require that material changes be communicated to the SEC as they occur; an NRSRO must promptly file an amendment to its Form NRSRO if any information therein becomes materially inaccurate.

In addition to requiring periodic updates to Form NRSRO, the NRSRO Regulations require each NRSRO to deliver annually certain financial reports and other information to the SEC. Further, the designated compliance officer at each NRSRO is required to file an annual report with the SEC discussing the NRSRO’s compliance with federal securities laws and its own policies and procedures, including a description of any material changes to the code of ethics and conflict of interest policies of the NRSRO and a certification that the report is accurate and complete. Commencing January 1, 2015, each NRSRO must also deliver a report to the SEC containing an assessment by management of the effectiveness during the fiscal year of the internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings.

Examinations

All NRSROs, whether located in the U.S. or elsewhere, are subject to an annual examination process and to further examination and enforcement by the SEC when appropriate.

Section 15E(p)(3) of the Exchange Act requires the SEC to conduct examinations of each NRSRO at least annually. Each examination must include, but is not limited to, a review of the following specified areas:

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| | <ul style="list-style-type: none"> • Whether the NRSRO conducts business in accordance with its policies, procedures, and rating methodologies ; • The management of conflicts of interest by the NRSRO; • Implementation of ethics policies by the NRSRO; • The internal supervisory controls of the NRSRO; • The governance of the NRSRO; • The activities of the designated compliance officer; • The processing of complaints by the NRSRO; and • The NRSRO's policies governing the post-employment activities of former staff of the NRSRO. <p>In addition to the required annual examinations, the SEC has broad discretion to conduct examinations of NRSROs whenever it considers an examination to be necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the Exchange Act.</p> <p>Enforcement</p> <p>The SEC has authority to bring enforcement actions against NRSROs for possible violations of the federal securities laws, rules and regulations. This includes the ability to censure, place limitations on the activities, functions, or operations of, suspend, or revoke the registration of any NRSRO upon the occurrence of certain events, including the failure to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity or the failure reasonably to supervise, with a view to preventing a violation of the securities laws, an individual who commits such violation. More broadly, the SEC is authorized to seek an injunction, civil penalty and/or equitable relief if it appears to the SEC that there has been a violation of the Exchange Act or any of the rules or regulations thereunder.</p> <p>Practice</p> <p><i>Establishment of OCR</i></p> <p>The Dodd-Frank Act required the SEC to establish an Office of Credit Ratings and provide it with sufficient staff. This Office was formally established in June 2012. OCR had 44 staff for fiscal year 2014 (and 6 more staff were requested in the budget for fiscal year 2015). In fiscal year 2014, approximately half of the staff focused on examinations, and the remaining half focused on policy and monitoring work. Staff recruited by OCR include former supervisors and CRA employees as well as attorneys. In addition, a quantitative analyst has been added to OCR's staff in fiscal year 2015.</p> <p><i>Registration</i></p> <p>Currently 10 CRAs are registered as NRSROs, of which two are foreign and are subject to the same process as the domestic NRSROs. With one exception, all the registrations took place in 2007. However an application to rate new asset classes is treated as a "mini registration".</p> <p><i>Examinations</i></p> <p>As indicated above, the Dodd-Frank Act requires the OCR to include eight areas for review in its examinations. Within such review areas, the OCR conducts a risk- assessment for each NRSRO to identify specific issues to focus on for each exam, and also identifies issues or risks that are present at multiple NRSROs. To this end, the OCR initially reviews information such as: each</p> |
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NRSRO's response to deficiencies identified in previous exams; Form NRSRO submissions and NRSROs' public disclosures; any tips, complaints, and referrals concerning NRSROs submitted to the SEC; and news articles and other sources. For large CRAs the examination team would consist of approximately 3-6 examiners; while for the smaller CRAs the examination team would consist of approximately 2-3 examiners. Certain examiners of the big 3 CRAs are exclusively dedicated to that exam. The OCR has generally implemented a practice of rotation of the exam team lead to avoid the risk of regulatory capture and provide fresh perspectives.

During an examination, OCR staff gathers information from the NRSRO and then typically visits one or more of the NRSRO's offices and interviews the NRSRO's analytical personnel, senior management, compliance personnel, board of directors, business development/marketing personnel, and other personnel. The OCR examination staff also reviews, among other things, documents received from the NRSRO including internal and nonpublic documents and other sources of information used to conduct its risk assessment, such as the Form NRSRO submissions, and tips, complaints, and referrals sent to the SEC.

Upon completion of the annual examination, OCR examination staff discusses the results of the examination with the corresponding NRSRO and issues a letter identifying any deficiencies and recommending remedial measures. An NRSRO is typically requested to submit a written response within 30 days of the final recommendations of the examination staff. Examples of remedial actions included that one or more of the examined NRSROs evaluate whether they have sufficient staff and resources to manage their volume of business and that they review their current disclosures relating to process and methodologies for rating certain asset classes to assess whether they are fully disclosing their ratings methodologies in compliance with the law.

In addition to the individual letters, the examination staff also prepares an annual public report summarizing the essential findings of the examinations, the responses of each NRSRO to any material regulatory deficiencies identified by the examinations, and whether the recommendations contained in previous public reports have been appropriately addressed. The public report for 2013 highlighted that NRSROs responded to the 2012 recommendations with remedial measures such as adopting new or revising existing procedures, enhancing or implementing new internal controls, implementing new software systems, and conducting compliance and analytical training. Further, NRSROs have added, or have begun to add, compliance resources, both in the form of experienced compliance personnel and in software systems and information technology infrastructure. NRSROs have also improved oversight by boards of directors or governing committees to which oversight duties have been assigned. In the report SEC staff noted five general areas of improvement among NRSROs:

- Enhanced documentation, disclosure, and Board oversight of criteria and methodologies;
- Investment in software or computer systems;
- Increased prominence of the role of the DCO within NRSROs;
- Implementation or enhancement of internal controls; and
- Adherence to internal policies and procedures.

The public report concluded that there has been a noticeable positive shift in the compliance culture of NRSROs.

OCR staff indicated that during 2014 they conducted the first examination abroad of affiliates of domestic CRAs. In addition, they have started to conduct thematic reviews.

Consistent with the IOSCO Final Report on Supervisory Colleges for Credit Rating Agencies, supervisory core and general colleges for CRAs were established for the three largest globally

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| | <p>active CRAs (Fitch, Moody’s and S&P). Two of the colleges are chaired by the SEC and the third one by ESMA. The first meeting of the core colleges took place in November 2013. It was a two day meeting where the regulators had meetings with each of the CRAs and meetings restricted to regulators. The second meeting of the core colleges for CRAs took place in December 2014; the core colleges met for three days (one day for each of the CRAs). The first meeting of the general colleges for CRAs took also place in December 2014 where the regulators met for one day.</p> <p><i>Enforcement</i></p> <p>In 2012 the SEC brought an enforcement action against an NRSRO and its president charging them with willful and material misrepresentations and omissions in the NRSRO’s application, pursuant to Form NRSRO, to the SEC to register as an NRSRO for issuers of ABS and issuers of government, municipal and foreign government securities. The NRSRO consented to the SEC’s order revoking its NRSRO registration with respect to issuers of asset-backed securities and issuers of government, municipal and foreign government securities, but providing for the right to re-apply for registration in these classes after 18 months. The president of the NRSRO was barred from association with any NRSRO registered in these two classes of credit ratings, with the right to apply to the SEC for re-entry after 18 months. The SEC’s order required the NRSRO to complete a comprehensive review of its policies, procedures, practices, and internal controls that related to the findings set forth in the SEC’s order and the findings of the 2012 examination by OCR staff. In addition, the settlement required the NRSRO to adopt, implement, and maintain policies, procedures, practices, and internal controls that correct the issues identified in the SEC’s order, the 2012 examination, and any deficiency identified in the NRSRO’s comprehensive review and to submit a report to OCR detailing the steps it took to address these issues. The settlement further required the NRSRO and its president to cease and desist from committing or causing future violations.</p> |
| Assessment | Fully Implemented |
| Comments | |
| Principle 23. | Other entities that offer investors analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them. |
| Description | <p>Sell side analysts</p> <p>SEC</p> <p>In 2003 and 2004, the SEC and the SROs which it oversees (collectively “U.S. Broker-Dealer Regulatory Agencies”) as well as other regulatory agencies settled charges against twelve of the leading U.S. BDs (the Global Settlement) in connection with their research analysis. The Global Settlement required a number of structural changes at the settling firms, such as information barriers between research analysts and investment bankers. The Global Settlement applies to BDs who account for roughly 80 to 90 percent of the equity underwriting activity in the U.S. The Global Settlement has been amended over time to remove aspects that are covered by U.S. Broker-Dealer Regulatory Agencies regulations. However, Global Settlement firms continue to be subject to more requirements than those that apply to the rest of the industry based on U.S. Broker Dealer Regulatory Agencies rules described below.</p> <p>SEC Regulation AC adopted in 2003 seeks to address conflicts of interest related to research analysis at an industry level. Regulation AC covers research on equity and debt securities. It requires that BDs include in research reports a statement by the analyst certifying that the views expressed in the report accurately reflect his or her personal views and disclosing whether his or</p> |

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| | <p>her compensation was, or will be, directly or indirectly, related to the specific recommendations or views in the research report. In addition, Regulation AC requires BDs to obtain periodic certifications by analysts in connection with the analyst's public appearances.</p> <p><i>Equity</i></p> <p>In addition to this general rule, pursuant to SOX provisions, the U.S. Broker-Dealer Regulatory Agencies adopted rules to address equity analyst conflicts of interests (NASD Rule 2711 and NYSE Rule 472).¹³ These rules address conflicts of interest that can arise when analysts work at firms that have investment banking or other business relationships with issuers. These rules also address conflicts of interest that can arise when the analyst or the firm owns securities of the issuer that an analyst covers. In particular, the SRO rules contain provisions concerning trading activities, financial interests, business relationships, reporting lines, and compensation, as well as other items, in a manner designed to increase an analyst's independence and manage conflicts.</p> <p><i>Restriction on trading by the analysts</i></p> <p>The rules place various restrictions on an analyst's personal trading. For example, the rules restrict the analyst, and his or her household members, from purchasing or receiving any securities before an issuer's initial public offering, if the issuer is principally engaged in the same type of business as companies that the analyst follows. In addition, the rules contain provisions that generally restrict an analyst, and his or her household members, from trading in any securities of an issuer that the analyst follows during certain periods before and after the publication of a research report, and from trading in a manner inconsistent with the analyst's most recent published recommendation regarding that security. The rules require prior approval by legal or compliance personnel of certain transactions by persons who oversee research analysts.</p> <p><i>Disclosure obligations</i></p> <p>In addition to trading restrictions, the rules place substantial disclosure obligations on member firms and analysts. The first category of disclosure is in relation to conflicts of interest arising out of ownership interests, including:</p> <p>If the analyst or a member of the analyst's household has a financial interest in the subject company, the existence and nature of such interest (including any option, right, warrant, future, long or short position; and</p> <p>Ownership by the member firm or one of its affiliates of 1 percent or more of the subject company's equity securities.</p> <p>The rules also require disclosure if an analyst, or his or her household member, serves as an officer, director or advisory board member of the subject company.</p> <p>The rules further require disclosure in research reports if the firm was making a market in the subject company's securities at the time a research report was published.</p> <p>In addition, the rules generally require various disclosures in research reports regarding investment banking business and compensation as well as other activities. For example, the rules require that a firm disclose in a research report if:</p> <p>The analyst received compensation based upon the firm's investment banking business or from</p> |
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¹³ These Rules were adopted prior to the creation of FINRA. They remain in place and are part of the framework under the supervision of FINRA.

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| | <p>the subject company in the past 12 months;</p> <p>The firm, or its affiliates, (i) managed or co-managed a public offering of securities for the subject company in the past 12 months; (ii) received compensation for investment banking services from the subject company in the past 12 months; or (iii) expects to receive or intends to seek compensation for investment banking services from the subject company in the next 3 months;</p> <p>The firm received compensation for products or services other than investment banking services in the past 12 months;</p> <p>The analyst or an employee who has the ability to influence the substance of a report knows that an affiliate has received compensation for products or services other than investment banking in the past 12 months;</p> <p>The firm or the analyst has reason to know that an affiliate received such compensation in the past 12 months; and</p> <p>A subject company is, or during the prior 12-month period was, a client of the firm and types of service provided to the subject company.</p> <p>In addition, the rules mandate certain compensation disclosures in public appearances.</p> <p><i>Reporting lines and independence of the analysts</i></p> <p>The rules generally provide that no analyst may be subject to the supervision or control of any investment banking department employee.</p> <p>In addition, the rules generally provide that no personnel engaged in investment banking activities may have influence or control over the compensatory evaluation of an analyst. The rules also require that analyst compensation be reviewed and approved by a committee that reports to a firm’s board of directors or to a senior executive officer of the firm. The committee cannot have representation from the firm’s investment banking department. Further, the rules delineate specific factors that the committee must consider in its review.</p> <p><i>Influence by issuers</i></p> <p>In addition, the rules address potential undue influence of issuers by placing restrictions on communications with the issuer. For example, these rules restrict a firm from sharing draft research reports with the subject company issuer other than as necessary to verify the factual accuracy of information in the draft report. Further, the draft report cannot contain certain information, such as the research rating or the price target. In addition, the rules require that the firm’s legal or compliance department be involved in this company review. A complete draft of the report must be submitted to legal or compliance personnel before a section of the report is sent to the subject company.</p> <p>Similar restrictions on internal review by non-research department personnel may reduce the possibility of an indirect conflict from the firm’s business relationships (e.g., a sales trader representing an institutional investor attempting to influence the outcome).The rules restrict when a firm may notify a subject company of a ratings change and prohibit a firm from offering favorable research, a specific rating, or price target to an issuer as consideration or inducement for the receipt of business or compensation.</p> <p>Also, the rules require disclosure of any other actual, material conflict of interest of the research analyst or member of which the research analysts knows or has reason to know at the time of publication of the research report or at the time of the public appearance. In regard to the manner of disclosure, the rules require prominence of disclosures. In particular, the rules provide</p> |
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that the required disclosures must be presented on the front page of a research report or the front page must refer to the page on which disclosures are found. In addition, these provisions require that the disclosures and references to disclosures be clear, comprehensive, and prominent.

Ethical behavior

The U.S. Broker Dealer Regulatory Agency rules require that any written or oral communication by an analyst with a current or prospective customer or internal personnel related to an investment banking services transaction be fair, balanced and not misleading, taking into consideration the overall context in which the communication is made.

Additional rule provisions promote the integrity of research by helping to insulate analysts from investment banking pressures. Investment banking personnel are prohibited from directing an analyst to engage in sales or marketing efforts related to an investment banking transaction, or communicating with a current or prospective customer about an investment banking transaction. These rules specifically mandate that no firm or firm employee involved in investment banking activities may retaliate against, or threaten to retaliate against, an analyst for issuing negative research that may adversely affect the firm's investment banking business.

Senior management responsibility

The U.S. Broker-Dealer Regulatory Agency rules require that firms adopt and implement written supervisory procedures reasonably designed to ensure that the firm and its employees comply with these rules regarding analyst conflicts. A senior officer of the firm must annually attest that the firm has adopted and implemented those procedures. The rules further require specific written policies and procedures reasonably designed to restrict or limit information flow between research department personnel and trading department personnel. The purpose of this rule is to prevent the firm trading ahead of information to be released in a research report.

Debt research

Neither the Global Settlement nor most U.S. Broker Dealer Regulatory Agency rules apply to fixed income research, though Regulation AC does. In the absence of specific U.S. Broker Dealer Agency research analyst rules beyond Regulation AC covering fixed income research conflicts, NASD (now FINRA) and NYSE generally rely on antifraud statutes and other SRO rules prohibiting fraud and requiring ethical conduct and a comprehensive supervisory scheme to oversee a firm's securities business.

Also, NASD (now FINRA) and NYSE encouraged firms to consider adopting industry-developed principles to address such conflicts. In 2004 the Bond Market Association (BMA), an industry association, issued voluntary, principle-based guidelines designed to help firms manage potential conflicts faced by fixed income analysts.

Pending proposals

A recent GAO report recommended a review of current requirements vis-à-vis the Global Settlement with a view to determine whether all firms should be subject to the same requirements; and reviewed potential expansion of current rules, beyond Regulation AC, regarding research on debt securities. FINRA has been working on both topics (see Regulatory Notice 11-11, March 2011 for debt research).

Monitoring

The SEC has conducted examinations of select firms not covered by the Global Settlement to analyze both voluntary compliance with the Global Settlement and compliance with the U.S. Broker Dealer Regulatory Agency rules. The firms reviewed were selected to represent larger,

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| | <p>mid-sized and smaller broker-dealers. SEC staff found that these firms had voluntarily adopted at least some of the Global Settlement requirements, but such controls were not as formal as for the firms covered by the Global Settlement. The SEC staff identified instances of non-compliance with the U.S. Broker Dealer Regulatory Agency rules, mainly related to disclosure of conflicts.</p> <p>CFTC</p> <p><i>FCMS and IBs</i></p> <p>Section 732 of the Dodd-Frank Act (amending section 4d of the CEA) directed FCMs and IBs to implement informational partitions between those researching or analyzing prices or markets for commodities and those involved in trading or clearing activities.</p> <p>CFTC Regulation 1.71 implements the conflict of interest provisions for FCMs and IBs set forth in the CEA and contains, among other things, provisions prohibiting improper interference with clearing decisions and undue influence on customers, as well as the disclosure of any financial interest that a research analyst maintains in any derivative of a type that the research analyst follows and the general nature of the financial interest.</p> <p>Under CFTC Regulation 1.71, FCMs and IBs are required to adopt written policies and procedures that are reasonably designed to ensure that the firm and its employees are in compliance with Regulation 1.71. Subsections 1.71(b) and (c) set forth most of the substantive requirements as follows:</p> <p>Restrictions on relationships with the research department including:</p> <p>Non-research personnel may not direct a research analyst's decision to publish a research report or direct the views and opinions in the report;</p> <p>Research analysts may not be under the supervision, control (including with respect to performance evaluation and compensation) of employees of the firm's business trading unit or clearing unit; and</p> <p>Non-research personnel may not review or approve a research report prior to publication except for certain specified reasons; and reviews must be done by authorized legal and compliance personnel.</p> <p>Restrictions on communications that provide that a research analyst's written or oral communication to customers relating to a derivative may not omit any material fact or qualification that would make the communication misleading to a reasonable person.</p> <p>Restrictions on research analyst compensation that prohibit FCMs and IBs from considering a research analyst's contribution to the firm's trading or clearing business in determining compensation.</p> <p>FCMs and IBs are prohibited from offering favorable research or threatening to change research to a customer as consideration or inducement for business or compensation.</p> <p>FCMs, IBs and their research analysts must comply with specific disclosure requirements relating to a research analyst's financial interest in any derivative that the research analyst follows.</p> <p>FCMs, IBs and their employees who are involved in the firm's trading or clearing activities are prohibited from retaliating against a research analyst employed by the firm or its affiliate as a result of a research report (made in good faith by the analyst) that may adversely affect the FCM's or IB's trading or clearing activities.</p> <p>The Regulation provides an exemption from the above requirements for smaller IBs that, over the preceding 3 years, have generated \$5 million or less in aggregate gross revenues from their</p> |
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IB activities. IBs qualifying for this exemption, however, must establish structural and institutional safeguards reasonably designed to ensure that the activities of persons who research or analyze the price or market for any commodity or derivative are separated by appropriate informational partitions from the review, pressure or oversight of persons involved in trading or clearing activities.

Regulation 1.71(e) also requires FCMs and IBs, regardless of size, to adopt and implement written policies and procedures that require them to disclose to their customers any material incentives and any material conflicts of interest regarding a customer's decision as to trade execution and/or clearing of a derivatives transaction.

Finally, subsection 1.71(d) sets forth specific requirements for FCMs related to clearing activities. Those provisions do not become effective until the date on which swap dealers and major swap participants are required to apply for registration under CFTC Regulation 3.10.

SDs and MSPs

The Dodd-Frank Act (amending Section 4 of the CEA) requires SDs and MSPs to implement conflict of interest systems and procedures that establish structural and institutional safeguards to ensure that the activities of any person within the firm relating to research or analysis of the price or market for any commodity or swap, or acting in a role of providing clearing services, are separated by appropriate informational partitions from persons whose involvement in pricing, trading, or clearing activities might potentially bias their judgment and contravene open access requirements or business conduct standards set forth in the Act.

Commission Regulation 23.605 implements the conflict of interest provisions set forth in the CEA for SDs and MSPs and requires, among other things, the disclosure of any financial interest in any derivative of a type that a research analyst follows, the general nature of the financial interest, and appropriate informational partitions between business trading units of a SD or MSP and clearing units of any affiliated clearing member of a DCO.

NFA framework

Research reports that are disseminated to the public would be considered promotional material under NFA rules. Therefore, research reports are subject to all of NFA's promotional material requirements, including the requirement of Compliance Rule 2-29 that the report not be misleading or omit facts that make it misleading. In addition, NFA Compliance Rule 2-4 requires Members and Associates to observe high standards of commercial honor and just and equitable principles of trade in the conduct of their commodity futures business. If a Member or Associate gave preferable treatment to certain customers or used information obtained in a research report to their advantage over customers, this conduct would violate NFA Compliance Rule 2-4.

NFA's Interpretive Notice entitled: Obligations to Customers and Other Market Participants prohibits these Members and their Associates from purposefully establishing, increasing, decreasing or liquidating a position in any SFP in anticipation of the issuance of a research report regarding the underlying security or a derivative based upon the underlying security. The Interpretive Notice recommends that Members develop and implement firewalls to isolate specific information within research and relevant departments to prevent the trading department from using the advance knowledge of the issuance of the research report. The Interpretive Notice also recognizes that supervisory procedures need to be adaptable to a firm's size and business practices and, therefore, it gives Members the flexibility to develop firewalls that are appropriate for their business models. Although NFA acknowledges that SFPs have traded on a limited basis, our regulatory oversight of these products has not found any issues with the use of research reports.

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| | <p><i>Monitoring</i></p> <p>Compliance with CFTC regulations in connection with conflicts of interest is conducted by the NFA through its regular examination program. NFA staff has indicated that their inspections have not found significant problems in connection with research analysis</p> <p>Other information service providers</p> <p>As indicated under Principle 7, the SEC and CFTC review the perimeter of regulation on a regular basis via different mechanisms. These reviews have not triggered concerns related to the need to regulate any other category of information service provider different from CRAs and sell side analysts. Neither did inquiries with market participants reveal concerns on the need to regulate any other category of information service provider.</p> |
| Assessment | Fully Implemented |
| Comments | The assessors note the lack of more comprehensive rules applicable to research for debt securities. However, Regulation AC does cover it and the antifraud provisions do apply to BDs in connection with such research. The assessors also note the existence of different requirements between the firms covered by the Global Settlement and those that are not covered by it. Work on both areas by FINRA is therefore welcome. |
| Principles for Collective Investment Schemes | |
| Principle 24. | The regulatory system should set standards for the eligibility, governance, organization and operational conduct of those who wish to market or operate a collective investment scheme. |
| Description | <p>CFTC</p> <p>Marketing and operating a CIS</p> <p>Under section 4m of the CEA, all individuals and firms (with limited exceptions) that intend to do business as a CPO (including marketing CPs) must register with the CFTC. Section 1a(11) of the CEA defines a CPO as any person who conducts a business of soliciting, accepting or receiving from others funds, securities or other property for the purpose of trading in commodity interests. The CFTC has delegated registration of CPOs to the NFA. NFA decisions on registration are subject to appeal to the CFTC and the courts. Natural person principals (which includes beneficial owners of more than ten percent of the firm’s capital) and APs must also register. Firms must submit form 7R.</p> <p>Eligibility criteria</p> <p><i>Integrity and competence</i></p> <p>The CEA (Sections 8a(2) and (3)) specifies factors that disqualify an applicant from registering with the CFTC. These include prior disciplinary and criminal offences. To register as an AP, a person must disclose background information including on employment and education, and pass proficiency tests before soliciting customers.</p> <p><i>Financial capacity</i></p> <p>CPOs are not required to meet any minimum financial requirements.</p> <p><i>Organizational requirements</i></p> <p>There are no specific requirements in the CEA or CFTC Regulations mandating specific human and technical resources, nor the obligation for the CPOs to have adequate internal controls and compliance or risk management as part of the registration process. These issues would arise after registration in relation to a firm’s ability to comply with its ongoing obligations. In</p> |

this regard, NFA Rule 2-9 imposes an obligation on CPOs to supervise their personnel. Based on this obligation, CPOs are required to implement compliance programs, which include the development of appropriate policies and procedures on day-to-day operations. They are also obliged to review their compliance program on an annual basis. There are no explicit requirements for CPOs to implement appropriate internal controls and risk management systems. However, the NFA has considered that these obligations are implicitly required by Rule 2-9, and therefore its supervision modules include the corresponding reviews of such arrangements.

Primacy of investor interests

CEA and CFTC Regulations create a regulatory system that is primarily disclosure based and CFTC Regulations create a range of disclosure obligations. CFTC Regulation 4.24 requires CPOs to disclose to pool participants, among other things, fees and expenses, potential conflicts, and any material transactions between the CPO and persons affiliated with it. The relationship between the CPO and pool participants depends on the form the pool takes (for example whether the pool is a limited partnership or an LLC) and the relevant general law relating to that relationship. Depending on the structure of the CPO, state corporate law may impose some form of fiduciary obligation on the CPO and some aspects of this may apply to the CPO's obligations to pool participants.

International cooperation

All pools offered to U.S. investors, including pools managed by foreign entities are required (with limited, de minimis, exceptions) to be registered under the CEA. In practice foreign operators prefer to constitute a separate domestic pool for U.S. investors.

For foreign based applicants, NFA also where appropriate performs additional background checks such as checks with foreign regulatory and self-regulatory bodies and Interpol. In some cases, NFA consults with foreign regulatory authorities to assess the fitness of applicants for registration whose applications disclose prior employment with a non-U.S. firm, or where the U.S. registrant has foreign principals.

Sanctions for non-compliance

If a registered CPO fails to comply with its regulatory obligations, NFA's Business Conduct Committee (BCC) is empowered to take action against the entity and impose sanctions, including expulsion, suspension, fine, censure, or any other fitting penalty, for any violation of its rules. The CFTC, through its DOE, can impose civil penalties for violations of CFTC Regulations ranging from a ban from registration to a monetary penalty. It can also seek criminal penalties and does so, especially in relation to breaches of the obligation to register (such as by illegal schemes).

Supervision and ongoing monitoring

Responsibility and powers of regulator

The CFTC and NFA are responsible for oversight of CPOs.

Under Section 17 of the CEA, as a RFA, NFA must:

Establish training standards and proficiency testing for persons involved in the solicitation of transactions, supervisors of such persons and all persons for which it has registration responsibilities, and a program to audit and enforce compliance with these standards; and

Establish minimum standards governing sales practices of its members and associated persons for transactions subject to the provisions of the CEA.

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| | <p><i>Registration</i></p> <p>The CFTC has delegated the registration function to NFA, which is responsible for authorization of CPOs. When an entity seeks to be registered as a CPO, it must submit a Form 7R and its Disclosure Document to NFA for review to determine compliance with CFTC Regulations as well as NFA membership rules. Form 7R provides details of the applicant including prior criminal and disciplinary history. At the time of registration, the NFA does not routinely make enquiries about an applicant's procedures, internal controls and risk management, and more generally its compliance arrangements, unless it has adverse information about the applicant's principals or advisers. In that case it makes more detailed enquiries.</p> <p>A CPO's principals and APs must complete a Form 8R and demonstrate that they have met the relevant competence standards (Series 3 examinations).</p> <p><i>Ongoing monitoring and examinations</i></p> <p>NFA, as an RFA, has oversight responsibility for CPOs and has instituted a program that monitors compliance by CPOs with all applicable CFTC Regulations and NFA rules, subject to oversight of its activities undertaken by the CFTC. Although the CFTC retains authority to conduct examinations, NFA has primary responsibility for examinations of CPOs and performs periodic examinations. The CFTC does not conduct direct examinations of CPOs.</p> <p>NFA conducts examinations of registered CPOs generally within the first year after them becoming active and then every 3 to 4 years to monitor compliance with the CFTC's Regulations and NFA's rules, with higher risk firms subject to more frequent examinations. NFA conducts a risk-based analysis to determine the frequency with which it conducts examinations and has a separate NFA risk assessment team that contributes to this process. A points system is used to score risks. Risk analysis takes into account information filed with the NFA, specific business factors and other information such as customer complaints or concerns that arise during NFA's review of a firm's Disclosure Document, financial statements or promotional material. NFA carried out 186 examinations of CPOs in calendar year 2012; 155 in 2013; and 100 up to November 2014. Common areas of focus include disclosure and performance reporting; review of promotional material; handling of pool funds; financial records; and financial reporting requirements; and valuation of assets.</p> <p>In its examinations, NFA reviews the compliance program developed by the CPOs, which must include review of policies and procedures, internal controls and risk management. To this end, the NFA has separate examination modules dealing with these topics. It has also taken enforcement actions for deficiencies in processes and procedures.</p> <p>NFA also reviews disclosure documents, pool quarterly reports (PQRs), pool certified annual financial statements, promotional material and investigative matters (customer complaints and referrals from other agencies). CFTC conducts ongoing oversight of NFA with respect to these responsibilities.</p> <p>Record-keeping and reporting</p> <p><i>Record-keeping</i></p> <p>CFTC Regulation 4.23 requires a CPO to make and keep books and records relating to the pool as well as to its operation as a CPO in an accurate, current and orderly manner in its main business office and in accordance with CFTC Regulation 1.31.</p> <p><i>Reporting</i></p> <p>CFTC Regulation 4.22(c) requires the distribution to pool participants of an annual report</p> |
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within 90 days of the period end. The report must include among other things financial statements of pool investments, and CFTC Regulation 4.22(d)(1) requires that these statements are prepared in accordance with GAAP, and that the financial statements be audited by an independent public accountant.

NFA requires CPOs to provide annual updates regarding their registration information and business operations. In addition, as any other category of registrants, CPOs must submit a self-assessment questionnaire on an annual basis.

Changes in management and operations

CFTC Regulation 4.26 requires each CPO to correct any defect in its Disclosure Document that it knows to be materially inaccurate or incomplete in any respect. Amendments to the Disclosure Document must be filed electronically with the NFA, which must accept them before they become operative. Changes must be made available to all existing participants within 21 days of the date on which the CPO first becomes aware of the need for the change. NFA review takes place within this 21 day period.

Conduct of business

NFA Rule 2-4 requires a CPO, like other registrants, to observe high standards of commercial honor and just and equitable principles of trade in the conduct of its commodity futures business. The regime is largely disclosure based, and CPOs are responsible for adhering to trading strategies and other information set out in the Disclosure Document and other documents governing the operation of the pool, and are required under CFTC Regulation 4.24(h)(2) to disclose any material restrictions or limitations on trading.

The relationship between a CPO and pool participants is not a fiduciary one, but anti-fraud provisions of the CEA are available to deal with misconduct such as churning and to enforce compliance with best execution requirements.

Allocation of trades

CFTC Regulation 1.35(b)(5) provides detailed rules for the post-trade allocation of transactions, including requirements that allocation be made in a fair and equitable manner, and that the general nature of the allocation methodology be disclosed to customers.

Due diligence in investments

There are no requirements in the CEA or CFTC Regulations regarding the CPO's due diligence in the selection of investments for its CP. This is a disclosure issue and CFTC Regulation 4.24(h) requires CPOs to provide a detailed description of the CP's investment program, including the types of commodity interests and other investments the pool will trade, the trading programs of any commodity trading advisors the CPO will employ, and the trading programs of funds or CPs in which the CPO plans to invest pool assets. CFTC Regulation 4.25 also requires detailed past performance statistics and information to be included in a CPO's Disclosure Document.

Fees and commissions

CFTC Regulation 4.24(i) requires CPOs' Disclosure Documents to include a complete description of all fees, commissions and other expense which the CPO knows or should know has been incurred by the CP for its preceding fiscal year and is expected to be incurred by the pool in its current fiscal year, including fees or other expenses incurred in connection with the pool's participation in investee CPs and funds.

Conflicts of interest

The CEA and CFTC Regulations do not mandate that a CPO take action to minimize conflicts of

interest, and the regime is disclosure based. CFTC Regulation 4.24(j) requires a CPO to include in its Disclosure Document a full description of any actual or potential conflicts of interest regarding any aspect of the pool on the part of the CPO, the trading manager (if any), any major CTA, the CPO of any major investee pool, any principal of these entities, and any other persons providing services to the CP. The CPO must also describe any other material conflict of interest with respect to the pool.

Delegation

Neither the CEA nor CFTC Regulations prohibit a CPO from delegating functions to another person or entity. If a CPO delegates its functions to another person or entity, the CPO remains legally responsible for its obligations under the CEA and CFTC Regulations. The delegating CPO is jointly and severally liable with the entity to which the CPO delegates its functions where the delegate is a related party.

Through CFTC staff letters allowing for delegation of this kind, the person or entity to which the CPO delegates its functions is itself required to register with the CFTC as a CPO and be a member of NFA. Regulatory oversight is maintained through periodic audits of CPOs by NFA. Both the NFA and CFTC have access to records and information about the delegated functions.

Generally, delegation by a CPO is performed through a contractual arrangement, and the CPO's ability to terminate that arrangement depends on the terms of the contract.

A CPO is required under CFTC Regulation 4.24 to disclose information about entities and individuals who provide services to the CP, any conflicts of interest that may arise, and any related party transactions

SEC

Under the federal securities legislation, a CIS vehicle is either an open-end fund (mutual fund), closed-end fund or a unit investment trust (UIT) registered under the ICA. Mutual fund and closed-end fund operators are IAs registered under the Advisers Act.

