



CFA Institute[®]
Investment Foundations

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Module 2: ETHICS AND REGULATION

Chapter 3: Regulation

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Module	Topic	Weight	LOS	Exam Qs	Hours to Study	Practice Qs
Module 1	Industry overview	5%	7	6	5	28
Chapter 1	The Investment Industry: A Top-Down View					
Module 2	Ethics and regulation	10%	14	12	10	91
Chapter 2	Ethics and Investment Professionalism					
Chapter 3	Regulation					
Module 3	Inputs and tools	20%	50	24	20	291
Chapter 4	Microeconomics					
Chapter 5	Macroeconomics					
Chapter 6	Economics of International Trade					
Chapter 7	Financial Statements					
Chapter 8	Quantitative Concepts					
Module 4	Investment instruments	20%	29	24	20	213
Chapter 9	Debt Securities					
Chapter 10	Equity Securities					
Chapter 11	Derivatives					
Chapter 12	Alternative Investments					
Module 5	Industry structure	20%	27	24	20	96
Chapter 13	Structure of the Investment Industry					
Chapter 14	Investment Vehicles					
Chapter 15	The Functioning of Financial Markets					
Module 6	Serving client needs	5%	12	6	5	76
Chapter 16	Investors and Their Needs					
Chapter 17	Investment Management					
Module 7	Industry controls	20%	24	24	20	154
Chapter 18	Risk Management					
Chapter 19	Performance Evaluation					
Chapter 20	Investment Industry Documentation					
	Total	100%	163	120	100	949

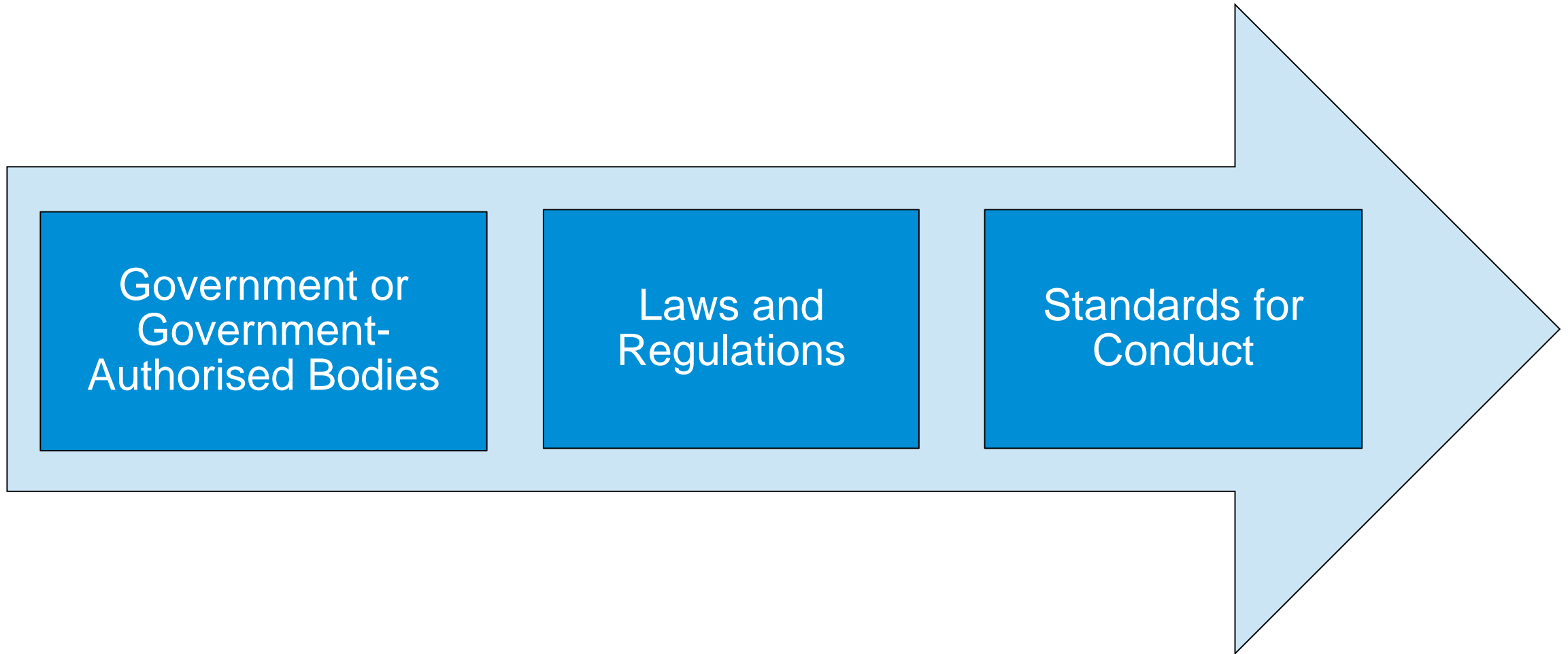
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AFTER COMPLETING THIS CHAPTER, YOU SHOULD BE ABLE TO DO THE FOLLOWING:

