

The Importance of Selective Federal Preemption in the U.S. Securities Regulatory Framework: A Lesson from Canada, Our Neighbor to the North

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| | |
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| INTRODUCTION..... | 394 |
| I. THE GLOBAL SECURITIES MARKET | 398 |
| A. U.S. Recognition of the Global Securities Market.. | 399 |
| 1. The Global Securities Market and the NASDAQ Stock Market, Inc. | 399 |
| 2. The Global Securities Market and the New York Stock Exchange (NYSE)..... | 400 |
| B. Canada’s Recognition of the Global Securities Market..... | 401 |
| C. Recognition of the Global Securities Market Beyond North America..... | 402 |
| D. The Importance of Domestic Stock Markets..... | 403 |
| E. Regulatory Response to the Global Securities Market..... | 404 |

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| | |
|--|-----|
| II. THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS | 405 |
| A. The IOSCO Standard | 408 |
| 1. Regulator Attributes Under the IOSCO Standard | 410 |
| III. REGULATORY FRAMEWORK OF U.S. SECURITIES MARKETS .. | 415 |
| A. Background | 415 |
| 1. Federal Regulation in the U.S. Securities Markets | 416 |
| a. How the Commission Performs its Regulatory Duties in the U.S. Securities Markets | 419 |
| 2. State Regulation of U.S. Securities Markets | 426 |
| a. North American Securities Administrators Association (NASAA) | 428 |
| 3. Selective Federal Preemption in the Securities Regulatory Framework | 431 |
| a. The National Securities Markets Improvement Act of 1996 | 432 |
| (1) Increased Use of Selective Federal Preemption in Securities Registration ... | 434 |
| (2) Selective Federal Preemption and Broker-Dealer Financial Responsibility .. | 436 |
| (3) Selective Federal Preemption and the Regulation of Investment Companies and Investment Advisers | 437 |
| b. The Securities Litigation Uniform Standards Act of 1998 Increased the Use of Selective Federal Preemption | 437 |
| c. Sarbanes-Oxley Act of 2002 (SOX) and Selective Federal Preemption | 440 |
| (1) Regulation of Accountant Conduct and Selective Federal Preemption | 440 |
| (2) Corporate Governance and Selective Federal Preemption | 442 |
| d. H.R. 2179 and Selective Federal Preemption .. | 443 |
| IV. CANADIAN REGULATORY FRAMEWORK | 445 |
| A. Overview | 445 |

| | |
|--|-----|
| 2006] <i>Federal Preemption in U.S. Securities Regulatory Framework</i> | 393 |
| 1. Canadian Securities Administrators | 445 |
| 2. Investment Dealers Association of Canada (IDA)..... | 448 |
| 3. The Mutual Fund Dealers Association of Canada (MFDA) | 450 |
| 4. Market Regulation Services, Inc. (RS)..... | 452 |
| 5. The Canadian Public Accountability Board (CPAB) | 454 |
| 6. Canadian Securities Industry Reorganizes in 1999 to Enhance Global Competitiveness | 454 |
| 7. Organization of the Canadian Securities Industry After 1999..... | 457 |
| 8. The Securities Regulatory Framework in Quebec..... | 458 |
| a. Commission des Valeurs Mobilières du Quebec (CVMQ)/Autorité des marchés financiers (AMF) | 458 |
| (1) Quebec's Approval of NASDAQ Canada Diminishes Canada's Efforts to Compete in the Global Securities Market | 459 |
| 9. The Ontario Securities Commission Regulates Canada's Premier Securities Markets | 463 |
| V. ANALYSIS | 466 |
| A. Securities Regulatory Frameworks of the U.S. and Canada: A Comparison with the IOSCO Standard | 466 |
| 1. Investor Protection..... | 467 |
| a. Disclosure of Material Information..... | 467 |
| b. Prohibition of Manipulative or Fraudulent Practices | 469 |
| (1) The Spitzer Phenomenon..... | 473 |
| c. Supervision of Market Intermediaries that Provide Investment Services | 475 |
| d. Minimum Standards for Market Participants . | 481 |
| 2. Ensuring that Markets are Fair, Efficient, and Transparent..... | 486 |
| 3. The Reduction of Systemic Risk | 487 |

| | |
|--|-----|
| B. The IOSCO Standard for Securities Regulator: Selective Federal Preemption Requires a Federal Securities Regulator | 489 |
| 1. The Absence of Selective Federal Preemption and a Federal Securities Regulator Adversely Impacts Canada's Securities Regulatory Framework..... | 491 |
| a. NASDAQ Canada and the Renegade Province of Quebec | 494 |
| C. Selective Federal Preemption Implemented by a Federal Securities Regulator—Lesson Learned..... | 496 |
| CONCLUSION | 498 |

INTRODUCTION

Selective federal preemption in a country's securities regulatory framework is required to compete successfully in the global securities market. It prevents balkanization of a country's securities regulatory framework. By definition, selective federal preemption includes some preservation of state or local authority in the securities regulatory framework to address local issues, i.e., issues particular to each state. At the local level, state securities regulatory authorities (SSRAs) have the power to bring, at a minimum, fraud actions that the federal regulator does not have the resources to address effectively. SSRAs are the "local cops on the securities beat,"¹ whose mission is to protect the small investor.² Selective federal preemption is needed to "maintain uniformity and certainty' in U.S. securities markets so that they remain ahead of markets 'in London, Frankfurt, Tokyo or Hong Kong.'"³ When signing the National Securities Markets Improvement Act of 1996 (NSMIA), which contained critical selective federal preemption provisions, President Clinton asserted that it was needed to "enhance capital formation and the com-

¹ *The Securities Fraud Deterrence and Investor Restitution Act of 2003: Hearing on H.R. 2179 Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on House Financial Services*, 108th Cong. 53 (2003) (testimony of Christine A. Bruenn, NASAA President and Maine Securities Administrator).

² The author defines small investors as individuals that invest relatively small amounts of money in the U.S. securities markets.

³ Rachel Witmer, *Litigation Reform: Gramm, Domenici, Dodd Introduce Bill To Federalize Securities Class Actions*, 29 Sec. Reg. & L. Rep. (BNA) 1401, 1402 (1997) [hereinafter Witmer, *Litigation Reform*].

petitiveness of the American economy”⁴ The Securities Industry Association (SIA) also agreed that NSMIA’s selective federal preemption provisions would “clear away some of the regulatory underbrush that adds to the cost of capital[,] without compromising investor protections.”⁵ Moreover, successful competition in the global securities market means that a country must have a securities regulatory framework that promotes uniformity without stifling systemic risk; uniformity and an appropriate level of systemic risk are necessary components in a securities regulatory framework for successful competition and innovation in the global securities market.⁶

A country’s securities regulatory framework is one of its most important competitive tools in the global securities market. A competitive securities regulatory framework promotes a large investor class, provides large pools of capital to encourage issuers and other market participants to take risk by expanding their businesses, and facilitates increased employment.⁷ Although some balkanization is necessary to combat local securities fraud, some level of federal preemption is required to avoid too much fragmentation in the securities regulatory framework. Too much fragmentation will increase the cost of capital to unacceptable levels, sending issuers in search of less expensive capital in securities markets with more uniformity in their regulatory framework.

A globally competitive securities regulatory framework also requires flexibility. It must be structured to respond quickly to constant change, one of the primary characteristics of the global securities market. Only a regulatory authority at the federal level will have the requisite power to respond effectively in a constantly changing global securities market. A federal regulatory authority would regulate all securities markets in a country, making decisions that bind all securities markets and market participants. In addition, the federal regulatory authority would have the power and the ability to craft a coherent policy for a country’s securities regulatory framework. Coherent policy is more likely to lead to uniformity and lower costs of capital, i.e., the creation of a more competitive securities market in the global

⁴ Statement on Signing the National Securities Markets Improvement Act of 1996, 2 PUB. PAPERS 1812 (Oct. 11, 1996).

⁵ Rachel Witmer, *Legislation: Congress Passes Major Securities Bill; Clinton Expected to Sign It OMB Says*, 28 Sec. Reg. & L. Rep. (BNA) 1211, 1212 (1996).

⁶ International Organization of Securities Commissions [IOSCO], *Objectives and Principles of Securities Regulation*, at 7, IOSCO Pub. Doc. 154 (May 2003), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf>.

⁷ See *Clinton Signs Long-Awaited Securities Reform Bill*, ON WALL STREET, Nov. 1, 1996, at 32, 32.

securities market.