Exchange traded funds (ETFs) are commonly structured as investment companies, and thus subject to the requirements of the ICA as well as the Securities Act disclosure and reporting regime. The SEC has provided exemptive relief that takes into account the specific features of ETFs and their differences from mutual funds, for example by permitting them to be bought and sold at market prices rather than redeemed at NAV. UITs are a small part of the overall CIS market. They are fixed period, fixed size and fixed portfolio vehicles, and involve no ongoing active management by the trustee.

REITs are not covered by the ICA framework as they invest in assets different from securities. Instead they are governed by the framework applicable to issuers. As a result their offering to the public is subject to disclosure requirements as set forth in Principle 16. There is a separate disclosure form S-11 where additional disclosures about the investment policies and properties of the REIT must be made. Most REITs are exchange listed and as a result the corporate governance requirements of the exchanges' listing requirements would apply to them. Many REITs are internally managed (i.e., they do not have a, IA). When externally managed (for example mortgage REITs), the officers of the management company are deemed to be officers of the REITs.

Mutual funds account for the vast majority of AUM. As at 31 December 2013, mutual funds accounted for 78 percent of total ICA regulated AUM; ETFs for 18 percent; closed-end funds for 3 percent; and UITs for less than 1 percent. Because of their importance, the following

description deals mainly with mutual funds.

Marketing and operating a mutual fund

To become the operator of a mutual fund, a person must register as an IA under Section 203 of the Advisers Act. The shares of a mutual fund can be marketed by the fund itself, its operator or a broker-dealer. Each of these entities is required to be registered with the SEC.

Eligibility criteria

A person may not be registered if he/she is subject to a statutory disqualification, which relates largely to a previous history of criminal and disciplinary sanctions. Similar to CPOs, there are no provisions under the ICA and the Advisers Act that mandate specific human and technical resources, nor the obligation for the IAs to MFs to have adequate internal controls and compliance or risk management as part of the registration process. States may impose educational and professional training requirements on the representatives of SEC-registered IAs who have a place of business in that state.

However, similar to CPOs a series of obligations apply on an ongoing basis, in particular the need for IAs to implement a compliance program. Under Advisers Act Rule 206(4)-7 IAs must have written compliance policies and procedures that are reasonably designed to prevent violations of the Advisers Act; review annually the adequacy of those policies and procedures; and designate a Chief Compliance Officer. In adopting this Rule, the SEC articulated its expectations about the minimum content of compliance policies and procedures. These include portfolio management processes; trading practices; proprietary trading; disclosure to clients; safeguarding of client assets; record keeping; marketing; and valuation. There is no explicit requirement for IAs to implement adequate internal controls and risk management; however, SEC staff indicated that in practice many of the elements that such a requirement would entail are covered by the IA's obligation to implement the compliance rule as well as other relevant rules such as the custody and recordkeeping rules.

For registered funds, a mutual fund's board of directors, particularly the independent directors, and the fund's shareholders bear primary responsibility for assessing the fitness and competence of the IA not only initially but on an on-going basis. A fund board must be composed of at least 40 percent independent directors; however SEC staff and market participants indicated that the practice is generally to have a majority of such directors. This practice has been triggered in part by exemptive relief for related party transactions given to investment companies provided that their board is composed of a majority of independent directors and the requirement for investment companies that pension plans invest in to have a majority of independent directors.

Under Sections 15(a) and (c) of the ICA, the terms of an IA's contract, and any renewal, must be approved by a vote of a majority of the fund's independent directors and by a vote of a majority of the holders of the fund's outstanding voting securities. The board of the mutual fund has a positive obligation to obtain the information necessary to assess the terms of the advisory contract agreement. Information about the IA and the contract, including the compensation to be paid under it, must be provided in the proxy statement provided to shareholders. To this end, mutual fund boards meet frequently with the IA. The current practice is to have at least quarterly meetings (aligned with financial reporting) and an annual meeting to review the performance of the fund as well as other issues including fees. Market participants emphasized the active role that mutual fund boards have in practice. This role is supported by additional requirements in the regulatory framework including the fact that the board must have independent legal counsel and the fund must have a Chief Compliance Officer. The SEC has taken enforcement actions against boards that have failed to meet their duties to oversee the

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| | <p>IAs.</p> <p>Mutual funds are subject to a minimum capital requirement of at least \$100,000 in net worth.</p> <p>For UITs, section 26(a)(1) of the ICA requires the trustee to be a bank with minimum capitalization of \$500,000. State trustee laws also apply and impose obligations on UIT trustees.</p> <p>Primacy of investor interests</p> <p>The U.S. Supreme Court has interpreted the Advisers Act as imposing a fiduciary standard that governs the conduct of fund operators (IAs). The fiduciary duty is enforceable by the antifraud provisions in Section 206 of the Advisers Act. IAs' fiduciary duty obliges them to act in the best interests of their clients, including mutual funds of which they are the operator, and to provide investment advice in the clients' best interests. As fiduciaries, operators owe their clients duties of loyalty, good faith, full disclosure of material facts and an obligation to avoid or disclose conflicts of interest.</p> <p>International cooperation</p> <p>Mutual funds, including foreign funds, generally must be registered with the SEC to operate in the US. Arrangements for cooperation with foreign regulators are described under Principles 13 and 14.</p> <p>Supervision and ongoing monitoring</p> <p><i>Responsibility and powers of regulator</i></p> <p>The SEC has authority to register and inspect mutual funds and IAs, investigate suspected violations and take remedial actions under the ICA and the Advisers Act. Violations of the legislation and SEC rules are subject to the full range of administrative, civil and criminal sanctions described under Principle 11.</p> <p><i>Registration</i></p> <p>The Advisers Act requires IAs seeking to become registered with the SEC to make detailed public disclosures in Form ADV. An IA generally provides the mutual fund's board of directors with a copy of this disclosure form, and it is publicly available.</p> <p>Both the mutual fund and the securities it issues must be registered. The fund must be registered under the ICA and the securities under the Securities Act. The registration document for open-end and closed-end mutual funds consists of three parts:</p> <p>A prospectus, containing the most essential information for investors to make an informed decision about investing in the fund;</p> <p>A statement of additional information (SAI) containing information that, while important, is not considered as essential to the investor's investment decision as the information contained in the prospectus; and</p> <p>A section containing other information (Part C). Part C contains exhibits to the registration statement that include the fund's articles of incorporation and/or bylaws, as well as all material contracts, such as the advisory contract and any distribution contracts.</p> <p>A UIT's registration statement consists of nine parts and requires a detailed description of the trust.</p> <p>Registration statements are public documents. For new funds, the SEC must declare the documents "effective" before sales of the fund are made. Where a new series is added to an already existing fund, post effective amendments to registration statements must be filed, and</p> |
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| | <p>become effective 75 days after filing without the need for SEC action.</p> <p>The SEC reviews all mutual fund registration statements, including post effective amendments to ensure appropriate disclosure. In these reviews, the SEC focuses on compliance with all disclosure requirements, including:</p> <ul style="list-style-type: none"> • Disclosure of fees and compensation arrangements; • Investment policies and associated risks; and • The role of the IA and other service providers. <p><i>Ongoing monitoring and examinations</i></p> <p>OCIE administers an examination program that covers mutual funds and their IA operators. This program is part of the examination program of IAs (i.e., there is no separate/differentiated program for IAs that operate mutual funds). Examinations are conducted primarily to determine whether funds and their operators continue to meet eligibility standards and whether their practices and procedures comply with the federal securities laws and regulations, and also to keep the SEC and its staff informed of developments in the industry.</p> <p>Each year, OCIE prepares (and publishes) National Examination Priorities which includes priorities for the asset management industry generally, and more specifically for the mutual fund industry. For example, for 2014 national priorities included alternative investment companies (with a focus on leverage, liquidity and valuation and governance practices) and MMFs (with a focus on how MMFs manage stress events). National priorities are developed by consultation across the SEC and by using a number of sources of information, including information in regulatory filings, information gathered through examinations, comments and tips received directly from investors and registrants, data maintained in third party databases, and interactions with registrants.</p> <p>Selection of firms for examination is based on a variety of quantitative and qualitative factors. One input into the overall process is the review of registrant-wide data elements and metrics that speak to certain risks at firms. OCIE's ORAS group and examination staff in Regional Offices and the Home Office leverage data analytics and other available information to identify firms that may pose higher risk (for example because of potential compliance stress, previous examinations, or complaints). This process feeds into the overall planning of firms to be examined, which is also governed by Examination Priorities put out each year by the National Examination Program..</p> <p>IM's REO performs ongoing monitoring of a select number of the largest asset managers selected for monitoring based on certain risk characteristics. REO engages senior management of these firms and fund boards in direct, ongoing discourse about market risks and events, as well as operational risks.</p> <p>In addition to examinations identified through its risk assessment process, 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 concerns. OCIE also conducts risk-targeted sweep examinations, which typically focus on a particular practice (such as soft dollar practices) among a number of mutual fund operators. Examinations of individual investment companies are also undertaken, often in conjunction with examination of the fund's IA.</p> <p>Examination teams typically consist of a senior manager, an examination manager and 2 to 3 examiners. SEC systems require a supervisor's approval be given in at least three points in the process to ensure quality standards are met. An examination report that includes any</p> |
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| | <p>deficiencies identified is provided to the firm, typically with a request for the firm to respond and provide details of remediation steps it has taken or intends to take.</p> <p>In fiscal year 2014, OCIE carried out approximately 170 examinations of IAs that operate mutual funds, out of a total population of over 1,600 firms in this category. Typically, the SEC also carries out examinations of around 100 investment companies each year out of a total of approximately 840 fund complexes.</p> <p>Record-keeping and reporting</p> <p><i>Record-keeping</i></p> <p>The ICA, the Advisers Act and related SEC rules require mutual funds and IAs to maintain and preserve detailed books and records. All books and records are subject to examination by the SEC at any time.</p> <p><i>Reporting</i></p> <p>Section 30(e) of the ICA requires a mutual fund to provide shareholders with annual and semi-annual reports and, under SEC rules, these reports must be provided within 60 days of period end. These reports must contain detailed information about the financial position of the fund; changes in net assets; and the amount and value of each security held.</p> <p><i>Changes in management and operations</i></p> <p>Information about management and organization must be described in an IA's Form ADV, and the IA must keep the information in its Form ADV current by promptly amending it to correct any responses that become materially inaccurate. A mutual fund is required to keep current its prospectus which contains information about its management and organization.</p> <p>Conduct of business</p> <p>As a fiduciary, an IA has an obligation to seek to obtain best execution for its clients, including mutual funds. The way trades are allocated across accounts managed by an IA must be fair and reasonable and consistently applied on a timely basis. The antifraud provisions apply to churning, and SROs, including FINRA, prohibit churning and excessive trading by BDs executing trades for clients, including a mutual fund.</p> <p>Conflicts of interest</p> <p>There are detailed provisions in the legislation and SEC rules dealing with conflicts of interest. Some conflicts are prohibited (for example, some transactions between the mutual fund and its affiliates or IA); some require shareholder approval (for example amendments to a distribution plan to increase materially the amount spent on marketing or distribution); some require independent review or approval by the fund's board, especially the independent directors. Conflicts must be disclosed. SEC rules require mutual funds and their IAs and principal underwriters to adopt codes of ethics governing the personal securities transactions of employees.</p> <p>Delegation</p> <p>There is no statutory prohibition on delegation of operator functions to other persons, if the advisory contract between the IA and the mutual fund permits the delegation. There is no statutory prohibition against the systematic and complete delegation of core functions (the advisory responsibilities) of the IA. If advisory responsibilities are delegated, the delegate is considered an IA and may perform services for the fund only under a written contract approved by a majority of the fund's shareholders and a majority of the fund's independent directors. The delegate must be also registered with the SEC as an IA. As an IA, the delegate owes a</p> |
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| | <p>fiduciary duty to the fund.</p> <p>Whether the IA is responsible for the actions of the delegate depends on the advisory and sub-advisory contracts. Both the IA and the delegate may be responsible for the actions of the delegate under some contracts; in other cases only the delegate is responsible. The SEC can bring an enforcement action against an IA for failure to supervise a delegate if the delegate violates the law and is subject to the IA's supervision. If the delegate is a sub-adviser, the ICA does not permit the IA to terminate the contract without approval by either a majority of the fund's directors or its shareholders. If the delegate is another kind of service provider, the ability to terminate the contract depends on the terms of the contract.</p> <p>Disclosure to investors of the delegation arrangements and the identity of the delegates is made as part of the shareholder vote approving the sub-advisory contract. In addition, a fund generally must disclose the same information about the delegate in its registration statement. The conflict of interest provisions described above apply equally to delegates.</p> |
| Assessment | Partly Implemented |
| Comments | <p>The main reason for the grade has been the limited examination coverage of IAs and investment companies (Key Question 8 of the Assessment Methodology). In addition, the assessors have also taken into account the absence of express eligibility requirements for CPO and IAs in particular in relation to internal controls and risk management (Key Question 2 of the Assessment Methodology).</p> <p>Examination coverage of IAs</p> <p>The SEC has an increasingly sophisticated system for carrying out risk assessments of IAs to MFs and identifying higher risk firms for examination. The initial assessment is conducted through automated tools, but staff from the regions conducts additional evaluations of firms to further refine the selection process. The examinations that do take place appear intensive and thorough. However, resource constraints mean that only a little over 10 percent of IAs are examined each year. Given that mutual funds are an important investment venue for retail investors, and that total mutual fund AUM is approximately \$17 trillion, the current rate of examinations is less than the importance the sector warrants.</p> <p>The assessors recognize that the number of examinations does not reflect other monitoring work the SEC carries out in this area, or other contact it has with the industry and individual firms. For example, all disclosures and reports filed by mutual funds and their IAs are examined by IM staff, and the SEC actively engages with the largest asset management firms. Nonetheless, as the IOSCO Assessment Methodology recognizes, on-site inspections are an essential tool in monitoring compliance for CIS.</p> <p>Eligibility requirements: internal controls and risk management</p> <p>The IOSCO Assessment Methodology requires that the regulatory framework for CIS set standards for eligibility that include human and technical resources and financial capacity (Key Question 2(e)) and internal controls and compliance arrangements (Key Question 2(f)). The IOSCO Assessment Methodology states explicitly that, to comply with Key Question 2, it is not necessary that a regulator assesses compliance with these eligibility criteria at the time of the initial approval of a CIS. Thus, while the requirements need to exist, the methodology allows their verification to take place at a moment different from registration.</p> <p>The assessors note that the current regime for IAs and CPOs is based on integrity and disclosure; and thus from a strictly technical perspective the standard of the methodology is not met, as no other requirement is needed for registration (irrespective of the moment of</p> |

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| | <p>verification).</p> <p>However, IAs and CPOs are subject to certain organizational and operational conduct obligations on an ongoing basis. In particular, they are required to implement compliance programs. Adherence to this obligation is monitored by the examinations undertaken by the relevant regulators (including the NFA’s examination of new registrants within their first year of operation). In the case of IAs, the role played by MF boards provides some further assurance on the adequacy of internal controls and compliance arrangements.</p> <p>Neither the rules of the SEC nor those of the NFA expressly require the implementation of adequate internal controls or risk management; however, the assessors agree that many of the elements that a risk management framework would entail are covered by the existing obligations. These include the compliance rule, custody and record-keeping rule for the SEC and the obligation to supervise, segregation and record-keeping requirements for the NFA. Thus, the assessors consider that the current framework broadly achieves the objectives that the Principles and Assessment Methodology seek to achieve.</p> <p>However, the authorities should consider the need for an explicit rule, not only to comply with the IOSCO Principles, but to ensure that their expectations in this area are well understood by the market. In this regard, the assessors note that the SEC is currently considering whether broad risk management programs should be required for mutual funds and ETFs to address the risks related to their liquidity and derivatives use, as well as measures to ensure the SEC’s comprehensive oversight of those programs. These developments are welcome.</p> |
| <p>Principle 25.</p> | <p>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.</p> |
| <p>Description</p> | <p>CFTC</p> <p>Legal form and investors’ rights</p> <p>CFTC Regulation 4.20(a) generally requires that a CPO operate its pool as a legal entity separate from the CPO. In practice, typically pools have been limited partnerships or LLCs, with the CPO acting as the general partner or the managing member. There has been an increase in the number of pools structured as investment companies, registered under the securities legislation as well as the CEA.</p> <p><i>Disclosure</i></p> <p>CFTC Regulation 4.24(d) requires a CPO to disclose the pool’s form of organization in the pool’s Disclosure Document distributed to prospective participants. The offering of an interest in the pool generally involves the provision of the organizational documents for the pool in conjunction with the Disclosure Document.</p> <p>Responsibility for monitoring compliance with form and structure requirements</p> <p>When an entity seeks to be registered as a CPO, it must submit a Disclosure Document to NFA for review to determine compliance with the CFTC Regulations and NFA rules prior to soliciting participants. CFTC Regulations require the Disclosure Document to be up to date and materially correct. NFA reviews all Disclosure Documents. The CFTC reviews NFA’s review of Disclosure Documents as part of the CFTC’s oversight of NFA.</p> <p><i>Investment and borrowing restrictions</i></p> <p>CFTC Regulation 4.24(h)(2) requires a CPO to disclose in its Disclosure Document any material restrictions or limitations on trading required by the pool’s organizational documents or otherwise.</p> |

Changes to investor rights

CFTC Regulation 4.26 requires all information in the Disclosure Document to be current, including information relating to rights of participants. It also requires a CPO to provide participants with notice of changes to the information in the Disclosure Document within 21 days of the date on which the CPO becomes aware of the changes (see also Principle 24). CFTC staff indicated that this deadline allows for NFA review of the changes. CFTC Regulation 4.24(w) requires a CPO to disclose all material information to existing or prospective pool participants even if the information is not specifically required by CFTC Regulations.

Separation of assets/safekeeping

The CEA does not contain provisions that require a separate custodian for CPs. CFTC Regulations require that all funds, securities and property received by a CPO must be received in the name of the CP. A CPO is not permitted to commingle the property of any CP with the property of any other person. In addition, CFTC Regulations require a CPO to disclose in its Disclosure Document the name of the entity (such as a bank, broker-dealer or custodian) that will hold the pool's assets. A CPO must disclose the manner in which the pool's assets will be held in segregation. If assets are held by an entity affiliated with the CPO, that fact would need to be disclosed.

In practice, most CP assets are held by parties other than the CPO. Of the approximately 6,000 pools for which CPOs had filed information with the CFTC on June 30, 2014, only 374 did not list a separate custodian or broker. Of that 374, 268 only invest in other funds or pools, per their schedule of investments, and 89 had a NAV of \$0. Of the remaining 17 pools without custodians, 13 have added a broker or custodian since the filing date. The authorities advised that, where a custodian is used, it may be a related party of the CPO, and this is likely to occur for larger CPOs that are members of financial services groups.

Winding up

CFTC Regulations require the filing of a final annual report containing financial statements within 90 days of a pool's permanent cessation of trading or the return of funds to participants. If necessary, Section 6c of the CEA provides the CFTC with the ability to obtain court orders to freeze pool and/or CPO assets and have receivers appointed to operate the CP for the benefit of participants.

SEC**Legal form and investors' rights**

There are no specific requirements as to the legal form of open-end or closed-end funds in the ICA. Under the Act, a fund 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 fund 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 funds are structured as business trusts or as corporations. A UIT must be organized under a trust indenture, contract of custodianship or agency, or similar instrument.

The ICA imposes some capital structure requirements on mutual funds. For example, Section 18 of the ICA requires that all common stock issued by a fund be voting stock and have equal voting rights. The Act provides that closed-end funds are permitted to have only one class of debt and one class of preferred stock in addition to one class of common stock.

Open-end funds must offer redeemable securities that entitle a fund investor to redeem shares at the fund's NAV. Closed-end funds do not issue redeemable securities.

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| | <p><i>Disclosure</i></p> <p>A fund must disclose in its registration statement whether it is an open-end or closed-end fund or a UIT, information about the redeemability of shares and the jurisdiction in which it is organized. The registration statement exhibits include copies of its organizational documents (such as articles of incorporation).</p> <p>Responsibility for monitoring compliance with form and structure requirements</p> <p>Responsibility for ensuring that requirements are observed rests primarily with the mutual fund board and with those who signed its registration statement. The SEC reviews fund registration statements to determine whether the fund has made the disclosures required by the registration form, including disclosure about the form and structure of the mutual fund. OCIE examinations would detect any material non-compliance by a mutual fund with its disclosed form and structure, and where appropriate enforcement action could be initiated.</p> <p><i>Investment and borrowing restrictions—fund liquidity rules</i></p> <p>Under SEC rules, open-end funds must have 85 percent of assets as liquid assets. In this context “liquid” means assets that can be sold within 7 days at their carrying value, which is understood to mean in normal market conditions.</p> <p>For MMFs, the SEC introduced new liquidity rules in 2010. These include:</p> <p>Daily Requirement: all taxable money market funds must hold at least 10 percent of assets in cash, U.S. Treasury securities, or securities that convert into cash (e.g., mature) within one day;</p> <p>Weekly Requirement: all money market funds must hold at least 30 percent of assets in cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less, or securities that convert into cash within one week;</p> <p>Rules restricting money market funds from purchasing illiquid securities if, after the purchase, more than 5 percent of the fund’s portfolio will be illiquid securities (defining as “illiquid” any security that cannot be sold or disposed of within seven days at carrying value).</p> <p>Changes to investor rights</p> <p>Under the ICA, some material changes (such as the approval of an advisory contract) require the approval of shareholders. Material changes that do not require shareholder approval (for example, changes in a fund’s investment objectives or strategy) require a fund to update its registration statement, including its prospectus, so that new shareholders or existing shareholders making a new investment are informed of the change. All registration statements are available through the SEC website. In practice, open-end funds generally provide updated prospectuses annually to shareholders. A closed-end fund discloses material changes in its annual reports to shareholders.</p> <p>A fund must provide shareholders with at least 60 days’ notice prior to changing a fundamental investment policy of investing at least 80 percent of the fund’s assets in the type of investments suggested by the fund’s name (SEC Rule 35d-1).</p> <p>Separation of assets/safekeeping</p> <p>Pursuant to Section 17(f) of the ICA and related rules, a mutual fund must place securities and similar investments in the custody of certain eligible custodians. For open-end and closed-end investment companies, eligible custodians include:</p> <p>Banks subject to federal or state regulation that have capital of at least \$500,000;</p> <p>Members of a national securities exchange (i.e., certain broker-dealers);</p> |
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| | <p>Securities depositories; FCMs and commodity clearing organizations; and Certain foreign entities subject to certain conditions.</p> <p>Because a UIT has no board to monitor custody arrangements, Section 26(a) of the ICA provides that a UIT may not maintain custody of its own assets, but must designate one or more banks (that have an aggregate capital of not less than \$500,000) as trustees or custodians.</p> <p><i>Related party trustee-custodian</i></p> <p>There is no requirement that a fund’s custodian be legally or functionally independent from the IA operator. If an operator or its affiliate acts as a fund’s custodian, however, the fund is deemed to have “self-custody”. A fund deemed to have self-custody is subject to additional obligations under ICA Rule 17f-2, which requires, among other things, that:</p> <p>The fund 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;</p> <p>The securities and similar investments must be physically segregated from those of any other person;</p> <p>The board of directors of the fund must designate which employees (not more than five persons) are authorized to have access to the assets; and</p> <p>Written notations must document each deposit or withdrawal of securities.</p> <p>In addition, the fund must employ an independent public accountant to verify, by actual examination, the fund’s assets at least three times each year (twice without prior notice). A certificate of this accountant, stating that the examination has been made, and describing its nature and extent, must be sent to the SEC after each examination.</p> <p>In practice, the use of the self-custody is rare, with less than 200 out of the 4,200 registered funds using it, and most custodians are independent.</p> <p>Winding up</p> <p>A mutual fund remains subject to all provisions of the ICA until it is deregistered. To deregister, the fund must obtain an order from the SEC declaring that it has ceased to be a fund 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. The SEC in practice has generally required that, to deregister, a fund must have distributed all assets to shareholders, sold its assets to another fund or merged with another fund.</p> |
| <p>Assessment</p> | <p>Broadly Implemented</p> |
| <p>Comments</p> | <p>The grade of this Principle is caused by the current regime applicable to CPs in connection with Key Question 8(b) of the IOSCO Assessment Methodology that requires special legal or regulatory safeguards in cases where the functions of custodian and/or depository are performed by the same legal entity responsible for the investment functions or its related entities.</p> <p>The assessors recognize that CFTC Regulations require a segregation regime rather than a “custody” regime and that such an arrangement is contemplated by the Assessment Methodology. Thus, in the assessors’ opinion the regime required by the CFTC meets the requirements of Key Questions 8(a) and 8(c). However, the current legal and regulatory</p> |

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| | <p>framework does not require additional safeguards to deal with the risks arising where the CPO (or a related entity) performs the custodian or depositary function. In this respect, while there is a widespread industry practice regarding the use of separate custodians, such custodians can be a related party (and this seems to be the case for larger groups) and thus, the additional safeguards required by the Assessment Methodology would still be necessary. Therefore the assessors recommend that consideration be given to amending the legislation to require additional safeguards where a CPO or a related entity has possession of pool assets.</p> <p>For mutual funds, additional safeguards are provided by the requirement that, where assets are held by the IA itself or its affiliate, an independent public accountant must examine the fund's assets at least three times during the year (twice in a surprise examination).</p> |
| <p>Principle 26.</p> | <p>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.</p> |
| <p>Description</p> | <p>CFTC</p> <p>In practice, most CPs are institutional funds only available to sophisticated investors, and only 10-15 percent have retail investors. Non-retail pools are distributed by private placement and do not need to comply with the disclosure rules described below. Retail pools are subject to both CEA Disclosure Document rules and, since they constitute a security under the securities legislation, Securities Act prospectus obligations. Compliance with both CEA and Securities Act disclosure obligations can generally be met in a single set of disclosure documents. The anti-fraud provisions apply to all disclosures made in connection with CPs, including non-retail pools.</p> <p>Disclosure to investors</p> <p><i>Offering documents</i></p> <p>CFTC Regulations require that a CPO provide a detailed Disclosure Document to prospective pool participants before accepting their subscriptions. Regulation 4.24 sets out detailed requirements for the Disclosure Document, including information about the pool and its operator; fees and expenses; conflicts of interest relating to the operation of the pool; risks of futures trading and specific risks of the pool; information on the pool's investment program and use of proceeds; and provisions relating to redemption. Regulation 4.25 regulates performance information, including by requiring it to be in a prescribed format. NFA Rule 2.35(a)(1) requires Disclosure Documents to be written using plain English principles.</p> <p>If a CPO knows or should know that the Disclosure Document is materially inaccurate or incomplete, it must correct that defect and distribute the correction within 21 calendar days.</p> <p><i>Periodic reports</i></p> <p>A CPO must provide a report to each participant at least monthly (quarterly for pools with less than \$500,000 in assets), which contains detailed financial information about the pool, including the realized and unrealized gains and losses for the pool, all management and advisory fees and brokerage commissions paid by the pool, and the net asset value of the pool.</p> <p>A CPO must also provide an annual report to each participant. This must contain all of the items of the monthly report, plus additional financial disclosures by way of a statement of financial condition of the pool for both the current and preceding fiscal year.</p> |

Regulator's powers

The NFA is responsible for reviewing all Disclosure Documents. Before using a Document, a CPO must receive an acceptance letter from the NFA. The CFTC conducts quarterly reviews of the NFA's review of Disclosure Documents by analyzing a sample of Disclosure Documents that have been accepted by the NFA.

Advertising

CFTC Regulation 4.41 prohibits fraudulent and misleading advertising in relation to CPs. NFA receives and reviews all promotional material used in the marketing of pools, and also proactively monitors advertising in broadcast media.

Accounting standards

CFTC Regulation 4.22 requires that the financial statements in the periodic and annual reports must be presented and computed in accordance with U.S. GAAP consistently applied. The pool's annual report must be certified by an independent public accountant.

Ensuring compliance with investment policies

All offering materials and account statements provided by a CPO to its participants must also be filed with NFA under CFTC Regulations. NFA reviews these documents, and conducts periodic on-site examinations of the CPO as a means of monitoring and assuring compliance with CFTC Regulations. Changes in the investment policy of a fund would require an updated Disclosure Document, which must be accepted by the NFA before it can be used.

SEC**Disclosure to investors***Offering documents*

Prospectuses for mutual funds must comply with detailed disclosure obligations set out in forms required for each type of fund, open-end (Form N-1A), closed-end (Form N-2) and UIT (Form N-8B-2). Prospectuses must contain all the information required by Key Question 5 of the IOSCO Methodology. They include requirements to disclose all information that is material to an investor's decision to invest. There are detailed requirements for disclosure of fees including the use of mandated fee tables. More detailed fee information is also available through the SAI that must be made available to investors.

In practice, most investors in closed-end funds acquire their shares in the secondary market and may not receive a prospectus because the prospectus delivery requirement applies only to the primary offer. For these investors, the main source of information on, for example, fees is the annual and semi-annual reports.

SEC rules require a summary of key information at the front of a fund's prospectus. This key information must be in plain English in a standardized order. Delivery of the summary prospectus to clients is optional, but if the fund chooses to deliver one, its content must be the same as the summary in the full prospectus, and investors must have access to the full prospectus on an Internet website.

Periodic reports

Section 30(e) of the ICA requires that funds provide annual and semi-annual reports to shareholders. The reports must include financial statements, 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 fund on that date, and a financial highlights schedule. The financial highlights information shows financial results for a single share of a fund. Only

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| | <p>the annual reports must include audited financial statements accompanied by a certificate of an independent public accountant registered with the PCAOB. Reports must be transmitted to shareholders within sixty days of the close of the relevant period.</p> <p>Sections 30(a) and (b) of the ICA and SEC Rule 30a-1 require a fund to file with the SEC a semi-annual report on Form N-SAR within 60 days of the close of the relevant period. Form N-SAR contains information designed to aid in the SEC’s monitoring of a fund’s operations.</p> <p><i>Material event reporting</i></p> <p>An open-end fund that continuously offers its shares to the public must have at all times a current, effective registration statement. As a result, an open-end fund amends its registration statement at least annually to include updated financial information, or more frequently, if necessary, to reflect material changes in its operations.</p> <p>The Securities Act requires a fund that is making a continuous offering of its securities to maintain a current statutory prospectus. A fund 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.</p> <p>Regulator’s powers</p> <p>To sell its shares to the public, a mutual fund must register itself under the ICA, and register the offering of its securities under the Securities Act. The Securities Act gives the SEC power to hold back or intervene in an offering if an offering document is found to contain incomplete, inaccurate, or false and misleading information,, for example through the use of stop orders (Section 8) and cease and desist orders (Sections 8A and 10(b)). As noted under Principle 24, the SEC reviews all registration documents and material amendments to them, including prospectuses.</p> <p>Advertising</p> <p>Like offering documents, all marketing materials are subject to the antifraud provisions of the federal securities laws and are prohibited from containing material misstatements or omissions. Different disclosure requirements apply depending on the type of advertisement.</p> <p>Section 24(b) of the Investment Company Act requires open-end investment companies and UITs and their underwriters, in connection with a public offering, to file copies of all of their advertisements and sales literature with the SEC or with FINRA (if the shares are sold by a FINRA member). Typically a fund’s shares are sold through BDs, and FINRA rules require a BD to file with FINRA any advertisement or sales literature that it uses to market the company. FINRA reviews these. Advertisements and sales literature filed with the SEC may be reviewed by the SEC staff as part of an inspection to ensure that the material is not false or misleading.</p> <p>Accounting standards</p> <p>The financial statements in a fund’s annual and semi-annual reports must be prepared in accordance with the U.S. GAAP. Regulation S-X requires that an independent public accountant registered with the PCAOB perform an audit of the fund’s financial statements in accordance with PCAOB standards and state that the financial statements are prepared in accordance with the U.S. GAAP.</p> <p>Ensuring compliance with investment policies</p> <p>OCIE examinations of funds and their IAs (described under Principle 24) include checking compliance with a fund’s stated investment policy or trading strategy.</p> |
| <p>Assessment</p> | <p>Fully Implemented</p> |

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| Comments | |
| Principle 27. | 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. |
| Description | <p>CFTC</p> <p>Under the CEA, issues relating to asset valuation and the redemption of interests in CPs are primarily dealt with through disclosure requirements. The disclosure regime is supplemented in some areas by CFTC Regulations.</p> <p>Asset valuation</p> <p><i>Principles for valuation</i></p> <p>CFTC Regulations require CPOs to use U.S. generally accepted accounting principles (GAAP) in calculating the net asset value of a pool. These principles include FAS 157 (now FASB ASC 820), Fair Value Measurements, which establishes a framework for measuring fair value and requires disclosure about fair value measurements.</p> <p><i>Timing</i></p> <p>There are no rules in the CEA or CFTC Regulations that deal with the timing of asset valuations other than those that require valuation at least monthly (quarterly for small pools) for the purposes of the account statement that is sent to all pool participants. Investors in exchange-traded products have access to daily market price information.</p> <p><i>Independent audit</i></p> <p>Annual financial reports of CPs must be audited by an independent public accountant.</p> <p>Pricing and redemption of interests</p> <p>CFTC Regulation 4.24(p) requires a pool's Disclosure Document to contain a complete description of any restrictions upon the transferability of a participant's interest in the pool, and a complete description of the frequency, timing, and manner in which a participant may redeem interests in the pool. The description about redemption must specify how the redemption value of a participant's interest will be calculated, the conditions under which redemption will be made (including the time between request for redemption and payment) and any restrictions on redemptions.</p> <p>CFTC Regulation 4.22 requires CPOs to distribute Account Statements to participants monthly (quarterly if the pool has AUM less than \$500,000). These reports include all material information relevant to the net asset value per participation of the pool. Similar information must be included in the Disclosure Document provided to any prospective participant.</p> <p><i>Pricing errors</i></p> <p>The regulatory regime (including NFA rules) does not contain specific provisions dealing with errors in the pricing of interests and the authorities are not aware of any industry standards or similar protocols that provide for the way in which investors who have been adversely affected by pricing errors are to be treated.</p> <p><i>Suspension/deferral of redemptions</i></p> <p>A pool's Disclosure Document must disclose the circumstances under which redemptions can be suspended. If a CPO were to suspend or defer redemptions in a manner inconsistent with its Disclosure Document it would need to update the Disclosure Document and provide a copy of the amended document to the NFA. In appropriate circumstances, such an action may also trigger an enforcement action by NFA or the CFTC. A CPO's quarterly report on Form</p> |

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| | <p>CPO-PQR is required to disclose any halt or any other material limitation on redemptions during the reporting period.</p> <p>Regulatory authority to monitor compliance</p> <p>The CFTC and NFA have the power to take action where a CPO has violated either CFTC or NFA rules with respect to valuation and redemption.</p> <p>SEC</p> <p>Asset valuation</p> <p><i>Principles for valuation</i></p> <p>Valuation of investment companies' portfolio securities is governed by the ICA and related SEC rules. These regulations require a fund to 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 fund's board of directors. The SEC has also addressed many issues relating to fund valuation and pricing in its Accounting Series Releases.</p> <p>Financial statements filed with the SEC generally must be prepared in accordance with U.S. GAAP. The FASB Accounting Standards Codification, which is the source of GAAP, requires investment companies to report investments at fair value.</p> <p><i>Where market prices not available</i></p> <p>Section 2(a)(41) of the ICA provides that the board of directors of a fund must determine, in good faith, the fair value of portfolio securities (and other assets) for which market quotations are not readily available. The methodology approved by the board must be consistent with U.S. GAAP.</p> <p><i>Timing</i></p> <p>ICA Rule 22c-1 generally requires that an open-end fund compute its NAV at least once daily, Monday through Friday.</p> <p><i>Independent audit</i></p> <p>The board of directors of the fund is responsible for overseeing the valuation of the fund's portfolio securities. Fund boards must approve the valuation criteria and are responsible for continuously reviewing valuation methods to assure that the valuations of portfolio securities are fair and accurate. ICA Rule 38a-1 requires a fund to adopt written policies and procedures to, among other things, regularly review the appropriateness and accuracy of the method used to value securities.</p> <p>As part of the annual audit, PCAOB registered independent auditors review and evaluate the processes used by funds to value their portfolio securities. This includes processes for the valuation of securities for which market quotations are readily available, and also the processes used by the board in arriving at fair value for other securities.</p> <p>Pricing and redemption of interests</p> <p><i>Requirement</i></p> <p>SEC Rule 22c-1 requires that sales and redemptions must be effected at the current net asset value next computed after receipt of an order to redeem, purchase or sell. Closed-end funds do not redeem their shares but they can repurchase them. Section 23 of the ICA generally prohibits a closed-end fund from selling its common stock at a price below current NAV. MMFs are subject to different rules and currently permitted to apply constant NAV for sales and redemptions. Recent rules which will become effective in 2016 would require institutional</p> |
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prime MMFs and institutional municipal MMFs to use variable NAV.