- 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.

LAWS AND REGULATION



LOS a: Define regulations.

OBJECTIVES OF REGULATION

1. Protect Consumers

Regulators protect consumers from abusive and manipulative practices, including fraud, in the market.

2. Foster Capital Formation and Economic Growth

Regulators seek to ensure healthy financial markets in order to foster overall economic development and reduce risk in financial markets.

3. Support Economic Stability

Regulators seek to ensure that financial firms, both individually and as an industry, do not engage in practices that could disrupt the economy.

LOS b: Describe the objectives of regulation.

OBJECTIVES OF REGULATION

4. Ensure Fairness

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.

6. Improve Society

Regulations may be used to achieve social objectives, such as increasing the availability of credit to a specific group, encouraging home ownership, increasing national savings rates, and helping prevent money laundering.

LOS b: Describe the objectives of regulation.

CONSEQUENCES OF REGULATORY FAILURE

Inadequate regulation and failure to enforce regulation can have a variety of consequences, including failing to meet the previous objectives.

- 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.

LOS c: Describe potential consequences of regulatory failure.

A TYPICAL REGULATORY PROCESS

1. Perceived Need: Can come from many directions—political pressure or forces within the industry—and may be developed proactively or reactively.



2. Legal Authority: Sometimes, more than one regulator has authority and responds to the same perceived need.




3. Analysis: Should consider all of the different regulatory approaches that can be used to achieve the desired outcome and weigh their costs and benefits.




LOS d: Describe a regulatory process and the importance of each step in the process.

A TYPICAL REGULATORY PROCESS

4. Public Consultation: Gives those likely to be affected by the regulations the opportunity to make suggestions and comments.



5. Adoption: The rule is adopted and may be clarified with the publication of “guidelines”, “Frequently Asked Questions”, etc.



6. Implementation: Some regulations take force immediately, and some are phased in over time. Firms need to monitor and learn about any changes.




LOS d: Describe a regulatory process and the importance of each step in the process.

A TYPICAL REGULATORY PROCESS

7. Monitoring: Activities include routine examinations of firms, investigation of complaints, and routine or special monitoring of individual activities.



8. Enforcement: Punishments include cease-and-desist orders and monetary fines, fees, or settlements and also may involve the loss of licences, a ban from the industry, and/or prison terms.



LOS d: Describe a regulatory process and the importance of each step in the process.