The U.S. securities markets,⁸ recognized as the premier securities market in the world, employs selective federal preemption in its securities regulatory framework. The Supremacy Clause of the U.S. Constitution states that the laws of the U.S. federal government shall be the supreme laws of the land.⁹ Accordingly, federal law displaces or preempts state law where it expressly states that state law is preempted, where it creates a comprehensive regulatory scheme which, de facto, preempts state law in the entire area of the law related to a particular subject matter, or where state law conflicts with federal law. Currently, selective federal preemption in the U.S. securities regulatory framework does not preclude state jurisdiction over, among other areas, securities fraud. “Congress has expressly preserved the role of the states in securities regulation’ in such areas as fraud in the sale of securities and investment advisory services.”¹⁰ However, since the enactment of NSMIA, greater levels of federal preemption have been employed in the U.S. securities regulatory framework.

Generally, selective federal preemption is used in the U.S. securities regulatory framework when a securities product or transaction will have a national impact on the U.S. securities markets, i.e., the effect of the product or transaction will not be confined to one state. When a securities product or transaction has a national impact, selective federal preemption is needed to ensure uniformity of regulatory requirements, thus reducing regulatory costs borne by issuers and other market participants. Such uniformity minimizes regulatory fragmentation at the state level. However, states retain power for securities products or transactions that do not have a significant impact in more than one state.¹¹ Generally, this means that state regulatory authori-

⁸ In this article the term “U.S. securities markets” only includes securities markets (and of course the types of securities traded on such markets) regulated by the U.S. Securities and Exchange Commission (Commission). The term does not include markets regulated solely by the Commodities Futures Trading Commission (CFTC). Commission regulated securities markets includes exchanges, the over-the-counter (OTC) markets, electronic communications networks (ECN), and other alternative trading facilities (ATF). The types of securities traded on markets regulated by the Commission include equities, mutual funds, real estate investment trusts (REITS), unit investment trusts (UIT), and equity-based derivatives, options, and futures. See generally U.S. Securities and Exchange Commission [SEC], <http://www.sec.gov/index.htm> (last visited Sept. 11, 2006).

⁹ U.S. Const. art. VI, cl 2.

¹⁰ *Jurisdiction And Procedure: Common Law Fraud Claims Not Preempted By Federal Securities Law, Court Concludes*, 33 Sec. Reg. & L. Rep. (BNA) 1634, 1635 (2001) (quoting *Zuri-Invest AG v. NatWest Finance Inc.*, 177 F. Supp. 2d 189 (S.D.N.Y. 2001)).

¹¹ The author recognizes that the State of New York is an exception to this general rule. See *infra* Section IIA.2 (discussing the impact of actions taken by the State of New York on the U.S. securities regulatory framework).

ties retain jurisdiction over securities fraud within their own jurisdictions.

Failure to implement a securities regulatory framework incorporating selective federal preemption may result in a country losing control of its securities markets—one of the most important components of its economy. Canada is an example of what may happen when a country fails to establish a securities regulatory framework capable of competing in the global securities market, i.e., it fails to include selective federal preemption in its securities regulatory framework. Canada's securities regulatory framework does not include a federal securities regulator authorized to set policy, rules, and regulations for the securities markets in its thirteen provinces and territories. The absence of selective federal preemption means that each province has the ability to thwart any significant efforts to implement changes in Canada's securities regulatory framework, which was designed to ensure that its securities markets remain competitive in the global securities market. Canada's fragmented regulatory framework has allowed the U.S. to assume regulatory authority over portions of Canada's securities markets and market participants. For example, NASDAQ Canada was established in 2000 in the province of Quebec, and primary regulation of NASDAQ Canada was delegated to the U.S. by amending Quebec's Securities Act.¹²

Successful competition in the global securities market is essential because having the premier securities market in the world generally means being the premier economic power in the world. Moreover, successful competition in the global securities markets means greater pools of capital will be available to a country's businesses than would otherwise exist with a less prominent global presence; this leads to economic growth and expansion, which, in turn, leads to increased levels of employment. A securities regulatory framework, which includes selective federal preemption, is more likely to facilitate fair, efficient, and liquid markets and, at the very least, a perceived level playing field for investors. Regulatory balkanization, the regulatory approach taken by Canada, is more likely to produce unfavorable consequences, e.g., migration of market participants and investors to securities markets outside the country's jurisdiction in search of transparent markets and better returns.

This article does not endeavor to identify the appropriate

¹² See The NASDAQ Stock Market, Inc., General Form for Registration of Securities Pursuant to Section 12(b) or 12(g) of the Securities Exchange Act of 1934 (Form 10), Amendment No. 1 (May 14, 2001), available at <http://www.shareholder.com/common/edgar/1120193/950172-01-500184/01-00.pdf>.

level of federal preemption required to compete successfully in the global securities market for each country. It only seeks to point out that selective federal preemption is a necessary component in a securities regulatory framework to compete successfully in the global securities market. Moreover, the author contends that selective federal preemption has been recognized as a necessary component for a globally competitive securities regulatory framework by a consensus of securities regulatory authorities in the global securities market. This consensus is reflected in the *Objectives and Principles of Securities Regulation*, published by the International Organization of Securities Commissions (IOSCO) in May 2003.¹³

This article will first describe the significant characteristics of the global securities market. Next, it will identify significant attributes of a securities regulatory framework that successfully includes selective federal preemption and a corresponding federal regulator, using the IOSCO Standard. It will then compare the characteristics of the regulatory frameworks and corresponding securities regulators in the U.S. and Canada to the IOSCO Standard. Next, it will describe and analyze what happens when a country fails to employ selective federal preemption in its securities regulatory framework, using Canada, our neighbor to the north, as an example.

I. THE GLOBAL SECURITIES MARKET

*The financial crisis of other nations can no longer exist in a vacuum. They affect every other nation as we move closer to a global economy.*¹⁴

The global securities market has arrived. In the twenty-first century, securities markets are inextricably intertwined and advanced technology facilitates the interconnectivity of world securities markets allowing capital and information to move quickly anywhere in the world. "During 1992, 94 foreign issuers accessed the U.S. public markets for the first time. Registered offerings by foreign issuers exceeded \$33 billion . . ." and 172 foreign issuers accessed the U.S. private markets for a cumulative total of \$13 billion.¹⁵ From 1990 through 2002, the number of foreign issuers registered with the Securities and Exchange Commission (the Commission) tripled from 434 to over 1300 from

¹³ IOSCO Pub. Doc. 154, *supra* note 6, at 7. The IOSCO is a key international standard-setting body in the global securities market; its members are securities regulatory authorities for the preeminent securities markets in the world. See Section III of this article.

¹⁴ 144 Cong. Rec. 3, 4401 (1998) (statement of Sen. Grams).

¹⁵ H.R. REP. NO. 103-179, at 12 (1993).

59 countries.¹⁶ Between 1986 and 1995, trading in foreign stocks in the U.S. increased from \$100.2 billion to approximately \$723.6 billion, and trading by foreign investors in U.S. stocks alone increased from \$277.5 billion to \$877.6 billion.¹⁷ In addition, domestic securities markets increasingly are being integrated into the global securities market leading to “competing, international combinations of stock exchanges” allowing investors “to trade any stock, any time, anywhere in a linked forum.”¹⁸

A. U.S. Recognition of the Global Securities Market

1. The Global Securities Market and the NASDAQ Stock Market, Inc.

In June 2000, NASDAQ conducted a private placement to “allow [NASDAQ among other things] to respond to current and future competitive challenges caused by technological advances and the increasing globalization of financial markets.”¹⁹ The proceeds were used to increase its global preeminence by attempting to extend its trading platform throughout the world.²⁰ The second phase of NASDAQ’s private placement was completed in January 2001 and raised \$180 million; the total amount raised in phases 1 and 2 was \$326 million.²¹ From 2000 until 2001, NASDAQ created stand-alone stock exchanges in Canada,²² Japan,²³ and Europe.²⁴ NASDAQ asserted

¹⁶ See SEC, GOVERNMENT PERFORMANCE AND RESULTS ACT (GPRA) 2004 ANNUAL PERFORMANCE PLAN AND 2002 ANNUAL PERFORMANCE REPORT 6 (2003) [hereinafter GPRA], available at http://www.sec.gov/about/gpra2004_2002.pdf.

¹⁷ *Departments of Commerce, Justice, and State, the Judiciary, and Related Agencies Appropriations for 1997: Hearings Before the Subcomm. on the Departments of Commerce, Justice, and State, the Judiciary, and Related Agencies of the H. Comm. on Appropriations*, 104th Cong. 635 (1996) (Justification of the Budget Estimates, Securities and Exchange Commission).