Disclosure

Disclosure of the procedures for subscription and redemption of shares is required in the prospectus of an open-end fund and a UIT.

The federal securities laws do not require that the prices of a fund be disclosed or published on a regular basis to investors other than in semi-annual reports. However, the price of a fund is generally available in financial publications and web sites and may also be available on the fund's or IA's website.

Pricing errors

The SEC indicated that it may bring an enforcement action against a fund or its IA if a pricing error violates, or results in violation of, the U.S. federal securities laws.

There are voluntary industry rules of practice, adopted by many funds, to address pricing errors. These include rules on the circumstances in which compensation should be made to shareholders for losses resulting from pricing errors.

The valuation procedures of a fund 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 would be corrected on a going-forward basis. A fund 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.

Suspension/deferral of valuations and redemptions

Under the ICA, funds 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 fund also may suspend redemptions:

For any period during which trading on the NYSE is restricted, as determined by the SEC; or

For any period during which an emergency exists, as determined by the SEC, as a result of which it is not practicable for a fund to either liquidate its portfolio securities or fairly determine its NAV.

Under rules made in 2010 and recently amended, MMFs are permitted to permanently suspend redemptions in certain circumstances in order to facilitate an orderly liquidation of the fund, if the board including a majority of independent directors approves the liquidation. Other amendments to come into effect in 2016 will allow the board of an MMF that holds other than government securities to temporarily suspend redemptions (impose redemption gates) in specified circumstances for a limited amount of time and will allow (and in some circumstances require) a non-government MMF's board to impose a liquidity fee on shareholder redemptions in certain circumstances.

Generally a fund (other than an MMF in specified circumstances) cannot suspend the right of redemption or postpone the date of payment more than seven days after the tender of the security to the fund or its redemption agent. The fund must amend its prospectus to discuss any suspension or deferral of redemption rights, and the amended prospectus must be filed with the SEC. Suspension of redemptions for other reasons requires an order from the SEC. The SEC can grant such an order only if it determines the order is necessary for the protection of the fund's shareholders.

Regulatory authority to monitor compliance

The SEC has the power to ensure compliance with the rules applicable to asset valuation and

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| | pricing through its examinations of registrants and through enforcement actions. OCIE reviews fund asset valuation and pricing during its examinations of funds, fund operators, and third-party administrators that perform operational and administrative functions. The SEC has taken enforcement actions for inappropriate valuation practices. |
| Assessment | Broadly Implemented |
| Comments | <p>The issue that impacted the grade for this Principle is the absence of any regulatory requirements, rules of practice and/or rules addressing pricing errors in CPs, as contemplated by Key Question 8 of the Methodology. In the assessors' view, what the Methodology envisages is rules that provide for the way investors are to be treated, if errors in the pricing of CIS interests occur, and goes further than merely accounting adjustments when errors are discovered. Express provisions, including where appropriate compensation arrangements, are a feature of many other jurisdictions, in some cases contained in industry rather than regulatory standards. The assessors acknowledge the authorities' observation that in practice there appear to be few examples of pricing errors in CPOs, and the issue does not appear to arise in customer complaints or NFA arbitration cases.</p> <p>In addition, the assessors note that there is a voluntary industry code of practice dealing with pricing errors for MFs, which deals with compensation to investors for losses arising from pricing errors. However, the code is voluntary and the SEC does not have explicit authority to enforce it, although in some cases it may be able to take action on pricing errors, if they resulted in a violation of the federal laws.</p> |
| Principle 28. | Regulation should ensure that hedge funds and/or hedge funds managers/advisers are subject to appropriate oversight. |
| Description | <p>Definition of HFs</p> <p>U.S. federal securities and commodities laws do not specifically define HFs.</p> <p>CIS in the U.S. are regulated by the ICA when the CIS invests primarily in securities and the CEA when the CIS invests primarily in commodities.</p> <p>A HF (as defined in the IOSCO Assessment Methodology) may be regulated by the ICA if it meets the definition of "investment company" and is ineligible for an exemption or exclusion. HFs and other private pools of capital that are not offered to the public typically rely on one of two statutory exclusions: (i) Section 3(c)(1) of the ICA excludes any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 investors and that does not make a public offering of such securities. (ii) Section 3(c)(7) of the ICA excludes any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers" (as defined by Section 2(a)(51) of the ICA) and that does not make a public offering of such securities. Qualified purchasers are generally individuals with \$5 million in investments or entities with \$25 million in investments.</p> <p>A HF (as defined in the IOSCO Assessment Methodology) may be regulated under the CEA, if it meets the definition of a "CP" described in Principle 24 and is ineligible for an exclusion or an exemption. In practice most HFs that invest in commodities are as a product exempted from registration.</p> <p>Registration of HF managers</p> <p><i>HFs that invest in securities</i></p> <p>Title IV of the Dodd-Frank Act expanded the categories of IAs that are subject to registration with the SEC. Pursuant to this Act each IA with AUM over S\$100 million must be registered</p> |

with the SEC, regardless of the number of clients, unless that adviser can fit within several exemptions that include the following three: (i) adviser to a “venture capital fund”; (ii) adviser solely to “private funds” with total U.S. assets under management (AUM) of less than \$150 million; or (iii) a foreign private adviser. Managers relying on exemptions (i) and (ii) above (known as “exempt reporting advisers,” or “ERAs”) are subject to examination by the SEC, and all advisers, even if exempt from registration continue to be subject to the antifraud provisions of the U.S. federal securities laws. As a result, the majority of advisers to HFs offered in the U.S. are subject to registration with the SEC.

Registration requirements for IAs to HFs

IAs to HFs registered with the SEC are subject to the same entry requirements as all other registered IAs. IAs, including IAs to HFs, register with the SEC by filing Form ADV. ERAs report certain information on Form ADV. Form ADV requires an IA to provide specific information upon registration that provides transparency into the business of the HF manager and on the HFs that it manages. The information provided by IAs that manage HFs upon registration includes: (i) background of organization and ownership; (ii) assets under management; (iii) services offered; (iv) types of clients, (v) fees charged; (vi) investment related affiliates; (vii) investment strategies utilized; (viii) identification of key service providers; and (ix) conflicts of interest. Forms ADV are public from the moment of filing and can be accessed via the SEC website.

Ongoing reporting requirements

Rule 204-1 under the Advisers Act requires registered advisers to complete and file an annual update of Part 1A and 2A of the Form ADV registration form through Investment Advisers Registration Depository (IARD). Advisers must file an annual updating amendment to Form ADV within 90 days after the end of the firm’s fiscal year. In addition to annual filings, amendments must be filed promptly whenever certain information contained in the Form ADV becomes inaccurate. Therefore, all information required at registration is required to be updated on an ongoing basis.

Pursuant to Section 204 of the Advisers Act and Rule 204(b)-1 IAs with at least \$150 million in private fund RAUM are subject to additional ongoing regulatory requirements through the filing of Form PF, to assist the FSOC in identification of systemic risk. Forms PF are filed on a confidential basis. Both the amount of information to be reported and the frequency with which Form PF must be filed depend on the amount of the adviser’s private fund RAUM and the types of private funds managed. Most advisers are required to file Form PF once a year, and report only basic information regarding the private funds they advise. This annual filing requirement includes general data such as the types of private funds that an adviser advises (e.g., private equity or HFs, and information relating to such funds’ size, leverage, types of investors, liquidity and performance). IAs to HFs must also report information about fund strategy, counterparty credit risk, and the use of trading and clearing mechanisms. Large private fund advisers must also provide more detailed information. The content and frequency of this more detailed reporting is different depending on the type of private fund the large adviser manages:

Advisers with at least \$1.5 billion in HF RAUM must file Form PF quarterly with respect to their HFs. Information required to be reported generally includes aggregate information on such funds’ exposures, geographical concentration, and turnover by asset class (not position-level information). For each Qualifying HF (i.e., \$500 million or more in net assets), additional information relating to each fund’s exposures, leverage, risk profile, and liquidity is required. These reports must be filed within 60 days.

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| | <p>Advisers with at least \$1 billion in combined liquidity fund and registered money market fund RAUM must file Form PF quarterly with respect to their liquidity funds. Information required to be reported generally includes each such fund's exposures, geographical concentration, and turnover by asset class (not position-level information), and direct and indirect forms of leverage and liquidity. These reports must be filed within 15 calendar days.</p> <p>Advisers with at least \$2 billion in private equity fund RAUM must file Form PF annually with respect to their private equity funds. Information required to be reported generally relates to each such fund's use of direct and indirect leverage (e.g., use of financing) and investments in financial institutions. These reports must be filed within 120 calendar days.</p> <p>Form PF requires the reporting of information on counterparty credit exposure in relation to OTC derivatives positions, loans, and loan commitments.</p> <p><i>Disclosure requirements towards clients</i></p> <p>As indicated above ADV Forms are public. In addition, registered IAs including those that manage HFs must provide clients and prospective clients with a brochure containing narrative disclosure of certain information about the firm. Any additional duty to provide documents to investors will depend upon the IA's contractual relationship with each client (i.e., the IA's duties as described in the private offering memorandum or advisory contract).</p> <p><i>Other ongoing requirements</i></p> <p>IAs to HFs are subject to the same ongoing obligations as other registered IAs, including:</p> <p>The "Books and Records Rule" (see Principle 24) which requires registered advisers, to make and keep true, accurate and current certain books and records relating to the firm's investment advisory business. Generally, most books and records must be kept for five years from the end of the year created, in an easily accessible location.</p> <p>Segregation of client assets rule, which generally makes it fraudulent for IAs to have custody of client funds or securities, unless certain conditions are met (as discussed under Principle 29). If an adviser has custody of client assets, an independent public accountant must verify all of those client assets by actual examination at least once during each calendar year.</p> <p>The "Code of Ethics Rule" which requires registered advisers to adopt a code of ethics which sets forth the standards of business conduct expected of the adviser's supervised persons and must address the personal trading of their securities.</p> <p>The "Advertising Rule" which prohibits advertisements by registered advisers that are false or misleading or contain any untrue statements of material fact.</p> <p>The "Compliance Rule" which, as described in Principle 24, requires registered advisers to (a) adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and rules that the Commission has adopted under the Advisers Act; (b) conduct a review, no less than annually, of the adequacy of the policies and procedures; and, (c) designate a chief compliance officer who is responsible for administering the policies and procedures.</p> <p>As any other IAs, IAs to hedge funds are subject to fiduciary duties.</p> <p><i>HFs that invest in commodities</i></p> <p>Prior to Dodd-Frank Act, CPOs of HFs were usually not subject to registration with the CFTC as most of them fell under an exemption from registration in cases where the pool operated by the CPO met certain requirements, including investor qualifications. The CFTC reviewed exemptions and exclusions in light of the expansion of the definition of commodities interest</p> |
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and eliminated the exemption listed above. As a result, CPOs that manage HFs must now register with the CFTC under the same terms of any other CPO. In practice the registration is conducted by the NFA pursuant to delegation.

Registration requirements

As any other CPOs, CPOs for HFs must submit to the NFA a Form 7R which provides details of the applicant including prior criminal and disciplinary history. The review that the NFA conducts is similar to any other CPO, and thus it primarily focuses on the integrity of the applicant. In addition, as any other CPO, CPOs of HFs must also provide information about their principals and APs.

Ongoing reporting requirements

As any other CPO, CPOs of HFs are required to provide an annual registration update regarding their own registration and the registration filings to their APs and principals, and complete the Annual Questionnaire.

In addition, CFTC Regulation 4.27 requires all CPOs registered with the CFTC to file a Form CPO-PQR with the NFA under the following rules:

Schedule A: All registered CPOs irrespective of their AUM must provide basic information about the CPO, AUM, pools managed by the CPO, certain service providers to those pools, monthly returns, and subscription and redemption activity.

Schedule B: CPOs with AUM in the amount of \$500 million or greater are required to provide the CFTC with the following information: pool borrowings, counterparty credit exposure, fund strategy, derivatives exposure, and a full schedule of investments.

Schedule C: CPOs with AUM greater than \$1.5 billion must also provide the following information to the CFTC: their operated pools' geographical exposure, liquidity, and risk testing based upon several specific scenarios.

Smaller CPOs and mid-size CPOs must file annually, within 90 days of the end of each calendar year; while large CPOs must file quarterly within 60 days of the end of the calendar year.

Disclosure requirements vis-à-vis investors

CPs that would classify as HFs under the IOSCO definition could (and generally) request regulatory relief from disclosure obligations based on Rule 4.7 (which overall allows regulatory relief for CPs whose participants are accredited investors). If regulatory relief is granted, the CPOs are subject to more streamlined obligations, as summarized below:

There is no obligation to file a disclosure document with the NFA; although the market practice is that the CPOs provide an offering memorandum to investors. Pursuant to CFTC rules if such memorandum is provided, a disclaimer must be made to the fact that it has not been reviewed by the NFA.

Account statements need to be provided only on a quarterly basis and the degree of information required is more streamlined. In practice, most CPOs continue to provide monthly statements.

The information required to be included in the Annual Report is also more streamlined.

Other ongoing requirements

CPOs that manage HFs are subject to the same ongoing requirements as any other CPOs, including:

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| | <p>Recordkeeping obligations: As described under Principle 24, CFTC Rule 4.23 imposes very detailed recordkeeping obligations on registered CPOs, both with respect to their funds and the CPO itself. CPOs that manage HFs could seek regulatory relief as Rule 4.7 pools. In that case, CPOs are still required to maintain at their main business address copies of the account statements and annual reports that they are required to distribute to investors, and all other books and records prepared in connection with their activities as the CPO of a Rule 4.7 pool. CPOs of Rule 4.7 pools must preserve such books and records for the same time periods as any other CPO.</p> <p>Asset protection: As described under Principle 25, CFTC Regulations require proper segregation by the CPO of all funds, securities and property of the pools it operates.</p> <p>General supervisory obligations: As described under Principle 24, NFA Compliance Rule 2-9 requires each NFA member to diligently supervise its employees and agents in the conduct of their commodity futures activities for or on behalf of the Member. Pursuant to this Rule, a CPO must establish and implement written supervisory policies and procedures with respect to various day-to-day operations.</p> <p>As any other CPO, CPOs to HFs do not have fiduciary duties stemming from the federal laws. However they are subject to antifraud provisions.</p> <p>Oversight authority</p> <p>Under Section 204(a) of the Advisers Act, the SEC has the authority to require IAs to maintain records and provide reports. Additionally, Section 204(b)(2) of the Advisers Act, added by Dodd-Frank Act, deems the records of a private fund to be the records of its IA, thereby giving SEC staff access to private fund records for examination or inspection.</p> <p>Similar powers over CPOs are provided to the CFTC by the CEA.</p> <p>The FSOC may subject certain nonbank financial companies to oversight by the Federal Reserve and additional prudential standards, if it determines that they could pose a threat to the financial stability of the United States. IAs and CPOs to HFs like all other financial companies, are subject to this regime. The evaluation of any nonbank financial company under the framework is company-specific. At the time of the assessment the FSOC had not considered necessary to designate any IA or CPO to HFs as systemically important.</p> <p>Enforcement authority</p> <p>As explained under Principle 10, the SEC and the CFTC have broad authority to enforce securities and commodities laws and their respective regulations against an IA or CPO that manages HFs.</p> <p>Sharing of information</p> <p>Pursuant to the federal securities and commodities laws as described in Principles 13-15, the SEC and CFTC can share information related to HFs advisers/operators with foreign supervisors. In addition, pursuant to the Dodd-Frank Act, the SEC has shared Form PF filings with the OFR, subject to the confidentiality provisions of the Act.</p> <p>Supervision of HF managers: practice</p> <p><i>HFs that invest in securities</i></p> <p>As indicated above a key mechanism for the ongoing supervision of HFs and the risks they pose are the periodic reports that IAs are required to submit to the SEC. Such reports are shared with the FSOC.</p> <p>In addition, the SEC launched the "Presence Exam Initiative" at the start of fiscal year 2013 to</p> |
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| | <p>examine a significant percentage of the advisers registered since the effective date of Title IV of the Dodd-Frank Act. These examinations have focused on the following areas: marketing, portfolio management, conflicts of interest, safety of client assets, and valuation.</p> <p>Finally, through the annual CEO certification requirement and the IA annual review requirements discussed in Principle 12, 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. OCIE staff review IAs' annual compliance reviews as part of the examinations of those entities. The SEC may also use the information provided in Form PF for the purpose of examining SEC registered IAs.</p> <p><i>HFs that invest in commodities</i></p> <p>The analysis of the reports that CPOs are required to submit is a key mechanism for ongoing monitoring of the risks posed by the funds managed by the CPOs.</p> <p>As explained under Principle 24, the NFA follows a risk-based approach for the supervision of CPOs. In addition to the quarterly reporting, NFA uses other data available (including complaints, as well as information from the SEC) to "score" the firms and determine whether they should be subject to on-site examinations. Notwithstanding the risk based approach, the NFA aims to conduct on-site examinations of non-FCM entities at least every 3-4 years. The scope of the examinations is determined based on the identification of areas of concern done by the risk analysis team. As indicated under Principle 24 the supervision modules include a review of the compliance program developed by the CPO.</p> |
| <p>Assessment</p> | <p>Fully Implemented</p> |
| <p>Comments</p> | <p>The current registration regime for IAs and CPOs that manage HFs is based on integrity criteria and disclosure requirements. In addition, both IAs and CPOs of HFs are subject to a set of ongoing organizational and operational conduct standards. The explanatory notes to Key Question 3 of the Assessment Methodology explicitly clarify that "there may be differences in how the jurisdictions handle this Question. Jurisdictions will determine what, and under what circumstances, standards for internal organization and operational conduct will be imposed on the HF managers/advisers".</p> <p>The assessors note that most of the elements that the Assessment Methodology provides as a reference are already part of the ongoing obligations of HF managers. While there is no explicit obligation to implement risk management arrangements, the assessors agree with the authorities that many of the elements required under such an obligation are currently covered by other obligations, such as the obligation to implement a compliance program, the custody/segregation rule, and the record-keeping requirements. Finally, the provision of audited financial statements is a market practice. In this context, the assessors consider that the current framework satisfies the requirements of the Assessment Methodology. However, as the authorities continue to analyze the risks posed by the HFs, the assessors encourage them to review whether an explicit obligation to implement a comprehensive risk management framework is required.</p> <p>Finally, the current regime does not impose capital requirements on IAs or CPOs that manage HFs. The footnotes to Key Question 7 of the Assessment Methodology explain that "prudential regulation may vary from one jurisdiction to the other. Each jurisdiction may decide what form of prudential regulation is appropriate to the risks posed by hedge funds". In this context, the assessors note that the current framework subjects both IAs and CPOs to certain ongoing requirements that can be considered prudential in nature, in particular certain reporting obligations (PF and CPO-PQR Forms), rules in connection with the segregation of clients' assets, and obligations related to the implementation of a compliance program (inasmuch as</p> |

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| | <p>this has required the establishment of appropriate policies and procedures). Further, the assessors note the powers afforded to the FSOC to impose additional prudential requirements on non-bank financial entities that it designates as systemically important. Thus, the assessors consider that the current framework meets the minimum requirements of Key Question 7 of the Assessment Methodology.</p> |
| <p>Principles for Market Intermediaries</p> | |
| <p>Principle 29.</p> | <p>Regulation should provide for minimum entry standards for market intermediaries.</p> |
| <p>Description</p> | <p><u>CFTC</u></p> <p>Authorization of licensees</p> <p><i>Basic requirement</i></p> <p>Section 8a of the CEA requires intermediaries that intend to do business in the markets regulated by the CFTC to be registered with the CFTC, subject to limited exceptions. Sections 4s(a) and (b) of the CEA prohibit a person from acting as an SD or MSP unless they are registered with the CFTC. Firms that act as market intermediaries must apply for NFA membership. The same applies to their APs, with the exception of those associated with SDs and MSPs.</p> <p>Registration categories include:</p> <p>SDs and MSPs;</p> <p>Futures industry participants:</p> <p>FCMs, who deal on exchange and hold customer assets and positions;</p> <p>IBs, who solicit or accept orders, but do not hold client assets or positions</p> <p>CTAs, who advise on dealing in futures and manage individual discretionary accounts, but who are not permitted to deal on behalf of customers or hold client assets.</p> <p>Floor brokers and floor traders, who trade on exchange floors;</p> <p>RFEDs, who deal in foreign exchange contracts with retail clients.</p> <p>(CPOs are dealt with under the Principles for CIS)</p> <p>Registration is performed by the NFA under authority delegated by the CFTC. The CFTC's rules on registration are set out in Parts 3 and 23 of its regulations, and NFA's requirements and procedures for registration are set out in Part 200 of its Manual/Rules.</p> <p><i>Integrity and competence</i></p> <p>NFA's registration process includes an examination of an applicant's past conduct and proficiency requirements. Form 7-R, used for applicants for registration, requires disclosure of the prior criminal or regulatory actions. Form 8-R, used for principals and APs of applicants, requires disclosure of criminal, civil, regulatory, financial, professional, educational and residential background, and evidence of the satisfaction of proficiency examination requirements. Applicants must submit fingerprint cards to enable criminal background checks to be carried out.</p> <p><i>Capital requirement</i></p> <p>CFTC Regulation 1.17 prescribes the minimum levels of adjusted net capital that FCMs and non-guaranteed IBs must have. CFTC Regulation 5.7 prescribes the minimum level of adjusted net capital for RFEDs. For SDs and MSPs, Section 4s(e) of the CEA requires the adoption of</p> |

rules establishing capital and margin requirements. If an SD or MSP applicant has a prudential regulator, that regulator's capital and margin rules apply; if there is no prudential regulator, CFTC rules apply. The CFTC is in the process of finalizing the SD and MSP capital and margin rules. No capital requirements exist for CTAs or floor brokers and traders.

Internal controls and risk management

Registration requirements for FCMs and IBs under the CEA focus on integrity and proficiency issues and do not explicitly require a specific assessment of the sufficiency of an applicant's internal controls and risk management prior to granting an FCM or IB registration. However, CFTC Regulation 1.11 requires each FCM to establish, enforce and monitor a system of risk management policies and procedures designed to monitor and manage the risk associated with the activities of an FCM; and to provide its risk management policies and procedures to the CFTC and to the firm's DSRO upon its application for registration or upon request by the CFTC. In addition, membership requirements established by the NFA include adequacy of internal controls and risk management. As a result, as part of its review of applications for membership the NFA requests firms to provide a copy of their procedures and processes and conducts a review of them. The NFA can also require an applicant to submit details about specific procedures, for example order routing systems, promotional materials and the supervision of APs. Applicants for registration must also provide certified financial statements. If there are material inadequacies in the accounting system, internal accounting control, or procedures for safeguarding customer funds or assets, the certified accountant must notify the applicant, who in turn must notify NFA, the DSRO, and the CFTC.

For SDs, registration requirements prescribed under the CEA require participants to demonstrate compliance with all CEA requirements, which include having in place appropriate policies, procedures and risk management.

In practice, the NFA initially conducted a provisional registration for which SDs were required to submit the information required by Form N-R. The NFA conducted a top line review to confirm that the applicant had submitted documentation covering all requirements (i.e., it was a review of completeness of documentation). If all information was submitted the applicant was granted temporary registration. The NFA is currently in the process of conducting a thorough review of applications with a view towards final registration. NFA reports its findings on these issues to the CFTC to seek comments and feedback.

Authority of regulator

The CEA and CFTC regulations give the CFTC (and the NFA as the CFTC's delegate) authority to refuse to register an intermediary if a statutory bar to registration exists. NFA decisions can be appealed to the CFTC, and CFTC decisions to the courts.

Section 8a(4) of the CEA allows the CFTC to suspend, revoke or place restrictions on the registration of any persons registered under the CEA in specified circumstances, which include violations of the CEA or CFTC Regulations. NFA Rule 501 allows the NFA to suspend, revoke or impose conditions on the registration of any registrant.

Ongoing requirements

CFTC Regulation 3.31 requires each registrant or applicant for registration to promptly correct any deficiency or inaccuracy in its registration information including information about its principals and APs.

Public disclosure of licensed intermediaries

NFA's Background Affiliation Status Information Center (BASIC), accessible through the NFA

website, contains information on each registrant, the category of license held by the firm or individual, the main office, its listed principals, and membership/registration history. Disciplinary actions against the firm or individual are also included.

Investment advisers

CTAs can manage discretionary accounts on behalf of clients and typically have authority to trade individual or pool accounts, but they are not permitted to deal on behalf of customers or to have custody of client assets. There is a limited exclusion from the definition of a CTA for FCMs with respect to advising which occurs and is solely incidental to their other business as an FCM. In this case, all the FCM requirements regarding record-keeping, protection of client assets, including segregation and periodic risk-based inspections, capital, and organizational requirements (see Principle 31) would apply fully.

CTAs' registration is disclosure based. CTAs are required to disclose specific information, including the business background of the CTA and its principals that will make trading or operational decisions, any material actions against the CTA and its principals, a description of the trading program and related risk factors, fees, any actual or potential conflicts of interest, and past performance of its client accounts (Regulations 2.34 and 4.35). Conflict of interest rules are based on a requirement to disclose and include material conflicts relating to the trading program offered by the CTA. CTAs are required to keep accurate, current and orderly books and records (CFTC Regulation 4.33).

SEC

Authorization of licensees

Basic requirement

Broker dealers

A person engaged in the business of effecting transactions in securities for the account of others, or buying and selling securities for their own account, through a broker or otherwise, must generally register as a broker-dealer (BD) with the SEC. Foreign broker-dealers who engage in such activities in the U.S. are required to register with the SEC except in connection with non-solicited transactions by U.S. investors and in certain other circumstances. As indicated in Principle 1, banks also enjoy certain targeted exceptions and exemptions from BD registration in connection with a limited set of activities, such as networking arrangements, trust activities, custody activities and sweep accounts.

BBDs must generally be members of FINRA unless they do not do business with the public. BDs may also need to register with the securities authority of one or more states, in accordance with the applicable laws of each state.

A BD registers with the SEC by filing an application for registration on Form BD. Form BD requests extensive background information about the applicant, including its principals, control persons (having 25 percent or more of the shareholdings of the company), and whether the applicant has been subject to criminal, regulatory or civil actions in connection with any investment-related activity.

The BD registration process is coordinated through the Central Registration Depository (CRD) system operated by FINRA. In practice, for a BD to be eligible to carry on business it generally must register with the SEC and be a member of an SRO, typically FINRA.

OTC derivatives dealers

OTC derivatives dealers are a special class of BDs that are exempt from certain broker-dealer requirements, including membership of an SRO, regular broker-dealer margin rules, and

membership of SIPC. They are registered directly by the SEC, and are subject to special requirements, including limitations on the scope of their securities activities as well as specified internal risk management control system, record-keeping, and reporting responsibilities. Very few participants are currently registered in this category; however, due to the new regulatory framework for swaps, several market participants have inquired about registering as an OTC derivatives dealer.

Security-based swap dealers (SBSD)

The Exchange Act definition of “dealer” does not include certain security-based swap dealers, but Section 15F of the Exchange Act prohibits any person from acting as an SBSBD without being registered with the SEC, and requires that the SEC issue rules to provide for registration of these entities. The SEC is in the process of finalizing rules for their registration.

Investment advisers

The SEC registers IAs that have \$100 million or more of assets under management or that provide advice to an investment company (CIS). Foreign IAs who provide services in the U.S. must also be registered unless that adviser can fit within an exemption (e.g., a foreign private adviser). An IA that has between \$25 million and \$100 million of assets under management must also register with the SEC, if it is not required to be registered as an adviser with, and is not subject to examination by, the state securities authority where it maintains its principal office and place of business. IAs that are not registered with the SEC 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 IA.

An IA registers with the SEC by filing an application for registration on Form ADV under the Advisers Act. Form ADV requests extensive information regarding the adviser’s background and business practices.

Municipal advisors

Section 975 of the Dodd-Frank Act amended Section 15B of the Exchange Act to create a new class of regulated persons, municipal advisors, and require these advisors to register with the SEC and comply with MSRB rules. As of October 1, 2010, it became unlawful for municipal advisors to provide certain advice to or on behalf of, or to solicit municipal entities or obligated persons without registering with the SEC. The SEC adopted an interim final temporary rule providing a temporary means for municipal advisors to satisfy the registration requirement. The SEC adopted a final rule providing for municipal advisor registration in September 2013. The SEC provided for a four month phased-in compliance period that began on July 1, 2014 and ended on October 31, 2014 for existing municipal advisors to comply with the requirement to register with the SEC on Form MA. All municipal advisors must register with the SEC by filing Form MA. The disclosures requested by Form MA are based generally on the disclosures required by Form BD for BDs and Form ADV for IAs and require extensive information on the applicant’s background, business and associated persons. A municipal advisor applicant must also provide information regarding natural persons associated with their municipal advisory firm and engaged in municipal advisory activities on the municipal advisory firm’s behalf by filing a Form MA-I for each such natural person.

Integrity

Registration may be denied for all classes of applicants on the basis of past criminal, administrative or civil action against the applicant or, in some instances, persons associated with the applicant, subject only to administrative or judicial review.

