

CHAPTER 3

REGULATION

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LEARNING OUTCOMES

After completing this chapter, you should be able to do the following:

- a** Define regulations;
- b** Describe objectives of regulation;
- c** Describe potential consequences of regulatory failure;
- d** Describe a regulatory process and the importance of each step in the process;
- e** Identify specific types of regulation and describe the reasons for each;
- f** Describe elements of a company's policies and procedures to ensure the company complies with regulation;
- g** Describe potential consequences of compliance failure.

INTRODUCTION

1

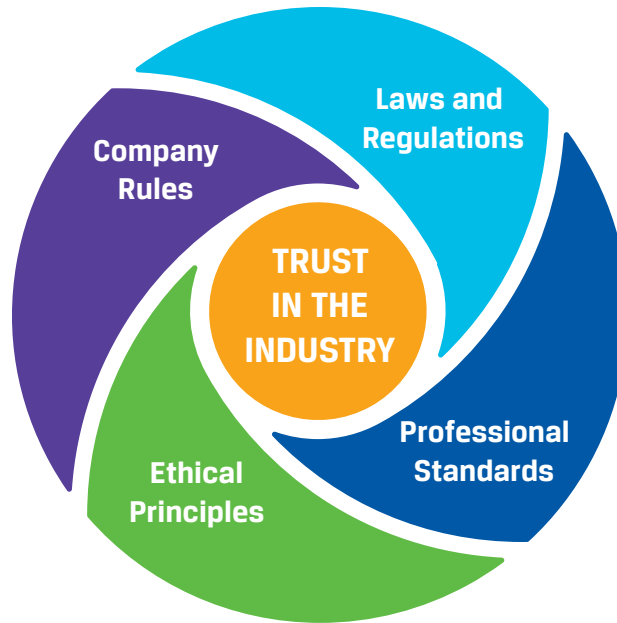
Rules are important to the investment industry. Without rules, customers could be sold unsuitable products and lose some or all of their life savings. Customers can also be harmed if a company in the investment industry misuses customer assets. Furthermore, the failure of a large company in the financial services industry, which includes the investment industry, can lead to a catastrophic chain reaction that results in the failure of many other companies, causing serious damage to the economy.

Recall from the Investment Industry: A Top-Down View chapter that regulation is one of the key forces driving the investment industry. Regulation is important because it attempts to prevent, identify, and punish investment industry behaviour that is considered undesirable. Financial services and products are highly regulated because a failure or disruption in the financial services industry, including the investment industry, can have devastating consequences for individuals, companies, and the economy as a whole.

Regulations are rules that set standards for conduct and that carry the force of law. They are set and enforced by government bodies and by other entities authorised by government bodies. This enforcement aspect is a critical difference of regulations with ethical principles and professional standards. Violations of ethical principles and professional standards have consequences, but those consequences may not be as severe as those for violations of laws and regulations. Therefore, laws and regulations can be used to reinforce ethical principles and professional standards.

It is important that all investment industry participants comply with relevant regulation. Companies and employees that fail to comply face sanctions that can be severe. More important, perhaps, than the effects on companies and employees, failure to comply with regulations can harm other participants in the financial markets as well as damage trust in the investment industry and financial markets.

Companies set and enforce rules for their employees to ensure compliance with regulation and to guide employees with matters outside the scope of regulation. These company rules are often called corporate policies and procedures and are intended to establish desired behaviours and to ensure good business practices.



An understanding of the regulatory environment and company rules is essential for success in the investment industry. In this chapter, many of the examples are drawn from developed economies primarily because the regulatory systems in these economies have had longer to evolve. Many of these systems have been adjusted over many years, so they not only protect investors and the financial system but also allow the investment industry to innovate and prosper.

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OBJECTIVES OF REGULATION

Regulators act in response to a perceived need for rules. Regulation is needed when market solutions are insufficient for a variety of reasons. Understanding the objectives of regulation makes it easier for industry participants to anticipate and comply with regulation.

The broad objectives of regulation include the following:

- 1 *Protect consumers.* Consumers may be able to quickly determine the quality of clothing or cars, but they may not have the skill or the information needed to determine the quality of financial products or services. In the context of the financial services industry, consumers include borrowers, depositors, and investors. Regulators seek to protect consumers from abusive and manipulative practices—including fraud—in financial markets. Regulators may, for instance, prevent investment firms from selling complex or high-risk investments to individuals.
- 2 *Foster capital formation and economic growth.* Financial markets allocate funds from the suppliers of capital—investors—to the users of capital, such as companies and governments. The allocation of capital to productive uses is essential

for economic growth. Regulators seek to ensure healthy financial markets in order to foster economic development. Regulators also seek to reduce risk in financial markets.