¹⁸ 3D HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, *SECURITIES AND FEDERAL CORPORATE LAW* § 23:34, at 23-73 (2d ed. 2006).

¹⁹ The NASDAQ Stock Market, Inc., Annual Report (Form 10-K), at F-7 (Mar. 28, 2002).

²⁰ The NASD sold 40% of NASDAQ during the first phase of its private placement that raised \$260 million for NASDAQ and \$74 million for the NASD. Greg Ip, *Nasdaq Looks to Europe: Are Preparations A Prelude to a Bid for London Exchange?* WALL ST. J., Nov. 1, 2000, at C1.

²¹ Press Release, The NASDAQ Stock Market, Inc., NASDAQ Completes Private Offering and Expands Board (Jan. 25, 2001), available at http://www.nasdaq.com/newsroom/news/pr2001/ne_section01_025.html.

²² “In April 2000, [NASDAQ] entered into a cooperative agreement with the Provincial Government of Quebec for the development of a new securities market within Canada called [NASDAQ] Canada.” The NASDAQ Stock Market, Inc., *supra* note 12, at 5.

²³ NASDAQ Japan began operating on June 19, 2000. *Id.*

²⁴ *Id.* at 6.

On March 20, 2001, NASDAQ entered into a non-binding letter of intent and is currently negotiating a definitive agreement with the London International Financial Futures and Options Exchange (LIFFE) to create a new U.S. joint venture company that will list and trade single stock futures. The products of

that the foundation to create a global exchange should be built on a strong regional presence in the dominant capital centers of the world. . . . [T]hose centers are the United States, Europe, and parts of Asia, particularly Japan. By establishing centers for . . . trading in these key regions, the foundation [would] be developed for electronically linking these markets to establish a global platform.²⁵

However, the severe down-turn in the securities markets in 2000, combined with its poor performance through 2002, halted NASDAQ's expansion and ultimately led to retrenchment with the closing of trading markets established in all countries except Canada. By 2003, NASDAQ's strategy for achieving global pre-eminence changed from creating standalone exchanges in other countries to becoming the premier market in the U.S. and being "a market the world's investors could count on."²⁶

2. The Global Securities Market and the New York Stock Exchange (NYSE)

The NYSE, in order to compete successfully in the global securities market, has changed its business model. On December 6, 2005, NYSE members voted to merge with Archipelago Exchange, an open, fully electronic exchange.²⁷ According to the NYSE's CEO, John A. Thain, the combined entity "will create a strong, dynamic and innovative enterprise capable of meeting the demands of investors and issuers throughout the world in the decades ahead [in order to compete] globally in a high-speed electronically connected world."²⁸ NYSE's CEO determined that the merger was necessary because publicly held exchanges in "London, Frankfurt, Toronto and Sydney are aggressively competing to expand their reach."²⁹ and market share in the global securities market. The SEC shares this view: "If the U.S. mar-

the new joint venture are expected to be traded through the LIFFE CONNECT™ electronic system.

²⁵ *Id.* at 4–5.

²⁶ NASDAQ, Inc., 2003 Annual Report, at 1 (Mar., 2004), available at <http://www.nasdaq.com/about/AR2003/2003AR.pdf>. NASDAQ began to implement this strategy by purchasing electronic communications networks (ECN), which provided more routing capacity, connectivity, and increased market share. *Id.* at 6. NASDAQ Japan closed on August 16, 2002 due to insufficient business. *Nasdaq Japan Inc. to Go 'Dormant'; Board Finds No 'Viable Path Forward'*, 34 Sec. Reg. & L. Rep. (BNA) 1382, 1382–83 (2002).

²⁷ 1247 out of 1307 members voted in favor of the merger, i.e., approximately 95.4% of members eligible to vote on the transaction. Press release, New York Stock Exchange, New York Stock Exchange Announces Certified Results of Dec. 6 Member Vote on Merger with Archipelago Holdings, Inc. (Dec. 7, 2005), available at <http://www.nyse.com/press/1133956348217.html>.

²⁸ Press Release, New York Stock Exchange, New York Stock Exchange and Archipelago Exchange Agree to Merge—NYSE Group, Inc. Will Become a Publicly Held Company (Apr. 20, 2005), available at http://www.nyse.com/pdfs/joint_release.pdf.

²⁹ *Id.*

kets fail to meet investor needs by offering the fairest and most efficient trading mechanisms possible, an increasingly competitive international environment will be sure to offer alternatives for investors.”³⁰

B. Canada’s Recognition of the Global Securities Market

Canada, in a report commissioned to study the need for regulatory change in its securities markets (The Wise Persons’ Committee Report), determined that:

Technological changes have radically increased the mobility of capital. . . .

. . . .

Between 1980 and 2000, private capital flows (including gross bank flows, portfolio flows and foreign direct investment) increased more than six-fold to nearly US\$4 trillion annually worldwide. By 2003, outstanding international debt securities worldwide totaled US\$10.3 trillion, a ten-fold increase from 1987 levels.

Multinational securities firms now conduct business around the world and around the clock. Exchanges and trading systems operate on a cross-border basis.³¹

In particular, cross-border transactions in Canadian equities have increased from 5% of GDP in 1990 to 38% of GDP in 2002. Canadian issuers raised more debt capital internationally than domestically, with a significant number of Canadian issuers inter-listed on foreign stock exchanges, including 78 on the NYSE and 81 on the NASDAQ.³² Moreover, there is a consensus among market participants in Canada’s securities markets that successful competition means competing effectively in an environment characterized by increasing international competition for capital—a clear recognition of the global securities markets.³³ The Ontario Securities Commission (OSC), the largest provincial securities markets regulator in Canada, contends that the existence of the global securities market is

evidenced by a number of trends, including:

- the growth of cross-border securities transactions;

³⁰ Press Release, SEC, NYSE’s Rescission of Rule 390 and Commission’s Request for Comment on Market Fragmentation (Feb. 23, 2000), *available at* <http://www.sec.gov/news/press/2000-14.txt>.

³¹ WISE PERSONS’ COMMITTEE TO REVIEW THE STRUCTURE OF SECURITIES REGULATION IN CANADA, IT’S TIME—WPC FINAL REPORT 2 (2003) [hereinafter WISE PERSONS’ COMMITTEE].

³² *Id.* at 6.

³³ University of Toronto Capital Markets Institute, *White Paper: A Symposium on Canadian Securities Regulation: Harmonization or Nationalization?*, at Executive Summary-i (Oct. 2002) (edited by James Baillie).

- an increasing number of additional listings of Canadian companies on foreign exchanges;
- the emergence of multinational securities firms servicing businesses from offices around the world; and
- an increasing number of strategic alliances and other connections between regulated financial markets in different parts of the world.³⁴

The Investment Dealers Association (IDA), Canada's largest national securities self-regulatory organization (SRO) representing all investment dealers, also recognizes the existence of the global securities market. The IDA agrees that "there is . . . only one world securities market."³⁵

The Province of Quebec acknowledges the existence of the global securities market.³⁶ It recommends further harmonization between Canada's provinces with respect to each province's securities laws.³⁷

C. Recognition of the Global Securities Market Beyond North America

Recognition of the global securities market is not confined to the U.S.; The Federation of European Securities Exchanges (FESE)³⁸ also recognizes the global securities market and asserts that it is "driven by advances in technology and telecommunications, is leading to a growing number of companies wishing to raise capital in more than one country [and that] [i]nvestors too are looking at integrated, or interconnected, international markets in order to maximise their return and spread their capital risk."³⁹ In February 2006, the Tokyo Stock Exchange decided to

³⁴ ONTARIO SECURITIES COMMISSION, FIVE YEAR REVIEW COMMITTEE FINAL REPORT ~ REVIEWING THE SECURITIES ACT 42 (2003), available at http://www.osc.gov.on.ca/Regulation/FiveYearReview/fyr_20030529_5yr-final-report.pdf [hereinafter FIVE YEAR REVIEW COMMITTEE FINAL REPORT].

³⁵ *Suitability Requirements*, IDA REP. (Investment Dealers Association of Canada), Summer 2000, at 7.

³⁶ See Harris, *supra* note 33, at 90.

³⁷ *Id.* at app., at xiv.