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| | <p><i>Capital requirement</i></p> <p>BDs must meet minimum net capital requirements. During the pre-membership process the BD must demonstrate that it has sufficient net capital to fulfill the requirements of the SEC's net capital and early warning rules. See further under Principle 30. OTC derivative dealers are also subject to special capital requirements.</p> <p>The Exchange Act does not impose any ongoing capital requirements on IAs and municipal advisors unless they are also registered as BDs.</p> <p><i>Competence</i></p> <p>For BDs, FINRA membership rules require that most persons associated with a BD register with FINRA using Form U4, and impose qualification requirements on those individuals based on their activities. To fulfill SRO requirements, all registered representatives, general sales personnel, principals, general 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 qualification examinations.</p> <p>For IAs and municipal advisors, only the firm but not the persons associated with it must register. The statutory framework is based on a disclosure regime rather than a review by the SEC of competence or proficiency requirements. According to the SEC staff, with respect to IAs this approach is based on the type of risks IAs have that are for the most part limited to investment risk; other safeguards are in place for other key risks such as custody. Part 2 of Form ADV, which must be provided to prospective clients, is designed to enable clients and prospective clients to evaluate the risks associated with a particular adviser. Many states also require the registration of the individual persons who are associated with state-registered IAs. The states may also impose certain educational and professional training requirements upon the representatives of SEC-registered IAs who have a place of business in that state. Although individuals are not required to separately register with the SEC, a municipal advisor must provide a Form MA-I with respect to each natural person associated with it and engaged in municipal advisory activities on its behalf. The Form MA-Is, along with the Form MAs, are publicly available on the SEC's website where prospective clients can access and review them.</p> <p><i>Internal controls</i></p> <p>FINRA membership rules require BDs, among other things, to have:</p> <ul style="list-style-type: none"> • Financial controls to ensure compliance with federal securities laws, rules and regulations; • Compliance, supervisory, operational and internal control practices including written supervisory procedures; • An appropriate supervisory structure; • Appropriate systems of customer protection, risk management and internal controls; and • A designated chief compliance officer. <p>Exchange Act Rule 15c3-4, which applies to OTC derivatives dealers and ANC BDs, 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. Registration of BDs whose only business is OTC derivatives dealing is with the SEC rather than FINRA.</p> |
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Under Rule 206(4)-7 of the Advisers Act, registered IAs must adopt and implement written compliance and control procedures (CP&P) reasonably designed to prevent the violation of the Advisers Act by the IA or any of its supervised persons. The SEC has issued detailed guidelines setting out minimum standards for advisers' CP&P. SEC Rules also require an IA to designate a single chief compliance officer (CCO) to administer the CP&P.

For municipal advisors, MSRB rulemaking to establish the full regulatory regime for municipal advisors is not yet complete. The Exchange Act requires that the rules of the MSRB with respect to municipal advisors, at a minimum, prescribe means reasonably designed to prevent acts, practices, and courses of business that are not consistent with a municipal advisor's fiduciary duty to its client, provide continuing education requirements for municipal advisors, and provide professional standards.

Authority of regulator

Assessment of applications for authorization

The SEC registration process for BDs focuses on assessing whether the applicant has submitted all the information required on Form BD and whether any statutory disqualification exists. An SEC order granting registration generally will not become effective until the BD becomes a member of an SRO, typically FINRA. FINRA's membership process in turn involves a more comprehensive review of the applicant.

For BDs, when a firm applies for membership, the applicant is subject to FINRA's pre-membership process, which requires it to file a new member application form (Form NMA) with detailed evidence of its ability to comply with the standards set in FINRA rules. This includes basic information about the applicant, written supervisory and record-keeping procedures, and bank statements. As well as reviewing this information, FINRA also conducts a membership interview with the applicant. During these interviews FINRA staff raise substantive questions that could lead the applicant to change the initial application (for example narrowing the type of products the firm would deal in). FINRA staff indicated that it is rare to deny applications. However, as a matter of policy FINRA conducts an examination of a new firm within six months to one year, depending on whether the firm has conducted any activity, in order to ensure that policies and controls as described in the application have in fact been implemented, and more generally that the firm is complying with applicable SEC and FINRA regulations. The SEC oversees FINRA's membership and licensing processes and procedures through its SRO registration and examinations program.

For IAs and municipal advisors, the SEC has responsibility for registration. When a prospective IA submits its initial completed Form ADV, the application is made available to the SEC and many state securities agencies through IARD. The SEC staff reviews the application to ensure (i) that the applicant meets the conditions for registration (for example, that the applicant has AUM of \$100 million or more); (ii) that all the information required in Form ADV has been submitted; and (iii) that no statutory disqualification exists as a result of previous criminal or disciplinary action. For the latter background checks are conducted. SEC staff also contacts the IA's CCO by phone to obtain information about how the IA developed its plans and procedures and what compliance plans are in place.

When a prospective municipal advisor submits its initial completed Form MA, the SEC staff reviews the application to ensure that the applicant has submitted all the information required in Form MA and all the required Form MA-I(s); and that no statutory disqualification exists as a result of previous criminal or disciplinary action. The SEC staff may perform cross checks of applicants through the use of the applicant's other registration numbers, such as other SEC registration numbers, to the extent available. The staff may contact the applicant to

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| | <p>ask questions as needed.</p> <p><i>Refusal of application</i></p> <p>The SEC can refuse licensing of a BD, subject to administrative or judicial review, if authorization requirements have not been met. Subject to an opportunity for a hearing, FINRA can condition or deny membership based on similar findings. It can also deny or condition membership, subject to an opportunity for a hearing, based on, among other things, failure to meet standards of financial responsibility or operational capability.</p> <p>Similarly, the SEC may refuse to register an IA or a municipal advisor if authorization requirements are not met, including in the case of IAs, that the adviser is prohibited from registering with the SEC (for example, because they do not meet the minimum AUM threshold).</p> <p>Generally the SEC has 45 days from receipt of an application to grant a registration or commence denial proceedings.</p> <p><i>Revocation/suspension of registration</i></p> <p>The SEC and FINRA generally have authority to withdraw, suspend or condition a BD's registration, and impose sanctions on BDs and their associated persons for violations of applicable law and related rules. The SEC has these powers in relation to IAs and municipal advisors.</p> <p>The SEC has a wide range of other sanctions it can impose on registrants (BDs, IAs and municipal advisors) for failure to comply with the securities laws. Sanctions available to the SEC are described under Principle 11.</p> <p>Generally the SEC and/or SROs have authority to prevent the employment of persons with a market intermediary where they find it is not in the public interest to allow such persons to associate with the market intermediary. If individuals associated with registrants commit certain willful misconduct, the SEC and/or SROs can bar them from future association with registrants. The SEC and/or SROs have this authority with respect to persons seeking to associate with a broker-dealer, investment adviser or municipal advisor.</p> <p>Ongoing requirements</p> <p>A BD must promptly file an amendment to its Form BD if the information on the form is or becomes inaccurate for any reason. In addition, SROs generally require that registered individuals promptly update their Forms U-4 if the information on that form is or becomes inaccurate.</p> <p>An IA's Form ADV must be updated each year by filing an annual updating amendment within 90 days of the adviser's fiscal year end. In addition, an investment adviser must amend its Form ADV to keep it current. If material information in an investment adviser's Form ADV becomes inaccurate, it must be amended promptly. Similar provisions apply to municipal advisors.</p> <p>Public disclosure of licensed intermediaries</p> <p>Completed Forms BD and the non-confidential portion of BDs' annual audited financial statements are publicly available through the SEC's public reference office. Form BD indicates the types of business conducted by a BD, as well as the states and SROs with which the BD is registered.</p> <p>In addition, FINRA compiles regulatory information from BDs and their registered associated persons, as well as from states and other sources. It maintains this information in its CRD</p> |
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system, including the status of the BD's registration. Certain information derived from CRD is made available free of charge to the public through FINRA's BrokerCheck system.

IAs and municipal advisors registration Forms (Forms ADV and MA) are publicly available on the SEC's website. Part 2B of Form ADV requires an IA to prepare a "brochure supplement" that contains information about each advisory employee that provides investment advice to clients. This supplement is not required to be filed with the SEC but must be made available to clients. Although individuals are not required to separately register with the SEC, a municipal advisor must provide a Form MA-I with respect to each natural person associated with it and engaged in municipal advisory activities on its behalf. Form MA-Is also are publicly available on the SEC's website where prospective clients can access and review them.

Investment advisers

To buy or sell securities on behalf of customers, an IA would also be required to be registered as a BD.

By Advisers Act Rule 206(4)-2, an IA cannot hold client assets as a "qualified custodian" unless it is separately regulated to hold assets (e.g., it is also registered and regulated as a BD, or it is chartered and regulated as a bank). Absent this qualification, an adviser must hold client assets with a qualified custodian such as a bank, BD, FCM or foreign custodian. At the custodian level, there are detailed safeguards regarding segregation and reporting to clients. Regardless of who acts as the custodian, the Advisers Act layers additional protections onto the custodian's safeguards, such as having and an independent public accountant conduct a surprise audit at least once a year. If the adviser or a related person of the adviser acts as a qualified custodian, the Advisers Act requires additional safeguards to apply, including:

the annual surprise audit must be performed by a PCAOB registered auditor, unless the related person is "operationally independent" of the IA (as defined in the custody rule); and

The auditor must report to the IA annually on internal controls relating to the custody of client assets.

In practice, as of January 2015 88 out of more than 11,500 registered IAs act as qualified custodians. In addition, there are 400 SEC-registered IAs for which a related person acts as qualified custodian in connection with advisory services the IA provides to its clients.

In addition, the Advisers Act deems an adviser to "have custody" in some circumstances where client assets are held by a qualified custodian but the IA can access client assets, for example where the IA has a power of attorney that permits it to access client funds to pay bills or transfer funds between accounts. In these circumstances the additional safeguards mentioned above apply. This definition of "custody" is broader than the concept of custody in the IOSCO Methodology which refers to physical holding of the assets.

For pooled investment vehicles (other than CIS), slightly different rules can apply. The pool's financial statements must be audited by a PCAOB registered auditor; the statements must be sent to investors annually; the custodian must send quarterly statements of account to each investor; and the pool's assets must be subject to a surprise audit.

Under Rule 204-2 of the Advisers Act, an IA is subject to detailed record keeping requirements. Under Advisers Act Rule 206(4)-7, IAs must also have written compliance policies and procedures that are reasonably designed to prevent violations of the Advisers Act; review annually the adequacy of those policies and procedures; and designate a Chief Compliance Officer.

An IA's fiduciary duty requires it to disclose to its clients and prospective clients any material

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| | <p>facts that might cause the adviser to render advice that is not disinterested. An IA 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.</p> <p>Extensive disclosures are also required in an IA’s Form ADV about business, ownership, clients, employees, business practices (especially those involving potential conflicts with clients), and any disciplinary events of the adviser or its employees. The SEC recently amended Part 1A and Part 2 of Form ADV to expand the amount of information collected and the way it is presented to clients.</p> <p>The Advisers Act contains requirements to mitigate conflicts, for example by requiring an IA to disclose to and obtain the consent of a client when it is acting as principal for its own account (Section 206(3)). Rule 204A-1 under the Advisers Act requires registered IAs to adopt codes of ethics setting out standards of conduct and requiring compliance with applicable federal securities laws. Codes of ethics must address personal trading and must require personnel to report personal securities holdings and transactions.</p> |
| <p>Assessment</p> | <p>Fully Implemented</p> |
| <p>Comments</p> | <p>For most intermediaries, registration requires membership of an SRO and the registration process in practice consists of a combination of the process required by the legislation and the membership process of the relevant SRO. The process required by the legislation, and related rules and forms, focuses largely on the integrity of an applicant, and its control persons and associated persons, and whether any statutory disqualifications are present. The membership processes conducted by FINRA and by the NFA (other than for CTAs) involve an assessment of the internal organization, risk management and supervisory systems of applicant firms, and competence requirements for individuals. The checks they make appear robust, and both carry out an examination of new registrant members within the first year after registration.</p> <p>For IAs, the situation is somewhat different. IAs are registered directly by the SEC and are subject only to the integrity checks required by the legislation and the conversation with the CCO. They are subject to comprehensive disclosure obligations which permit a customer to make an informed decision about the competence of the IA, its personnel, and its business. They are also subject to certain ongoing obligations including the need to implement a compliance program.</p> <p>The IOSCO Assessment Methodology expressly contemplates a disclosure-based regime for IAs as an alternative to more substantive licensing criteria. The assessors note that the Methodology requires advisers permitted to have custody of client assets to be subject to the requirements that apply to other intermediaries, including an assessment of internal organization, risk management and supervisory systems and, as applicable, capital requirements. In this context it is important to recognize that the Assessment Methodology defines custody as meaning “physically” holding client assets; and that, for an IA itself to hold assets in this way, it would need separate authorization as a qualified custodian by seeking authorization as a BD.</p> <p>The Advisers Act and related rules in some circumstances deem an adviser to have custody of client assets if it can access client assets, but this is not “custody” in the sense it is used in the Assessment Methodology. Because of these differences in the notion of custody, the assessors conclude that the disclosure-based approach to the registration of IAs complies with the requirements of Key Question 7 of the Assessment Methodology.</p> <p>The situation is similar for futures industry CTAs, as they are not permitted either to deal on</p> |

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| | <p>behalf of clients or hold client assets. Full disclosure, as required by the CEA and CFTC requirements is therefore consistent with the Methodology.</p> <p>However, the assessors understand that in the U.S. context, IAs are typically portfolio managers with substantial assets under management (total AUM is about \$63 trillion, of which about \$17 million is in mutual funds). CTAs may also and in practice do operate discretionary accounts. From that perspective, the assessors encourage the authorities to consider whether there is a need to implement more comprehensive internal control and risk management requirements relating to portfolio management.</p> |
| Principle 30. | <p>There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.</p> |
| Description | <p>CFTC</p> <p>Capital requirement</p> <p>Capital requirements apply to SDs, MSPs, FCMs, RFEDs and IBs, but not to CTAs, floor brokers and floor traders. IBs do not require capital if their obligations are guaranteed by an FCM and they deal only through that FCM.</p> <p>For FCMs, the minimum adjusted net capital requirement under the current Regulation 1.17(a) is the greatest of:</p> <ul style="list-style-type: none"> • \$1,000,000; • The FCM's risk-based capital requirement, computed as eight percent of the total risk margin requirement for positions carried by the FCM in customer accounts and non-customer accounts; • The amount of adjusted net capital required by the NFA; or • For securities brokers and dealers, the amount of net capital required by SEC Rule 15c3-1(a). <p>“Adjusted net capital” is defined as an FCM’s “current assets”- in this context meaning liquid assets - less all liabilities (except certain qualifying subordinated debt), and further reduced by certain capital charges (haircuts) to reflect potential market and credit risk of the firm’s current assets.</p> <p>When determining current assets, Regulation 1.17(c)(2) specifically excludes certain items such as unsecured receivables, and also requires unrealized losses to be deducted, and unrealized profits added to the extent that they are secured or are on exchange-traded positions and thus take account of some off-balance sheet items. Other assets must be marked to market, including all long and all short positions in commodity options traded on a contract market; all listed security options; and all long and short securities and commodities positions. Further, the rule sets out values to be attributed to any commodity option that is not traded on a contract market and to any unlisted security option.</p> <p>Haircuts apply to an FCM’s futures and futures options; its inventory; fixed price commitments and forward contracts; and to its securities and security options. The CFTC has harmonized the haircuts applied to securities and securities options with the haircuts required under the SEC’s net capital rule.</p> <p>Regulation 1.12(b) requires FCMs to provide immediate notification to the CFTC and their DSROs if the FCM’s capital falls below:</p> <ul style="list-style-type: none"> • 110 percent of the risk-based capital requirement; |

- 150 percent of the minimum dollar requirement, or of the requirement for minimum capital under NFA rules; or
- If the FCM is a securities BD, the early warning level established under SEC rules.

For IBs subject to minimum capital requirements, the minimum adjusted net capital requirement is the greatest of:

- \$45,000;
- The amount of adjusted net capital required by the NFA; or
- For securities brokers and dealers, the amount of net capital required by SEC rules.

For SDs and MSPs capital and margin requirements are in the process of being finalized. The CEA provides that SDs and MSPs that have a prudential regulator must meet the capital and margin requirements established by that regulator; where there is no prudential regulator, the SD or MSP must meet requirements set out in CFTC Regulations. CFTC proposed regulations provide that SDs and MSPs that are also FCMs are required to meet existing FCM requirements to hold minimum levels of adjusted net capital, with a higher minimum fixed dollar net capital requirement of \$20 million. SDs and MSPs that are not FCMs and are nonbank subsidiaries of U.S. bank holding companies would be required to meet a minimum capital requirement of \$20 million Tier 1 capital as defined in bank regulations, the minimum risk-based ratio requirement that would apply as if the SD itself were a bank holding company, or any higher amount required by a registered futures association of which such SD or MSP is a member. SDs and MSPs that are neither FCMs nor bank holding company subsidiaries would be required to maintain tangible net equity equal to \$20 million, plus additional amounts for market risk and OTC derivatives credit risk. The proposed capital requirements for SDs and MSPs do not have the same liquid assets requirements as the FCM capital requirements.

Risk-sensitivity of capital requirements

The objective of the CFTC's FCM and IB net capital rule is to require registrants to maintain a minimum base of liquid assets in excess of their liabilities to finance their business activity. The requirements in CFTC Regulation 1.17 are mostly focused on mitigating market risk, credit risk, and liquidity risk.

The capital requirements of FCMs are directly related to margin requirements for the futures and options positions of their customers and non-customers. Also, FCMs with proprietary positions in futures or options on futures must deduct from their net capital 100 percent of the margin requirements for these positions (or 150 percent if the FCM is not a clearing member). FCMs' and IBs' capital requirements reflect market moves because their assets are required to be marked to market.

Record-keeping and reporting

Record-keeping

CFTC Regulation 1.18 requires FCMs and IBs to prepare and keep current ledgers which show each transaction affecting asset, liability, income, expense and capital accounts consistently with the Form 1-FR (or the FOCUS Report if a securities BD).

CFTC Regulation 23.201(b)(2) requires SDs and MSPs to maintain records reflecting all assets and liabilities, income and expenses, and capital accounts as required by the CEA and CFTC regulations.

Reporting

CFTC Regulation 1.17(a)(3) provides that each FCM and IB must be in compliance with capital requirements at all times and must be able to demonstrate such compliance to the satisfaction of the CFTC or the designated SRO. CFTC Regulation 1.12 requires immediate notification to the CFTC and the designated SRO should an FCM not be in compliance with minimum capital requirements.

FCMs must report their net capital computations to the CFTC and SROs as of month end and IBs every six months. The financial reporting requirements are set out in CFTC Regulation 1.10. Other relevant recordkeeping and reporting requirements deal with the financial condition of FCMs and IBs and with the customer funds held by FCMs.

As well as the obligation to report to the CFTC and the relevant SRO when capital levels fall below specified thresholds (see above), CFTC Regulation 1.12(g)(1) requires that, if the net capital of an FCM declines by 20 percent or more from the amount last reported, the FCM must provide notice within 2 business days of the event or series of events causing the reduction in net capital.

In addition, FCMs must submit quarterly reports on large exposures to the CFTC, which now shares them with the corresponding SROs.

Independent audit

For FCMs, RFEDs, and IBs, CFTC Regulation 1.10 requires the filing with the CFTC of annual financial reports certified by an independent certified public accountant, within 90 days of period end. The independent public accountants must be registered and in good standing under the laws of the relevant state licensing authorities. In addition, certified public accountants that conduct examinations of FCMs must be registered with and subject to examinations by the PCAOB.

An accountant who discovers a material inadequacy in the course of an audit is required under CFTC Regulation 1.16 to notify the FCM or IB, who, in turn, must notify the CFTC, NFA and the appropriate DSRO.

Under proposed CFTC Regulations certain SDs and MSPs will be required to file annual audited financial statements with the CFTC and with any registered futures association of which they are members. This proposed rule applies to SDs and MSPs that are not subject to the capital requirements of a prudential regulator, or designated by the FSOC as a SIFI.

Monitoring by regulator

Both the CFTC and the SROs receive and review the monthly financial reports that include information on the computation of minimum capital requirements.

Historically the SROs have been responsible for the front line supervision of individual firms. However, the CFTC's DSIO also conducts monitoring of the financial position of FCMs. To this end, the CFTC has automated systems to detect anomalies in a firm and trends in the industry that could be of concern. If necessary it conducts on-site examinations on firms. In addition, the CFTC conducts sweeps with the purpose of gaining a deeper understanding of how a specific issue is dealt with in the industry. For example, recent sweeps included a review of liquidity across the industry. For other intermediaries (i.e., IBs) the CFTC relies on NFA monitoring.

Regulator's powers of intervention

CFTC Regulation 1.17(a)(4) provides that an FCM that fails to demonstrate that it holds sufficient capital to meet the required minimum must transfer all customer accounts and

immediately cease doing business as an FCM until it is able to demonstrate compliance with the capital requirements. The FCM may trade only for liquidation purposes during this period unless prohibited from doing so by its DSRO or the CFTC.

The CFTC and the DSROs can take other steps, such as requiring an FCM in difficulty to do daily instead of monthly capital reporting.

CFTC proposed regulations (Proposed Regulation 23.105) require an SD or MSP to notify the CFTC if it knows or ought to know that the firm does not maintain tangible net equity in excess of its minimum requirement. An early warning notice is required if net tangible equity falls below 110 percent of the required amount.

Risks from outside the regulated entity

Affiliate risk generally is addressed through record-keeping and reporting obligations. Under CFTC Regulations 1.14 and 1.15, in computing their tangible net equity FCMs are required to consolidate the assets and liabilities of any subsidiary or affiliate for which the FCM guarantees the obligations or liabilities. Consolidated and consolidating annual financial statements must be submitted to the CFTC along with a map of how the affiliates related to the FCM. Also, certain off-balance sheet items such as unrealized gains on futures positions must be reported as non-current assets in the capital computations of FCMs and IBs.

CFTC proposed Regulation 23.102 would also require an SD or MSP in computing its tangible net equity to consolidate the assets and liabilities of any subsidiary or affiliate for which the SD or MSP guarantees the obligations or liabilities. Proposed Regulation 23.103 provides that for purposes of computing specific and general market risk charges to capital, off-balance sheet positions are included.

SEC

Capital requirement

There are capital requirements for BDs, but not for firms that are only IAs (including those that are deemed to "have custody" under the Advisers Act) or municipal advisors. Exchange Act Rule 15c3-1 (the net capital rule, NCR) requires all BDs to maintain net capital in specified amounts that are determined by the type of business conducted by the BD. The NCR is a net liquid assets test designed to promote the orderly liquidation of a firm, without disruption for customers. If a firm's net capital falls below the required minimum, it must cease doing securities business. In 2013, the SEC amended the NCR to also require a BD to cease conducting securities business if certain insolvency events occur.

The NCR requires that a BD perform two calculations:

A computation of the minimum amount of net capital the BD must maintain; and

A computation of the amount of net capital the BD is maintaining.

The minimum required dollar amount varies from \$5,000 for the least risky type of activity (such as a business limited to selling mutual funds) to \$250,000 for the most risky type of activity (such as holding customer funds and assets). The minimum net capital requirement is the greater of these fixed-dollar amounts and an amount determined by applying one of two financial ratios:

A 15-to-1 aggregate indebtedness to net capital ratio (basic method), and for firms in their first year of operation an 8-to-1 ratio; or

2 percent of aggregate debit items ratio (alternative method).

The alternative method is generally used by firms that hold customer funds and securities, and in practice is used by many larger BDs. It ties the minimum capital requirement to the amount of aggregate customer receivables.

For the purpose of calculating net capital, fixed assets and other illiquid assets are excluded, as are most unsecured receivables. Discounts (haircuts) are applied to the value of assets held on the BD's books based on the nature of those assets, reflecting their liquidity, market and credit risks (for example, non-marketable securities are generally subject to a 100 percent haircut). Other charges apply, such as capital charges related to fail-to-deliver contracts that are outstanding for more than five days.

Alternative Net Capital (ANC) BDs and OTC derivative dealers are permitted, with the SEC approval, to calculate net capital using internal models as the basis for taking market risk and credit risk charges in lieu of the standardized haircuts for classes of positions for which they have been approved to use models. The NCR imposes substantially higher minimum capital requirements for ANC BDs (currently \$500 million in net capital, \$1 billion in tentative capital and an early warning level of \$5 billion) and for OTC derivatives dealers. SEC staff indicated that, while very few participants are currently registered as OTC derivatives dealers, as a result of the new regulatory framework for swaps, several market participants have inquired about registering as one.

SEC staff emphasized that the Commission has broad authority to approve a BD's use of the ANC computation. SEC staff conduct a thorough review of the firm's systems, including its internal models and the control environment. This review takes about one year. The approval must be granted at Commission level. Currently only 6 firms have been approved to use the ANC. There is currently a proposal to increase the minimum net capital of ANC BDs to \$1 billion, minimum tentative net capital to \$5 billion and the early warning level to \$6 billion.

Concentration risk is addressed via a concentration charge. The charge generally applies if a position has a market value of more than 10 percent of the net capital of a BD. If a concentrated position exists, before computing haircuts for the position, the BD must deduct an amount equal to 50 percent of the standard haircut for the position, on that portion of the position that exceeds 10 percent. If the BD uses models to compute haircuts, the charge would be expected to increase if a concentrated position exists. It is expected that ANC broker-dealers incorporate stress testing into their policies and procedures.

SROs have the ability to set capital requirements for BDs 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 if the SRO has rules in place that permit them to do so.

The NCR is in itself a net liquid assets test. All ANC BDs also perform an internal liquidity stress test for a minimum of a 30 day stress period. In addition, the SEC has proposed a liquidity stress test for ANC BDs and is currently reviewing whether the proposed liquidity stress test requirements should be imposed on all carrying brokers.

The SEC is also considering whether a specific leverage ratio should be imposed on the carrying BDs.

Reserve account

SEC Rule 15c3-3 (the Customer Protection Rule) requires that every BD obtain and maintain possession and control of customer fully paid and excess margin securities, and maintain a reserve account that contains at least the net dollar amount of cash the BD owes to its customers. The customer reserve formula permits the BD to offset customer credit items only

with customer debit items.

Physical possession or control of securities means the BD must hold these securities in one of the locations specified in Rule 15c3-3 and free of liens or any other interest that could be exercised by a third party to secure an obligation of the BD. Permissible control locations include a bank and a clearing agency.

As for cash, pursuant to amendments introduced in 2013 a BD is prohibited from depositing cash in its customer reserve account at an affiliated bank and limited in the amount of cash a BD can deposit in any one bank to meet its minimum required customer reserve deposit.

The Dodd-Frank Act amended the Securities Investor Protection Act of 1970 (SIPA) to take into account futures and options on futures held in a portfolio margin account carried as a securities account pursuant to an SEC-approved portfolio margining program. As a result, persons who hold futures positions in a portfolio margining account carried as a securities account would be entitled to SIPA protection.

Record keeping and reporting

Record-keeping

BDs are required to make, keep and preserve records regarding their net capital computation under the SEC's record-keeping rules (Rules 17a-3 and 17a-4). BDs are required to monitor their capital on a daily basis.

Reporting

Exchange Act Rule 17a-5(a) requires all BDs to file unaudited financial 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. All broker-dealers must include their net capital computations in the financial report (commonly called the FOCUS Report). The SEC has delegated the responsibility for receiving those reports to each firm's designated examining authority (DEA). The SEC generally is able to access these reports electronically, and receives information regarding them in database format from the SROs.

Under Exchange Act Rule 17a-11 (the early warning rule), a BD must promptly notify the SEC and its DEA, when, among other things:

- Its net capital falls below 120 percent of its required net capital;
- If the firm computes its net capital using the alternative method, the firm's net capital falls below 5 percent of aggregate debit items;
- If the firm computes its net capital using the basic method, if the firm's aggregate indebtedness is in excess of 1,200 percent of its net capital;
- If its net capital falls below the minimum required amount; or
- If the firm fails to keep current the books and records required by SEC rules.

SROs also have early warning rules, which in some cases have higher thresholds than the SEC's early warning rule.

Independent audit

According to Exchange Act Rule 17a-5(d), each BD must file an audited annual report with the SEC, the BD's DEA, SIPC if the BD is a member, and each SRO of which it is a member unless the SRO waives the requirement by rule. The report must be audited by an independent public accountant registered with the PCAOB.

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| | <p>Monitoring by regulator</p> <p>The capital levels of a BD, and its compliance at all times with minimum capital requirements, is monitored through filings of periodic and annual reports made by the BD, and through on-site inspections. The BD's DEA regularly monitors compliance with capital levels. SROs inspect BDs that hold customer funds and securities at least once each year. Other BDs are also subject to on-site examinations by SROs, although they may be examined less frequently.</p> <p>While SROs are the front line supervisors, the SEC also may review a firm's filings. In particular, the SEC has recently constituted a program for Large Firm Monitoring through which it conducts ongoing monitoring of the largest, most complex BDs in order to enhance OCIE's ability to identify risks at these firms.</p> <p>Regulator's powers of intervention</p> <p>The Exchange Act and the regulations prohibit a BD from continuing to do securities business if it does not have sufficient net capital. A BD is restricted from withdrawing capital if certain parameters have been broken. The SROs also have rules that restrict the activities of a BD in financial difficulty. The SEC and SROs regularly use these authorities.</p> <p>Risks from outside the regulated entity</p> <p>The NCR requires that a BD 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 obligations or liabilities. In addition, a BD must take a capital charge to the extent of any obligations it has assumed with respect to its affiliates.</p> <p>Rule 17h-1T sets out specific record-keeping requirements applicable to BDs and provides guidelines to be used in establishing which affiliates are "material" for purposes of the rules, and therefore whose information is subject to these record-keeping 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 BDs to file quarterly reports concerning these records.</p> <p>ANC BDs must file with the SEC the consolidated and consolidating financial statements for the ANC BD's ultimate holding company, the holding company's most recent capital measurements computed in accordance with Basel standards, as reported to its 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.</p> |
| Assessment | Fully Implemented |
| Comments | <p>Both the SEC and the CFTC use a net capital approach to the setting of capital standards for intermediaries such as BDs and FCMs. The IOSCO Assessment Methodology recognizes a net capital regime as one of the main alternative approaches to the setting of capital standards for intermediaries. The net capital approach is designed to ensure sufficient liquid assets are available at all times to meet the claims of customers and creditors, and to allow an orderly liquidation in the event of failure. In the SEC's NCR, liquidity is the focus, market and credit risk are explicitly dealt with through the haircut regime, and concentration risk is explicitly provided for. Other risks such as operational risk are dealt with implicitly by the inherent conservatism of the haircut regime and the conservative treatment of assets and liabilities in the calculation of capital requirements. The CFTC's capital rules are similarly structured. Under both SEC and CFTC rules, capital requirements increase as the volume of business and</p> |

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| | <p>therefore risk increases.</p> <p>The early warning thresholds imposed by the SEC, the CFTC, and the SROs, functions as a de facto higher minimum capital requirement by creating incentives to ensure intermediaries do not become subject to additional scrutiny by breaching reporting trigger points.</p> <p>Both the SEC's and the CFTC's capital rules apply on a solo basis, and the registered entity is required at all times to be in compliance. This is consistent with the Assessment Methodology.</p> <p>The SEC's rules for ANC BDs give it the power to impose additional conditions on a regulated entity on a case-by-case basis. In practice, it has used these powers to impose a higher minimum capital requirement in one case, and to subject some of the firms under this regime to more stringent reporting requirements. This framework allows, if necessary, additional conditions to be imposed on a firm relating to liquidity or leverage.</p> <p>The SEC has proposed changes to its rules for ANC BDs that would, among other things:</p> <p>Increase the minimum tentative net capital requirement to \$5 billion (the early warning threshold under the current rules); and</p> <p>Require the liquidity pool to be maintained at all times in the BD, not its holding company.</p> <p>The assessors encourage the SEC to continue this review.</p> |
| <p>Principle 31.</p> | <p>Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters.</p> |
| <p>Description</p> | <p>CFTC</p> <p>Management, supervision and organizational requirements</p> <p>CFTC Regulation 166.3 requires every registrant (except APs with no supervisory duties), to diligently supervise the handling by its partners, officers, employees and agents of all activities relating to its business as a CFTC registrant.</p> <p><i>FCMs</i></p> <p>CFTC Regulation 1.11 sets out detailed requirements for FCM's risk management programs, including requirements for review and testing by internal audit independent of the business unit, or a third party audit service reporting to staff independent of the business unit. The annual review of the risk management program must be reported to the chief compliance officer (CCO), senior management and the governing body of the FCM. CFTC staff noted that with the mandatory risk management requirements, CCOs have become more involved in firms' compliance with the risk management program.</p> <p>CFTC Regulation 1.10 establishes a requirement for review of certain FCM operations by outside auditors. The annual audit for FCMs and IBs must use procedures that provide reasonable assurance that they will discover any material deficiencies in the accounting system, in the internal accounting controls, and in the FCM's or IB's system for safeguarding customer and firm assets. Regulations 1.14 and 1.15 impose risk assessment, recordkeeping and reporting requirements.</p> <p><i>SDs and MSPs</i></p> <p>CFTC Regulation 23.602 requires SDs and MSPs to establish and maintain a system to</p> |

diligently supervise all activities relating to the business performed by their partners, members, officers, employees, and agents (or persons occupying a similar status or performing a similar function). This system must be reasonably designed to achieve compliance with the requirements of the CEA and CFTC Regulations.

CFTC Regulation 23.600 requires SDs and MSPs to have a risk management program and to report quarterly to senior management and the governing body on the operation of that program. Risk management programs must be reviewed and tested annually, or on any material change in the business of the SD or MSP. Annual testing must be performed by qualified internal audit staff that are independent of business units, or by a qualified third party audit service.

Direct Electronic Access

CFTC Regulation 38.607 requires a DCM that permits direct electronic access by customers to have in place effective systems and controls reasonably designed to facilitate FCMs' management of financial risk, such as automated pre-trade controls that enable member FCMs to implement appropriate financial risk limits (see also Principle 33).

CFTC Regulation 37.202 requires a SEF to provide impartial access to markets and market services. The CFTC has interpreted this to mean that a SEF should allow participants to access its platform via intermediation or direct access.

Protection of clients

Client funds and assets

CEA Section 4d(a)(2) and CFTC Regulation 1.20 require FCMs to separately account for customer funds on their books and records, and segregate customer funds from their own funds and funds of other persons. An FCM is permitted to pool all customer funds in a single account or in multiple accounts, and these accounts must be clearly identified as containing funds belonging to the FCM's customers. Customer funds must be deposited with a bank, trust company, DCO, or another FCM under an account name that clearly identifies the funds as belonging to customers of the depositing FCM and held in segregation as required by the CEA and CFTC Regulations.