- 3 *Support economic stability.* The higher proportion of debt funding used in the financial services industry, particularly by financial institutions, and the interconnections between financial service industry participants create the risk of a **systemic failure**—that is, a failure of the entire financial system, including loss of access to credit and collapse of financial markets. Regulators thus seek to ensure that companies in the financial services industry, both individually and as an industry, do not engage in practices that could disrupt the economy.
- 4 *Ensure fairness.* All market participants do not have the same information. Sellers of financial products might choose not to communicate negative information about the products they are selling. Insiders who know more than the rest of the market might trade on their inside information. These information asymmetries (differences in available information) can deter investors from investing, thus harming economic growth. Regulators attempt to deal with these asymmetries by requiring fair and full disclosure of relevant information on a timely basis and by enforcing prohibitions on insider trading. Regulators seek to maintain “fair and orderly” markets in which no participant has an unfair advantage.
- 5 *Enhance efficiency.* Regulations that standardise documentation or how to transmit information can enhance economic efficiency by reducing duplication and confusion. An efficient dispute resolution system can reduce costs and increase economic efficiency.
- 6 *Improve society.* Governments may use regulations to achieve social objectives. These objectives can include increasing the availability of credit financing to a specific group, encouraging home ownership, or increasing national savings rates. Another social objective is to prevent criminals from using companies in the financial services industry to transfer money from illegal operations to other, legal activities—a process known as **money laundering**. As a consequence of the transfer, the money becomes “clean”. Regulations help prevent money laundering, detect criminal activity, and prosecute individuals engaged in illegal activities.

Specific regulations are developed in response to the broad objectives of regulation. A regulation can help to achieve multiple objectives. For example, rules about insider trading protect consumers (investors) and promote fairness in financial markets. Specific types of regulation are discussed in Section 4 of this chapter.

CONSEQUENCES OF REGULATORY FAILURE

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Inadequate regulation and failure to enforce regulation can have a variety of consequences, including failing to meet the objectives above. The results of a regulatory breakdown can harm customers and counterparties as well as damage trust in the

financial services industry, which includes the investment industry. Customers may lose their life savings when sold unsuitable products or customers could be harmed if an investment firm misuses customer assets. Furthermore, the failure of one large company in the financial services industry can lead to a catastrophic chain reaction (contagion) that results in the failure of many other companies, causing serious damage to the economy.

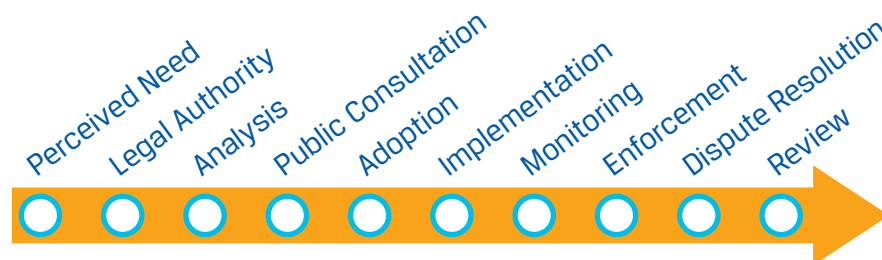
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A TYPICAL REGULATORY PROCESS

The processes by which regulations are developed vary widely from jurisdiction to jurisdiction and even within jurisdictions. This section describes steps involved in a typical regulatory process and compares different types of regulatory regimes.

Exhibit 1 shows steps in a typical regulatory process, from the need for regulation to its implementation and enforcement.

Exhibit 1 The Regulatory Process



- 1 Identification of *perceived need*. Regulations develop in response to a perceived need. The perception of need can come from many sources. There may, for instance, be political pressure on a government to react to a perceived flaw in the financial markets, such as inadequate consumer protection. Forces within the investment industry, such as lobbying groups, may also attempt to influence regulators to enact rules beneficial to their or their clients' interests. Regulation may be developed proactively in anticipation of a future need; or regulation may be developed reactively in response to a scandal or other problem.
- 2 Identification of *legal authority*. Regulatory bodies need to have the authority to regulate. Sometimes more than one regulator has authority and can respond to the same perceived need.
- 3 *Analysis*. Once a need is identified, regulators conduct a careful analysis. The regulators should consider all the different regulatory approaches that can be used to achieve the desired outcome. Possible approaches include mandating and/or restricting certain behaviours, establishing certain parties' rights and responsibilities, and imposing taxes and subsidies to affect behaviours. The

analysis also needs to carefully weigh the costs and benefits of the proposed regulation, even though the benefits are often difficult to quantify. In other words, does the cure cost more than the disease? Regulations impose costs, including the direct costs incurred to hire people and construct systems to achieve compliance, monitor compliance, and enforce the regulations. These costs increase ongoing operating costs of regulators and companies, among others. A regulation may be effective in leading to desired behaviours but very inefficient given the costs associated with it.

In some countries, regulators explicitly consider the competitive position of their country's financial services industry, which includes the investment industry, when they are developing regulation.¹ Regulators are aware of the need for innovation and try not to arbitrarily stifle new ideas.