³⁸ Established in 1974, FESE represents the interests of European securities exchanges as regulated markets. FESE has twenty-four full members representing approximately forty securities exchanges and clearing houses from all EU countries, and Iceland, Norway, and Switzerland. Federation of European Securities Exchanges, About Members, <http://www.fese.be/en/?inc=cat&id=4> (last visited Feb. 8, 2007). Members include the Athens Exchange, Italian Exchange, London Stock Exchange, Budapest Stock Exchange, Euronext, Stockholm Stock Exchange, and Irish Stock Exchange. Federation of European Securities Exchanges, Full Members, <http://www.fese.be/en/?inc=page&id=7> (last visited Feb. 8, 2007).

³⁹ Federation of European Securities Exchanges, The Federation, <http://www.fese.be/federation/index.htm> (last visited Aug. 16, 2006); see also Reena Aggarwal, *Demutualization and Corporate Governance of Stock Exchanges*, 15 J. APPLIED CORP. FIN. 105-13, (2002).

invest approximately \$27 million to upgrade its trading systems.⁴⁰ In addition, in 2002, “the Australian Stock Exchange (ASX) ranked 12th in the world in terms of size and 16th in terms of turnover.”⁴¹

D. The Importance of Domestic Stock Markets

Securities markets are one of the most important tools that a country has for raising investment capital and efficiently allocating the country’s investment capital among competing businesses. They enable businesses and governments to raise debt and equity capital from public investors in order to fund operations. Accordingly, securities markets are vital to the growth, development and strength of market economies. They also “support corporate initiatives, finance the exploitation of new ideas[,] facilitate the management of financial risk . . . [and] have become central to individual wealth and retirement planning.”⁴² Moreover, capital markets are among the key factors in promoting a country’s long-term economic growth.⁴³ “Countries that are best able to channel savings into productive investments will register higher rates of growth and more rapid increases in living standards.”⁴⁴

In 1975, the U.S. Congress amended the federal securities laws because it recognized that “[t]he securities markets of the United States are indispensable to the growth and health of this country’s and the world’s economy.”⁴⁵ The 1975 amendments were designed to assist U.S. securities markets in adapting and responding to changing economic and technological conditions domestically and beyond U.S. borders. Without this flexibility, Congress believed that the U.S. might lose its status as an international financial center and that its economic, financial, and

⁴⁰ *Tokyo Stock Exchange Plans \$27 Million in Upgrades, and More*, WALL ST. & TECH., Feb. 23, 2006, <http://www.wallstreetandtech.com/showArticle.jhtml?articleID=180207050>.

⁴¹ Sydney Media, Fact Sheet—Global Sydney, <http://www.sydneymedia.com.au/html/2291-global-sydney.asp> (last visited Oct. 7, 2006).

⁴² IOSCO Pub. Doc. 154, *supra* note 6, at 1.

⁴³ WISE PERSONS’ COMMITTEE, *supra* note 31, at 4.

⁴⁴ *Id.*

⁴⁵ *The Structure of Securities Markets: Hearings on the Emerging Structure of U.S. Securities Markets and the Appropriate Role for Regulation Before the S. Comm. on Banking, Housing, and Urban Affairs*, 106th Cong. 217 (2001) (statement of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission). \$190 million was raised for the NASD. Phases 1 and 2 of NASDAQ’s private placement reduced the NASD’s ownership significantly resulting in ownership by approximately 2,900 investors. NASDAQ investors include NASDAQ-listed companies, dealer firms, and institutional investors. Press Release, NASDAQ, NASDAQ Completes Private Offering and Expands Board (Jan. 25, 2001), *available at* http://www.nasdaq.com/newsroom/news/pr2001/ne_section01_025.html.

commercial interests would suffer.

Like the U.S., Canada understands the importance of its securities markets to the overall health of its economy. Moreover, Canada's securities markets "are especially important in financing emerging companies that have yet to display the financial track record of more established concerns."⁴⁶

E. Regulatory Response to the Global Securities Market

Securities markets are essential to the health of the economy⁴⁷ and successful businesses. They are also a key underlying component to the employment of individuals and their ability to save and invest for retirement, education, and other essential needs. Effective competition means that a country attracts foreign businesses seeking equity capital and maintains its own domestic businesses. A sound, efficient securities regulatory framework is essential to having dynamic and fair capital markets. A regulatory framework that is slow, rigid, complex, and that adapts poorly to the pace of change in the global securities market will not facilitate successful competition.

An appropriate regulatory framework in the global securities market should be designed to compete effectively in a world of changing technology and fluid borders. Accordingly, a competitive securities regulatory framework must include a strong central authority with a dual mission of protection of investors and consistent treatment for capital seekers. "[R]egulators must strike a fine balance between ensuring efficient capital markets for issuers and maintaining adequate protection for investors."⁴⁸ Conversely, poorly regulated markets inhibit capital formation and economic growth. As early as 1993, the Commission realized that it would "need to devote even greater attention and more resources to address issues raised by cross-border offerings and listings, without either disadvantaging U.S. companies vis-a-vis their international rivals or compromising investor protection."⁴⁹ Accordingly, the Commission's "mission is to administer and enforce the federal securities laws in order to protect investors, and to maintain fair, honest, and efficient markets."⁵⁰

⁴⁶ WISE PERSONS' COMMITTEE, *supra* note 31, at 4. "In 2002, capital markets provided 88% of the long-term financing of Canadian firms, compared to only 73% in 1990." *Id.* Canada's economy relies heavily on raw materials (e.g., lumber and ores), not finished products. Only the largest of such companies qualify for listing on U.S. securities markets.

⁴⁷ "A sound and progressive financial system, of which capital markets are a critical component, is a key driver of long-term economic growth." *Id.*

⁴⁸ *Id.* at 3.

⁴⁹ H.R. REP. NO. 103-179, at 12-13 (1993).

⁵⁰ GPRA, *supra* note 16, at 16.

Among the regulators of the world's largest securities markets, there seems to be a loose consensus of the nuts and bolts of an appropriate regulatory framework, i.e., one that is designed to compete effectively in the global securities market. This consensus is reflected in the *Objectives and Principles of Securities Regulation* published by the IOSCO.⁵¹

II. THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

IOSCO is one of the "world's key international standard setting bodies"⁵² in the global securities market. IOSCO's mission is to promote cooperation and provide expertise to set standards for securities regulatory frameworks. Accordingly, its members have agreed to: (1) "cooperate together to promote high standards of regulation in order to maintain just, efficient and sound markets;" (2) "exchange information on their respective experiences in order to promote the development of domestic markets;" (3) "unite their efforts to establish standards and an effective surveillance of international securities transactions;" and (4) "provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses."⁵³

IOSCO members are Securities Regulatory Authorities (SRAs) for the preeminent securities markets in the world, including the United States, Germany, Japan, China, Great Britain, and Canada.⁵⁴ IOSCO has approximately 180 members that regulate more than ninety percent of the world's securities markets.⁵⁵ Members are classified as ordinary,⁵⁶ associate,⁵⁷ and af-

⁵¹ See IOSCO Pub. Doc. 154, *supra* note 6, at 1.

⁵² Securities and Futures Commission, IOSCO, <http://www.sfc.hk/sfc/html/EN/iosco/iosco.html> (last visited Oct. 6, 2006); see also Jane Diplock, Chairman, Executive Committee of IOSCO & Securities Commission, New Zealand, *Is Regulation Keeping Up With Or Fettering Cross-Border Developments?*, (Feb. 17, 2006) (transcript available at <http://www.sec-com.govt.nz/speeches/jds170206.shtml>). IOSCO began in 1983 to replace its predecessor, the Inter-American Regional Association (IARA). IARA, created in 1974, was composed of Securities Regulatory Authorities from North and South America. IOSCO, *Historical Background*, <http://www.iosco.org/about/index.cfm?section=history> (last visited Oct. 7, 2006).

⁵³ IOSCO, *General Information*, <http://www.iosco.org/about/> (last visited Oct. 6, 2006).

⁵⁴ Because there is no single securities regulatory entity authorized to bind the Canadian securities markets, only certain Canadian provincial securities regulators are members of IOSCO—Ontario, Quebec, Alberta, and British Columbia. See IOSCO, *Membership and Committees Lists: Active Member Organizations and Contacts*, <http://www.iosco.org/lists/> (last visited Oct. 6, 2006).

⁵⁵ See *id.*; IOSCO, *Historical Background*, <http://www.iosco.org/about/index.cfm?section=history> (last visited Oct. 7, 2006).