A TYPICAL REGULATORY PROCESS

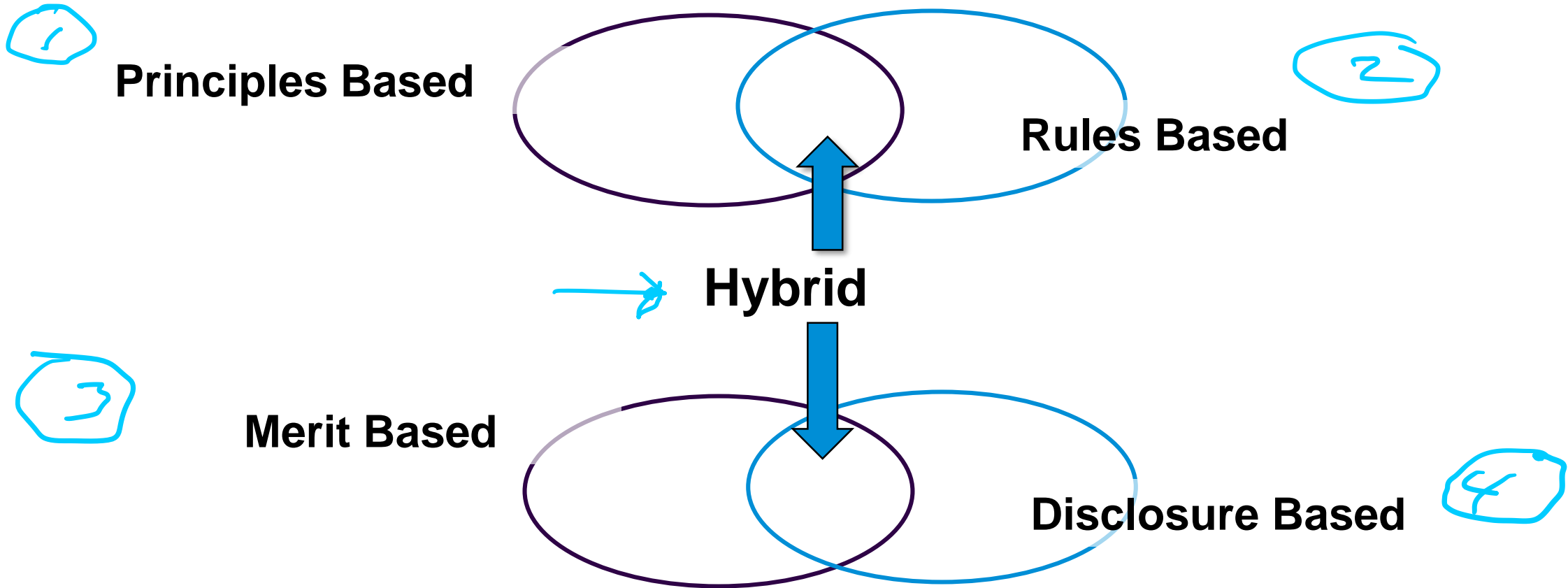
9. Dispute Resolution: A fair, fast, and efficient dispute resolution system can improve the market's reputation for integrity and promote economic efficiency.



10. Review: Rules can become obsolete as technology and the industry change. A good regulatory system has procedures in place for regularly reviewing rules to determine their effectiveness and whether any changes are necessary.

LOS d: Describe a regulatory process and the importance of each step in the process.

CLASSIFICATION OF REGULATORY REGIMES



LOS d: Describe a regulatory process and the importance of each step in the process.

TYPES OF REGULATIONS: GATEKEEPING RULES

Personnel

- Standards for integrity and competency
- Licensing exams

Financial Products

- Must generally comply with numerous regulations before they can be sold to the public

LOS e: Identify specific types of regulation and describe the reasons for each.

TYPES OF REGULATIONS: OPERATIONAL RULES



LOS e: Identify specific types of regulation and describe the reasons for each.

TYPES OF REGULATIONS: DISCLOSURE RULES

Corporate Issuers	<ul style="list-style-type: none">• Audited financial statements• General business information• Use of proceeds• Information about management• 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.
Disclosure Triggers	There may be significant disclosures designed to inform the market of potential takeover activity, directors' dealings in shares of the company, or short positions.

LOS e: Identify specific types of regulation and describe the reasons for each.

TYPES OF REGULATIONS: SALES PRACTICE RULES



LOS e: Identify specific types of regulation and describe the reasons for each.

TYPES OF REGULATIONS: TRADING RULES

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	Market manipulation involves taking actions intended to move the price of a stock in order to generate a short-term profit.
Insider Trading	Because material nonpublic 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.

LOS e: Identify specific types of regulation and describe the reasons for each.

TYPES OF REGULATIONS: TRADING RULES

Front Running	Placing an order ahead of a customer's order to take advantage of the price impact that the customer's order will have.
Brokerage Practices	Investment managers may use arrangements in which brokerage commissions are used to pay for external research.

LOS e: Identify specific types of regulation and describe the reasons for each.

OTHER TYPES OF REGULATION

Proxy Voting Rules

Anti-Money-Laundering Rules

Business Continuity Planning Rules

LOS e: Identify specific types of regulation and describe the reasons for each.

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.

Policies and procedures also guide employees with matters outside the scope of regulation.

LOS f: Describe elements of a company's policies and procedures to ensure the company complies with regulation.