- 4** *Public consultation.* Regulators often ask for public comment on proposed regulations. This public consultation gives those likely to be affected by the regulations an opportunity to make suggestions and comments, on such issues as costs, benefits, and alternatives, to improve the quality of the final regulations. A regulation may go through several rounds of proposal, consultation, and amendment before it is adopted.
- 5** *Adoption.* The regulation is formally adopted by the regulator. Regulators may clarify formal rules by publishing guidelines, frequently asked questions (FAQs), staff interpretations, and other documents. Companies or individuals that do not comply with these published pronouncements put themselves at risk of violating regulations.
- 6** *Implementation.* Regulations need to be implemented by the regulator and complied with by those who are affected by them. Some regulations go into effect immediately and some are phased in over time. Because companies have a duty to comply with relevant new regulations, they need to monitor information from regulators and act on any changes. Sometimes regulators will contact companies directly about a new regulation, but not always.
- 7** *Monitoring.* Regulators monitor companies and individuals to assess whether they are complying with regulation. Monitoring activities include routine examinations of companies, investigation of complaints, and routine or special monitoring of specific activities. Routine examinations may check for compliance with such items as net capital requirements and safeguarding of customer assets. Regulators may check whether a company has compliance procedures in place and whether the company is actually following these procedures. Regulators may also have systems in place for receiving and investigating complaints about violations. They may also monitor for certain prohibited or required activities. For example, regulators may routinely investigate all purchases just before a takeover announcement to determine whether there has been any insider trading.
- 8** *Enforcement.* For a regulatory system to be effective, it must have the means to identify and punish lawbreakers. Punishments include cease-and-desist orders and monetary fines, fees, and settlements. In the case of individuals,

¹ For example, the United Kingdom's Financial Services Authority took into account "the desirability of maintaining the competitive position of the UK" (www.fsa.gov.uk/pages/About/Aims/Principles/index.shtml).

punishments also may involve the loss of licences, a ban from working in the investment industry, and even prison terms. The loss of reputation resulting from regulatory action, even when the individual is not convicted or punished, can have significant effects on individuals and companies.

- 9 *Dispute resolution.* When disputes arise in a market, a fair, fast, and efficient dispute resolution system can improve the market's reputation for integrity and promote economic efficiency. Mechanisms that provide an alternative to going to court to resolve a dispute—often known as alternative dispute resolutions—have been developed globally. These typically use a third party, such as a tribunal, arbitrator, mediator, or ombudsman, to help parties resolve a dispute. Using alternative dispute resolutions may be faster and less expensive than going to court.
- 10 *Review.* Regulations can become obsolete as technology and the investment industry change. For this reason, a good regulatory system has procedures in place for regularly reviewing regulations to determine their effectiveness and whether any changes are necessary.

Although the creation of regulation often involves the processes just outlined, regulations can be created less formally. Sometimes, regulators will issue informal guidance that may not have the formal legal status of written regulations but will affect the interpretation and enforcement of regulations. Enforcement officials may decide, for instance, that a previously acceptable practice has become abusive and start sanctioning individuals and companies for it. This potential is one of the reasons why individuals and companies should maintain ethical standards higher than the legal minimums.

4.1 Classification of Regulatory Regimes

The type of regulation that an individual or company encounters will affect how they respond to and comply with it. The way that regulations are classified can differ between countries, so it is important to understand the types of regulatory regimes, particularly if your company operates at a global level.

Regulatory regimes are often described as “principles-based” or “rules-based”. In a **principles-based** regime, regulators set up broad principles within which the investment industry is expected to operate. This avoids legal complexity and allows regulators to interpret the principles on a case-by-case basis. **Rules-based** regimes provide explicit regulations that, in theory, offer clarity and legal certainty to investment industry participants. However, real-world regulatory regimes are usually hybrids of these two types. For example, US regulation is often described as rules-based. One such rule is that insider trading is banned. Yet, the rule includes no statutory definition of insider trading—prosecutions are made under the broad anti-fraud provisions

of US law that outlaw any type of fraud or manipulation.² Equally, UK regulation is often described as principles-based, yet some regulations—such as those for credit unions—are very detailed.

Regulatory systems can also be designed as “merit-based” or “disclosure-based”. In **merit-based** regulation, regulators attempt to protect investors by limiting the products sold to them. For example, a regulator may decide that a hedge fund product is highly risky and should only be available to investors that meet certain criteria. Investing in hedge funds is usually restricted to investors that have a certain level of resources and/or investment expertise. **Disclosure-based** regulation seeks to ensure not whether the investment is appropriate for investors, but only whether all material information is disclosed to investors. The philosophy behind disclosure-based regulation is that properly informed investors can make their own determinations regarding whether the potential return of an investment is worth the risk.

Again, the real world regulatory environment is often a hybrid of these two types of regulation. For example, although US regulation is mostly disclosure-based, US regulators sometimes impose extra burdens of disclosure and restrict access to products that they think lack merit, are highly risky, or are poorly understood.

TYPES OF FINANCIAL MARKET REGULATION

5

The broad objectives of regulation discussed in Section 2 are used by regulators to create sets of rules. Each set of rules focuses on a type of investment industry activity. These rules include the following:

- Gatekeeping rules
- Operations rules
- Disclosure rules
- Sales practice rules
- Trading rules
- Proxy voting rules

² To be precise, US prosecutions for insider trading are typically made under US SEC Rule 10b-5, which does not mention insider trading directly. It states, “It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

a. To employ any device, scheme, or artifice to defraud,

b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.”