⁵⁶ Ordinary members include: Australian Securities and Investments Commission, China Securities Regulatory Commission, France—Autorité des marchés financiers, Ger-

filiate.⁵⁸ Ordinary members are voting members, while associate members are not allowed to vote.⁵⁹ Affiliate members are SROs, have no vote, and are ineligible for membership in the Executive Committee and the Presidents' Committee.⁶⁰ Affiliate members are eligible for membership in the SRO Consultative Committee.

IOSCO is administered by a General Secretariat, but performs its regulatory standard setting responsibilities through committees. IOSCO's committees include a Presidents' Committee, an Executive Committee, a SRO Consultative Committee, and various Regional Committees. The Presidents' Committee consists of all the presidents of member agencies and is authorized to achieve IOSCO's mission. The Executive Committee consists of two sub-committees: The Technical Committee and the Emerging Markets Committee. The Executive Committee has nineteen members, including the chairpersons of its sub-committees and each regional committee,⁶¹ one ordinary member elected by each regional committee, and nine ordinary members elected by the Presidents' Committee. Members of the Technical Committee include the Ontario Securities Commission, Quebec—Autorité des marchés financiers, the Commission, and the U.S. Commodity Futures Trading Commission; essentially, Technical Committee members include SRAs from the world's larger and more developed securities markets.⁶² The SRO Consultative Committee (SROCC) was established to provide information to

many—Bundesanstalt für Finanzdienstleistungsaufsicht, Japan—Financial Services Agency, Canada—Ontario Securities Commission, Canada—Quebec Autorité des marchés financiers, Russia—Federal Service for Financial Markets of Russia, and U.S. Securities and Exchange Commission. IOSCO, Ordinary Members, http://www.iosco.org/lists/display_members.cfm?memID=1&orderBy=none (last visited Oct. 24, 2006).

⁵⁷ Although not eligible to vote or to be elected to the Executive Committee, associate members are members of the Presidents' Committee. IOSCO, Categories of Members, <http://www.iosco.org/about/index.cfm?section=categories> (last visited Oct. 6, 2006). Associate members include the British Columbia Securities Commission (Canada), Alberta Securities Commission (Canada), U.S. Commodity Futures Trading Commission, and the North American Securities Administrators Association, Inc. (NASAA). IOSCO, Associate Members, http://www.iosco.org/lists/display_members_print.cfm?memid=2 (last visited Oct. 6, 2006).

⁵⁸ IOSCO, Membership and Committees Lists: Active Member Organizations and Contacts, <http://www.iosco.org/lists/> (last visited Oct. 6, 2006).

⁵⁹ IOSCO, Categories of Members, <http://www.iosco.org/about/index.cfm?section=categories> (last visited Oct. 9, 2006).

⁶⁰ *Id.*

⁶¹ IOSCO, Structure of the Organization, <http://www.iosco.org/about/index.cfm?section=structure> (last visited Oct. 8, 2006). Regional committees include Asia-Pacific Regional Committee, Inter-American Regional Committee, Africa/Middle-East Regional Committee, and European Committee. *Id.*

⁶² IOSCO, Members of the Technical Committee, http://www.iosco.org/lists/display_committees.cfm?cmtid=3 (last visited Oct. 8, 2006). Other members of the Technical Committee are: Australia, France, Germany, Hong Kong, Italy, Japan, Mexico, The Netherlands, Spain, Switzerland, and The United Kingdom. *Id.*

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 407

assist those considering foreign business operations and investment in the global securities market; specifically, it provides information about the rules and requirements for membership in SROs of IOSCO member countries. SROCC also provides investor education information, including broker-dealer and investment adviser registration status and dispute resolution procedures. SROCC has sixty-one IOSCO affiliate members; SROCC members include the Montreal Exchange in Quebec; the Mutual Fund Dealers Association of Canada; the Market Regulation Services Inc. in Ontario, Canada; and the National Association of Securities Dealers, Inc. (NASD) and the NYSE in the U.S.⁶³ Regional Standing Committees were established to address problems specific to regions in which certain IOSCO members are located. There are four Regional Standing Committees: (1) the Africa/Middle-East Regional Committee,⁶⁴ (2) the Asia-Pacific Regional Committee,⁶⁵ (3) the European Regional Committee,⁶⁶ and (4) the Inter-American Regional Committee.⁶⁷

IOSCO's *Objectives and Principles of Securities Regulation* (OPSR) represents a consensus among SRAs regarding the goals and infrastructure of an effective securities regulatory framework in the global securities market.⁶⁸ IOSCO members are

⁶³ IOSCO, SRO Consultative Committee (SROCC), <http://www.iosco.org/committees/srocc/> (last visited Oct. 8, 2006).

⁶⁴ Africa/Middle-East Regional Committee members include Nigeria, Algeria, Kingdom of Bahrain, Dubai, Egypt, Ghana, Israel, Jordan, Kenya, Malawi, Republic of Mauritius, Morocco, Sultanate of Oman, South Africa, Tanzania, Tunisia, Uganda, United Arab Emirates, West African Monetary Union, and Zambia. IOSCO, Members of Africa/Middle-East Regional Committee, http://www.iosco.org/lists/display_committees.cfm?cmtid=7 (last visited Oct. 8, 2006).

⁶⁵ Asia-Pacific Regional Committee Members include Thailand, Australia, Bangladesh, Brunei, People's Republic of China, Chinese Taipei, Hong Kong, India, Indonesia, Japan, Korea, Kyrgyz Republic, Malaysia, Mongolia, New Zealand, Pakistan, Papua New Guinea, Philippines, Singapore, Sri Lanka, and Vietnam. IOSCO, Members of the Asia-Pacific Regional Committee, http://www.iosco.org/lists/display_committees.cfm?cmtid=6 (last visited Oct. 8, 2006).

⁶⁶ European Regional Committee members include Belgium, Albania, Armenia, Austria, Federation of Bosnia and Herzegovina, Bulgaria, Republic of Croatia, Republic of Cyprus, Czech Republic, Denmark, Estonia, Finland, Former Yugoslav Republic of Macedonia, France, Germany, Gibraltar, Greece, Guernsey, Hungary, Ireland, Isle of Man, Italy, Jersey, Republic of Kazakhstan, Lithuania, Grand Duchy of Luxembourg, Malta, The Netherlands, Norway, Portugal, Romania, Russia, Republic of Serbia, Slovak Republic, Slovenia, Spain, Republic of Srpska, Sweden, Switzerland, Turkey, Ukraine, and United Kingdom. IOSCO, Members of the European Regional Committee, http://www.iosco.org/lists/display_committees.cfm?cmtid=4 (last visited Oct. 8, 2006).

⁶⁷ Inter-American Regional Committee members include Brazil, Argentina, the Bahamas, Barbados, Bermuda, Bolivia, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Honduras, Jamaica, Mexico, Ontario, Republic of Panama, Peru, Quebec, Trinidad and Tobago, U.S., Uruguay, and Venezuela. Associate Members (non-voting) include Alberta and British Columbia. IOSCO, Members of the Inter-American Regional Committee, http://www.iosco.org/lists/display_committees.cfm?cmtid=9 (last visited Oct. 8, 2006).

⁶⁸ Initially, the OPSR was adopted in 1998 and updated most recently in May 2003.

committed to the objectives and principles enumerated in the OPSR and “intend to use their best endeavors within their jurisdiction[s] to ensure adherence to [the] principles [stated in the OPSR].”⁶⁹ Although compliance with the regulatory framework set out in the OPSR is not mandatory, it may be used by SRAs to determine whether their domestic regulatory frameworks facilitate fair, efficient, and transparent markets within the global securities market. Such regulatory frameworks are more likely to protect investors and attract issuers and other market participants. “IOSCO recognizes . . . that domestic securities markets are increasingly being integrated into a global market.”⁷⁰ Moreover, a globally competitive securities market requires a flexible regulatory framework which can respond swiftly to a global securities market in a constant state of development. Accordingly, the objectives and principles enumerated in the OPSR are deemed, for the purpose of this article, to facilitate effective, and therefore competitive, regulation in the global securities market.

A. The IOSCO Standard

IOSCO asserts that, in the global securities market, competitive securities markets require a regulatory framework that fosters capital formation and economic growth, with an emphasis on competition.⁷¹ Such a regulatory framework would be based on three objectives implemented by adhering to thirty principles of securities regulation, which have been grouped into eight categories in its OPSR.⁷² The three objectives are: (1) the protection of investors; (2) ensuring that markets are fair, efficient and transparent; and (3) the reduction of systemic risk.⁷³

Under IOSCO’s regulatory framework, effective investor protection requires issuers and other market participants to disclose material information to investors (both retail and institutional investors), prohibits manipulative or fraudulent practices in the securities markets, mandates supervision of market intermediaries or operators of exchanges that provide investment services,

IOSCO Pub. Doc. 154, *supra* note 6.