COMPANY POLICIES AND PROCEDURES: SUPERVISION WITHIN COMPANIES

Hiring and Training

Continuing Education

Documentation

LOS f: Describe elements of a company's policies and procedures to ensure the company complies with regulation.

COMPANY POLICIES AND PROCEDURES: COMPENSATION PLANS



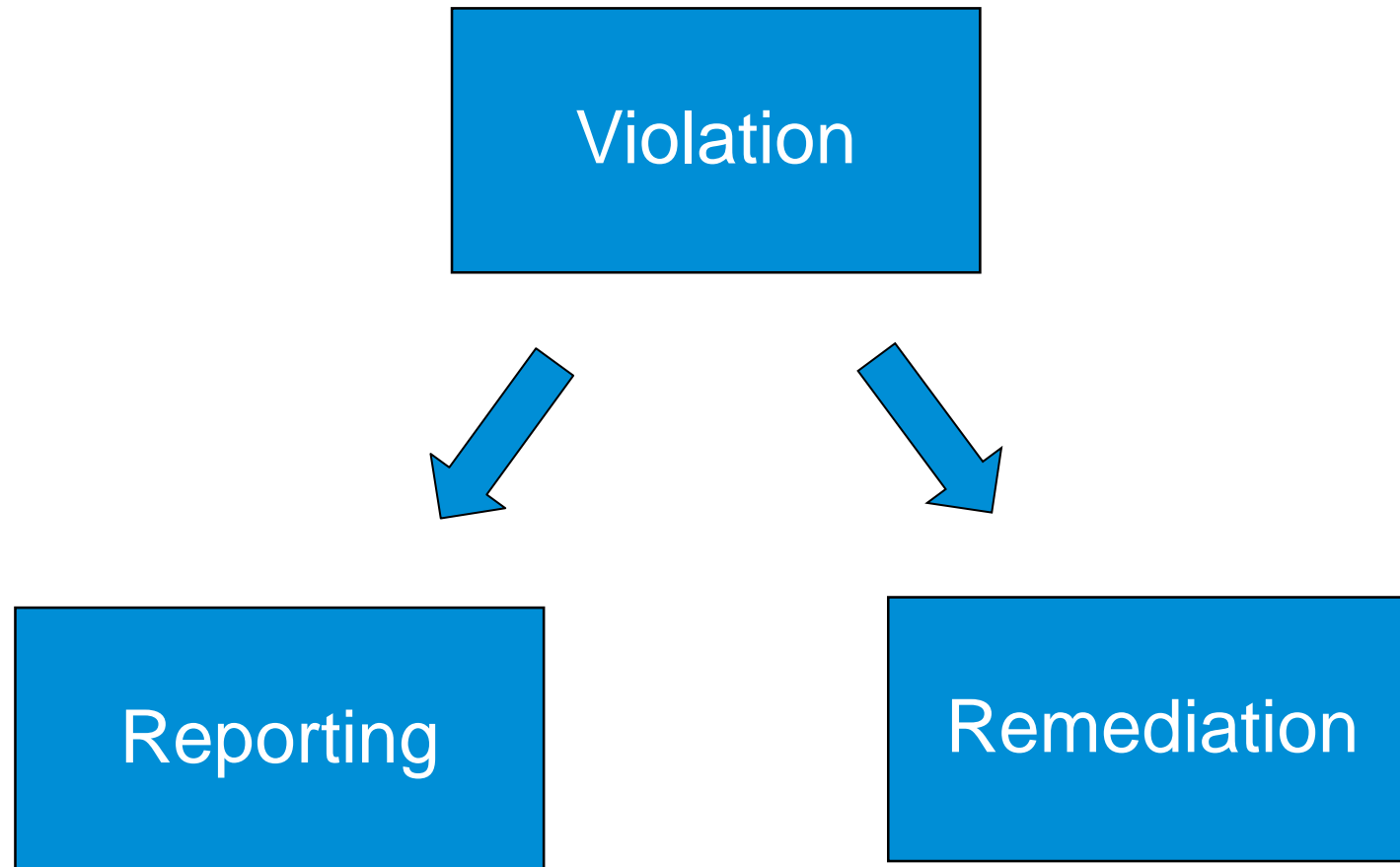
Bonuses Can Affect Behavior

Employee Behavior

Bonuses for reaching target sales levels may motivate employees to make more sales, but they can also motivate employees to break rules and engage in deception in order to make those sales.