- Anti-money-laundering rules
- Business continuity rules

5.1 Gatekeeping Rules

Gatekeeping rules govern who is allowed to operate as an investment professional as well as if and how products can be marketed.

Personnel. One of the primary activities of regulators is screening investment industry personnel to ensure that they meet standards for integrity and competency. Even honest people can do tremendous damage if they are untrained or incompetent. For this reason, regulators in most financial markets require individuals to pass licensing exams to make sure that industry personnel have an understanding of the financial laws and of financial products in general.

Financial products. Financial products must generally comply with numerous regulations before they can be sold to the public. In disclosure-based regimes, the regulators monitor the accuracy of the disclosures; in merit-based regimes, the regulators pass judgement on the merits of the investments.

Gatekeeping rules are necessary because some financial products are complicated to understand, and sellers of these products may have incentives to offer and recommend the wrong products to a client. For example, between 2002 and 2008, Hong Kong SAR banks and brokerage firms sold a total of HK\$14.7 billion of Lehman Brothers' investment products—mainly unlisted notes linked to the credit of various companies—to about 43,700 individual investors. After Lehman's bankruptcy in 2008, investors lost most, if not all, of the principal amount they had invested.

5.2 Operational Rules

Regulations may dictate some aspects of how a company operates.

Net capital. It is important that companies in the financial services industry have sufficient resources to honour their obligations. History shows that highly leveraged companies (companies with a high amount of debt relative to equity) pose a risk not only to their own shareholders, but also to their customers and the economy as a whole. Bankruptcies of even small companies in the financial services industry can be disruptive. The aggregate effects of a large number of small collapses can have a serious impact on the overall economy.

The collapse of larger entities can result in global financial contagion, a situation in which financial shocks spread from their place of origin to other locales or markets. Contagion occurred in the 1997 Asian crisis—a crisis that began in some Asian countries and spread across the globe. Contagion also took place during the financial crisis of 2008. Regulators seek to prevent excessive risk taking by imposing capital requirements that limit the amount of leverage that companies in the financial services industry, particularly a financial institution, can use. More information about the effect of leverage on a company's performance is provided in the Financial Statements chapter.

Handling of customer assets. Most jurisdictions impose rules that require customer assets to be strictly segregated from the assets of an investment firm. Even with regulations, however, companies may be tempted to use these valuable assets in ways that have not been approved by the customer. Even if there is no intentional diversion of customer funds, mishandling or poor internal control of these assets exposes customers to the risk of loss. Any reported problems in this area may damage the reputation of the entire investment industry.

5.3 Disclosure Rules

In order for markets to function properly, market participants require information, including information about companies and governments raising funds, information about the specific financial instruments being sold and traded, and information about the markets for those instruments. Rules specify what information is included and how the information is disclosed.

Corporate issuers. Regulators typically require corporate issuers of securities to disclose detailed information to potential buyers before the offering of securities. This requirement is to ensure that investors have enough information about what they are buying to make informed decisions. The disclosures generally include audited financial statements, information about the general business of the company, the intended use of the proceeds, information about management, and a discussion of important risk factors.

Market transparency. Information about what other investors are willing to pay for a security, or the price they just paid, is valuable to investors because it helps them assess how much a security is worth. But investors generally do not want to reveal private information. Regulation requires the dissemination of at least some information regarding the trading environment for securities.

Disclosure triggers. A company may be exposed to various types of compulsory regulatory disclosure requirements. Stock exchanges and market regulators typically have a range of disclosures, which may be required as soon as a trigger event occurs or a threshold is reached. For holdings in a particular stock, there can, for example, be significant shareholder disclosures designed to inform the market of potential takeover activity, directors' dealings in shares of the company, or short positions.

5.4 Sales Practice Rules

Some consumers seeking financial advice find it difficult to assess the quality of the advice they are receiving. These consumers may be vulnerable to abusive sales practices by sellers who are more concerned about their own profit than the customers' best interests. For instance, some providers may be inclined to push products that pay the highest commission. Regulators deal with potential sales practice abuses in various ways.

Advertising. Regulators may control the form and content of advertising to ensure that advertising is not misleading. For example, regulators often disapprove of such advertised promises as "guaranteed" returns and "sure win" situations. Providers of

products and services to investors may be tempted to exaggerate past performance by displaying only winning time periods or winning strategies. Regulators seek to counteract this tendency by creating standards for the reporting of past performance.

Fees. Regulators may impose price controls to limit the commissions that can be charged on the sale of various financial products as well as to limit the mark-ups and mark-downs that occur when investment firms trade securities with their customers out of their own inventories.

Information barriers. Many large firms in the investment industry offer investment banking services to corporate issuers and, at the same time, publish investment research and provide financial advice. This situation creates potential conflicts of interest. For instance, firms may publish biased investment advice in order to win more lucrative investment banking business. Similarly, research analysts may be under pressure to publish favourable research reports on securities in which the firm has large positions in its own inventory. Regulators attempt to resolve conflicts of interest by requiring firms to create barriers—virtual and physical—between investment banking and research.