⁶⁹ *Id.* at 3. IOSCO members intend to seek changes in their jurisdictions to the extent implementation of IOSCO objectives and principles with respect to securities regulation are impeded by a members’ policies or legislation. *Id.*

⁷⁰ *Id.* at 1.

⁷¹ *Id.* at 8.

⁷² The categories are principles relating to the regulator, for self-regulation, for the enforcement of securities regulation, for cooperation in regulation, for issuers, for collective investment schemes (e.g., mutual funds), for market intermediaries (e.g., brokers and dealers), and for the secondary market (e.g., exchanges, alternative trading systems (ATSs), and clearing and settlement systems). *Id.* at i–iii.

⁷³ *Id.* at i.

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 409

and prescribes minimum standards for market participants.⁷⁴ IOSCO's regulatory framework also includes the notion that investors must perceive that they have fair access to material information⁷⁵ before and after trading, and during market operation hours. Moreover, the regulatory framework must not favor some investors over others, and must punish effectively any investor who attempts to manipulate securities markets or to engage in other unfair and fraudulent behavior.⁷⁶

Under the IOSCO Standard, investor protection requires, among other things, that investors receive full disclosure of material information to facilitate informed investment decisions. At a minimum, full disclosure of material information includes accurate and complete financial statements.⁷⁷ Under the IOSCO, financial statements are "key components of disclosure requirements . . . [and] accounting and auditing standards . . . should be of high and internationally acceptable quality."⁷⁸ The notion that full and accurate disclosure of all material information about a particular security results in informed investment decisions rests on the basic assumption that investors receiving full disclosure have the knowledge and skill to understand, analyze, and act reasonably based on the information provided. Finally, investor protection also requires consistent enforcement of securities laws as well as an effective, relatively inexpensive, neutral mechanism in which investors can resolve disputes with market participants.⁷⁹

The IOSCO Standard mandates a regulatory framework capable of establishing and maintaining fair, efficient, and transparent securities markets.⁸⁰ This means that the regulatory framework must ensure that all market participants (including brokers, dealers, and exchanges) perceive that they are competing on a level playing field. The regulatory framework must require, at the very least, the imposition of licensing and initial and ongoing minimal capital requirements. Capital requirements should be set at levels designed to ensure that market intermediaries have sufficient capital to meet the requirements of their customers (investors), counterparties, or the dissolution of their

⁷⁴ *Id.* at 6–7, 12.

⁷⁵ *Id.* at 12. Material information is information that a reasonable investor requires to make an informed investment decision. *See* *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); *Basic Inc. v. Levinson, Inc.*, 485 U.S. 224 (1988).

⁷⁶ IOSCO Pub. Doc. 154, *supra* note 6, at 6.

⁷⁷ *Id.*

⁷⁸ *Id.* at 5.

⁷⁹ *Id.* at 6.

⁸⁰ *Id.*

business without loss to their customers.⁸¹ The regulatory framework must also include “a comprehensive system of inspection, surveillance and compliance programs.”⁸²

The IOSCO Standard also requires the reduction of systemic risk, i.e., the risk that market intermediaries (e.g., brokers and dealers) will fail or cease to be going concerns and adversely impact securities markets.⁸³ Implementation of this objective requires laws and procedures specifying minimum capital requirements and adequate operational controls. When a market intermediary ceases to be an ongoing concern, the regulatory framework must include rules and procedures to facilitate the orderly winding down of the market intermediary’s business and, most importantly, attempt to confine the effect of its failure so that it does not affect adversely other market intermediaries.⁸⁴ The IOSCO Standard also states that the establishment of efficient and accurate procedures for clearing and settling securities transactions reduces systemic risk.⁸⁵ However, the IOSCO Standard cautions against eliminating systemic risk in the regulatory framework because risk-taking by market intermediaries is essential to success in the global securities market.⁸⁶

The IOSCO Standard also describes the attributes of the entity or entities charged with implementing a country’s securities regulatory framework.⁸⁷ These attributes are of particular importance because the author contends that the securities regulator described in the IOSCO Standard should be established at the federal level and must be authorized to impose some level of federal preemption in order to compete successfully in the global securities market.

1. Regulator Attributes Under the IOSCO Standard

Under the IOSCO Standard, a globally competitive securities regulatory framework requires an independent and accountable regulator with responsibilities and authority enumerated clearly in the applicable law.⁸⁸ However, the IOSCO Standard does not require the establishment of a single regulatory entity; the term

⁸¹ *Id.* at 5.

⁸² *Id.*

⁸³ *Id.* at 6–7.

⁸⁴ *Id.* IOSCO recognizes that such an orderly winding down may include laws other than the regulator’s securities laws. *Id.* at 7. Perhaps the country’s securities regulator might do well to have a department that reviews bankruptcy proceedings to ensure that investors and market intermediaries are treated fairly.

⁸⁵ *Id.*

⁸⁶ *Id.* at 7.

⁸⁷ *Id.* at 9–11.

⁸⁸ *Id.* at 9.

regulator may include sharing the regulator responsibilities and authority with two or more government or quasi-government agencies.⁸⁹ The regulator must be operationally independent to avoid influence from political entities and the securities industry. Moreover, regulator independence requires sufficient and stable funding, i.e., funds to both hire and to retain skilled and qualified staff. Accountability requires public monitoring of the regulator and judicial review of orders issued in connection with its regulatory activities. The regulator must have these attributes along with a steady source of funds to perform its responsibilities.

The regulator must be clear and consistent in the exercise of its authority and in the formulation of policy. Under the IOSCO Standard, this means that in performing its responsibilities, the regulator must be consistent, comprehensive, transparent, fair, and equitable.⁹⁰ In promulgating rules to effect policy, the regulator should use a process that allows for participation and consultation by the public, including market participants and investors, and others affected by regulator rulemaking and underlying policy. Moreover, the IOSCO Standard requires procedural fairness and an analysis of whether specific rules and their underlying policies unnecessarily burden capital formation.⁹¹

The regulator must actively promote the education of investors and market participants. A regulatory framework based on disclosure requires that both investors and market participants possess the financial knowledge and skills to understand and act upon the information disclosed by issuers. Market participants must also receive continuing education regarding securities products and applicable securities laws, rules, and regulations. In essence, the regulator “should . . . play an active role in the education of investors and other participants in capital markets.”⁹²

Under the IOSCO Standard, the regulator uses the assistance of SROs to fulfill its regulatory functions and responsibilities.⁹³ Although not a requirement under the IOSCO Standard, it is recommended that the regulator oversee SROs.⁹⁴ Specifically, an SRO should be required to “meet appropriate standards before . . . exercis[ing] its authority. . . . [and o]versight of the SRO should be ongoing.”⁹⁵ SROs are useful in the regulatory

⁸⁹ *Id.* at 9 n.11.

⁹⁰ *Id.* at 10.

⁹¹ *Id.* at 11.

⁹² *Id.*

⁹³ *Id.* at 12–13.

⁹⁴ *See id.* at 12.

⁹⁵ *Id.* at 19.

framework because they have expertise about market operations and practices and, generally, have a greater ability to respond quickly to changes in the securities markets. Most importantly, SROs are more likely to spot a violation of securities laws before the regulator. In addition, the IOSCO Standard presumes that, with respect to policy and rulemaking, SROs are likely to be in a better position to determine whether a particular rule or regulation will impose too great a burden on the securities industry even though it achieves a laudable goal, such as investor protection.⁹⁶ Finally, the IOSCO Standard presumes that the regulator will delegate duties to the SRO that the SRO has the “incentive[] to perform most efficiently.”⁹⁷ Despite the usefulness of SROs in the regulatory framework, the IOSCO Standard requires that SROs be monitored closely, at all times, by the regulator.⁹⁸ This means that the regulator must approve SRO rules before they are implemented, i.e., before they are required to be followed by the SROs’ members. The regulator must ensure that SRO rules, and the manner in which they are implemented by the SRO, are fair and enforced consistently in accordance with applicable securities laws and regulations.⁹⁹

The IOSCO Standard recognizes that a significant drawback in the delegation of authority by the regulator to an SRO is that there is a *prima facie* conflict of interest when the SRO is responsible for the regulation of its members and the operation and regulation of a securities market¹⁰⁰ simultaneously.¹⁰¹ When the regulation of members and market centers are combined, there may be pressure from the SRO’s members to favor the market center, which is a profit center, over the regulation of member compliance, which is always a cost center. Accordingly, the regulator must monitor the SRO to whom it has delegated regulatory authority closely and must intervene when needed; the regulator must also retain the authority to investigate, inspect, and enforce securities laws in circumstances under which it has delegated such authority to an SRO.¹⁰² Under the IOSCO regulatory

⁹⁶ *See id.* at 12–13.