Regulation 1.20 requires an FCM to obtain a written acknowledgment prior to or contemporaneously with the opening of the customer account with the depository holding customer funds (except that an acknowledgment letter is not required if the funds are deposited by an FCM with a DCO that has rules requiring the segregation of the customer funds in accordance with the requirements set out in the CEA and CFTC Regulations). The written acknowledgment letter must provide: (i) CFTC staff with read-only electronic access to transaction and account balance information in the accounts; (ii) authorization for the depository to allow CFTC staff to examine accounts containing futures customer funds; and (iii) authorization for the depository to respond promptly and directly to any request from CFTC staff or DSRO staff for confirmation of account balances or other information regarding the accounts.

FCMs are required to maintain at all times a sufficient amount of funds in the customer segregated accounts to repay each customers' total account balances, including both funds used as margin and funds intended to be used as margin in the future, as well as proceeds. FCMs are also required to keep in the omnibus account the full amount of unmet margin calls from all customers without netting. The prohibition on using one customer's funds to margin another customer's position means that the FCM must cover any customer margin shortfalls with its own capital, but in practice this is done as of the end of the business day based upon

clearing house settlement prices and the FCM may recognize customer margin payments received up until 6:00 pm Eastern Time on the next business day in computing the amount of the margin deficiency as of the close of business on the previous business day. By contrast, customer deficit balances must be covered by firm capital at all times. If the FCM is bankrupt and there is a deficiency of funds in the omnibus account, the bankruptcy code provides for pro rata distribution.

CEA Section 4d(f) requires the segregation of cleared swaps pertaining to customers, as well as associated collateral. Pursuant to this provision, Part 22 of the CFTC Regulations requires cleared swaps customer collateral to be segregated from the FCM's own property, but permits the cleared swaps collateral of all FCM cleared swaps customers to be kept together pre-bankruptcy in one account (legally segregated operationally commingled, LSOC). In practice this means that in the event of a bankruptcy of the FCM, the margins of each customer are protected and cannot be used to meet uncovered margins of other customers.

Regulations applicable to futures allow hypothecation of collateral in form but not in value (i.e., FCMs must have at all times 100 percent of the correct value of customers' margins in segregation). Following MF Global bankruptcy, the CFTC approved new regulations that tightened the type of assets in which customer collateral can be invested. The CFTC emphasized the existence of additional controls to check on FCMs' compliance with their customer protection rules. For example, each FCM is now required to file formal segregation computation on a daily basis with both the CFTC and with the FCM's DSRO. Prior to the revised customer protection rules, an FCM was only required to file a formal segregation computation with the CFTC on a monthly basis. The daily segregation computations show the total amount of funds held in segregated accounts for customers and the total amount of funds due to the customers as of the end of each business day. Any shortfall in segregation is therefore immediately identified. In addition, every depository holding customer funds for any FCM is required to provide a daily written confirmation of account balances to the FCM's DSRO. The daily confirmations provide the DSROs with a mechanism to independently verify that the information reported by the FCMs is accurate and substantiated by the depositories.

Additional controls and checks on FCMs' compliance with the CFTC customer protection rules include the requirement that each depository must enter into a standard form written acknowledgment letter for each account opened by the FCM. Under the acknowledgment letter, the FCM and the depository agree to provide CFTC staff with read-only electronic access to account balance and transaction information. CFTC staff can access this information directly using its own access information. The acknowledgment letter further provides that the FCM authorizes the depository to provide CFTC staff with access to examine the accounts and authorizes the depository to respond to CFTC staff and DSRO staff inquiries regarding account balances and transactions in the accounts.

Investor complaints

CFTC Regulation 166.5 sets out requirements that registrants must include in a customer account agreement with respect to dispute resolution procedures, including the use of arbitration procedures. Three fora exist for the resolution of disputes: civil court litigation, CFTC reparations proceedings, and arbitration conducted by an SRO or other private organization.

CFTC Regulation 23.504 requires SDs and MSPs to execute written trading relationship documentation with their counterparties, which must cover all terms governing the trading relationship, including dispute resolution. CFTC Regulation 23.201(b)(3) requires that SDs and MSPs retain records of any complaint received, including the disposition of the complaint and

the date the complaint was resolved.

Section 14 of the CEA permits anyone complaining of a violation of the CEA or the CFTC's rules to apply to the CFTC for an order awarding damages caused by the violation. These reparations procedures offer a variety of methods to resolve claims, including a voluntary procedure based on the submission of written documents and a summary procedure for claims of less than \$30,000.

Client information, know your client and suitability rules

AML requirements and PATRIOT Act require intermediaries to conduct identity checks of their customers. CFTC Regulation 1.37 requires each FCM, RFED, IB and member of a contract market to record in permanent form details about customers for whom they operate accounts.

CFTC Regulations 23.402(b) and 23.402(c) require SDs to have systems to record details of each counterparty whose identity is known to the SD prior to the execution of a transaction.

CFTC Regulation 1.55 requires detailed disclosures, including prescribed risk disclosures and firm-specific information, to be made before an FCM or IB opens an account with a customer. NFA's Know Your Customer rule (2-30) requires each Member to obtain extensive information about each customer's experience, income, net worth and age before opening an account. Based on that information, the Member has to make a judgment as to the amount of disclosure that is adequate and must decide whether the customer requires additional risk disclosures beyond the standard disclosures required by CFTC regulations. In some cases, the only adequate risk disclosure that the Member can provide is that futures trading is too risky for that customer. This is true even if the Member makes no recommendations to the customer.

NFA Compliance Rule 2-4 requires that each FCM, or in the case of introduced accounts, the IB, make available to its customers, prior to the commencement of trading, information concerning the costs associated with futures transactions.

CFTC Regulation 23.431 requires an SD or MSP to disclose to non-dealer counterparties material information concerning the swap in a manner reasonably designed to allow the counterparty to assess the material risks and characteristics of the swap and the incentives and conflicts of interest that the SD or MSP may have in connection with the swap.

NFA Compliance Rule 2-4 provides that Members and Associates must observe high standards of commercial honor and just and equitable principles of trade in the conduct of their commodity futures business. Part 23 of the CFTC's Regulations requires that SDs and MSPs communicate in a fair and balanced manner based on principles of fair dealing and good faith with respect to any communication between the SD or MSP and any counterparty, and prohibits fraud, manipulation, and other abusive practices. An SD acting as an advisor to a "special entity" (which includes government agencies and employment benefit plans) has a duty to make a reasonable determination that any swap or trading strategy involving a swap recommended by the SD is in the best interests of the special entity.

CFTC Regulations contain detailed record-keeping requirements, including transaction records, and records about customer funds and accounts. These requirements apply to FCMs and where appropriate IBs. SDs and MSPs are also subject to record-keeping requirements. CFTC Regulation 1.31 requires all books and records required by the CEA and CFTC regulations to be kept for a period of five years and to be readily accessible during the first 2 years of the 5-year period. All books and records must be open to inspection by any representative of the CFTC or DOJ.

CFTC Regulation 1.33(a) requires that FCMs provide monthly statements to customers who have active accounts. Regulation 1.33(b) requires that each FCM furnish trade confirmations no later than the next business day. For customers of an IB, the carrying FCM provides these statements.

Conflicts of interest

The regulatory regime for conflicts is primarily disclosure based, and CTAs are subject to mandatory conflict disclosure obligations.

There are explicit rules in Part 155 of the CFTC's regulations that require FCMs and IBs to establish and enforce internal rules, procedures and controls to ensure, to the extent possible, that orders received from customers are transmitted before any order in the same commodity for the benefit of a proprietary account.

CFTC Regulation 23.431(a)(3) requires SDs and MSPs to disclose to any counterparty to a swap the material incentives and conflicts of interest that the SD or MSP may have in connection with a particular swap, including any compensation or other incentive from any source that the SD or MSP may receive in connection with the swap.

Supervision

Supervision of intermediaries takes place at a number of levels. Front line responsibilities are with the SROs (exchanges and NFA). The NFA has supervision responsibilities for CTAs. In the case of FCMs, the allocation of responsibility for supervision of compliance with financial requirements, including a daily review of the segregation calculation, is governed by the JAC arrangements, under which the CME is the DSRO for the majority of FCMs, with NFA playing this role for around 20 FCMs. CME supervision of FCMs also includes monitoring compliance with the sales practices and AML obligations of FCMs for which it is the DSRO.

NFA has an Examinations group consisting of about 200 people. The CFTC requires the NFA to inspect all FCMs for which it is the DSRO on at least once every 15 months. In practice a second horizontal examination on compliance with segregation requirements is also carried out annually. For non-FCMs and CTAs, the NFA uses a risk scoring system, based on analysis of the data it holds on registrants and its knowledge of individual entities, to select registrants for examination and the areas of focus of that review. The time since the last examination is a factor used in the risk system. The NFA does not use a rigid cycle for examination of these registrants but expects to conduct an on-site inspection about every 3 to 4 years. On average, the NFA carries out between 550 and 650 examinations each year. In recent years, the NFA has been doing a higher number of examinations for cause. The number of disciplinary actions (member responsibility actions) resulting from examinations has increased.

The NFA also reviews all registrants' disclosure documents and monitors promotional material. It has also been active in the supervision of retail foreign exchange activity. Examinations of SDs have commenced.

The exchanges also monitor compliance by their members with obligations under the legislation, exchange rules and NFA rules. Monitoring includes member compliance with their trade practice obligations in relation to market activity (for example, the prohibitions on wash trades and other abusive practices).

Within the CFTC, the Examinations group is comprised of approximately 40 staff members, mostly auditors and accountants. The Examinations group activities in relation to monitoring the financial condition of FCMs and related examinations are described in Principle 30. In general, the CFTC conducts a limited number of examinations given the frontline responsibility of the NFA. In fiscal year 2014, the examinations branch of DSIO performed 11

limited scope reviews of FCMs, one for cause examination of a swap dealer, and no examinations of IBs. With respect to CPOs and CTAs, CFTC staff does not directly examine CPOs and CTAs. According to CFTC senior staff, its examinations are increasingly shifting to an approach focusing on the control environment and risk management processes. The work of the Examinations group is supplemented by the Registration and Compliance group, which reviews annual and quarterly reports for compliance with legislative and rule requirements.

All SROs have mechanisms for taking disciplinary action against members, and the NFA and the large exchanges have significant numbers of investigations and disciplinary proceedings in process at any given time. Each SRO meets quarterly with the CFTC and shares information about current investigations. The NFA also meets quarterly with law enforcement agencies such as the FBI.

SEC

Management, supervision and organizational requirements

BDs

To comply with their obligations, including the financial responsibility rules such as the NCR, the Customer Protection Rule, the Hypothecation Rules and the Quarterly Count Rule and associated reporting obligations, BDs must have in place appropriate systems of control to manage risk.

SRO rules, including those of FINRA, require BDs to implement a supervisory system reasonably designed to achieve compliance with applicable securities laws, regulations and rules. Under those rules, BDs must appoint a chief compliance officer (CCO), and the chief executive must certify annually that the BD has in place policies and procedures to establish, review and modify compliance procedures. Under SRO rules, internal examinations of aspects of a BD's business must be carried out at least once each year, and results reported to senior management.

In addition to monthly or quarterly FOCUS reports, BDs must prepare and file with the SEC annual reports consisting of a financial report and either a compliance report or an exemption report, as well as reports prepared by an independent public accountant covering the financial report and the compliance report or the exemption report. SROs also have rules requiring members to file an annual report.

OTC derivatives dealers and ANC broker-dealers are explicitly required to establish, document, and maintain a system of internal risk management controls to manage the risks associated with their business activities, including market, credit, leverage, liquidity, legal, and operational risks. The management of ANC broker-dealers and OTC derivatives dealers is required to periodically review, in accordance with written procedures, their business activities for consistency with risk management guidelines.

The Exchange Act authorizes the SEC to sanction a broker-dealer or any associated person that fails to reasonably supervise another person subject to the firm's or the person's supervision that commits a violation of the federal securities laws. The Exchange Act provides an affirmative defense against a charge of failure to supervise where reasonable procedures and systems for applying the procedures have been established and effectively implemented without reason to believe those procedures and systems are not being complied with (Exchange Act Sections 15(b)(4)(E) and (b)(6)(A)). The SEC's policy regarding failure to supervise emphasizes that it is the responsibility of broker-dealers and their supervisory personnel to supervise their employees.

Investment advisers

An investment adviser is required to disclose information regarding its management and organizational structure on its Form ADV. Rule 206(4)-7 under the Advisers Act requires an investment adviser to adopt and implement written CP&P reasonably designed to prevent the violation of the Advisers Act by the investment adviser or any of its supervised persons; review annually the adequacy of those policies and procedures; and to appoint a CCO to administer the CP&P. An investment adviser's 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. All supervisors, including senior management, are subject to liability for failure to supervise.

If an adviser is deemed to "have custody" of client assets under the Advisers Act, an independent public accountant must verify all those assets 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.

Direct Electronic Access

SEC Exchange Act Rule 15c3-5 applies to BDs with access to trading in securities by virtue of being an exchange member or an ATS subscriber. It also applies to access to trading on an ATS that the BD operating the ATS provides to its non-BD subscribers. A BD with market access, or that provides a customer or any other person with access to an exchange or ATS through the use of its market participant identifier or otherwise, is required to establish, document, and maintain a system of risk management controls and supervisory procedures that, among other things, are reasonably designed to:

Systematically limit the financial exposure of the BD that could arise as a result of market access; and

Ensure compliance with all regulatory requirements that are applicable in connection with market access.

The rules establish detailed standards that these systems must meet. The SEC has recently conducted a sweep to review how BDs have implemented their obligations under this new rule (see below).

Protection of clients*Fair treatment of clients*

BDs are subject to comprehensive statutory requirements as well as SEC and SRO rules designed to promote business conduct that protects investors from abusive practices. FINRA rules require BDs to deal fairly with customers and observe high standards of commercial honor and just and equitable principles of trade, and impose more specific obligations such as having a reasonable basis of recommending transactions to a client, best execution and disclosing conflicts of interest.

BDs have a duty of fair dealing towards their customers that is derived from the anti-fraud provisions of the federal securities laws. Under the "shingle" theory, by virtue of engaging in the brokerage profession, a BD impliedly represents to those persons with whom it transacts business that it will deal fairly with them, consistent with the standards of the profession.

SRO rules also require BDs to deal fairly with customers. For example, FINRA rules:

Require a BD to have a reasonable basis for believing that any recommended transaction or investment strategy involving a security or securities is suitable for the customer;

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| | <p>Impose a duty of best execution on BDs;</p> <p>Require a BD to engage in fair and balanced communications with the public; provide timely and adequate confirmation of transactions; and disclose conflicts of interest; and</p> <p>Give customers the opportunity for redress of disputes through arbitration.</p> <p>IAs have a fiduciary obligation (imposed by Section 206 of the Advisers Act as interpreted by the courts) to act in the utmost good faith with respect to their clients. This general obligation is supplemented by detailed statutory provisions such as those relating to conflicts and the protection of material non-public information.</p> <p><i>Conflicts of interest</i></p> <p>BDs are required under relevant circumstances, such as when making a recommendation, to disclose material conflicts of interest to their customers. The federal securities laws and SRO rules also restrict broker-dealers from participating in certain transactions that may present particularly acute potential conflicts of interest. In other instances, the federal securities laws require broker-dealers to mitigate conflicts by engaging in specified actions.</p> <p>Research analysts are subject to detailed conflict rules (described under Principle 23).</p> <p>An IA must disclose all material facts regarding a conflict or potential conflict so that a client or prospective client can make an informed decision whether to enter into or continue an advisory relationship with the adviser, or take action to protect himself or herself against the conflict. As a fiduciary, an adviser owes its clients undivided loyalty and must take steps reasonably necessary to fulfill his or her fiduciary obligations.</p> <p>Specific provisions in the Advisers Act deal with potential adviser conflicts, such as those relating to performance fees, and proprietary dealings by the adviser.</p> <p><i>Client funds and assets</i></p> <p>As indicated above, a number of SEC financial responsibility rules provide for the protection of customer funds and assets, including the Customer Protection Rule, the Hypothecation Rules, and the Quarterly Count Rule.</p> <p>The Customer Protection Rule requires a broker-dealer to segregate customer securities and cash from the firm's proprietary business activities. The Rule requires that every BD obtain and maintain possession or control of customer fully paid and excess margin securities, which means that it must hold them itself, or as is more common, hold them in a satisfactory location. This Rule also requires that a broker-dealer maintain a reserve account that contains (at least) the net dollar amount of cash the broker-dealer owes to its customers (in accordance with a prescribed formula).</p> <p>The Hypothecation Rules prohibit a broker-dealer from hypothecating customers' fully paid and excess margin securities.</p> <p>The 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.</p> <p>As described in Principle 30, new rules effective in 2014 require the audit report to be accompanied by a separate compliance report through which the auditor must evaluate the BD's compliance with its financial responsibility rules (including the net capital and customer protection rules).</p> <p>The regime for IAs that "have custody" of customer funds and assets is described under Principle 29.</p> |
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| | <p><i>Investor complaints</i></p> <p>Exchange Act Rule 17a-3(a)(18) requires BDs to maintain:</p> <p>A record for each written customer complaint received regarding an associated person, including the disposition of the complaint; and</p> <p>A record indicating that each customer has been provided with a notice with the address and telephone number to which complaints may be directed.</p> <p>In addition, SRO rules require BDs to document and respond to all customer complaints. Pursuant to SRO rules, BDs must report to the SROs specified events related to customer complaints, as well as statistical and summary information on customer complaints. SROs' arbitration rules are designed to effectively facilitate the resolution of disputes involving members, associated persons of members, and customers. Today, substantially all disputes are heard in arbitration, and the vast majority of brokerage-related arbitration claims are handled through the forum of one SRO, FINRA.</p> <p>For IAs, dissatisfied clients can sue under state law, and Section 215 of the Advisers Act provides a client with a limited private right of action for contracts made in violation of the Advisers Act, to void the contract or for restitution.</p> <p>Client information, know your client and suitability rules</p> <p><i>Client identity</i></p> <p>Client identity requirements are established for financial institutions by the BSA (administered by FinCEN) and elaborated by provisions of the PATRIOT Act. The PATRIOT Act requires BDs to establish a written customer identification program (CIP) with procedures for, among other things, obtaining and retaining customer identifying information and verifying customer identity.</p> <p>SROs also have rules dealing with AML compliance and customer account information.</p> <p>IAs must conduct financial transactions for their clients through financial institutions that are subject to BSA requirements, including customer identification requirements.</p> <p><i>Know your customer and suitability</i></p> <p>Under SEC Rules, BDs must obtain and retain certain information regarding customers that open accounts (including the beneficial owners of accounts). Information required includes the customer's employment status, net worth, annual income, and investment objectives. Firms are required to update this customer account record information at least once every three years.</p> <p>BDs 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 anti-fraud provisions of the federal securities laws.</p> <p>IAs 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 reasonable determination that the investment advice provided is suitable for the client based on the client's financial situation and investment objectives.</p> <p><i>Records</i></p> <p>SEC rules make detailed provisions for the creation and retention by BDs of books and records, including for example detailed records about all purchases and sales of securities.</p> |
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The length of time a BD must preserve records depends on the type of record (for example, 6 years for records of securities transactions; 3 years for trade confirmations).

The Advisers Act imposes extensive recordkeeping obligations on IAs, SEC Advisers Act Rule 204-2 requires an adviser to maintain business accounting records as well as records that relate to the fiduciary nature of its business. Additional records must be maintained in certain circumstances (for example 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.

Disclosure to clients

Under the anti-fraud provisions, a BD's duty to disclose material information to its customer is based upon the scope of the relationship with the customer. For transaction only accounts the material information the BD is required to disclose to its customer is limited to the details of the transaction. When recommending a security, a broker-dealer may be liable if it does not give honest and complete information. A broker-dealer also may be liable if it does not disclose material adverse facts of which it is aware.

For certain types of transactions, the legislation and SRO rules require disclosure documents to be given to the client, sometimes including mandated forms of disclosure. Examples include disclosures relating to penny stocks, credit terms in margin transactions, day trading risk disclosures, and disclosure about options and securities futures. A BD participating in a securities distribution registered under the Securities Act must deliver a preliminary prospectus to the client.

For BDs, written contracts are required for certain types of accounts (such as margin accounts, options accounts and discretionary accounts). In practice, most broker-dealers have a customer sign a customer agreement, although they are not required to do so.

The investment advisory contract forms the basis for the relationship between the investment adviser and its clients. Section 205 of the Advisers Act and related rules contain a number of provisions relating to items required to be included or prohibited from inclusion in an investment advisory contract.

Registration requirements under the Advisers Act require IAs to provide to their clients (and prospective clients) disclosure documents that are written in a plain English standardized format and provide meaningful, current disclosure of the business practices, conflicts of interest and background of the investment adviser and its advisory personnel.

Reports to clients

A BD is required to send its customers written trade confirmations, account statements, and other reports disclosing activities and transactions it has taken on the customer's behalf. SRO rules require that a broker-dealer send each customer an account statement at least quarterly showing the client's security positions and account balances. The industry practice is to send monthly account statements to customers with activity in their accounts during that month.

The Advisers Act generally does not require an investment adviser to send account statements to its clients. An investment adviser may use a BD to effect trades and the BD would be responsible for providing these documents. However, many IAs do send monthly or quarterly account statements to their clients. IAs are not required to report performance, but it is market practice to do so. This reporting is subject to the antifraud provisions.

Advisers Act Rule 206(4)-2 requires an investment adviser that has custody of client assets to have a reasonable belief, after due inquiry, that the qualified custodian that maintains the

client assets sends 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, and all debits, credits, and transactions in the client's account during the period.

Information about remuneration

FINRA rules require BDs to provide customers with adequate notice prior to their implementation or change of a service fee. BDs should provide written notice to customers of all service charges when accounts are opened, and at least 30 days prior to the implementation or change of any service charge.

Investment adviser compensation arrangements are required to be disclosed extensively in Form ADV. Part 1A of Form ADV requires IAs to disclose the nature of their compensation arrangements. Part 2A of Form ADV requires additional disclosures about how an adviser is compensated for its services.

Supervision

Broker-dealers

SROs have front line responsibility for overseeing BDs' compliance with federal securities laws and SRO rules. BDs that are members of multiple exchanges have a single DEA, which is the SRO that is primarily responsible for the firms' financial and operational regulation. In practice, many SROs have entered into an agreement with FINRA under Exchange Act Rule 17d-2 to allocate DEA responsibility to FINRA, and FINRA is the SRO responsible for examinations of almost all 4,400 BDs.

FINRA's member regulation program is risk-based with regard to both the frequency of examinations and their scope. Frequency is dictated by the impact of the firm as measured by variables such as employees, branch offices, and revenue as well as the risks presented by the firm's business lines and activities taking into account factors such as the registered representatives the firm employs, the products it sells and the customers it does business with. There are four levels of impact against which a firm is measured (1-4) and five levels of risk (A-E). From a risk perspective, the highest risk firms categorized as A or B risk are examined annually; C firms on a 2-year cycle; D firms on a 3-year cycle; and E firms on a 4-year cycle. Additionally, all impact 1 firms, which are typically the largest carrying and clearing firms, are reviewed annually.

FINRA's Member Regulation Department conducts routine cycle examinations and for cause examinations. The Member Regulation Department consists of approximately 1,100 staff, including over 800 staff in the District Offices, over 200 staff in the Risk Oversight and Operational Regulation Group (ROOR), and over 80 staff in its Shared Services Department. As part of the routine cycle examinations FINRA develops a list of priorities which is shared ex-ante with the SEC in order to obtain its feedback.

Cycle examinations are conducted in the District Office Program and by the Risk Oversight and Operational Regulation Group (ROOR). The District Offices examine for business conduct risk at all member firms and financial and operational risk at primarily introducing firms. ROOR examines for financial and operational risk at the largest carrying and clearing broker-dealers (190 firms) and their affiliates. FINRA carries out about 1,700 cycle examinations each year, and about 3,000 for cause examinations. Cause matters are typically triggered by customer complaints, terminations for cause, regulatory tips, arbitrations, litigation, referrals from other regulators and other sources, and sweep examinations. Some 8 to 10 percent of FINRA examinations result in formal investigations and disciplinary action.

The Market Regulation Department's Trading and Financial Compliance Examinations (TFCE)

group within FINRA's Market Regulation unit conducts cycle, cause, and sweep examinations of broker dealers in FINRA's capacity as an SRO/DEA. In addition, TFCE conducts cycle, cause, and sweep examinations pursuant to various agreements with exchange clients. TFCE is composed of four units: Equities, Options, Trading Examinations, and Financial Operations (FinOp). TFCE - Equities and Options conduct primarily cycle trading examinations on behalf of FINRA's exchange clients and FINRA. TFCE - FinOp conducts primarily cycle, financial, and operational examinations, including FinOp DEA examinations performed under an RSA. As an adjunct to the trading exam cycle program, TFCE's Trading Examinations Unit (TEU) conducts primarily equities and options cause and sweep examinations. Cause and sweep examinations may be initiated and/or involve a review of: issues identified during a cycle examination or surveillance review; issues raised in a complaint or referral; compliance with a new rule or regulatory requirement; FINRA management or RSA exchange client input; or the industry's response to an emerging regulatory issue

In addition, a separate department of FINRA, consisting of 65 people, reviews promotional material relating to BDs' marketing of their services and compliance with SEC rules relating to product distribution by BDs. Some 100,000 filings are reviewed each year, 85 percent of which are from continuously offered mutual funds.

As well as having oversight of FINRA's supervision of BDs, the SEC also conducts direct examinations of BDs. The SEC has a dedicated team of 300 staff for BD examinations.

OCIE has in place a program of examinations that is based on national priorities decided on an annual basis. The process of setting up these priorities involves a dialogue between OCIE and other divisions of the SEC, as well as feedback from FINRA and the SEC Commissioners. Last year the SEC published for the first time its annual priorities for the examination program. According to OCIE staff, the SEC is using publication as a way to affect firm behavior (as once an issue is highlighted as a priority, firms start analyzing their own compliance with these priorities). This list of priorities is used by Regional and Home Office examination staff to help plan examinations for the upcoming year. In some cases, examinations are selected solely based on a priority and in other cases, a priority is a focus area within an examination. Sometimes, in the case of a tip, complaint or referral for example, an examination may focus on a high risk investor protection area that is not necessarily addressed in the list of priorities for the year however conducting an examination in these cases would be consistent with a risk-based approach. Regional budgets also take into account the need to leave room for the regions to include also topics that are of concern for the particular region.

OCIE uses a risk-based approach for selecting which firms to examine and draws on a variety of data sources, including registrants' reports, FINRA's reports and TCRs, supported by technology. For each BD in addition to the national priorities, the examination would focus on the specific areas that pose the highest risk.

Important examination initiatives for 2014 have involved cybersecurity; sales practices and fraud; retirement issues, AML and market access rule.

The SEC carried out 443 direct examinations of BDs in FY 2012; 438 in FY 2013; and 493 in FY 2014.

In addition to its examination program, OCIE has recently instituted a large firm monitoring program (LFM). As described in Principle 30, this program focuses on large and complex firms that could pose significant risk to the markets and to their customers due to their size, complexity, and connectivity with other large firms and financial institutions. This group includes the largest BDs. LFM conducts its monitoring primarily by meeting periodically with firms' risk and control functions, including: market risk; credit risk; treasury; finance; internal

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| | <p>audit; operations; operational risk; legal; compliance (including AML); and new products. Using the information gathered at these meetings, LFM provides information to other OCIE staff regarding individual firm and cross firm risks and developments for use in examination planning. The LFM team also supports OCIE’s enterprise risk management reviews, which include meetings between senior regulators and firms’ senior management, board members, and heads of control functions. Eleven examinations of large firms were carried out in each of 2012 and 2013.</p> <p>The SEC copies FINRA on all deficiency letters it sends to BDs as a result of its examinations, and receives copies of all FINRA examination reports.</p> <p><i>Investment advisers</i></p> <p>The SEC is responsible for the supervision of IAs and no SROs are involved. It has a dedicated team of 450 staff for the examination of IAs.</p> <p>The IA population is large (some 11,500 registered IAs) and diverse. It includes IAs who are the operators of mutual funds (see further under Principle 24), IAs who are also BDs, managers of private client discretionary accounts and other asset managers.</p> <p>OCIE uses a risk based approach to the supervision of IAs. It uses information contained in IAs’ Form ADV and other information filed with the SEC, as well as other data sources including TCRs to select firms to be inspected. As described under Principle 24, OCIE’s ORAS group leverages data analytics and other available information to identify firms that may pose higher risk (for example because of potential compliance stress, disclosures, previous examinations, or complaints) This information, and on-the-ground information from regional offices, is used to identify firms to be examined. As with BDs, there are national priorities for IAs. Examinations of IAs focus on the national priorities, but also include firm-specific issues. For 2014, focus areas in the national program included: safety of assets and custody; conflicts of interest inherent in some IA business models; marketing/performance; wrap fee programs; quantitative trading models; and payments for distribution.</p> <p>OCIE conducted 1,004 examinations of IAs in FY 2011; 974 in FY 2012; 964 in FY 2013 and 1,150 in 2014. For FY 2014, these figures include approximately 170 examinations of the over 1,600 IAs that are mutual fund operators.</p> <p>The number of examinations for 2014 represents roughly 10 percent of the IA population and 30 percent of AUM. The SEC staff acknowledges that this coverage is limited and has meant in practice that firms may go without inspection for extended periods of time. On the other hand, a new population of IAs is now subject to registration, putting further pressure on its resources. To address these challenges the SEC included in its 2014 priorities focused, risk-based examinations of IAs that have been registered for more than three years but have not yet been examined.</p> <p>The SEC is also continuing an initiative to examine a significant percentage of the advisers registered since the effective date of the Dodd-Frank Act. The five key focus areas of these examinations are marketing, portfolio management, conflicts of interest, safety of client assets, and valuation. The vast majority of these new registrants are advisers to HFs and private equity funds that were not registered or regulated by the SEC prior to the Dodd-Frank Act, and have never been examined by the SEC.</p> |
| <p>Assessment</p> | <p>Broadly Implemented</p> |
| <p>Comments</p> | <p>The issue of concern under this Principle is the supervision of IAs, and in particular their coverage by examinations (see also under Principle 24 regarding IAs that operate CIS).</p> |

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| | <p>Securities and derivatives intermediaries other than IAs are covered by the examination programs of the SROs, notably FINRA and the NFA, and also by some direct examinations by the SEC and the CFTC. For these intermediaries, especially the larger BDs and FCMs, examination coverage is adequate and examinations appear to be well focused and thorough, and there is good evidence of appropriate follow up by the SROs and the regulators. The SROs appear well resourced (for example, the NFA’s budget and size have doubled in the last 2-3 years) and have well qualified and experienced staff.</p> <p>For IAs, the situation is somewhat different. The population is large, and has changed in composition since the Dodd-Frank Act, with a larger proportion of smaller advisers now subject to state jurisdiction and HF and private equity advisers being brought under the SEC’s jurisdiction. In fiscal year 2014, 11,523 regulated IAs had \$63.1 trillion in AUM; this is in contrast with, for example, fiscal year 2011 where 11,728 regulated advisers had \$43.5 trillion in AUM.</p> <p>SEC resources to conduct examinations are limited. On average, only a little over 10 percent of the population is covered each year. The SEC is actively engaged in ensuring that priority is given to the new adviser population and to advisers that have not been previously examined. It also employs sophisticated systems to identify firms that are higher risk. Nonetheless, senior SEC officials acknowledge that in this area they would like to do more. Given that some \$63 trillion of assets are managed by this part of the industry (of which about \$17 trillion is in mutual funds) a more active presence in the market through increased on-site examinations is warranted.</p> <p>The assessors acknowledge that the definition of what constitutes an examination is narrow and applies only where a formal request for documents is made; and that a focus only on the number of examinations does not reflect other supervisory interactions with the IA population, such as informal requests for information or other forms of monitoring. Nevertheless, examinations are a critical component of effective supervision, and the current relatively low coverage of the IA population indicates the need for more resources to be devoted to this activity.</p> <p>Although it has not affected the grade for this Principle, the assessors note the absence of a suitability requirement for futures intermediaries, especially for retail customers. This contrasts with the positive obligation of securities intermediaries to ensure that advice and recommendations are suitable for the client. The NFA points out that its know-your-customer rule provides comparable protection to that afforded by the suitability rule of securities markets; that in the securities industry, investors can purchase a wide variety of securities with varying degrees of risk potential that serve very different investment objectives; and that in contrast, all futures and swaps contracts are highly volatile and risky instruments. Therefore the NFA has considered that “it makes no sense to say that a customer is suitable to invest in heating oil futures but not in Treasury note futures. Instead, the determination has to be made on a customer by customer basis rather than a contract by contract or transaction by transaction basis”. This appears to meet the requirement of Key Question 12 of the IOSCO Assessment Methodology.</p> |
| <p>Principle 32.</p> | <p>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.</p> |
| <p>Description</p> | <p><u>CFTC</u></p> <p>Plans for dealing with failure of regulated firm</p> <p>The CFTC has a market disruption contingency plan which sets out a framework to deal with specific types of events, from a capital incident, liquidity incident, natural event (such as a</p> |

hurricane) to the failure of an intermediary. For each type of event, the plan provides guidance on the type of information needed, the type of issues that would need to be escalated and the divisions that would need to be involved.

Early warning

A variety of methods are available to the CFTC to enable it to ascertain when an FCM may be experiencing financial distress, including the obligations of FCMs to notify the CFTC when early warning capital thresholds are met. The CFTC may also receive notification from an FCM's DSRO or a DCO that the FCM is not meeting its financial obligations, or may soon be unable to meet them.