Suitability standards. Regulation seeks to hold those in the investment industry accountable for the advice that they give to their clients. Any advice or recommendation should be suitable for the client (consistent with the client's interests). Some participants in the investment industry are held to an even higher standard, frequently called a fiduciary standard. Under this standard, any advice or recommendation must be both suitable for the client and in the client's best interests. In order to advise or make recommendations, it is critical to “know your customer”—gather information about a client's circumstances, needs, and attitudes to risk.

Restrictions on self-dealing. Many firms in the investment industry sell financial products such as securities directly to investors out of their own inventories. This practice allows them to provide faster service and better liquidity to their customers as well as to provide access to proprietary financial products that may not be available elsewhere. However, self-dealing potentially creates a conflict of interest because the firm's interests may differ from those of the consumer. The firm wants to charge the highest price to the customer, who wants to pay the lowest price. There can also be confusion among customers as to whether the firm is acting as a principal (the firm is taking the other side of the trade) or an agent (the firm is working for the client, but not trading with that client). Regulators may deal with the potential conflict in a number of ways. They may impose “best execution” requirements, require disclosure of the conflict, or ban self-dealing with customers.

5.5 Trading Rules

Regulations are often designed to set investment industry standards as well as to prevent abusive trading practices.

Market standards. Government regulation can be used to set, for example, the standard length of time between a trade and the settlement of the trade (typically three business days for equities in most global markets).

Market manipulation. Regulators attempt to prevent and prosecute market manipulation. **Market manipulation** involves taking actions intended to move the price of a stock to generate a short-term profit.

Insider trading. A market in which some participants have an unfair advantage over other participants lacks legitimacy and thus deters investors. For this reason, most jurisdictions have rules designed to prevent **insider trading**. Because material non-public information flows through companies in the financial services industry about the financial condition of their clients and their trading, regulators often expect companies to have policies and procedures in place to restrict access to such information and to deter parties with access from trading on this information.

Front running. As with insider trading, regulators may ensure that companies have procedures in place to deter front running and to monitor employees' personal trading. **Front running** is the act of placing an order ahead of a customer's order to take advantage of the price impact that the customer's order will have. For example, if you know a customer is ordering a large quantity that is likely to drive up the price, you could take advantage of this information by buying in advance of that customer's order.

Brokerage practices. In some countries, investment managers may use arrangements in which brokerage commissions are used to pay for external research. These are referred to as soft money (soft dollar) arrangements. Rather than paying cash for the research, the broker directs transactions to a provider. The payment of commissions on those transactions, possibly made from client accounts, give the brokerage firm access to the research produced by the provider. Regulators may have regulations regarding the use of such arrangements because client transactions could be directed to gain access to research rather than being used in clients' interests.³

5.6 Proxy Voting Rules

In some countries, brokers are required to distribute voting materials to their customers, gather voting instructions, and submit them for inclusion in the counting of votes. In other countries, corporate issuers distribute materials directly to shareholders. Regulation determines what procedures are used for conducting proxy votes.

5.7 Anti-Money-Laundering Rules

Companies in the financial services industry can be used by criminals to launder money, to facilitate tax evasion, and to fund terrorism. Governments naturally want to deter such activities and they may use their regulatory power over companies in the financial services industry to do so. Regulations may require companies to confirm and record the identity of their clients; to report payments, such as dividends, to tax authorities; and to report various other activities, such as large cash transactions.

³ CFA Institute also has ethical standards for the use of soft dollars. See CFA Institute, *CFA Institute Soft Dollar Standards: Guidance for Ethical Practices Involving Client Brokerage* (2011): www.cfapubs.org/doi/pdf/10.2469/ccb.v2004.n1.4005.

5.8 Business Continuity Planning Rules

Given the essential nature of financial services to the economy, regulators may be concerned about business continuity in the event of disasters, such as fires, floods, earthquakes, and epidemics. Regulators want to be assured that customer records are adequately backed up and that companies have plans in place to recover from a disaster.

Regulations affect all aspects of the investment industry, from entry into it to exit from it.

6

COMPANY POLICIES AND PROCEDURES

Companies within the investment industry, like all companies, are expected to have **policies** and **procedures** (also referred to as corporate policies and procedures) in place to ensure employees' compliance with applicable laws and regulations. Policies are principles of action adopted by a company. Procedures are what the company must do to achieve a desired outcome. Although company policies and procedures do not have the force of law, they are extremely important for the survival of companies. Policies and procedures establish desired behaviours, including behaviours with respect to regulatory compliance. Indeed, companies may be sanctioned or even barred from the investment industry for not having policies and procedures in place that ensure compliance with regulations. Policies and procedures also guide employees with matters outside the scope of regulation. Recall from the Ethics and Investment Professionalism chapter that policies and procedures are important in helping to prevent undesirable behaviour.

Companies use a similar process as regulators when setting corporate policies and procedures. Typically, corporate policies and procedures respond to a perceived need. Companies establish systems to make employees aware of new policies and procedures, to monitor compliance, and to act on failures to comply. It is important to document policies and procedures so that the company can prove it is in compliance when inspected by regulators. It is also important to document that the company follows and enforces its policies and procedures.