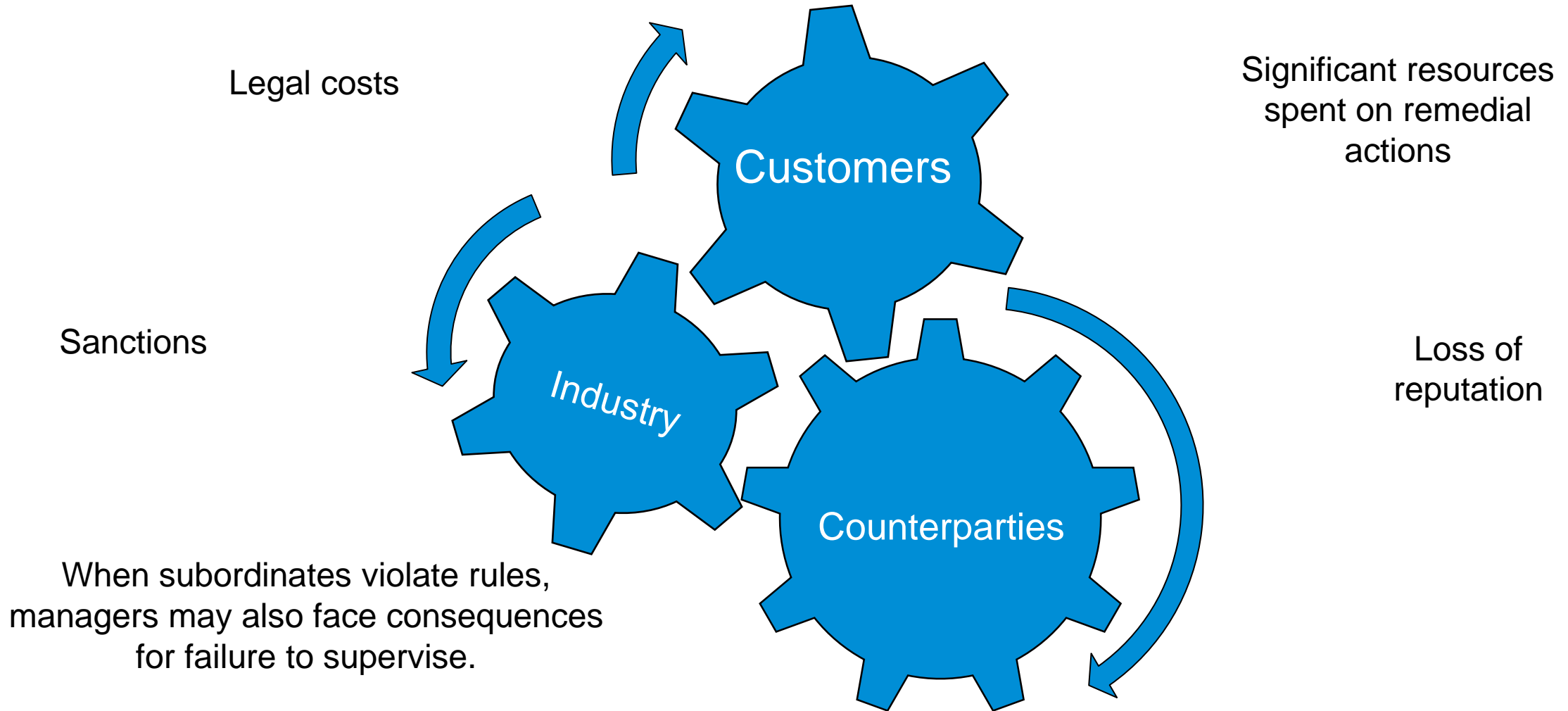
LOS f: Describe elements of a company's policies and procedures to ensure the company complies with regulation.

COMPANY POLICIES AND PROCEDURES: PROCEDURES FOR HANDLING VIOLATIONS



LOS f: Describe elements of a company's policies and procedures to ensure the company complies with regulation.

CONSEQUENCES OF COMPLIANCE FAILURE



LOS g: Describe potential consequences of compliance failure.



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