Regulator's powers to intervene

If the CFTC determines that an FCM is likely to fail, then it will attempt:

To cause the transfer of customer accounts. Under CFTC Regulation 1.17(a)(4), if an FCM holds less capital than the amount specified in its minimum capital requirement, it generally must transfer all customer accounts and immediately cease conducting business as an FCM, until the FCM is able to demonstrate compliance with its minimum capital requirement; and

To determine the effects that such failure would have on the counterparties of the FCM, as well as on the futures markets. In most instances, if the FCM is clearing transactions through a DCO, the failure would cause minimal disruption to counterparties and the futures markets.

If a DCO currently cannot collect payments from a member, or if a DCO believes that it will shortly be unable to collect such payments, the DCO will declare the member to be in default. The rules of the DCO govern the management of such default. Usually, such rules would permit the DCO to:

Liquidate or transfer positions carried by the defaulting member;

Access all property held in the proprietary accounts of the defaulting member;

Access all property held in the customer account of the defaulting member, if the default of the member to the DCO resulted from the default of a customer to the member; and

Access any amounts that the defaulting member had contributed to the guarantee fund.

Bankruptcy

Under section 6(c) of the CEA, the CFTC has the authority to request the appointment of a monitor, receiver, curator or other administrator for an FCM that the CFTC has reason to believe is violating or has violated any provision in the CEA and the CFTC Regulations.

The CEA and CFTC regulations, in conjunction with the Bankruptcy Code, provide a clear framework for the CFTC and the insolvency officer (trustee) to follow in managing the failure of an FCM. Part 190 of the CFTC Regulations and Subchapter IV of Chapter 7 of the Bankruptcy Code deal specifically with the bankruptcy of commodity brokers, including FCMs.

If an FCM becomes the subject of bankruptcy proceedings, Subchapter IV of Chapter 7 of the Bankruptcy Code and CFTC Regulation Part 190 apply and allow the prompt and effective transfer of customer positions and associated collateral to a financially solvent transferee FCM, or the prompt return of customer property.

For FCMs that are members of SIPC because they are also BDs, bankruptcy would be conducted under SIPA procedures as described below.

Investor compensation

There is no insurance scheme or guarantee fund for customer recompense in the event of intermediary failure when there is a shortfall in customer property, although there are significant regulatory requirements to keep customer property segregated, identify a shortfall quickly, transfer business, and provide priority claims to customer property under bankruptcy.

SEC**Plans for dealing with failure of regulated firm**

If the SEC staff became aware of a BD approaching financial difficulty, they would assemble all available information, contact the BD's DEA and, if the firm is an introducing firm, its clearing firm. In these circumstances, the SEC must also contact SIPC to inform it of the situation so that SIPC can assess whether it should initiate a liquidation proceeding. Once SIPC determines that a member BD has failed or is in danger of failing to meet its obligations to customers and the firm is either insolvent or not in compliance with the SEC's financial responsibility rules, SIPC may file an application in court to initiate a proceeding to liquidate the BD. If SIPC's application is granted, the court appoints a trustee for the BD. If SIPC elects not to commit its funds, the SEC may petition a U.S. district court to order SIPC to act.

SBSDs that are not BDs are subject to the stockholder provisions of the Bankruptcy Code instead of SIPA's liquidation provisions. SIPC is not involved in liquidations under the Bankruptcy Code.

Early warning systems

BDs are subject to obligations under the early warning rule (described under Principle 30) to provide notice promptly (but within 24 hours) to the SEC, and under SRO rules to its DEA, when reporting trigger levels are reached. If a BD fails to make a required deposit in its reserve bank account, it must immediately notify the SEC and its DEA.

Regulator's powers to intervene

The SEC, SIPC, and a firm's DEA have the authority to restrict the activities of a BD that is in or approaching financial distress. The Exchange Act and related regulations prohibit a BD from continuing to conduct a securities business if the firm does not have sufficient net capital. A BD's stockholders and partners are not allowed to withdraw equity capital from the BD if, among other things, the BD's net capital falls below 120 percent of the minimum net capital requirement. The SEC has also approved DEA rules that allow the DEA to restrict a broker-dealer's activities if it is in or approaching financial difficulty, such as limits on business expansions; and rules requiring a BD in or nearing financial difficulty to actively reduce its business.

In a SIPC supervised liquidation proceeding, the trustee works to restore securities and cash to customers as soon as possible. The trustee and its staff close the BD's offices and take control of its books and records. In a failed BD with accurate records, the trustee and SIPC may arrange to have some or all customer accounts transferred to another broker-dealer. Customers whose accounts are transferred are notified promptly of the move.

Use of powers

The SEC has used its power to take action in response to firm failures on numerous occasions, including in the case of failures of major BDs during the financial crisis.

Investor compensation

Under a SIPA liquidation, customers of a failed broker-dealer receive all securities (such as

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| | <p>stocks and bonds) that are already registered in their names or are in the process of being registered. After this first step, the firm’s remaining customer assets are 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 repay customers fully, the SIPC Fund (see below) is available to supplement the distribution, up to a ceiling of \$500,000 per customer, including a maximum of \$250,000 for cash claims (increased from \$100,000 by the Dodd-Frank Act). These payments can be made at any time during the liquidation process and in practice have been made at an early stage, with SIPC then having a claim on the proceeds of the liquidation.</p> <p>SIPC maintains the SIPC Fund, which constitutes an insurance program for member BDs’ customers. Target for this Fund is \$2.5 billion and the current level is around \$2.1 billion. The Fund is funded by an annual assessment from SIPC’s members, which is deposited in the SIPC Fund to reach the fund target. Assessments in 2013 were approximately \$418 million. If the need arises, the SEC has authority to lend SIPC up to \$2.5 billion that the SEC would, in turn, borrow from the Treasury.</p> <p>Communication and cooperation with other regulators</p> <p>The board of SIPC is structured under SIPA to ensure domestic cooperation. SIPA requires that one director be a Treasury employee appointed by the Secretary of the Treasury and one director be a Federal Reserve Board employee appointed by the Federal Reserve Board. The President appoints the remaining five directors, with three members coming from the securities industry and two members coming from the general public with no association with the securities industry for the previous two years.</p> <p>The SEC works closely with SIPC, and is permitted to participate as a party in any SIPC proceedings. The SEC also works with domestic and foreign regulators on broker-dealer liquidations and has processes in place for quickly contacting other regulators’ key decision makers.</p> <p>Title II of the Dodd-Frank Act contemplates expanding cooperation between domestic regulators by providing an alternative insolvency regime for the orderly liquidation of large financial companies, including some large BDs. In the case of a BD determined to be systemically important under section 203 of the Dodd-Frank Act, the Federal Reserve Board and the SEC, in consultation with the FDIC, are authorized to issue a written orderly liquidation recommendation to the Secretary of the Treasury. The determination could be made at the point the firm hit difficulties, and is not limited to those the FSOC had previously designated as systemically important. The SEC and the FDIC, in consultation with SIPC, are working together to propose rules that further define this process.</p> |
| Assessment | Fully Implemented |
| Comments | |
| Principles for the Secondary Markets | |
| Principle 33. | The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight. |
| Description | <p>Trading systems requiring authorization</p> <p><i>Exchanges</i></p> <p>The definition of an exchange is in the Exchange Act. An exchange is 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</p> |

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 marketplace and the market facilities maintained by such exchange (Section 3(a)(1) Exchange Act).

Rule 3b-16 defines whether a system would qualify as an exchange. A system meets the Rule's criteria, if it brings together the orders for securities of multiple buyers and sellers and uses established, non-discretionary methods under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade. A system that meets these criteria must either register with the SEC as a national securities exchange or seek an appropriate exemption. One frequently used exemption is for alternative trading systems (see below). A system could also or be exempted based on limited volume; no such exemptions currently apply.

Order routing is specifically excluded from the definition of an exchange, as are single-dealer systems that incidentally match undisplayed orders. Market makers may also operate systems that match customer orders under certain conditions without being considered to be exchanges. According to the SEC staff, such crossing of customer orders is however not done in a systematic manner. The SEC continuously monitors the broker-to-broker bilateral networks to assess whether they may develop towards multilateral systems.

A DCM may register by notice filing with the SEC as a national securities exchange for the purposes of listing and trading security futures products. Such notice registration is effective immediately. Currently there is only one exchange that trades both commodity and security futures: OneChicago, LLC.

Alternative trading systems

Rule 3a1-1(a)(2) under the Exchange Act provides that a system will be exempt from the statutory definition of an exchange, if it registers as a broker-dealer and complies with Regulation ATS. An ATS trading solely in government securities and certain other related instruments is not required to comply with Regulation ATS. Rule 300(a) of Regulation ATS defines an ATS as a system that meets the criteria of Rule 3b-16. Similar to an exchange, an ATS is required to be a multilateral system. The Regulation ATS definition implies that the BD itself would be an ATS. However, in practice a BD operates an ATS that is a system rather than a separate legal entity. In many cases, BDs trade on own account in their ATS or their affiliated BD conducts such trading. This is permitted under Regulation ATS, subject to compliance with the relevant conflicts of interest requirements on BDs (see Principles 8 and 31). Contrary to a national securities exchange, an ATS is not an SRO and does not set rules governing its subscribers' conduct other than their trading conduct on the ATS itself, or discipline its subscribers other than by exclusion from trading.

As of the end of December 2014, there were 88 ATSs that had an active Form ATS on file with the SEC. At the same time, information published by FINRA included 39 equity ATSs. The other ATSs organized trading in fixed income instruments. There is no public, consolidated information available on the trading models and subscribers of these ATSs and the specific instruments they organize trading in. Varying levels of such information is publicly available on the ATSs' websites. The large majority of ATSs are dark pool ATSs that provide no pre-trade transparency, with a few equity ATSs operating as lit Electronic Communication Networks (ECNs). The assessment of this Principle focuses on the equity ATSs, because they operate equity trading systems similar to those of national securities exchanges. In contrast, trading in fixed income instruments takes place primarily OTC.

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| | <p><i>Designated contract markets</i></p> <p>Any market that seeks to provide a trading facility to trade futures, options on futures or options on commodities must apply to the CFTC to become a DCM, unless an exemption or exclusion applies. Currently there are no exemptions; the prior exemptions on exempt commercial markets and exempt boards of trade were removed by the Dodd-Frank Act.</p> <p><i>Swap execution facilities and security-based swap execution facilities</i></p> <p>A swap execution facility is a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system. Any such multilateral trading facility must register with the CFTC as either a DCM or SEF (Section 5h(a)(1) CEA). SEF registration is only available for swap trading facilities that limit participation to ECPs.</p> <p>The definition of security-based swap execution facility (SB SEF) in Section 3(a)(77) of the Exchange Act is the same as the one for a SEF in the CEA. SB SEFs will have to register with the SEC (Section 3D Exchange Act) by the date to be specified in the relevant SEC final rules. In the interim, SB SEFs are permitted to operate without registering.</p> <p><i>Foreign boards of trade</i></p> <p>CFTC Regulation 48.3 requires a foreign board of trade (FBOT) that provides its members or other participants located in the U.S. with direct access to its electronic trading and order matching system to register with the CFTC.</p> <p>General registration requirements</p> <p><i>National securities exchanges</i></p> <p>Section 6(b) of the Exchange Act includes the criteria that an applicant has to fulfill in order to be registered as a national securities exchange. They include (see also Principle 9):</p> <ul style="list-style-type: none"> • Having the organization and capacity to enforce compliance by its members and their associated persons with the Exchange Act, the SEC rules and regulations, and the exchange rules; • Enabling any registered broker or dealer to become an exchange member; • Assuring a fair representation of its members in the selection of the exchange's directors and providing that one or more directors is a representative of issuers and investors; • Providing for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities; and • Providing for appropriate and fair procedures for disciplining its members for law or rule violations. <p>An applicant must also demonstrate its ability to operate as part of the National Market System (Section 11A Exchange Act). In particular, it must satisfy the following Regulation NMS requirements:</p> <p>The Order Protection Rule, which requires exchanges and other trading centers, including ATSS,¹⁴ to establish policies and procedures reasonably designed to prevent the execution of</p> |
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¹⁴ This requirement also applies to exchange specialists, OTC market makers or any broker-dealer that executes orders internally by trading as principal or crossing orders as agent.

trades at prices inferior to automated quotations that are the best quote of another exchange or another automated trading center, subject to applicable exceptions;

The Access Rule, which requires fair and non-discriminatory access to quotations, establishes a limit on access fees to harmonize the pricing of quotations across different exchanges and other trading centers, and requires rules addressing locked and crossed markets; and

The Sub-Penny Rule, which prohibits market participants from accepting, ranking, or displaying orders for securities priced \$1.00 or more in increments smaller than a penny.

Section 6(a) of the Exchange Act includes the general requirements for the content of an application to register as a national securities exchange. The application must include the rules of the exchange and the information prescribed in SEC Rule 6a-1 and Form 1. This covers, among other issues, the following:

- Information about the exchange operators;
- The manner of operation of the trading system, including the means of access; the procedures for entering and displaying quotes; procedures of executing, reporting, clearing and settling transactions; and fees;
- Lists of officers, governors and members of all standing committees;
- For exchanges with one or more owners, shareholders or partners that are not also members of the exchange, lists of shareholders that own 5 percent or more of a class of voting shares;
- Criteria for exchange membership and the conditions and process for suspension or termination of membership;
- A list of all members; and
- A schedule of all securities listed or traded on the exchange.

The SEC must publish notice of the application for public comment and, generally within 90 days of publication, by order grant the registration or institute proceedings to determine whether the application should be denied. The SEC must grant such registration, if it finds that the relevant requirements are satisfied and deny a registration if it cannot make this finding. Once registered, a national securities exchange becomes an SRO. (Section 19(a) Exchange Act).

Alternative trading systems

To comply with Regulation ATS, a firm needs to register as a BD and become a member of an SRO (in practice FINRA). A BD wishing to operate an ATS must file a notice (an Initial Operation Report) with the SEC on Form ATS at least 20 days prior to commencing operation as an ATS. This requires providing certain information on the ATS, including:

A description of the class of subscribers and of any differences in access to services offered by the ATS to different groups or classes of subscribers;

The name of any entity, other than the BD operating the ATS, that will be involved in the operation of the ATS, including the execution, trading, clearing and settling of transactions;

The manner of operation of the ATS, procedures governing entry of orders, means of access, and procedures governing execution, reporting, clearing and settlement of transactions effected through the ATS;

Procedures for ensuring subscriber compliance with system guidelines;

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| | <p>A copy of the ATS' subscriber manual and any other materials provided to subscribers; and</p> <p>A brief description of the ATS's procedures for reviewing system capacity, security, and contingency planning procedures.</p> <p>The responsibility for the review of Forms ATS and the continuous monitoring of ATSs lies with the SEC's Trading and Markets Division's Office of Market Supervision. While the SEC does not approve Forms ATS, Office of Market Supervision attorneys review them for compliance with the Form ATS instructions as well as potential inconsistencies with Regulation ATS and applicable federal securities laws. A form that complies with the requirements for the Form ATS will be considered complete and deemed to be filed with the SEC as of the day it was received. If a form does not meet the requirements, it is considered incomplete, deemed not filed, and must be resubmitted to the SEC. In such cases, the ATS would not be in compliance with Regulation ATS.</p> <p>Forms ATS are not required to be published; however a few BDs have voluntarily published them. In addition, the SEC Chair has asked SEC staff to prepare a recommendation to the Commission to expand the information about ATS operations submitted to the SEC and to make the information available to the public.</p> <p>In addition to the above process with the SEC, a registered BD that is already a FINRA member and plans to operate an ATS must file an application for approval of a change in its business operations under FINRA Rule 1017. The application is made electronically on the Continuing Membership Application Form. The form is reviewed by FINRA's Department of Member Regulation that works closely with FINRA's Market Regulation Group in case of a change related to operating an ATS. In the connection of reviewing such a change, FINRA staff consider the ability of the BD to comply with, among other matters, the Regulation ATS requirements. They also evaluate the applicant's business plan, the manner in which orders interact in the ATS, and the ATS' connectivity arrangements. As part of this review, FINRA gets a copy of the Form ATS. The Department of Member Regulation generally has to make a decision on the application within 45-60 days of receiving the application, depending on whether it requires the applicant to attend an interview or provide additional information. A member may not implement the change in its business operations until the conclusion of the FINRA proceeding.</p> <p>Regulation ATS includes additional requirements for certain types of ATS. The order display and execution access requirements under Rule 301(b)(3) apply to ATSs that display their orders to at least one person other than an employee and whose average daily trading volume in a particular NMS stock was at least five percent of the stock's average daily trading volume (measured in shares) during at least four of the preceding six months. The fair access requirement under Rule 301(b)(5) of Regulation ATS applies to an ATS, including a dark pool ATS, when its trading volume reaches or exceeds the five percent threshold, unless an exception stipulated in Rule 301(b)(5)(iii) applies. According to current requirements, an ATS with an at least 20 percent market share must also follow certain procedures to ensure the capacity, integrity and security of its trading system (Rule 301(b)(6)).¹⁵</p> |
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¹⁵ This threshold has been lowered and amended to be calculated on the basis of average daily dollar volume in Regulation Systems Compliance and Integrity (Regulation SCI) (see the section on technical system standards and procedures below for further details). The new requirements will apply to equity ATSs with at least one percent market share of the average daily dollar volume in all NMS stocks, or five percent market share in any single NMS stock together with 0.25 percent market share in all NMS stocks.

DCMs

To be designated and maintain designation as a contract market, a board of trade must comply with the 23 Core Principles set forth in Section 5(d) of the CEA. Applicants for designation must submit a Form DCM and follow the application procedures set forth in CFTC Regulation 38.3. The application must include information sufficient to demonstrate compliance with the CEA Core Principles, including a copy of all rules, technical manuals, other guides or instructions for users of, or participants in, the market; a description of the trading system, algorithms, security and access limitation procedures; and copies of any agreements that enable or empower the applicant to comply with the Core Principles.

The CFTC reviews new applications pursuant to the 180-day time frame and procedures specified in Section 6(a) of the CEA. The CFTC may approve or deny the application or, if deemed appropriate, designate the applicant as a contract market subject to conditions.

SEFs and SB SEFs

To be registered and maintain registration, a SEF must comply on a continuing basis with the 15 Core Principles stipulated in Section 5h(f) of the CEA. CFTC Regulation 37.3 sets forth the requirements and procedures for registration as a SEF. The application must include information sufficient to demonstrate compliance with the CEA Core Principles. The CFTC issues an order granting registration upon its determination that the applicant has demonstrated compliance with the CEA and regulations applicable to SEFs. If appropriate, the registration may be granted subject to conditions.

Similarly, SB SEFs will have to comply with 14 Core Principles and any other rule that the SEC may ultimately adopt. The SEC has proposed rules on the registration process for SB SEFs and for compliance with the 14 Core Principles.

FBOTs

Criteria, procedures and requirements for registration as an FBOT are set forth in Section 4(b) of the CEA and Part 48 of the CFTC's regulations. In determining whether to register an FBOT, the CFTC evaluates whether the FBOT's home regulatory authority oversees the FBOT in a manner that is comparable to the CFTC's oversight of DCMs. After registration, an FBOT is not subject to the CFTC's oversight, except in relation to trading in so called linked contracts (see Principle 36).

Prudential requirements and clearing and settlement arrangements*National securities exchanges*

National securities exchanges do not generally assume principal, settlement, guarantee or performance risk. Instead, the clearing and settlement of securities transactions occurs through registered CCPs and CSDs that operate separately from exchanges and are registered with the SEC as clearing agencies. The national securities exchanges' level of funding may differ depending on their business model, trading systems, regulatory responsibilities, and types of members.

ATS

Similar to any other BD, an ATS operator must have sufficient clearing capabilities in place by either becoming a member of a clearing agency, or by being affiliated with a member of a clearing agency through which the ATS can clear and settle trades. The BDs' capital requirements are discussed in Principle 30.

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| | <p><i>DCMs</i></p> <p>DCM Core Principle 21, Financial Resources, requires a DCM to have adequate financial, operational, and managerial resources to discharge its responsibilities. The financial resources are considered to be adequate, if they exceed the DCM's operating costs for a one year period, calculated on a rolling basis.</p> <p>DCM Core Principle 11 requires a DCM to establish and enforce rules and procedures for ensuring the financial integrity of transactions entered into on or through the facilities of the contract market (including the clearing and settlement of transactions with a registered DCO).</p> <p><i>SEFs and SB SEFs</i></p> <p>SEFs are subject to the same financial resources requirements as DCMs (SEF Core Principle 13). Similarly, transactions executed on or through a SEF that are required to be cleared or that are voluntarily cleared have to be cleared through a DCO.</p> <p>Market surveillance, member supervision, dispute resolution and appeal procedures</p> <p><i>National securities exchanges</i></p> <p>The Exchange Act requires national securities exchanges to be able to enforce compliance by their members and persons associated with their members with the Exchange Act, the SEC rules and regulations, and their own rules. To register as an exchange requires submitting to the SEC information on all arrangements for monitoring, surveillance and supervision of the trading system and its participants. The SEC considers whether the applicant has adequate surveillance measures and sufficient resources, including staff expertise and capital, to monitor its markets. The SEC evaluates each applicant's ability to conduct member and market surveillance and to address any potential violations of the market's rules or the U.S. federal securities laws. All exchanges must tailor their surveillance functions to their markets' characteristics. If applicable, the SEC determines whether the applicant has made sufficient arrangements with reliable and capable third parties to implement systems that will meet the applicable statutory standards.</p> <p><i>ATS</i></p> <p>As noted above, ATS are not required to conduct market surveillance. ATSs are not SROs, but are required to be members of an SRO. Therefore, as BDs required to meet supervisory obligations under the SRO rules, ATSs have responsibility for monitoring trading activity that occurs on or through their systems. In addition, as discussed in Principle 9, SROs have an obligation to enforce compliance by their members with the federal securities laws and the SRO rules.</p> <p><i>DCMs</i></p> <p>DCM Core Principle 2 requires a DCM to establish, monitor and enforce compliance with rules prohibiting abusive trading practices and to have the capacity to detect, investigate and apply sanctions to any person that violates the rules of the DCM. The applicant must demonstrate the means to monitor trading conduct, to supervise the system, and to address disorderly trading conditions (CFTC Regulations 38.250 and 38.251).</p> <p>DCM Core Principle 12 requires a DCM to establish and enforce rules to protect markets and market participants from abusive practices and to promote fair and equitable trading on the DCM. CFTC's regulations require trade practice monitoring systems to monitor trading and supervise rule compliance by members; a market surveillance system to deter, detect and address manipulation; and a disciplinary process to address violations of exchange rules. A DCM must establish and maintain sufficient compliance staff and resources to conduct audit</p> |
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trail reviews, trade practice surveillance, market surveillance, and real-time market monitoring, and have the ability to address unusual market or trading events and to complete any investigations in a timely manner (CFTC Regulation 38.155(a)).

DCM Core Principle 4 requires a DCM to have the capacity and responsibility to prevent manipulation, price distortion, and disruptions of the delivery or cash settlement process through market surveillance, compliance, and enforcement practices and procedures, including methods for conducting real-time monitoring of trading; and comprehensive and accurate trade reconstructions.

SEFs and SB SEFs

SEF Core Principle 2 requires SEFs to establish and enforce trading, trade processing, and participation rules that will deter abuses and have the capacity to detect, investigate, and enforce those rules, including means to provide market participants with impartial access to the market and to capture information that may be used in establishing whether rule violations have occurred. SEFs are required to establish a rule enforcement program for the monitoring, surveillance and supervision of the SEF and its market participants (CFTC Regulation 37.203). They also need to have disciplinary procedures and sanctions in place to enforce trading, trade processing, and participation rules that will deter abuses (CFTC Regulation 37.206).

SEF Core Principle 4 requires a SEF to monitor trading in swaps to prevent manipulation, price distortion, and disruptions of the delivery or cash settlement process through surveillance, compliance, and disciplinary practices and procedures, including methods for conducting real-time monitoring of trading and comprehensive and accurate trade reconstructions. A SEF must also establish and enforce rules governing trading procedures and trade processing. A SEF is also required to have access to sufficient information to assess whether trading in swaps listed on its market, in the index or instrument used as a reference price, or in the underlying commodity for its listed swaps is being used to affect prices on its market (CFTC Regulation 37.404(a)).

Similar requirements are expected to apply to SB SEFs.

Technical system standards and procedures

National securities exchanges and ATS

The SEC has issued two ARP statements that set forth its view that the SROs should voluntarily establish comprehensive planning and assessment programs to determine their systems' capacity and vulnerability. In ARP I, published in 1989, the SEC recommended that the SROs' programs should have three objectives: (i) establishing current and future capacity estimates; (ii) conducting periodic capacity stress tests; and (iii) obtaining 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, published in 1991, the SEC set forth its views on: (i) the nature of the reviews that the SROs are encouraged to obtain with respect to their automated trading and information dissemination systems; (ii) the contents of the SROs' annual reports on major systems changes and a process for provision of notifications of material systems changes; and (iii) notifications of significant systems problems.

As noted above, ATSS meeting or exceeding a 20 percent market share become subject to certain system related requirements, including the requirement to perform an independent review of their system controls according to established audit procedures and standards.

On November 19, 2014, the SEC adopted Regulation SCI to replace the ARP statements and

system related requirements in Regulation ATS applicable to certain equity ATSs. Among other things, Regulation SCI requires an SCI entity, which include national securities exchanges and ATSs trading certain equity securities above specified dollar volume thresholds (see footnote above), to:

- Establish, maintain, and enforce policies and procedures reasonably designed to ensure that its systems have adequate levels of capacity, integrity, resiliency, availability, and security;
- Establish, maintain, and enforce policies and procedures reasonably designed to ensure that its systems operate in compliance with the Exchange Act, the SEC 's rules and regulations under the Exchange Act, and the entity's rules and governing documents;
- Take timely corrective action in response to systems disruptions, systems compliance issues, and systems intrusions (together, SCI events);
- Notify the SEC on certain SCI events and material changes to its systems;
- Disseminate information to applicable members or participants about certain SCI events;
- Conduct an annual review of its compliance with Regulation SCI, submit a report of the annual review to its senior management, and provide the report of the annual review, along with any response by senior management, to the board of directors (or its equivalent) and the SEC;
- Designate certain members or participants to participate in the testing of its business continuity and disaster recovery plans at least once every 12 months, and coordinate the testing with other entities on an industry- or sector-wide basis; and
- Make, keep, and preserve records relating to its compliance with Regulation SCI.

Regulation SCI will become effective 60 days after publication in the Federal Register, with required compliance generally to begin nine months later, and required compliance with the business continuity and disaster recovery plan testing provision to begin an additional 12 months after that.

DCMs, SEFs and SB SEFs

DCM Core Principle 20 requires DCMs to establish and maintain a program of risk oversight to identify and minimize sources of operational risk through the development of appropriate controls and procedures and the development of automated systems that are reliable, secure, and have adequate scalable capacity; establish and maintain emergency procedures, backup facilities, and a plan for disaster recovery that allow for the timely recovery and resumption of operations and the fulfillment of the responsibilities and obligations of the DCM; and periodically conduct tests to verify that backup resources are sufficient to ensure continued order processing and trade matching, price reporting, market surveillance, and maintenance of a comprehensive and accurate audit trail.

The requirements on SEFs in SEF Core Principle 14 are identical to the above. The requirements planned to be applied to SB SEFs are similar.

Ability to deal with disorderly trading conditions

Cross-market trading halts for securities

In May 2012, the SEC approved a NMS Plan to Address Extraordinary Market Volatility (known as Limit-Up Limit-Down or LULD) proposed by the SROs that is intended to prevent erroneous trades and moderate volatility in the market for individual equity securities. The

LULD has been implemented on a pilot basis. It prevents trades in individual securities from occurring outside of a specified price band, which varies depending on the security and time of day. Trading pauses occur if the price moves to and remains outside of the band for a specified period. An individual stock enters a limit state if its price moves a certain percentage—generally 5, 10 or 20 percent—over a five minute period. If the market does not naturally exit the limit state within 15 seconds, there is a five minute trading pause, at the conclusion of which trading resumes under normal reopening procedures. SROs, ATs, and BDs executing internally must establish policies and procedures reasonably designed to prevent trades from occurring outside the applicable price band, to honor any trading pause, and to otherwise comply with the NMS Plan.

DCMs

CFTC Regulation 38.255 requires a DCM to establish and maintain risk control mechanisms to prevent and reduce the potential risk of price distortions and market disruptions, including, but not limited to, market restrictions that pause or halt trading in market conditions prescribed by the DCM. DCM Core Principle 6 requires the DCM, in consultation or cooperation with the CFTC, to adopt rules to provide for the exercise of emergency authority, as is necessary and appropriate, including the authority to liquidate or transfer open positions in any contract; to suspend or curtail trading in any contract; and to require market participants in any contract to meet special margin requirements.

SEFs

A SEF must have the authority to adjust trade prices or cancel trades when necessary to mitigate market disrupting events caused by malfunctions in its system(s) or platform(s) or errors in orders submitted by members and market participants (CFTC Regulation 37.203). CFTC Regulation 37.405 requires a SEF to establish and maintain risk control mechanisms to prevent and reduce the potential risk of market disruptions, including market restrictions that pause or halt trading under market conditions prescribed by the SEF. SEF Core Principle 8 also provides for the exercise of emergency authority, in consultation or cooperation with the CFTC, as is necessary and appropriate, including the authority to liquidate or transfer open positions in any swap or to suspend or curtail trading in a swap.

Record-keeping

National securities exchanges

Every exchange is required to make and keep for prescribed periods of time such records, furnish such copies thereof, and make and disseminate such reports as prescribed by the SEC in Rule 17a-1 (Section 17(a) Exchange Act).

ATS

An ATS is subject to certain reporting and record-keeping requirements set forth under Regulation ATS (including maintaining an audit trail of all orders and transactions entered into the system) as well as the record-keeping requirements of registered broker-dealers (see Principle 31).

DCMs

DCM Core Principle 10 requires a DCM to maintain rules and procedures to provide for the recording and safe storage of all identifying trade information in a manner that enables it to use the information to assist in the prevention of customer and market abuses and to provide evidence of any violations of its rules. These requirements are further specified in CFTC Regulations 38.551, 38.552 and 38.256.

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| | <p><i>SEFs and SB SEFs</i></p> <p>SEF Core Principle 10 requires a SEF to maintain records of all activities relating to its business, including a complete audit trail in a form and manner acceptable to the CFTC for a period of 5 years. CFTC Regulation 37.406 requires a SEF to have the ability to comprehensively and accurately reconstruct all trading on its facility. Similarly, the Exchange Act requires SB SEFs to maintain audit trails and records of all activities relating to the business of their facilities and comply with any other recordkeeping and reporting requirements the SEC may adopt.</p> <p>Delegation and outsourcing</p> <p><i>National securities exchanges</i></p> <p>There are no specific requirements on outsourcing by exchanges. However, the SEC would be able to supervise outsourced activities on the basis of the general requirement of the Exchange Act that national securities exchanges must always be able to fulfill their obligations under the Act.</p> <p><i>DCMs and SEFs</i></p> <p>DCMs and SEFs are required to provide the CFTC with copies of any service provider agreements as a registration application exhibit. If a CFTC registered entity delegates a function to another registered entity, the CFTC has the regulatory authority to access the books and records of a registered entity to which the function was delegated. If a registered entity outsources a function to a non-registered entity, the CFTC maintains the authority to obtain relevant books and records from the registered entity itself.</p> <p>Admission of securities and derivatives</p> <p><i>National securities exchanges</i></p> <p>An exchange's listing criteria are set out in its rules. Pursuant to Section 19(b) of the Exchange Act and Rule 19b-4, every SRO has to file with the SEC any proposed rule, or any proposed change to a rule. The rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect the investors and the public interest (Section 6(b)(5) of the Exchange Act).</p> <p>The listing of certain new derivative products¹⁶ does not require prior approval of the rule changes by the SEC, if the SEC has approved the SRO's trading rules, procedures and listing standards for the product class that would include the new product (Exchange Act Rule 19-4(e)).</p> <p><i>DCMs and SEFs</i></p> <p>Under Section 5c of the CEA and Part 40 of the CFTC regulations, DCMs and SEFs must inform the CFTC of the types of products to be traded on the DCM or SEF through either of two methods: (i) self-certification (CFTC Regulation 40.2); or (ii) voluntary submission of new products for the CFTC's review and approval (CFTC Regulation 40.3). CFTC prior approval is required for certain enumerated agricultural commodities.¹⁷</p> |
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¹⁶ An option, warrant, hybrid securities product or any other security, other than a single equity option or security futures product, whose value is based, in whole or in part, upon the performance of, or interest in, an underlying instrument.

¹⁷ This relates to contracts on the commodities enumerated in Section 1a(9) of the CEA with open interest.

For contracts filed under the self-certification procedure, DCMs and SEFs are required to assume primary responsibility for ensuring that the contracts meet, on a continuous basis, the applicable statutory and regulatory requirements. The procedure requires DCMs and SEFs to file their submissions no later than the opening of business on the business day preceding the initial listing of the product. The submission must include the product's rules, the intended listing date, a certification by the DCM or SEF that the product complies with the CEA and CFTC Regulations, a concise explanation and analysis of the product and its compliance with applicable provisions, and a certification by the DCM or SEF posted on its website that a notice of pending product certification is with the CFTC. If requested by the CFTC staff, the DCM or SEF must provide additional information or data that demonstrates that the contract meets the relevant requirements. The CFTC may stay the listing of a contract while its proceedings are pending for filing a false certification or while a petition to alter or amend the contract terms and conditions is pending.