Regulators also expect supervisors of subordinate employees to make sure that the employees are in compliance with the company's policies and procedures and with relevant regulation. Regulators may discipline higher-level executives for misdeeds within a company because the executives did not supervise their employees properly, even when the executives had no involvement whatsoever in the misdeeds.

6.1 Supervision within Companies

Just as it is important for regulators to supervise companies in the investment industry, it is also vital that companies supervise their employees. With large amounts of money at stake, a single rogue employee can cause significant harm or even bring down a company.

Supervision starts even before a new employee joins a company. The company should conduct background checks to make sure that the prospective employee is competent and of good character. The employee's initial orientation and training should emphasise the importance of compliance with corporate policies and procedures and with relevant regulations.

It is not enough to train new employees. It is important to also provide continuing education to reinforce the mission-critical nature of compliance with corporate policies and procedures and with relevant regulations. It is also important to have documented systems in place to ensure that employees follow the company's compliance procedures. For example, a company may have rules in place to deter insider trading and front running.

A company must also be able to prove to regulators that it has established good corporate policies and procedures and that they are being followed. Good documentation, such as keeping records of employees' continuing education, is essential to prove compliance and enforcement. The Investment Industry Documentation chapter provides a discussion of documentation in the context of the investment industry.

6.2 Compensation Plans

Companies need to be aware of the potential effects of compensation plans on employees' behaviour. For example, bonuses for reaching target sales levels may motivate employees to make more sales, but they may also motivate employees to break rules and engage in deception to make those sales. Adherence to good compliance practices should be a standard part of employees' performance reviews and a factor in determining bonuses.

6.3 Procedures for Handling Violations

No matter how honest and well-meaning employees are, sooner or later, there will be some rule violations. A culture of cover-up is dangerous for a company because once unethical employees discover that it is possible to hide problems, they will be tempted to take advantage of that. Companies need to have procedures in place for employees to report problems without fear of retribution, as well as procedures for handling problems in an effective manner.

CONSEQUENCES OF COMPLIANCE FAILURE

7

Failure to comply with regulations and policies and procedures can have significant consequences for employees, managers, customers, the company, the investment industry, and the economy. Companies may fire employees and managers that fail to comply with regulations and policies and procedures. When a regulatory action occurs, even if no formal charges are brought, the legal costs to individuals and firms involved in dealing with it can be high.

Regulators have many ways of disciplining firms and individuals that violate informal rules. Sanctions for individuals may include fines, imprisonment, loss of licence, and a lifetime ban from the investment industry. When subordinates violate rules, managers may also face consequences for failure to supervise. Even long after the issue is resolved, the regulatory sanctions remain a matter of public record that can haunt the individuals involved for the rest of their lives. The economic damage from loss of reputation can be huge.

Companies also face sanctions including fines, loss of licences, and forced closure. A company may be forced to spend significant resources in corrective actions, such as hiring outside consultants, to demonstrate compliance. Companies interact with regulators on an ongoing basis, so running afoul of a regulator's opinion in one area can lead to problems in other areas.

Compliance failures affect more than just the company and its employees. Customers and counterparties can be harmed and trust in the investment industry and financial markets damaged. Customers may lose their life savings and counterparties may suffer losses. At the extreme, the failure of one large company in the financial services industry can lead to a catastrophic chain reaction (contagion) that results in the failure of many other companies, causing serious damage to the economy.

SUMMARY

If every individual and every company acted ethically, the need for regulation would be greatly reduced. But the need would not disappear altogether because regulation does not just seek to prevent undesirable behaviour but also to establish rules that can guide standards that can be widely adopted within the investment industry. The existence of recognised and accepted standards is important to market participants, so trust in the investment industry depends, in no small measure, on effective regulation.

Some important points to remember include the following:

- Regulations are rules carrying the force of law that are set and enforced by government bodies and other entities authorised by government bodies. It is important that all investment industry participants comply with relevant regulation. Those that fail to do so face sanctions that can be severe.
- Financial services and products are highly regulated because a failure or disruption in the financial services industry, which includes the investment industry, can have catastrophic consequences for individuals, companies, and the economy as a whole.
- Regulation is necessary for many reasons, including to protect consumers; to foster capital formation and economic growth; to support economic stability; to promote fair, efficient, and transparent financial markets; and to improve society.

- A typical regulatory process involves determination of need by a legal authority; analysis, including costs and benefits; public consultation on proposals; adoption and implementation of regulations; monitoring for compliance; enforcement, including penalties for violations; dispute resolution; and review of the effectiveness of regulation.
- Regulation may be principles-based or rules-based and merit-based or disclosure-based.
- The types of regulations that have been developed in response to perceived needs include rules on gatekeeping, operations, disclosure, sales practice, trading, proxy voting, anti-money-laundering, and business continuity planning.
- Corporate policies and procedures are rules established by companies to ensure compliance with applicable laws and regulations, to establish processes and desired behaviours, and to guide employees.
- Documentation is important for demonstrating regulatory compliance.
- Employees' activities can have negative consequences for managers (supervisors) and companies. It is vital to make sure that employees are competent and of good character. They should receive training to ensure that they are familiar with their regulatory responsibilities, corporate policies and procedures, and ethical principles. Employees' behaviour and actions should be adequately supervised and monitored.
- Failure to comply with regulation and policies and procedures can have significant consequences for employees, managers, customers, the firm, the investment industry, and the economy.