⁹⁷ *Id.* at 12.

⁹⁸ *Id.* at 12–13.

⁹⁹ *Id.* at 12.

¹⁰⁰ For example, this conflict was recognized and eliminated when the Commission approved NASDAQ’s application to become a registered exchange, thus elevating it to SRO status and relieving the NASD of this responsibility. Press Release, NASDAQ, SEC Approves NASDAQ’s Exchange Registration Application (Jan. 16, 2006), *available at* <http://ir.nasdaq.com/releasedetail.cfm?ReleaseID=184424>. Prior to January 1996, the NASD was also the primary regulator or SRO for NASDAQ and other trading systems that compete with NASDAQ such as electronic communication networks or ECNs.

¹⁰¹ IOSCO Pub. Doc. 154, *supra* note 6, at 13.

¹⁰² *Id.*

model, effective delegation of certain regulatory responsibilities and functions by the regulator to an SRO include drafting rules, which must be approved by the regulator prior to implementation, designed to assure member compliance with applicable securities laws and SRO rules;¹⁰³ assuring fair and consistent treatment of SRO members and prospective members; establishing member conduct standards to promote investor protection;¹⁰⁴ enforcing SRO rules and imposing appropriate sanctions as well as cooperating with regulator-initiated investigations and enforcement actions; and assuring fair representation of the SRO's members on its board of directors.¹⁰⁵

The IOSCO Standard requires a regulator with comprehensive enforcement powers, including inspection, investigation and surveillance powers.¹⁰⁶ At a minimum, the regulator must have sufficient power to obtain data, documents and other records from individuals and/or firms that the regulator determines may have violated applicable securities laws, or that may have relevant information. The regulator's power should include the authority to impose administrative sanctions, and/or to seek orders from courts or tribunals, and, where appropriate, to enter into enforceable settlements and to accept binding undertakings.¹⁰⁷

Effective implementation of a regulator's enforcement powers under the IOSCO Standard requires a regulatory framework that routinely uses inspection and surveillance. For example, the regulator's inspection and surveillance powers should be routine, not in response to a suspicion of violations of applicable securities laws. Acknowledging that regulator resources may be limited, inspections by the regulator should be prioritized beginning with areas "of high risk to investors or which threaten systemic stability."¹⁰⁸ Again, the regulator may delegate its power of inspection to SROs or other third parties under proper supervision.¹⁰⁹

Effective enforcement in the global securities market may require crossing jurisdictional lines.¹¹⁰ Specifically, regulators

¹⁰³ *Id.* This includes avoiding the promulgation of rules that may create uncompetitive situations and prohibiting rules that allow members and/or market participants to gain an unfair competitive advantage over other members and/or market participants.

¹⁰⁴ *Id.* The regulator, along with the SRO, must ensure that the SRO's rules do not conflict with public policy established by the regulator.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.* at 14–15.

¹⁰⁷ *Id.* at 15.

¹⁰⁸ *Id.* at 14–15.

¹⁰⁹ IOSCO recommends that SROs or other third parties conducting inspections on behalf of the regulator should be "subject[ed] to disclosure and confidentiality requirements." *Id.* at 14.

¹¹⁰ IOSCO Standard also recognizes the need for domestic cooperation in an effective

must have the power and the resources to handle cases involving cross-border misconduct. Accordingly,

the regulator [must have] authority to obtain information . . . that may be relevant to investigating and prosecuting potential violations . . . relating to securities transactions, and that such information can be shared directly with other regulators or indirectly through authorities in their jurisdictions for use in investigations and prosecutions of securities violations.¹¹¹

This principle is crucial to effective implementation of the IOSCO Standard, which states that “[d]omestic laws need to remove impediments to international cooperation [between securities regulators]. . . . The inability to provide regulatory assistance can seriously compromise efforts towards effective securities regulation.”¹¹² Regulators must provide regulatory assistance to their regulatory counterparts in other countries.¹¹³ Providing such regulatory assistance requires establishing cooperative arrangements that allow information sharing across country borders. Moreover, regulators must determine whether such information sharing arrangements sufficiently identify systemic threats to the stability of their domestic securities markets. For example, will the financial failure of a market intermediary in the U.S. cause the financial failure of a market intermediary in Canada? Another benefit of cross-border informational sharing arrangements is that “a significant part of an issuer’s commercial activity [may] take place in a country other than the one in which its stock is listed.”¹¹⁴ This is certainly the case in large, well-developed securities markets such as the U.S. “Fraud, market manipulation, insider trading and other illegal conduct that crosses jurisdictional boundaries can and does occur more and more frequently in a global market aided by modern telecommunications.”¹¹⁵ Accordingly, IOSCO recommends that its members

regulatory framework. *Id.* at 15–16.

¹¹¹ *Id.* at 16.

¹¹² *Id.* at 17.

¹¹³ *Id.*

¹¹⁴ *Id.* at 18.

¹¹⁵ *Id.* “It is also common for scheme promoters, managers and custodians to be located in several different jurisdictions and they may not be in the same jurisdiction as investors to whom the scheme is promoted.” In addition, “[s]imilar financial products may be traded on various markets in several countries. . . . [T]here are many derivatives in which the underlying product or reference price is traded, produced or derived on foreign markets.” *Id.* IOSCO lists several examples of violations of securities laws that might necessitate cooperation between international regulators:

[1] shifting the proceeds of crime [from domestic] to foreign jurisdictions; [2] wrongdoers fleeing to a foreign country; [3] routing [fraudulent] transactions through foreign jurisdictions to disguise the identity of parties or the flow of funds; [3] the use of foreign accounts to hide beneficial ownership of shares; and [4] the facilitation of cross-border breaches through the use of international communications media, including the Internet.

memorialize information sharing arrangements in the form of a Memorandum of Understanding (MOU).¹¹⁶ Although the form and content of MOUs will necessarily differ in light of the particular facts and circumstances, IOSCO recommends that MOUs should, at a minimum, identify: (1) the circumstances in which assistance may be requested; (2) the type of information that may be shared; (3) procedures to maintain the confidentiality of information provided; and (4) how the shared information may be used.¹¹⁷

“IOSCO recognizes that sound domestic markets are necessary to the strength of a developed domestic economy and that domestic securities markets are increasingly being integrated into a global [securities] market.”¹¹⁸ Accordingly, successful competition in the global securities market means that the regulatory frameworks of the U.S. and Canadian securities markets must closely resemble the IOSCO Standard.

III. REGULATORY FRAMEWORK OF U.S. SECURITIES MARKETS

A. Background

Prior to 1996, responsibility for regulating the U.S. securities markets was more evenly shared between federal and state regulatory authorities. In fact, state regulation of U.S. securities markets began before federal securities laws were enacted. In 1911, Kansas was the first state to enact securities laws, followed by New York in 1921. State securities regulatory authorities (SSRAs) were considered the local cops on the beat, the front lines in the war against securities fraud in their respective jurisdictions. However, the stock market crash in October 1929 and its fallout was a cataclysm that facilitated acceptance of federal regulation of U.S. securities markets.¹¹⁹ Beginning in 1933, Con-

Id.

¹¹⁶ *Id.* at 19.

¹¹⁷ *Id.* Information may also be required concerning financial and other supervisory information, technical expertise, surveillance and enforcement techniques along with investor education information. *Id.* IOSCO also recommends including a public policy exception to the provision of information in MOUs. *Id.* at 20.

¹¹⁸ *Id.* at 1.