DCMs and SEFs may voluntarily request the CFTC to approve a new or dormant product prior to its listing. A product request for approval must include similar documentation as required under the self-certification procedure. All products submitted for CFTC approval are generally deemed approved 45 days after receipt by the CFTC or at the conclusion of an extended period. However, the CFTC, at any time during its review, may notify the DCM or SEF that it will not, or is unable to, approve the product because the submission lacks sufficient information for a determination.

In practice the large majority of contracts is subject to the self-certification procedure.

DCM Core Principle 3 requires that listed contracts not be readily susceptible to manipulation. In order to demonstrate compliance with this requirement, DCMs listing new futures contracts must provide the CFTC with certain information, including data and information to support the contract's terms and conditions and a detailed cash market description for physical and cash-settled contracts. For futures contracts settled by physical delivery, the terms and conditions should be designed to avoid impediments to delivery so as to promote convergence between the price of the futures contract and the cash-market value of the commodity. Specific requirements are included in CFTC Regulations 38.252 and 38.253.

Admission of market participants

National securities exchanges

A national securities exchange must have rules that permit any registered BD or natural person associated with a BD to become its member (Section 6(b)(2) Exchange Act). An exchange's ability to deny membership is limited pursuant to Section 6(c) of the Exchange Act. An exchange must deny membership to any non-registered BD and may deny membership to any BD 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 may deny membership to a BD that does not meet the financial responsibility or operational capability standards or have the minimum level of training, experience or competence prescribed by the exchange's rules. In addition, an exchange may deny membership to a BD that has engaged or is likely to engage in acts or practices that are inconsistent with just and equitable principles of trade.

Further, the exchange's rules may not be designed to permit unfair discrimination between BDs and may not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.

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 SRO member to

the quotations in a NMS 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. Rule 610(c) also limits the amount of fees that may be charged by a trading facility to access its best bids and offers.

ATS

If an ATS accounted for five percent or more of the average daily trading volume during at least four of the preceding six calendar months in any equity security, municipal security, or corporate debt security, it would need to comply with the fair access requirements of Rule 301(b)(5)(ii) of the Exchange Act. Specifically, these ATSs would be required to establish written standards for granting access to trading on their systems and maintain these standards in their records (Rule 301(b)(5)(ii) and Rule 303(a)(2)(ii)). Such ATSs would be prohibited from unreasonably prohibiting or limiting any person's access to their services by applying their access standards in an unfair or discriminatory manner. Certain ATSs specified in Rule 301(b)(5)(iii) of the Regulation ATS would not need to comply with the fair access requirement, even if they exceeded the five percent threshold.

DCMs

CFTC Regulation 38.151(b) requires a DCM to provide its members, persons with trading privileges, and independent software vendors (ISVs) with impartial access to its markets and services, including by having access criteria that are impartial, transparent, and applied in a non-discriminatory manner. CFTC Regulation 38.151(b)(2) requires that the DCM provide comparable fee structures for members, persons with trading privileges, and ISVs receiving equal access to, or services from, the DCM. CFTC Regulation 38.151(c) requires a DCM to establish and impartially enforce rules governing any decision by the DCM to deny, suspend, or permanently bar a member's or a person with trading privileges access to the DCM. Accordingly, any decision by a DCM to deny, suspend, or permanently bar a member's or person with trading privileges access to the DCM must be impartial and applied in a non-discriminatory manner.

SEFs and SB SEFs

SEF Core Principle 2 requires SEFs to provide market participants with impartial access to the SEF. CFTC Regulation 37.202 requires SEFs to provide any eligible contract participant and any ISV with impartial access to their markets and market services, including any indicative quote screens or any similar pricing data displays. SEFs have to have impartial criteria governing access, comparable fee structures and impartial enforcement of rules for limiting access.

SB SEFs will be required to establish and enforce trading, trade processing, and participation rules that include means to provide market participants with impartial access to the market.

Order routing and order execution procedures

National securities exchanges

An exchange's rules are required to cover its order routing and execution procedures. As part of the exchange registration process, the SEC reviews such procedures. They can only be approved, if they are consistent with relevant securities laws and regulations, including those with respect to precedence, front running and trading ahead of customer orders, and are not unfairly discriminatory.

The SEC analyzes any proposed rule that would give 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. Section 11(b) of the Exchange Act provides for the regulation of specialists and odd-lot dealers, and requires that the rules of the SRO reflect the appropriate rules for their registration and activities.

The terms of any service that impacts access to the exchange and its facilities, such as co-location services, including the fees charged for such services, are required to be filed as proposed rule changes. When reviewing such rule changes, the SEC takes into account Section 6(b)(4) of the Exchange Act that requires that the rules of the exchange provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities. Further, the rules of the exchange cannot be designed to permit unfair discrimination between customers, issuers, brokers, or dealers (Section 6(b)(5) Exchange Act) or impose any burden on competition not necessary or appropriate in furtherance of the Exchange Act (Section 6(b)(8)).

ATS

OCIE and FINRA have examined BDs that operate ATSs. They may review a BD's algorithmic trading system or proprietary trading system to ensure that it fairly allocates and executes orders, does not discriminate among certain types of orders, and does not use non-public information about order flow obtained through the BD's other business activities to benefit the firm's own account. The ATS reviews may also focus on the BD's order handling practices and processes.

DCMs

DCM Core Principle 7 requires a DCM to make available to market authorities, market participants, and the public information on the rules, regulations, and mechanisms for executing transactions on or through the DCM. DCM Core Principle 9 requires DCMs to provide a competitive, open, and efficient market and a mechanism for executing transactions that protects the price discovery process of trading in the centralized market of the DCM. CFTC Regulation 1.38, which applies to commodity futures and options, requires competitive execution. It permits certain noncompetitive trades that are executed pursuant to rules that have been approved by the CFTC. The DCM applicant must attach Exhibit Q to its application on Form DCM, which requires a description of the applicant's trading system and trade matching algorithm and examples of how that algorithm works in various trading scenarios involving various types of orders. DCM rulebooks are also required to be publicly available.

SEFs

Applicants for registration as a SEF must meet statutory requirements that execution rules are disclosed to the regulator and to market participants, and are fairly applied to all participants. SEF rulebooks are required to be publicly available. A SEF applicant must also explain the operation of its trading system or platform and the manner by which the trade functionality requirement of CFTC Regulation 37.3(a)(2) is satisfied. Transactions in swaps that are subject to the trade execution requirement have to be executed either in an order book or in a request for quote system that operates in conjunction with an order book where the requests have to be submitted to at least three participants in the system.

For trading systems or platforms that enable market participants to engage in transactions through an order book, the SEF applicant must attach as Exhibit Q to its Form SEF an explanation of any trade matching algorithm and examples of how that algorithm works in various trading scenarios involving various types of orders. For trading systems or platforms that enable market participants to engage in transactions through a request for quote system, the SEF applicant must attach as Exhibit Q to Form SEF an explanation of how a requester

may transact on resting bids or offers along with the responsive orders.

Direct market access

National securities exchanges and ATSS

In November 2010, the SEC adopted Rule 15c3-5—Risk Management Controls for Brokers or Dealers with Market Access. This Rule is applicable to BDs with access to trading in securities by virtue of being an exchange member or an ATS subscriber. It is also applicable to broker-dealer operators of an ATS that provides market access to non-BD subscribers. A BD with market access, or that provides a customer or any other person with access to an exchange or ATS through the use of its market participant identifier or otherwise, is required to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks of this business activity.

Specifically, the risk management controls and supervisory procedures are required to be reasonably designed to:

- Prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds, or that appear to be erroneous;
- Prevent the entry of orders unless there has been compliance with all regulatory requirements that must be satisfied on a pre-order entry basis; and
- Prevent the entry of orders that the BD or customer is restricted from trading, restrict market access technology and systems to authorized persons, and assure appropriate surveillance personnel receive immediate post-trade execution reports.

There are no specific regulatory requirements on exchanges themselves to have in place automated pre-trade controls that would enable intermediaries to implement appropriate risk limits. However, Rule 15c3-5 permits broker-dealers to use third party technology, which may be provided by an exchange or other service provider, provided that the broker-dealer maintains direct and exclusive control of the risk management system.

DCMs

CFTC Regulation 38.607 requires DCMs that permit direct electronic access by customers to have in place effective systems and controls reasonably designed to facilitate the FCM's management of financial risk, such as automated pre-trade controls that enable member FCMs to implement appropriate financial risk limits. A DCM must implement and enforce rules requiring the member FCMs to use the provided systems and controls.

Access to trading information

National securities exchanges, ATSS and SB SEFs

The NMS Plans require participating SROs to collect and promptly report both pre- and post-trade information to NMS plan processors. The processors are then responsible for consolidating the information and disseminating it to the public, including all market participants. The SROs must report the stock symbol, volume, and price at which transactions were executed to the plan processor, in most cases (see Principle 35) within 10 seconds after the time of execution. The same requirement applies to trades made on an ATS. In practice exchanges and ATSS report transactions on an as real-time basis as technologically possible. Last sale and trade data is reported on the consolidated tape, an electronic system that reports the latest price and volume data on sales of exchange-listed stocks. If a transaction is not reported within the set deadline, the SRO must designate the last sale price as "late" on

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| | <p>the report to the NMS plan processor.</p> <p>Even though it is not a regulatory requirement, in practice exchanges provide the ability to subscribe to direct access to their proprietary trading information. This enables exchange members and other market participants to implement more effective risk monitoring and risk management controls than those based on the NMS data (see Principle 35).</p> <p>SB SEFs will be required to make public timely trade information on the basis of SEC rules pending finalization.</p> <p><i>DCMs and SEFs</i></p> <p>DCMs and SEFs are required to provide to market participants, on a fair, equitable and timely basis, information regarding prices, bids and offers, as applicable to the market.</p> |
| <p>Assessment</p> | <p>Broadly Implemented</p> |
| <p>Comments</p> | <p>ATs and other off-exchange trading methods</p> <p>The preamble to the IOSCO Assessment Methodology notes that the word “markets” should be understood in its widest sense, including any facility to trade equity and debt securities, options and derivative products. It further notes that in addition to traditional organized exchanges, secondary markets should be understood to include various forms of non-exchange trading systems, such as ATs, multilateral trading facilities (MTFs), and proprietary systems developed by market intermediaries. However, the preamble concludes that for assessment purposes the Methodology is directed to topics that have been addressed by IOSCO reports and names multilateral systems, such as exchanges and other similar regulated trading systems, as the main focus of the assessment.</p> <p>For the above reason, this assessment has focused on national securities exchanges and ATs. However, the current single dealer/market maker bilateral trading systems may continue to converge towards multilateral systems. While these systems are not further discussed in the assessment of this Principle (however, see Principle 35), the assessors agree with the SEC that there is a need to closely follow the developments in this area and adjust the regulatory framework, if needed.</p> <p>There are two main shortcomings that have led to the grade for this Principle. Most importantly, ATs are not required to disclose their order execution rules and procedures to market participants, although some ATs have provided additional information on their websites or published their Forms ATS. ATS subscribers typically get additional information. This voluntary approach is not sufficient to comply with Key Questions 5(a), 5(b) and 6 of the IOSCO Assessment Methodology. Therefore, the assessors consider that it is important that the SEC pursues the initiative of the SEC Chair to enhance public information about ATS operations.</p> <p>Secondly, applying the fair access requirements to an ATS only after it would reach or exceed a relatively high market share of five percent in a particular NMS security does not comply with Key Question 4(c) of the Assessment Methodology. The assessors consider that the current five percent threshold should be removed or at a minimum, significantly lowered.</p> <p>The current approach to authorizing new ATs is based on a requirement for the BD to inform the SEC of the planned establishment of an ATS on Form ATS, together with the requirement for the BD to file an application with FINRA on a change in its business operations. Within the limits of their respective processes, the SEC and FINRA seek to assess the ATs’ order execution procedures and the operational and other competence of the BD in relation to operating an ATS. This appears to comply with the minimum requirements of the Assessment</p> |

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| | <p>Methodology. However, the SEC and FINRA are encouraged to further ensure that their processes provide a sufficiently in-depth analysis of the order execution procedures of a new ATS, in particular for fairness, and focus on ensuring that there is sufficient evidence of a BD's operational and other competence specific for ATS operations.</p> <p>Requirements on national securities exchanges</p> <p>The obligation to ensure sufficient pre-trade controls applies to BDs. Exchanges are not subject to any particular requirements in this regard. The assessors consider that this approach is sufficient to comply with the minimum requirement of Principle 33. However, the assessors encourage the SEC to consider whether additional requirements could be applied to exchanges themselves to further enhance their ability to manage the risks arising from direct electronic access.</p> <p>Listing of new products on DCMs</p> <p>Key Question 4.(c) of the IOSCO Assessment Methodology requires the regulator to approve the rules governing the admission of securities (or derivatives) to trading. While the CFTC does not approve the DCMs' rules on the admission of (new classes of) futures or options, the assessors consider the current system with the CFTC's ability to stay the listing of a new contract to be sufficient for the purposes of compliance with Principle 33.</p> |
| <p>Principle 34.</p> | <p>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.</p> |
| <p>Description</p> | <p>Market surveillance</p> <p><i>Securities exchanges</i></p> <p>Subject to SEC oversight, the SROs have the primary responsibility for the daily surveillance of trading activities. All securities exchanges conduct their own real-time "market watch" surveillance. Certain exchanges also perform their own market specific surveillance activities (other than for insider trading) in-house, while some have contracted part of their surveillance programs to FINRA through RSAs. For example, NASDAQ OMX Group outsources cross-market surveillance functions to FINRA, but uses NASDAQ's own surveillance technology to run specific surveillance patterns for NASDAQ's three markets. NYSE Group announced in October 2014 that its subsidiary NYSE Regulation will start directly performing the market surveillance functions for NYSE Group's three equities exchanges and two options exchanges on January 1, 2015.</p> <p>After the recent integration of the BATS Exchange into FINRA's program, FINRA conducts cross-market surveillance for 99 percent of the U.S. listed equity market. FINRA's cross-market surveillance aims at detecting potentially illegal trading behavior across multiple markets. After the January 1, 2015 change, FINRA will also continue to retain the cross-market surveillance responsibility for the NYSE Group's exchanges. FINRA also provides equity market insider trading surveillance to all U.S. exchanges pursuant to the Consolidated Insider Trading Plan 17d-2 agreement.</p> <p>FINRA conducts automated options surveillance in hybrid and electronic options marketplaces for approximately 40 percent of U.S. options exchange trading. Through RSAs, FINRA conducts varying levels of oversight of trading activity on NYSE Arca; NYSE MKT; International Securities Exchange; International Securities Exchange Gemini; BATS Options operated by BATS Exchange; BOX Options Exchange; NASDAQ Options Market; NASDAQ OMX PHLX; and NASDAQ OMX BX Options. Options insider trading surveillance is conducted</p> |

by the CBOE as contracted by the Options Regulatory Surveillance Authority operated by all the 11 U.S. options exchanges.

SEC

The SEC's Market Surveillance Group in the Enforcement Division's Office of Market Intelligence has oversight over all domestic equity and securities options markets. It can obtain surveillance and/or trading data from the SROs and coordinates with them to detect any anomalous market activity, including suspicious trading by particular persons and/or entities.

In July 2011, the SEC adopted the new Large Trader Reporting Rule 13h-1 and the new Form 13H under Section 13(h) of the Exchange Act to enhance its ability to identify large market participants, collect information on their trading, and analyze their trading activity. The new rule requires large traders¹⁸ to register with the SEC by submitting Form 13H through the EDGAR system. The SEC assigns each large trader a unique identification number to be provided to the trader's BD, which will be required to maintain transaction records for each large trader and report that information to the SEC upon request. Large trader registration information is available to EDGAR authorized SEC staff users, including staff from TM, Enforcement, and OCIE.

The large trader reporting requirements provide the SEC with information that supports its investigative and enforcement activities. For example, the SEC can obtain enhanced transaction data, including the large trader ID number and the execution time of its transactions each time it requests data through the Electronic Bluesheets System. In addition, the large trader reporting requirements can help the SEC assess the impact of large trader activity on the securities markets, to reconstruct trading activity following periods of unusual market volatility, and to analyze significant market events for regulatory purposes.

The SEC launched MIDAS in 2013. MIDAS collects and processes data from the consolidated tapes and proprietary feeds of each equity exchange. In addition to data on listed stocks and exchange-traded products, MIDAS also collects and processes data on equity options and futures contracts. This data includes posted orders and quotes, modifications and cancellations, and trade executions. Among other things, the SEC can use MIDAS to identify possibly troublesome or illegal behavior and reconstruct market events.

DCMs

Under Core Principle 2, a DCM is required to conduct effective trade practice surveillance, market surveillance, and real-time market monitoring, maintain an automated trade surveillance system capable of detecting and investigating potential trade practice violations, and conduct real-time market monitoring of all trading activity on its electronic trading platform(s) to identify disorderly trading and any market or system anomalies. The automated system must load and process daily orders and trades no later than 24 hours after the completion of the trading day. In addition, the automated trade surveillance system must have the capability to detect and flag specific trade execution patterns and trade anomalies.

In practice, some DCMs conduct the above activities in-house, while the NFA provides trade practice surveillance and market surveillance services for the rest. 16 SEFs have also

¹⁸ A person is considered to be a large trader, when it (directly or indirectly) exercises investment discretion over one or more accounts and effects transactions exceeding two million shares or \$20 million during a calendar day or twenty million shares or \$200 million during a calendar month (Rule 13h-1(a)(7)). In fiscal year 2013, 2948 large traders had registered with the SEC.

outsourced these surveillance activities to the NFA.

CFTC

The CFTC monitors trading and positions of market participants on an on-going basis. Each day, for all active futures and options contract markets, the CFTC's market surveillance staff monitors the activities of large traders, and examines all price spikes, scheduled news release periods of market-sensitive data, all daily settlements in the major commodities and futures and options contracts. Staff also tracks key price relationships, and relevant supply and demand factors in a review for potential market problems. Periodically, CFTC staff conducts deep forensic examinations of trading in physical or derivatives products to uncover market abuses stemming from cash markets that influence derivatives values.

SEC supervision of trading systems

Rule approval

An exchange must file any proposed change in, addition to, or deletion from its rules with the SEC (Section 19(b)(1) Exchange Act). This process is described in more detail in Principle 9.

Reporting

A national securities exchange is required to submit to the SEC within 10 days amendments to certain exhibits of its Form 1 registration (Rule 6a-2(a)). 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 listed securities. Further, every three years an exchange must file completely updated information on the exchange's governing documents, managers, and facility operators. In lieu of making periodic filings, an exchange may make the required information available through several alternatives, including through publications and Internet websites controlled by the exchange. Rule 6a-3 also requires exchanges to submit to the SEC certain additional information, including notices, circulars, bulletins, and lists or periodicals that the exchange issues or makes generally available to members, participants or subscribers.

ATS are required to file with the SEC quarterly reports on their activities on Form ATS-R within 30 days of the end of the quarter. Information to be reported includes a list of all subscribers and all securities traded, and statistics on trading volume and value. They must also amend their Form ATS to correct any inaccurate information within 30 days after the end of the relevant quarter and at least 20 calendar days prior to implementing a material change to the operation of the ATS.

The CCO of a SB SEF will be required to submit to the SEC the SB SEF's annual financial report and a report containing a description of the SB SEF's compliance with the Exchange Act and its policies and procedures, including its code of ethics and conflict of interest policies (Section 3D(d)(14)(C) Exchange Act).

Examinations

The SEC's examinations of the exchanges' self-regulatory functions are discussed in Principle 9.

The SEC has also implemented a Technology Control Program (TCP), through which its staff conducts reviews of the exchanges' trading and information technology systems to evaluate whether they have sufficient capacity and resiliency to accommodate increased volumes and disruptions to normal operations. In addition to reviewing systems capability, the TCP staff also considers whether the exchange has sufficient capital to maintain its automated systems, and appropriate staff with technical expertise. Besides routine examinations, the TCP staff

may perform for cause or special focus examinations.

OCIE's TCP staff also monitors exchanges and certain high volume ATSS' planned significant system changes and responds to reports of system failures and disruptions. TCP staff also regularly meets with the exchanges' information technology staff.

CFTC supervision of DCMs and SEFs

Rule approval

Section 5c(c) of the CEA requires DCMs and SEFs to file with the CFTC new rules and rule amendments. In addition to the self-certification of products discussed under Principle 33, DCMs and SEFs may self-certify to the CFTC new rules and rule amendments and implement them no earlier than 10 business days following the CFTC's receipt of the submission (CFTC Regulation 40.6). Alternatively, they may voluntarily submit new rules and rule amendments for the CFTC review and approval (CFTC Regulation 40.5). See Principle 9 for further details.

Reporting

DCMs and SEFs have to report material changes in their operations on an ongoing basis to the CFTC. They also have to submit quarterly financial statements to the CFTC within 40 days of the end of their first three fiscal quarters and within 60 days of the end of their fiscal year.

Examinations

The CFTC's examinations on the exchanges' self-regulatory functions are discussed in Principle 9.

In addition, the CFTC conducts systems safeguards examinations, where it reviews one or more of the following areas: (i) enterprise risk management and governance; (ii) information security; (iii) capacity planning; (iv) systems operations; (v) systems development methodology; (vi) business continuity and disaster recovery; and (vii) physical security. Such examinations are conducted at the systemically important DCMs every 12-18 months.

Enforcement

SEC

The SEC has the authority under Section 19(a)(3) of the Exchange Act to cancel, suspend, or revoke an SRO's registration. If the SEC finds that an 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, must cancel its registration. Section 19(h) of the Exchange Act provides the SEC with the authority to impose penalties on SROs for certain violations of the federal securities laws and/or exchange rules. Specifically, the SEC has the authority to: (i) suspend or revoke the registration of an SRO; (ii) censure or impose limitations on its activities; and (iii) remove from office or censure officers or directors of an SRO for violations of the Exchange Act or the SRO's rules.

The SEC has taken enforcement actions against national securities exchanges. These include an action against the NYSE for alleged compliance failures that gave certain customers improper early access to trading information, where NYSE and its parent company NYSE Euronext agreed to a \$5 million penalty and undertakings to settle the SEC's charges. The SEC also brought a settled action against NASDAQ for securities laws violations resulting from NASDAQ's poor systems and decision-making during the IPO and secondary market trading of Facebook shares. NASDAQ agreed to settle the SEC's charges by paying a \$10 million penalty.

The SEC's ability to cancel, suspend or revoke the registration of a BD, including an ATS, is

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| | <p>discussed in Principle 29. The SEC can also apply various penalties discussed in Principle 10. It has recently taken enforcement action against two ATS operators for alleged violation of confidentiality requirements.</p> <p><i>CFTC</i></p> <p>The CFTC has the power to direct DCMs and SEFs to alter or supplement their rules and to take such action as it deems necessary to maintain or restore orderly trading (Sections 8a(7) and (9) CEA). It can also suspend or revoke a registrant’s registration based on a failure or refusal to comply with any of the provisions of the CEA, CFTC regulations, or CFTC orders (Sections 5(d)(1), 5b(c)(2), 5h(a)(1) and 6(b) CEA).</p> |
| Assessment | Fully Implemented |
| Comments | |
| Principle 35. | Regulation should promote transparency of trading. |
| Description | <p>National market system</p> <p>Pre- and post-trade transparency requirements in securities and options markets are built around the principles set forth in Regulation NMS. Section 11A(a)(2) of the Exchange Act directs the SEC to facilitate the establishment of a national market system (NMS) for securities. The NMS is intended to link all markets for qualified securities through communication and data processing facilities (Section 11A(a)(1) Exchange Act). There are currently several NMS plans that the SEC has approved. The Consolidated Quotation (CQ) Plan/Consolidated Tape Association (CTA) Plan (for which the Securities Industry Automation Corporation (SIAC) serves as the exclusive processor) and NASDAQ UTP Plan (for which NASDAQ serves as the exclusive processor) coordinate the dissemination of real-time quote and trade information in equity securities. The Options Price Reporting Authority (OPRA) Plan (for which SIAC serves as the exclusive processor) provides, through market data vendors, current options quotations and last sale information from participant options exchanges.</p> <p>The Exchange Act requires that all securities information processors (SIPs) have equitable access to market information from the exclusive processors of that information on terms that are fair and reasonable (Section 11A(c)(1)(C) Exchange Act). The SEC must also ensure that all persons may obtain market information on terms that are not unreasonably discriminatory (Section 11A(c)(1)(D) Exchange Act). Any limitation of access by a registered SIP to its services is subject to review by the SEC (Section 11A(b)(5) Exchange Act).</p> <p>Pre-trade transparency for securities</p> <p>Rule 602 of Regulation NMS requires exchanges and FINRA to establish procedures and mechanisms for collecting bid and offer information from responsible brokers and dealers and for making it available to vendors. Responsible brokers and dealers must promptly submit to an exchange or FINRA their best bids, best offers, and quotation sizes for any NMS security. The exchanges and associations must then promptly submit this information to the NMS plan processors that use the data to produce the consolidated tape. Fee-based access to the consolidated tape is available to anybody. However, most non-professional investors do not pay fees, because their brokers provide them with access to the consolidated tape as part of the brokerage service.</p> <p><i>Limit order display rule</i></p> <p>Rule 604 of Regulation NMS provides that exchange specialists and OTC market makers must display public customer limit orders for NMS stocks that improve the bid or offer of the specialist or market maker. In addition, specialists and market makers must include the size of</p> |

public customer limit orders for NMS stocks that are priced equal to the specialist's or market maker's bid or offer. However, this requirement does not apply to customer limit orders for at least 10,000 shares or \$200,000 (block size).

ATS

As noted in Principle 33, an ATS that displays its orders to at least one person (other than an ATS employee) will become subject to the order display and execution access rule, if its market share in a particular NMS stock was five percent or more during at least four of the preceding six months. Currently there are no such ATSs. Therefore all current equity ATSs can operate as dark pools without pre-trade transparency to their subscribers or to the public. However, due to the Regulation NMS Order Protection Rule (Rule 611), trading on an ATS can only take place at prices that fall at or between the current national best bid and offer (NBBO). In practice, this is achieved by, for example, pegging the order prices to the midpoint of the NBBO. Both ATSs and national securities exchanges can decide whether the reference price they use is derived from an NBBO calculated from the NMS feed or the exchanges' proprietary feeds.

Market makers

Real-time reporting of quotes made in the OTC market is also required, if the quote is communicated by a registered market-maker or any OTC market maker whose executed volume in the security is greater than 1 percent of the aggregate trading volume in such security.

Hidden orders

Some exchanges currently have order types that are completely hidden, i.e. they are not displayed in the order book, but can match against displayed orders, subject to the priority rules of the relevant exchange. Such order types and priority rules are subject to the SEC's approval as part of the SRO rule approval process. As in the case of dark pool ATSs, trades based on hidden orders have to occur at prices that comply with the Regulation NMS Order Protection Rule. The exchange order types, including their transparency features, are analyzed and approved on a case by case basis.

The SEC staff has also conducted some analytical work on on-exchange dark trading. This includes publishing a data series that measures the percentage of exchange-based trading volume that results from executions against hidden (undisplayed) orders.¹⁹ In addition, OCIE included the review of order types in its National Examination Programs in 2013 and 2014. In June 2014, the SEC Chair asked the exchanges to conduct comprehensive reviews of their order types and how they operate in practice, and as part of this review, consider appropriate rule changes to help clarify the nature of their order types. Since these rule changes were published for comments after the end of the assessment mission, the assessors have not discussed with the SEC what the potential impact of these changes on pre-trade transparency may be.

Priority for displayed orders

The exchange rules typically provide that displayed orders receive priority over undisplayed orders at the same price (see e.g., BATS Rule 11.2 (Priority of Orders); and NYSE Rule 72

¹⁹ Hidden Volume Ratios, October 9, 2013, available at <http://www.sec.gov/marketstructure/research/highlight-2013-02.html>. The analysis showed that the hidden volume ratio for stocks was typically between 11 percent and 14 percent.

(Priority of Bids and Offers and Allocation of Executions).

Dissemination

In practice most NMS quote information is submitted by the exchanges. It is also possible to use FINRA's Alternative Display Facility (ADF), but it is currently used only by one ATS (LavaFlow ECN) to display its best quotes. It does this on a voluntary basis, because it operates a lit trading system rather than a dark pool.

Exchanges also make their full order book available to subscribers of their real-time proprietary data feeds. Rule 603(a) prohibits an exchange from releasing data related to quotes and trades to its customers through proprietary feeds before it sends its quotes and trade reports to the SIPs. However, in practice the proprietary feeds are available to subscribers in a more expeditious manner than the NMS feed that is prone to additional delays due to the extra step of being routed through the NMS plan processors.

Pre-trade transparency for commodity futures and options

DCMs

DCM Core Principle 9 requires a DCM to provide a competitive, open, and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market. CFTC Regulation 1.38 requires that the purchase and sale of commodity futures and options on or subject to the DCM rules is executed openly and competitively by open outcry or posting of bids and offers or by other equally open and competitive methods. In practice, all DCMs utilize central limit order books, with some still maintaining a trading floor alongside electronic trading.

Iceberg orders

DCMs allow for the use of iceberg order types, which are designed to permit the hidden part of an order to retain the time priority of the order's initial visible part.

Non-competitive trades

Transactions which are executed non-competitively in accordance with the DCM's written rules are exempted from pre-trade transparency (Regulation 1.38). This includes exchanges of derivatives for related positions, office trades and transfer trades for bona fide business purposes (Regulation 38.500).

In addition, an FCM, acting as principal or agent, can enter into or confirm the execution of a futures contract if it is reported, recorded, or cleared in accordance with the rules of a DCM or DCO. This enables, among other trades, recording off order book block trades under the DCMs' rules. Currently the relevant thresholds are determined in each DCM's rules. The conversion of certain swaps to futures in connection with the removal of the former registration exemptions for certain markets thereafter led to a lowering of the block trade thresholds. This trend has continued, allegedly also due to competitive pressure. According to the CFTC staff, this applies in particular to energy futures, where in some cases the block trade threshold is only one trading lot.

The CFTC proposed in 2012 rules and related guidance on block transactions, including relevant size, price and reporting requirements. The initial thinking behind the rules was that the thresholds would need to be set in such a manner that a certain, relatively high percentage (such as 85 percent) of trading would take place through the central limit order book. However, the CFTC ultimately decided not to finalize those rules at that point of time, and continues to work on them. Pending the finalization of the rules, the CFTC has had limited ability to address any concerns it may have had about the lowering of the block trade

thresholds.

Dissemination

DCMs are required to provide impartial access to their markets to independent software vendors, which are free to collect, aggregate and disseminate trade information to the public.

Pre-trade transparency for swaps and security-based swaps

One of the statutory objectives of the SEF registration requirement is to promote pre-trade transparency in the swaps market (Section 5h(e) CEA). The CFTC has interpreted that pre-trade transparency refers to making information about a swap available to the market, including bid and offer prices, quantity available at those prices, and other relevant information before the execution of a transaction. In practice most SEFs are request for quote systems, and therefore do not provide the same type of pre-trade transparency as an order book based system.

Pre-trade transparency is specifically waived for swap transactions that are large in scale and qualify as block trades (Part 43 CFTC Regulations). A block trade in a swap occurs away from a SEF or DCM trading system or platform, but pursuant to the SEF or DCM rules, and has a notional or principle amount at or above the minimum block threshold. A large notional off-facility swap is an off-facility swap that does not meet the definition of a block trade, but is for a notional or principle amount in excess of the minimum block threshold.

Similar requirements are included in the SEC's proposed pre-trade transparency requirements for SBS.

Post-trade transparency for securities

Rule 601(a) of Regulation NMS requires exchanges and associations (i.e., FINRA) to file transaction reporting plans for approval with the SEC. Rule 601(b) prohibits BDs from executing any transaction in any NMS security unless there is an effective transaction reporting plan with respect to reporting transactions in such security. Rule 601 also requires BDs that are members of an exchange or FINRA to promptly transmit to the SRO all information required by the NMS plans. The NMS plans require participating SROs to collect and promptly report post-trade information to the NMS plan processors. The processors are then responsible for receiving the post-trade information from the participants, consolidating it, and disseminating it to the public, including all market participants.

Pursuant to the applicable NMS plans for equities, the SROs must report the stock symbol, volume, and price at which transactions were executed to the NMS plan processor after the time of execution. Last sale and trade data is reported on the consolidated tape. If a transaction is not reported within the required time periods, the SRO must designate the last sale price as "late" on the report to the NMS plan processor. The SROs must also keep a transaction record of all trades for audit purposes.

FINRA Rules 6300A and 6300B require OTC transactions in NMS securities to be reported to the FINRA transaction reporting facility (TRF) as soon as practicable but within no later than 10 seconds. On May 14, 2014, the CTA filed with the SEC an amendment to the CTA Plan, which, if approved by the SEC, will also reduce from the current 90 seconds to 10 seconds the amount of time within which trades are to be reported to the CTA Plan processor. The amendment to the CTA Plan was published for comments on December 31, 2014. The 10-second reporting requirements would represent the outer limit; in practice post-trade transparency information is provided within milliseconds of trades. There is no delay for reporting or disseminating block trade information.