CHAPTER REVIEW QUESTIONS

- 1 Consequences are most severe for market participants who violate which of the following?
 - A Regulations
 - B Ethical principles
 - C Professional standards
- 2 Regulations that affect the financial services industry are *most likely* needed because:
 - A power is equally distributed among industry participants.
 - B the same information is available to all industry participants.
 - C a high number of interconnections exists among industry participants.
- 3 Which of the following *best* describes a broad objective of regulation in the context of the financial services industry?
 - A To protect consumers
 - B To eliminate financial risk
 - C To enforce corporate policies and procedures
- 4 Regulations to ensure that companies in the financial services industry do not engage in practices that could cause failures in the financial markets *most likely* have:
 - A a social objective.
 - B an efficiency objective.
 - C an economic stability objective.
- 5 Regulations intended to increase the national savings rate and encourage home ownership *most likely* have:
 - A a social objective.
 - B a fairness objective.
 - C an economic stability objective.

- 6 In working toward ensuring fairness in the markets, regulators *most likely* attempt to:
- A increase information asymmetries.
 - B maintain fair and orderly markets.
 - C prevent public release of insider information.
- 7 Which of the following is *most likely* a regulatory failure?
- A Only inadequate regulation
 - B Only failure to enforce regulation
 - C Both inadequate regulation and failure to enforce regulation
- 8 The step in the regulatory process at which regulators weigh the costs and benefits of a proposed regulation is the:
- A analysis.
 - B identification of perceived need.
 - C dispute resolution process.
- 9 In establishing a merit-based rule, regulators are *most likely* to:
- A restrict access to specific products deemed to be risky.
 - B mandate disclosure of information relevant to decision making.
 - C establish broad principles within which the industry is expected to operate.
- 10 Which of the following is *most likely* the first step in a typical regulatory process?
- A Public consultation
 - B Compliance monitoring
 - C Perceived need identification
- 11 In the regulatory process, regulators must assess whether firms and individuals are complying with regulations. This step in the regulatory process is *best* described as:
- A monitoring.
 - B enforcement.
 - C implementation.

- 12 Insider trading is *best* defined as:
- A trading for internal company accounts before placing a customer's order.
 - B trading based on material, non-public information that is likely to affect prices.
 - C taking actions intended to move the price of a security to generate a short-term profit.
- 13 Regulations that require large financial firms to create virtual and physical barriers between investment banking activities and research activities are examples of:
- A trading rules.
 - B gatekeeping rules.
 - C sales practice rules.
- 14 Regulations that attempt to prevent market manipulation are examples of:
- A trading rules.
 - B operational rules.
 - C sales practice rules.
- 15 An objective of establishing corporate policies and procedures is to:
- A promote economic growth and stability.
 - B ensure compliance with laws and regulations by employees.
 - C set standards for employee conduct that carry the force of law.
- 16 With respect to corporate policies and procedures, when should supervision of employees begin?
- A Before an employee is hired
 - B During an employee's orientation
 - C During an employee's job training
- 17 The consequences of failure to comply with regulations and corporate policies and procedures:
- A include costs to only the firm and employees.
 - B range from individual costs to damage to the global economy.
 - C are borne by the employee who failed to comply and not by the employee's supervisor or employer.

18 Regulatory sanctions against firms include:

- A** only financial penalties.
- B** only financial penalties and loss of licences.
- C** financial penalties, loss of licences, and forced closure.

ANSWERS

- 1 A is correct. Consequences are most severe for violations of regulations. B and C are incorrect because violations of ethical principles and professional standards have consequences, but those consequences may not be as severe as those for violations of regulations, which carry the force of law.
- 2 C is correct. Regulations that affect the financial services industry are needed because a high number of interconnections exist among industry participants. The interconnections between industry participants create the risk of a systemic failure. A and B are incorrect because there are differences in the relative power and access to information among industry participants, which creates a need for regulation.
- 3 A is correct. The protection of consumers is a broad objective of regulation in the context of the financial services industry. B is incorrect because the reduction of risk may be an objective of regulation, but the elimination of risk in the financial services industry is not possible. C is incorrect because corporate policies and procedures are set by companies and are intended to ensure good business practices and compliance with regulation; however, the enforcement of internal company policies is not an objective of regulation.
- 4 C is correct. Regulations to ensure that companies in the financial services industry do not engage in practices that could cause failures in the financial market have an economic stability objective. A is incorrect because social objectives of regulation include increasing the availability of credit to a specific group, encouraging home ownership, increasing national savings rates, and preventing criminal activity. B is incorrect because efficiency objectives of regulation are intended to reduce costs and increase economic efficiency. For example, the adoption of rules to standardise documentation or how to transport information.
- 5 A is correct. Regulations intended to increase the national savings rate and encourage home ownership have a social objective. B is incorrect because the fairness objective of regulation seeks to promote fair and orderly markets in which no participant has an unfair advantage. C is incorrect because economic stability objectives seek to ensure that companies in the financial services industry do not engage in practices that could disrupt the economy.
- 6 B is correct. Regulations seek to maintain fair and orderly markets by promoting rules that eliminate unfair advantages to select participants. A is incorrect because information asymmetries refers to some market participants having more information relevant to an investment than other participants. Regulations seek to reduce information asymmetries, not to increase them. C is incorrect because regulations seek to prevent participants from trading on inside information to the detriment of other market participants. Public release, or dissemination, reduces the unfair advantage of insider information.

- 7 C is correct. Both inadequate regulation and failure to properly enforce regulations are examples of regulatory failure, potentially resulting in harm to market participants and the industry as a whole.
- 8 A is correct. Analysis is the step in the regulatory process at which regulators weigh the costs and benefits of a proposed regulation. B is incorrect because the identification of perceived need is the step at which a future need or a previous problem is perceived to exist and leads to regulation. C is incorrect because the dispute resolution process is the step that identifies how disputes may be handled.
- 9 A is correct. In a merit-based regulatory system, regulators attempt to protect consumers by limiting the products sold to them. B is incorrect because disclosure-based, not merit-based, regulatory systems mandate disclosure of information relevant to decision making. In a disclosure-based system, regulators do not decide whether a product is good or bad for consumers, but merely ensure that consumers have sufficient information to make their own decisions. C is incorrect because principles-based, not merit-based, regulatory systems establish broad principles within which the industry is expected to operate. In fact, most regulatory systems are hybrids that draw on each of the four approaches: rules-based, principles-based, merit-based, and disclosure-based. As a result, some regulations will be very detailed, some will establish broad principles, some will attempt to protect consumers by limiting access to products considered risky or harmful, and some will focus on ensuring that appropriate information is provided.
- 10 C is correct. In a typical regulatory process, the first step is identification of a perceived need. Perceived need for regulation may be proactive in anticipation of need or in response to a current situation. A is incorrect because public consultation is part of the regulatory step, but it comes after the identification of a need, identification of legal authority, and analysis. B is incorrect because compliance monitoring occurs after the regulation is in place.
- 11 A is correct. In a typical regulatory process, the step that involves monitoring firms and individuals for compliance, including such things as examinations and investigations, is the monitoring step. B is incorrect because the enforcement step of the regulatory process involves regulators identifying and punishing compliance violations. C is incorrect because the implementation step of the regulatory process is when a new regulation goes into effect and may include informing firms and individuals about the new regulations.
- 12 B is correct. Insider trading is trading based on material, non-public information. A is incorrect because trading for internal company accounts before placing a customer's order is front running. C is incorrect because taking actions intended to move the price of a stock to generate a short-term profit is market manipulation.
- 13 C is correct. Regulations that require large financial firms to create virtual and physical barriers between investment banking activities and research activities are examples of sales practice rules. Sales practice rules attempt to address potential conflicts of interest when financial service providers have a financial stake in the decisions that their clients make. Such regulation also includes controls on advertising and pricing. A is incorrect because trading rules focus on

trading practices in the market and trading activity of financial participants to ensure fair, organised, and efficient markets. B is incorrect because gatekeeping rules are intended to ensure that industry personnel meet standards for competency and integrity and that financial products offered meet certain standards.

- 14 A is correct. Regulations that attempt to prevent market manipulation are examples of trading rules. Trading rules focus on trading practices in the market and trading activity of financial participants to ensure fair, organised, and efficient markets. Market manipulation involves investors taking actions intended to move the price of a stock to generate a short-term profit. B is incorrect because operational rules are related to how a company operates; operation rules include rules with respect to financial leverage and how customer accounts are handled. C is incorrect because sales practice rules are intended to ensure that industry professionals treat clients appropriately with regard to the products recommended and fees charged. Furthermore, such rules are intended to reduce potential conflicts of interest an industry professional might face in the sale and recommendation of a financial product.
- 15 B is correct. An objective of establishing corporate policies and procedures is to ensure compliance with laws and regulations by employees. A is incorrect because promoting economic growth and stability are broad objectives of regulation. C is incorrect because corporate policies and procedures do not carry the force of law.
- 16 A is correct. Supervision begins before employees are hired; the company should conduct background checks to ascertain the competence and character of prospective employees. B and C are incorrect because initial orientation and training should emphasise the importance and role of corporate policies and procedures as well as regulatory compliance, but those occur after the employee has been hired.
- 17 B is correct. The consequences of failure to comply with regulations and corporate policies and procedures can have far-reaching consequences. A is incorrect because these failures affect more than just the company and its employees. C is incorrect because supervisors and the employer may be assigned some responsibility for the failure.
- 18 C is correct. Failure to comply with regulations and internal policies may result in regulatory sanctions, including fines, loss of licences, and forced closure. A and B are incorrect because sanctions can include fines, loss of licences, and forced closure.