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| | <p>Rule 601(f) provides the SEC with the authority to grant exemptions from post-trade transparency. Generally, the only transactions that are excluded from the NMS plans are those that are not comparable to regular open-market transactions, such as options exercises, purchases pursuant to a tender offer, and primary-market issuance (e.g., an IPO).</p> <p>Post-trade transparency for futures and options</p> <p>DCM Core Principle 8, Daily Publication of Trading Information, requires that a DCM make available to the public accurate information on settlement prices, volume, open interest, and opening and closing ranges for actively traded contracts on the contract market (see CFTC Regulation 38.450). While this is the only statutory post-trade transparency requirement, immediate trade-by-trade post-trade transparency is generally required in DCM rules. These typically permit delayed publication of block trade information, with delays ranging from 5 to 15 minutes.</p> <p>Post-trade transparency for swaps and security-based swaps</p> <p>SEFs and DCMs must transmit all swap transaction data for publicly reportable swap transactions executed on or pursuant to the SEF or DCM rules to an SDR as soon as technologically practicable after execution. The SDR must then, as soon as technologically practicable after it has received the data, disseminate the swap transaction information to the public, unless the swap is a block trade that is subject to a time delay in public dissemination. SDRs have to make the transaction information freely available to the public in a non-discriminatory manner through their websites (CFTC Regulation 43.3). Post-trade public dissemination of transaction data is deferred for large transactions that qualify as a block trade or large notional off-facility swap transaction under Part 43 of the CFTC Regulations.</p> <p>SB SEFs will be required to make public timely information on price, trading volume, and other trading data on security-based swaps to the extent to be prescribed by the SEC.</p> <p>Information on and monitoring of dark trading</p> <p>National securities exchanges are required to describe their order types and order execution procedures in their rules. An ATS must disclose such information in its Form ATS, Exhibit F, which is submitted to the SEC, but not required to be published. .</p> <p>Exchange transactions are currently identifiable from the consolidated tape. While ATSs must report their trade information to FINRA for inclusion in the consolidated tape, all ATS transactions are currently identified as OTC transactions without identifying the ATS on which the transaction was executed.</p> <p>Additional data concerning ATS trading activity recently became available as a result of FINRA Rule 4552 approved by the SEC. The rule requires ATSs to report to FINRA aggregate weekly trading volume and number of trades executed within the ATS on a security-by-security basis. The new regime also requires each individual ATS to use a unique market participant identifier, which can be used only for reporting orders and trades that occur on the ATS to FINRA. FINRA makes the reported volume and trade count information for equity securities publicly available on its website.</p> <p>The SEC staff continues to evaluate the impact of dark liquidity on the price discovery process and market quality, pursuing a data-driven approach.</p> |
| Assessment | Broadly Implemented |
| Comments | <p>Commodity futures and options</p> <p>Pending the finalization of the CFTC block trade rules, current block trade thresholds for</p> |

futures and options are based on each DCM's rules. Without a final CFTC Regulation, it is difficult for the CFTC to address any concerns about the lowering of the thresholds over the past few years. This lack of appropriately framed pre-trade transparency derogations, as required by Key Question 2a of the Assessment Methodology, has been taken into account in the grade for this Principle. It is important that the CFTC promptly finalizes its block trade rules to provide a regulatory basis for assessing the appropriateness of DMCs' pre-trade transparency waivers for block trades.

While the design of the DCMs' iceberg order type is somewhat unconventional, and may not be optimal from pre-trade transparency perspective, the assessors have not taken it into account in the grade of this Principle, given lack of specific guidance in the Assessment Methodology on the interpretation of the requirement for transparent orders to have priority over dark orders.

Equity securities

As discussed in Principle 33, dark pool ATSs do not currently provide sufficient public information on the manner they handle and execute orders, as required by Key Question 2.(e). This deficiency has been taken into account in the grade of this Principle.

In addition, the assessors note that a significant proportion of trading in the U.S. equity markets currently takes place without pre-trade transparency.²⁰ Current pre-trade transparency level on the U.S. equity markets is impacted by various factors:

Most of the equity ATSs operate as dark pools, using order types that are executed at or within the current NBBO to enable the ATSs to comply with the Order Protection Rule;

National securities exchanges use order types that may be completely undisplayed (fully hidden orders in contrast to iceberg orders); and

A relatively large proportion of trading takes place outside exchanges and ATSs through various OTC trading mechanisms.

The IOSCO Assessment Methodology focuses on pre-trade transparency requirements applied by trading systems (i.e., exchanges and ATSs in the case of the U.S.). Regulation NMS frames those requirements, together with exchange rules and ATS market models. The two key derogations from pre-trade transparency (as defined in the Assessment Methodology) are trading occurring on dark pool ATSs and exchanges' dark order types. Regulation NMS constrains both trading methods by requiring such trading to take place at or within the current NBBO. As a result, the requirements of the Assessment Methodology as to having conditions for derogations from pre-trade transparency are complied with. Nevertheless, there may be benefits in the SEC continuing to deepen its analysis of the pre-trade transparency impact of various exchange and ATS order types and the reference prices dark order types are permitted to use to ensure that current derogations do not adversely impact the price discovery process. This is particularly important given the differences in the timeliness of the NMS and proprietary feeds.

Additional public information on the extent of dark pool trading has recently become available through FINRA reporting requirements. The SEC's MIDAS system provides information on the extent of on-exchange dark trading. Therefore the SEC is in a position to

²⁰ As noted in the introduction of this report, estimates on the value of trading on dark pools and OTC have ranged between 28 and 40 percent in 2012-2014. As noted above, the proportion of on-exchange dark trading ranged between 11 and 14 percent in 2013.

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| | monitor the development of dark pools and dark orders. |
| Principle 36. | Regulation should be designed to detect and deter manipulation and other unfair trading practices. |
| Description | <p>Fraud and market manipulation</p> <p><i>Securities</i></p> <p>Fraud and market manipulation are prohibited under the federal securities laws. Section 17(a) of the Securities Act prohibits fraud, material misstatements, and omissions of fact in the offer or sale of any security. Section 10(b) of the Exchange Act 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. Rule 10b-5 implements Section 10(b) of the Exchange Act and 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. Section 9 of the Exchange Act prohibits manipulative practices in connection with the trading of securities. Section 15(c) of the Exchange Act prohibits fraudulent and manipulative conduct by BDs. Section 14(e) of the Exchange Act prohibits fraudulent, deceptive, and manipulative acts in connection with a tender offer.</p> <p>Front running and trading ahead of customer orders are also illegal under the anti-fraud provisions of the federal securities laws. SEC Rule 10b-21 includes a specific naked short selling anti-fraud rule, according to which it is a manipulative device or contrivance to deceive about a seller’s intention or ability to deliver securities in time for settlement.</p> <p><i>Commodity futures and options</i></p> <p>A range of violations can be enforced under the CEA. These include:</p> <ul style="list-style-type: none"> • Price manipulation, cornering a market, squeezing a futures contract, and communication of false information that tend to affect commodity prices (Sections 6(c), 6(d) and 9(a)(2) CEA); • Position limit violations (Section 4a(e) CEA); • Trade practice violations, such as wash trades, accommodation trades and fictitious sales (Section 4c(a) CEA); • Disruptive practices, such as violating bids or offers, spoofing, and disregard for the orderly execution of transactions during the closing period (Section 4c(a) CEA); and • Use or attempted use of any manipulative device, scheme or artifice to defraud, untrue or misleading statement, false report or any act that operates or would operate as a fraud (Section 4b(a) CEA). <p>Insider trading</p> <p><i>Securities</i></p> <p>Under U.S. law, insider trading is generally described as trading on the basis of material nonpublic information that has been used or obtained in breach of a fiduciary duty or a duty of trust or confidence. The fundamental prohibition against insider trading under the federal securities laws is not based on an explicit statutory prohibition. Instead, federal courts have interpreted the general anti-fraud provisions of Section 17(a) of the Securities Act, as well as</p> |

the Exchange Act (primarily Section 10(b) and Rule 10b-5 thereunder) to prohibit trading based on material nonpublic information in violation of a duty. It is also unlawful for a tippee to trade on material nonpublic information that the tippee knew or should have known was communicated by a tipper in breach of a duty owed by the tipper.

There are also specific provisions relating to the disclosure of insider information and insider trading:

Section 14(e) of the Exchange Act and corresponding Rule 14e-3 prohibit tipping and trading while in possession of material, nonpublic information in connection with a tender offer;

SEC Regulation FD 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 (such as stock analysts or holders of the issuer's securities); and

Section 16(b) of the Exchange Act imposes liability for short-swing profits in the issuer's stock upon officers, directors, and beneficial owners of more than 10 percent of any class of equity security, who may be in a position to obtain material, nonpublic information. These corporate insiders must disgorge to the issuer any profit realized as a result of a purchase and sale of equity securities occurring within a six-month period.

Commodity futures and options

The CEA does not prohibit trading in the commodity futures and options markets on the basis of lawfully obtained material nonpublic information. The thinking has been that such trading has limited applicability to futures trading, because it would hinder the traders' ability to hedge the risks of their commercial enterprises. Therefore it is not a violation to withhold information that a market participant lawfully possesses about market conditions. However, the knowing communication of false or misleading information that tends to affect commodity prices is a violation of Section 9(a)(2) of the CEA. In addition, depending on the facts and circumstances, a person who engages in deceptive or manipulative conduct in connection with swaps or commodity futures or options for example by trading on the basis of material nonpublic information in breach of a pre-existing duty to disclose (under another law, rule, agreement, understanding, or some other source), or by trading on the basis of material nonpublic information that was obtained through fraud or deception, may be in violation of CFTC Rule 180.1. The CFTC considers that this would enable it to address conduct where trading is conducted with knowledge of information that is subject to a specific disclosure requirement.

Further, Section 9(e) of the CEA prohibits insider trading and disclosure of insider information by employees and board and board committee members of the NFA, a DCM or a registered entity. Insider trading by other persons on the basis of such information is also prohibited. Section 746 of the Dodd-Frank Act also added an insider trading prohibition regarding information emanating from Federal government departments and agencies that may affect or tend to affect the price of any commodity in interstate commerce or swap (Section 4c(a)(4) CEA).

Monitoring

Securities

The division of responsibilities between the SROs and the SEC in conducting surveillance of the market for market manipulation, insider trading and other market abuse is described in Principle 34.

The SROs' electronic monitoring is designed to identify unusual trading activity, which is then reviewed by the SROs to determine if market participants have violated any laws or rules. SROs monitor trading both on an intra-day basis and after the close of the trading day.

To detect insider trading, FINRA has established automated surveillance systems that monitor trading for aberrant movements in stock prices or volumes of shares traded and generate alerts if they move outside of set parameters. If, in reviewing the trading associated with the alert, FINRA staff determines that there is a strong likelihood of insider trading, they can expand the review to a full investigation.

In 1996, the SEC ordered FINRA (then NASD) to design and implement an audit trail system that would capture a time-sequenced record of orders and transactions from the receipt of an order through its execution or cancellation. In response, FINRA developed OATS. BDs entering orders into the marketplace are responsible for reporting order details to OATS. In 1999, the SEC ordered the NYSE to design and implement a similar system. In response, the NYSE established its Front End Systemic Capture (FESC) and Order Tracking System (OTS). When FINRA added NYSE-listed securities to OATS, and NYSE adopted OATS rules in October 2011, NYSE discontinued its FESC and OTS systems.

In 2012, the SEC adopted a new Rule 613 under the Exchange Act to require the national securities exchanges and FINRA to create, implement, and maintain a consolidated audit trail (CAT) that would collect and identify every order, cancellation, modification, and trade execution for all exchange-listed equities and equity options across all U.S. markets. The CAT will increase the data available for investigating illegal activities and improve the ability to reconstruct broad-based market events. The SROs' plan was submitted to the SEC on September 30, 2014. The transitional period for the new system will last three years from the effective date of the plan.

The SEC's Market Surveillance Group coordinates with the SROs to detect anomalous market activity, including suspicious trading. In addition, the SEC uses technology to review all merger and acquisition activity and major market moving events in coordination with the relevant SRO so that the SRO can conduct the proper review of the market activity. For example, if the SEC finds unusual activity in the equity or options market, it alerts each market to the activity to heighten surveillance of that activity.

Commodity futures and options

In the case of commodity futures and options markets, a key element in reducing the threat of market manipulation or congestion (especially during trading in the delivery month) is requiring the DCMs to adopt speculative position limits or position accountability for each contract. For any contract that is subject to a position limit established by the CFTC, the DCM must set the position limits at a level not higher than the position limitation established by the CFTC (DCM Core Principle 5; CFTC Regulation 38.300). CFTC staff contacts large position holders to understand the business practices behind positions and the execution of economic physical substitution and orderly futures position liquidations.

As described in Principle 34, the DCMs and NFA conduct market and trade practice surveillance in commodity futures and options markets. In swaps markets, the majority of SEFs have outsourced the function to the NFA.

Enforcement

SEC

The number of SEC market abuse enforcement actions is presented in the table below.

Number of SEC Market Abuse Enforcement Actions

| Fiscal year | 2009 | 2010 | 2011 | 2012 | 2013 | Total |
|---------------------|-------------|-------------|-------------|-------------|-------------|--------------|
| Market manipulation | 39 | 34 | 35 | 46 | 50 | 204 |
| Insider trading | 37 | 53 | 57 | 58 | 44 | 249 |

Source: SEC

CFTC

Over the past four fiscal years (2011-2014), the CFTC has taken enforcement action in a total of 15 cases of manipulation, attempted manipulation and false reporting of market information (2011: 3; 2012: 2; 2013: 4; 2014: 6). During the same time period, its enforcement actions addressed a total of 34 trade practice violations (2011: 6; 2012: 15; 2013: 7; 2014: 6), including first actions taken in 2013 using its anti-spoofing/disruptive trading authority enacted under the Dodd-Frank Act.

Cross-market trading*Intermarket Surveillance Group*

There are mechanisms for information sharing and surveillance among the markets. Currently, all U.S. national securities exchanges and FINRA are members of the Intermarket Surveillance Group (ISG), an industry organization created in 1981 to coordinate intermarket surveillance among the major U.S. exchanges. It has since grown into an international group of exchanges and market regulators that perform frontline market surveillance in their respective jurisdictions. 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. Membership in the ISG is open to all recognized market centers that have rules and regulations designed to detect and deter possible abuses in their marketplaces and meet certain other requirements. The ISG is not subject to regulatory oversight, nor does it file rule changes with the CFTC or the SEC or seek approval when it considers requests from securities or futures exchanges to become a member.

The goal of the ISG's information sharing is to coordinate regulatory efforts to address potential intermarket manipulations and trading abuses. Participants in the ISG must have the ability to share regulatory information and otherwise cooperate with other ISG participants in connection with regulatory matters affecting their markets. The ISG focuses on information sharing among markets that trade securities, options on securities, security futures products, and futures and options on broad-based security indexes. Many DCMs are also members of the ISG.

Membership in the ISG carries with it a commitment to share information required for regulatory purposes with other members. ISG agreements provide that information that is shared must be kept strictly confidential and used only for regulatory purposes. Such information is shared on an as-needed basis and only upon request. In connection with the routine sharing of information, the ISG has defined certain types of violations that can occur across markets, and has allocated responsibility for surveillance for such activity to the appropriate member. In addition, U.S. securities exchanges, via the facilities of the Securities Industry Automation Corporation (SIAC), routinely share trading information electronically.

Generally, the full ISG meets twice a year. Meetings are open only to representatives of

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| | <p>members, prospective members, SIAC representatives, and by invitation appropriate governmental authorities such as the CFTC, SEC, the UK Financial Conduct Authority, and, on occasion, international organizations such as IOSCO. Senior market surveillance or market regulation personnel represent member organizations. From time to time, and at the discretion of the Chairman of the ISG, subgroups may be formed to address specific issues of importance.</p> <p><i>Joint Compliance Committee</i></p> <p>To foster improvements and uniformity in their systems and procedures used for trade practice compliance, the futures exchanges have formed the Joint Compliance Committee (JCC). The JCC has developed uniform definitions of trade practice offenses and typically meets twice a year to share information on automated compliance systems and other surveillance matters with a view to improving exchange compliance programs.</p> <p><i>Specific requirements on FBOTs with linked contracts</i></p> <p>An FBOT applying for registration to provide direct access to its trade matching system to members and other participants located in the United States is required to identify any contract that it will make available in the United States that is linked to a contract listed on a DCM or has any other relationship with a DCM listed contract (CFTC Regulation 48.7(c)(3)). Once registered, such FBOT must comply with specific conditions for registration, including the ongoing obligations regarding linked contracts set forth in CFTC Regulation 48.8(c)(2).</p> <p>Specific obligations relating to linked contracts include a requirement to report to the CFTC on a quarterly basis any member that had positions in a linked contract above the applicable FBOT trade position limit, whether a hedge exemption was granted and, if not, whether disciplinary action was taken. The FBOT must also provide to the CFTC trade execution and audit trail data for the CFTC’s trade surveillance system on a trade date plus one basis. Finally, if the CFTC directs the DCM that lists the contract to which the FBOT’s contract is linked to take emergency action with respect to the contract, the FBOT must promptly take similar action.</p> |
| Assessment | Fully Implemented |
| Comments | |
| Principle 37. | Regulation should aim to ensure the proper management of large exposures, default risk and market disruption. |
| Description | <p>Clearing and settlement</p> <p><i>Equities</i></p> <p>The clearing of on exchange equities trades takes place at the National Securities Clearing Corporation (NSCC). It also clears off exchange equities trades between two brokers, including those made on ATSS. Equity trades settle at T+3 at the Depository Trust Company (DTC).</p> <p><i>Commodity futures and options trades</i></p> <p>Commodity futures and options trades have to be cleared on a DCO. Many DCMs operate also as DCOs (such as the Chicago Mercantile Exchange (CME)). ICE Futures U.S. trades are cleared at ICE Clear U.S.</p> <p>Large exposure monitoring and management in securities markets</p> <p><i>SEC</i></p> |

The SEC's net capital rule requires that a BD apply haircuts to a securities position to account for the risks of the position to the firm. These charges include specific capital charges if the BD exceeds certain position limits. If the market value of a securities position exceeds 10 percent of the tentative net capital of the BD, the BD must apply an additional haircut to the amount in excess. (See Principle 30).

As part of helping to ensure that a BD remains in capital compliance at all times (see Principles 30 and 32), the SEC staff and the relevant DEA's staff monitor and evaluate the risk of open positions and credit exposures. The SEC and DEA monitoring and oversight is accomplished via the ongoing review of monthly and quarterly FOCUS reports, regular meetings and discussions with the firms, and regular examinations. BDs are also required to provide to the SEC upon request information on the size and beneficial ownership of positions held by direct customers of market intermediaries.

National securities exchanges

In case a BD poses a financial risk to the market, its SRO has a range of actions it may invoke under appropriate circumstances, acting in coordination with the SEC. 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 BD down, either through imposition of a suspension or bar, or by revocation of the BD's membership.

The margin rules also help SROs control the risk of open positions. Although the Federal Reserve's Regulation T sets minimum initial margin levels, the SROs are responsible for setting margin maintenance requirements. In addition, the SROs may set initial margin levels higher than those set pursuant to Regulation T. 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.

Clearing agencies

The SEC has adopted rules concerning risk management requirements for CCPs (SEC Rules 17Ad-22(b)(1)–(4)). Currently the CCPs registered with the SEC have implemented these requirements by applying the following procedures: (i) measuring credit exposures at least once a day; (ii) setting margin coverage at a 99 percent confidence level over a set period; (iii) using risk-based model parameters to set margin requirements; (iv) establishing a fund that mutualizes losses of defaults by one or more participants that exceed margin coverage; and (v) maintaining sufficient financial resources to withstand the default of at least the largest participant family (in the case of SBS transactions, the default of two largest participant families).

To limit its risks, a clearing agency may place a member on a watch list. If a member fails to comply with the clearing agency's operational standards and requirements, its continued activities with the clearing agency may be limited, or it may be required to post an additional deposit to the clearing fund. A clearing agency may also prohibit a member from taking on new positions, if it deems the member to be a financial concern.

DTCC Limit Monitoring

In mid-2014 the DTCC launched a risk management tool (DTCC Limit Monitoring) that alerts clearing firms to trading activity that is nearing the credit limits they have set for their own and their correspondents' accounts, enabling them to step in and manage potential risk. Clearing firms can utilize the information generated by this risk mitigation tool to help determine what action is appropriate for their executing firm. Through the NSCC's role in

clearing the majority of securities trades, the DTCC Limit Monitoring combines almost all broker-to-broker equity, listed corporate and municipal bond and unit investment trust trading in the U.S. to provide aggregated exposure data that can be used to monitor the behavior of market participants.

In near real-time, the NSCC's Universal Trade Capture service feeds to DTCC Limit Monitoring all broker-to-broker trading cleared from all exchanges, ECNs, and a range of dark pools and liquidity destinations in the U.S. Users have the ability to set limits on specific trading activities for individual clients at the executing broker level, including the ability to modify such limits intraday. Users also have the ability to enter start of day exposure information in an automated fashion. When the pre-selected "early warning" limit is reached or a breach on the established limit has occurred, a standard protocol message is disseminated alerting the affected clearing broker.

Using this system is compulsory for all NSCC member clearing firms that need to monitor correspondent firms and NSCC member proprietary trading firms.

Large exposure monitoring and management in commodity futures and options markets

CFTC reporting requirements

Every trading day, DCMs must report to the CFTC each clearing member's open long and short positions, purchases and sales, exchanges of futures for cash, and futures delivery notices for the previous trading day. This data is reported separately by proprietary and customer accounts by futures month, and for options by puts and calls, expiration date and strike price. (Part 16 CFTC Regulations).

In addition, clearing members, FCMs, and foreign brokers (reporting firms) file daily reports with the CFTC. The reports show the futures and options positions of traders with positions at or above specific reporting levels set by the CFTC. Since traders frequently carry futures positions through more than one broker and control or have a financial interest in more than one account, the CFTC regularly collects information that enables its surveillance staff to aggregate related accounts. Reporting firms must file a form that identifies each new account with reportable positions for each futures contract. In addition, if a trader's position reaches a reportable level, the trader may be required to file a more detailed identification report to identify accounts and reveal any relationships that may exist with other accounts or traders. (Part 17 CFTC Regulations).

CFTC market surveillance staff may investigate further the positions of large traders by instituting a special call. A special call is designed to gain additional information about a firm's traders and/or about a participant's trading and delivery activity, including information on persons who control or have a financial interest in the account. The special call may also request information about positions and transactions in the underlying commodity. This mechanism may be used when a trader is using too many firms to be easily monitored through required reports. (Parts 18 and 21 CFTC Regulations).

Routine reports are required from DCOs, as well as clearing members and swap dealers with reportable positions in certain covered physical commodity swaps. Such large trader reporting provides the CFTC with data regarding large positions in swaps that are linked, directly or indirectly, to a list of U.S.-listed physical commodity futures contracts. This system is intended to enable the CFTC to identify significant traders in the covered physical commodity swaps and to collect data on their trading activity in order to reconstruct market events. (Part 20 CFTC regulations).

In some specific contracts, traders that hold positions are required to disclose their full portfolio of related products through a special call. These exposure forms are filed before the last day of trading of a specific contract month and are forwarded to the CFTC surveillance staff. The need for this special disclosure derives from the existence of a large physical OTC market that is linked to the futures contract, and for positions that are not observable by the exchange.

CFTC risk surveillance program

In addition to the above mentioned reporting requirements, the CFTC also conducts more sophisticated analysis. DCR's Risk Surveillance Group (RSG) defines risk as the potential that a market participant may not fulfill its financial obligations on a contract subject to the CFTC's jurisdiction under the CEA. RSG attempts to identify positions in cleared products that pose significant financial risk to confirm that these risks are being appropriately managed. The RSG undertakes these tasks at the trader level, the clearing member level, and the DCO level. That is, it identifies both traders that pose risks to clearing members and clearing members that pose risks to the DCO. It then evaluates the financial resources and risk management practices of traders, clearing members, and DCOs in relation to those risks.

The risk surveillance program contains four primary components: i) identifying traders, clearing members, and DCOs at risk on the basis of their account characteristics and current market conditions; ii) estimating the magnitude of the risk through stress testing and other risk estimation techniques; iii) comparing the risk to the available financial resources (initial margin, trader assets, clearing member capital, and DCO resources); and iv) assessing the risk management practices of the traders, clearing members, and DCOs. RSG uses a number of tools to perform the above tasks. Improving and integrating these tools is an ongoing process. Currently RSG does not have the same ready access to financial information about traders or self-clearing firms that it has about FCMs and DCOs.

The program for futures and options is well-established. RSG is in the process of developing tools and techniques to address interest rate swaps and CDS and to integrate the swaps program with the futures and options program.

DCMs and SEFs

DCM Core Principle 6 provides that a DCM, in consultation or cooperation with the CFTC, must adopt rules to provide for the exercise of necessary and appropriate emergency authority, including the authority to liquidate or transfer open positions in any contract; suspend or curtail trading in any contract; and require market participants in any contract to meet special margin requirements. In situations where a contract is fungible with a contract on another platform, emergency action to liquidate or transfer open interest must be directed, or agreed to, by the CFTC or CFTC staff. The DCM must promptly notify the CFTC of the exercise of its emergency authority.

Similar requirements apply to SEFs.

Sharing of information

SEC

There are certain arrangements for the sharing of large trader and other concentration risk, both domestically and, to some extent, cross-border. The SEC has an MOU for information sharing with the Federal Reserve and is in contact with other financial regulators both in the U.S. and abroad about observed key developments and the risks they pose to individual firms and the broader marketplace. In addition, the SEC has entered into bilateral agreements with various agencies that allow it to share information on a timely basis with those agencies. The

SEC also participates in supervisory colleges with other U.S. regulators. These include colleges of supervisors established by holding company supervisors for each large global financial institution and ongoing supervisory meetings to discuss ANC BDs (see Principles 30 and 31).

CFTC

The CFTC and DCMs have arrangements to share information, including on large exposures. The CFTC essentially has the same large exposure information as the DCMs. When the DCMs manage position limits, they inform the CFTC of any exemptions granted. The DCMs are able to monitor the exposure size within each contract on an intraday basis. Conversations occur between exchange and CFTC staff when liquidations or acquisitions of large exposures create a heightened concern.

The Boca Declaration on Cooperation and Supervision of International Futures Markets and Clearing Organizations (Declaration), and its companion Exchange MOU were created in 1995 to address the challenge of accessing information about large exposures of exchange members and market participants trading on multiple exchanges. Under the Declaration, the occurrence of agreed triggering events affecting an exchange member's financial resources, positions, price movements or price relationships, or events suggesting manipulation or other abusive conduct, prompt the sharing of information.

The CFTC also has a special arrangement in place with regards to WTI Crude Oil, because ICE Europe trades a financially settled futures contract whose settlement price is directly linked to a NYMEX contract. Given that these two contracts form effectively a single market, the CFTC and the UK FCA entered on November 17, 2006 into a MOU, under which the FCA and CFTC share information on a daily basis regarding large exposures.

Default procedures

Clearing agency member failure

Clearing participants that clear customer positions are registered BDs and, as such, are subject to the SEC's customer protection rules in Rule 15c3-3 and the rules on the hypothecation of customer securities in Rule 8c-1 (see Principle 31). In addition, the insolvency of a BD that has customer accounts is administered by the SIPC pursuant to SIPC's framework (see Principle 32).

Registered clearing agencies are required to establish, implement, maintain and enforce written policies and procedures reasonably designed to make key aspects of their default procedures publicly available and establish default procedures that ensure that they can take timely action to contain losses and liquidity pressures and to continue meeting their obligations in the event of a participant default (SEC Rule 17Ad-22(d)(11)). In practice, clearing agency rules typically state what constitutes a default, identify whether the board or a committee of the board may make that determination, and describe what steps the clearing agency may take to protect itself and its participants.

The rules of a clearing agency must be designed to assure the prompt and accurate clearing and settlement of securities and the safeguarding of securities or funds which are in the custody or control of the clearing agency or for which it is responsible (Section 17A(b)(3)(F) Exchange Act). Registered clearing agencies have rules granting them authority to take over accounts, manage positions, and utilize the defaulting participant's collateral to meet the participant's settlement obligations. In this regard, clearing agencies typically attempt, among other things, to close out, hedge or liquidate a defaulting participant's positions.

Articles 8 and 9 of the Uniform Commercial Code provide legal certainty with respect to a clearing agency's lien on participants' collateral. Provisions in the U.S. Bankruptcy Code,

Federal Deposit Insurance Act, Federal Deposit Insurance Corporation Improvement Act, and 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.

Clearing agencies are not required to distinguish between their participants' customer and proprietary positions. Instead, they generally treat their participants as principals. In the event of a participant default, the clearing agency will work with the receiver appointed by the SIPC to distribute customer cash and securities.

DCO member failure

A DCO is required to provide information concerning the rules and operating procedures governing the clearing and settlement systems (including default procedures) to market participants (Section 5b(c)(2)(L) CEA). Most DCOs make their default procedures accessible to the public via their website.

If the CFTC determines that an FCM is likely to fail, it will attempt to cause the transfer of customer accounts. Pursuant to CFTC Regulation 1.17(a)(4), if an FCM holds less capital than the amount specified in its minimum capital requirement, it generally must transfer all customer accounts and immediately cease conducting business as an FCM, until such time as it is able to demonstrate compliance with its minimum capital requirement. The FCM itself or its DSRO would actually arrange the transfer of customer accounts. The role of the CFTC would be to facilitate such transfer as necessary (e.g., grant relief from certain notice requirements applicable to such transfer under CFTC Regulation 1.65).

If a DCO cannot collect payments from a member, or if it believes that it will shortly be unable to collect such payments, it would generally declare the member to be in default. The DCO rules govern the management of such default. Usually, such rules permit the DCO: (i) to liquidate or transfer positions carried by the defaulting member; (ii) to access all property held in the proprietary accounts of the defaulting member; (iii) to access all property held in the customer account of the defaulting member, if the default of the DCO member resulted from the default of the member's customer; and (iv) to access any amounts that the defaulting member had contributed to the guarantee fund. If the above do not cover all DCO losses, the rules of the DCO may permit the DCO: (i) to access the amounts that non-defaulting members had contributed to the guarantee fund; (ii) to look to its own capital; and (iii) to levy an assessment on all members.

Short selling

Rules

Regulation of Short Sales (Regulation SHO) has four general principles. First, it contains detailed provisions regarding when a sell order can be marked long, short, or short exempt. An order can be marked long only if the seller is deemed to own the security being sold and the security is in the broker or dealer's possession or control or it is reasonably expected that this will be the case no later than the settlement day of the transaction. Second, Regulation SHO's locate requirement directs a broker or dealer, prior to effecting a short sale, to borrow or enter into an arrangement to borrow the security. Third, Regulation SHO requires that a clearing firm deliver securities by settlement date, or if the clearing firm has not done so, immediately purchase or borrow securities to close out a fail to deliver position resulting from a short sale by no later than the morning of T+4. Fourth, Regulation SHO includes a price test that effectively restricts the price at which short sales can be made. The price test is triggered whenever the price of the security drops 10 percent or more from the prior trading day's closing price. Once triggered, the price test prevents short sales from being effected at or

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| | <p>below the National Best Bid (NBB).</p> <p>Regulation SHO provides certain exceptions. For example, Regulation SHO defines when a person, broker or dealer is deemed to own a security for short sale purposes, and provides certain exceptions to the deemed-to-own requirements for a broker or dealer that is engaged in certain arbitrage or hedging activity. Regulation SHO also provides an exception from the locate requirement for market makers engaged in bona fide market making activity. In addition, for such market makers, the close out requirement is extended to the morning of T+6.</p> <p>As noted in Principle 36, SEC Rule 10b-21 includes a specific naked short selling anti-fraud rule, according to which it is a manipulative device or contrivance to deceive about a seller's intention or ability to deliver securities in time for settlement. The SEC has taken enforcement action in 2014 under these provisions.</p> <p><i>Reporting and monitoring</i></p> <p>Several SROs provide on their websites daily aggregate short selling volume information for individual equity securities. The SROs also provide website disclosure on a one-month delayed basis of information regarding individual short sale transactions in all exchange-listed equity securities. In addition, the SEC discloses on its website twice a month fails to deliver data for all equity securities. The SROs' websites also provide the threshold securities list for those securities for which the SRO is the primary market.</p> <p>The SEC has an examination and enforcement program to monitor for, and prosecute, violations of these rules. Also, the SROs have varying programs in place to monitor short selling activity, including, but not limited to, failures to deliver in equity securities.</p> |
| <p>Assessment</p> | <p>Fully Implemented</p> |
| <p>Comments</p> | <p>The IOSCO Assessment Methodology assigns the responsibility for monitoring open positions or credit exposures on unsettled trades to market authorities. A market authority refers to the authority in the jurisdiction that has statutory or regulatory powers over a market. It further notes that the relevant market authority, depending on a jurisdiction, may be a regulatory body, an SRO, and/or the market itself.</p> <p>The complexity of the U.S. market structure and the existence of multiple regulators and SROs, national securities exchanges, DCMs, and CCPs makes assessing this Principle particularly challenging. Individual market authorities—in particular CCPs—are subject to requirements to monitor open positions in the markets that they clear. In the case of commodity futures and options, this is complemented by ongoing monitoring by the CFTC. Individual market authorities also have sufficient powers to require additional information and to take appropriate action. They have also developed various mechanisms to facilitate sharing of information both domestically and internationally.</p> <p>While the clearing agencies are not required to distinguish between their participants' customer and proprietary positions, the SIPC process can be considered to provide the means to protect customer funds and assets as required under Key Question 4 of the Assessment Methodology (see Principle 32). The CFTC has wide powers to intervene in the case of a potential failure by, for example, requiring the transfer of customer accounts (see Principle 32).</p> <p>As a result, the minimum requirements of the IOSCO Assessment Methodology appear to be complied with, due to which this Principle has been assessed as Fully Implemented. However, the authorities are encouraged to review whether the current mechanisms are sufficient to provide them with a comprehensive view of the total exposures of market participants that</p> |

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| | are active across various markets (equity, fixed income, commodity futures and options). |
| Principles Relating to Clearing and Settlement | |
| Principle 38. | Securities settlement systems and central counterparties should be subject to regulatory and supervisory requirements that are designed to ensure that they are fair, effective and efficient and that they reduce systemic risk. |
| Description | |
| Assessment | Not Assessed. |
| Comments | |