¹¹⁹ Before the stock market crashed in October 1929, there was negligible support for regulation of the U.S. securities markets by the federal government. However, it is estimated that “of the \$50 billion in new securities . . . half became worthless.” SEC, *The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, <http://www.sec.gov/about/whatwedo.shtml> (last visited Sept. 6, 2006) [hereinafter SEC, *Investor’s Advocate*]. Banks also lost significant sums of money during the period, which spurred an economic crisis, subsequently leading to demand for federal regulation of the U.S. securities markets by key market participants. It was believed that the public’s faith in the stock market must be restored in order for the economy to recover. *Id.*

gress passed federal statutes to regulate U.S. securities markets.¹²⁰

1. Federal Regulation in the U.S. Securities Markets

Federal regulation of U.S. securities markets began in 1933 with the passage of the Securities Act of 1933 (the Securities Act) and was quickly followed by the Securities Exchange Act of 1934 (the Exchange Act). The Exchange Act created the Commission, a single federal regulatory authority to regulate U.S. securities markets.¹²¹ The Commission's mandate is to regulate U.S. securities markets by administering and enforcing federal securities laws and by promulgating rules that implement the regulatory framework prescribed in federal securities laws.¹²² At the time of the passage of the Securities Act and the Exchange Act, there was a consensus that the maintenance of fair, efficient, and orderly securities markets facilitates greater investor participation, liquidity, and efficient capital formation in U.S. securities markets.

The federal securities laws consist of the Securities Act of 1933,¹²³ the Securities Exchange Act of 1934,¹²⁴ the Trust Inden-

¹²⁰ Securities Act of 1933, 15 U.S.C. §§ 77a–77bbbb (2000); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78lll (2000); Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1–80b-21 (2000); and Investment Company Act of 1940, 15 U.S.C. §§ 80a-1–80a-64 (2000).

¹²¹ Securities Exchange Act of 1934, 15 U.S.C. §78d (2000). The Commission consists of five commissioners, four Divisions and eighteen Offices. Although headquartered in Washington, D.C., the Commission has eleven regional and district Offices throughout the U.S. Commissioners are appointed by the President with the advice and consent of the Senate. The President also designates one of the Commissioners as Chairperson. Each Commissioner is appointed to a five-year term ending on June 5 of each year. The terms of each Commissioner are staggered so that only one Commissioner's term ends each year on June 4. No more than three Commissioners may belong to the same political party. SEC, *Investor's Advocate*, *supra* note 119.

¹²² The Commission is only authorized to bring civil actions in federal court and administrative proceedings internally. Although criminal actions may be initiated under federal securities laws, only the Office of the U.S. Attorney is authorized to bring such actions. Commissioners meet to conduct activities authorized under federal securities laws. Commission meetings are open to the public unless confidential matters are discussed, for instance whether to issue a formal order of investigation. A formal order of investigation is an order issued by the Commission authorizing its staff to issue subpoenas to compel documents and testimony. Formal orders of investigation and information obtained pursuant to such orders are non-public. SEC, About the Division of Enforcement, <http://www.sec.gov/divisions/enforce/about.htm> (last visited Sept. 20, 2006); SEC, *Investor's Advocate*, *supra* note 119; 17 C.F.R. § 203.5 (2005).

¹²³ 15 U.S.C. §§ 77a–77aa (2000). The Securities Act prohibits fraud in the offer and sale of securities and requires disclosure of material information to investors to facilitate an informed investment decision. See SEC, *Investor's Advocate*, *supra* note 119. When enacted, the Securities Act “specifically preserved the right of each of the states to regulate the offering of securities in that state.” SEC, REPORT ON THE UNIFORMITY OF STATE REGULATORY REQUIREMENTS FOR OFFERINGS OF SECURITIES THAT ARE NOT “COVERED SECURITIES” 1 (1997), available at <http://www.sec.gov/news/studies/uniform.htm> [hereinafter SEC, REPORT ON UNIFORMITY OF 1997].

¹²⁴ §§ 78a–78nn. The Securities Exchange Act prohibits fraud in the purchase and

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 417

ture Act of 1939,¹²⁵ the Investment Advisers Act of 1940,¹²⁶ and the Investment Company Act of 1940,¹²⁷ and are based on the principle of full disclosure of information required by a reasonable investor to make an informed investment decision. According to the Commission:

The main purposes of [the federal securities laws] can be reduced to two common-sense notions:

Companies publicly offering securities for investment dollars must tell the public the truth about their businesses, the securities they are selling, and the risks involved in investing.

People who sell and trade securities—brokers, dealers, and exchanges—must treat investors fairly and honestly, putting investors' interests first.¹²⁸

The Commission promotes full disclosure in U.S. securities markets by requiring issuers and other market participants to provide comprehensive and accurate information to investors with respect to: 1) the offer, sale, and purchase of securities; 2) the efficient and fair operation of securities exchanges and the over-the-counter market (OTC); and 3) the operations and sales practices of market participants.¹²⁹ Section 5 of the Securities Act prohibits the offer and sale of securities through interstate commerce unless the issuer registers its securities with the Commission.¹³⁰ Registration with the Commission requires the

sale of securities in the secondary market and authorizes the Commission to register, regulate, and oversee market participants, including broker-dealers, securities self-regulatory organizations (SROs), such as the NYSE and the NASD. SEC, *The Laws that Govern the Securities Industry*, <http://www.sec.gov/about/laws.shtml> (last visited Sept. 20, 2006) [hereinafter *The Laws that Govern*].

¹²⁵ §§ 77aaa–77bbb. The Trust Indenture Act of 1939 prescribes the content of trust indenture agreements between issuers and their respective bondholders. SEC, *The Laws that Govern*, *supra* note 124.

¹²⁶ §§ 80b-1–80b-21. The Investment Advisers Act of 1940 requires registration of investment advisers—firms or individuals compensated for providing investment advice to investors—with assets under management of \$25 million dollars or more in order to protect investors. SEC, *The Laws that Govern*, *supra* note 124.

¹²⁷ §§ 80a-1–80a-64. The Investment Company Act of 1940 regulates the operation and sales practices of investment companies, i.e., companies, including mutual funds, that primarily invest, reinvest, and trade in securities and offer their own securities to investors. The Public Utility Holding Company Act of 1935 is no longer under the jurisdiction of the Commission. SEC, *The Laws that Govern*, *supra* note 124.

¹²⁸ See SEC, *Investor's Advocate*, *supra* note 119.

¹²⁹ This principle of adequate disclosure assumes, of course, that those receiving the disclosure have the ability to comprehend such information and have the investment skills and/or knowledge to use the information to make sound investment decisions. The jury is still out on whether this is actually the case, despite the Commission's efforts towards investor education. The Commission offers educational information on its website including, but not limited to, the EDGAR database, which contains disclosure documents that issuers whose securities are publicly traded must file with Commission. See *generally* SEC, *Filings & Forms (EDGAR)*, <http://www.sec.gov/edgar.shtml> (last visited Sept. 20, 2006).

¹³⁰ 15 U.S.C. § 77e.

issuer to make disclosures of material facts—information required by a reasonable investor to make an informed investment decision.¹³¹ Accordingly, issuers must file a registration statement with the Commission, which contains, among other things, a prospectus.¹³²

An issuer may avoid registration of its securities by qualifying for a specific exemption from the registration requirement under § 5 of the Securities Act. Generally, an exemption is based on the type of security being offered and sold or the type of securities transaction. For example, securities issued by banks, municipal authorities, charitable and/or religious entities, and certain employee benefit plans are exempt from the registration requirements of § 5 of the Securities Act.¹³³ Transactions that are exempt from the registration requirements of § 5 of the Securities Act include secondary market transactions by persons other than the issuer or an affiliate of the issuer, non-public offerings by the issuer, and sales by brokers or dealers.¹³⁴ Section 3(b) of the Securities Act authorizes the Commission to create exemptions from the registration requirements of § 5 of the Securities Act.¹³⁵ For example, a limited offering authority is available for offerings of less than \$5 million¹³⁶ and is expressed in Securities Act Rules 504 (limited to \$1 million or less),¹³⁷ 505,¹³⁸ 701,¹³⁹

¹³¹ See *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (holding an omitted fact is material if there is a substantial likelihood a reasonable investor would have considered the matter significant).

¹³² A prospectus includes, among other things, a description of the issuer, its organization and financial condition, the terms of the prospective offering, and independently audited financial statements. After the issuer files the appropriate registration statement with the Commission, the appropriate division of the Commission determines whether to review the issuer's registration statement based on non-public criteria. The Commission must promptly tell the issuer whether its registration statement will be reviewed prior to becoming effective. Generally, if the Commission decides to review the issuer's registration statement, it must provide comments to the issuer within thirty days of the date that the issuer filed its registration statement with the Commission. When the Commission completes its review process and the issuer has supplied any additional information requests by the Commission, the issuer requests the Commission to declare its registration statement effective so that it may offer and sell its securities to public investors. See SEC, REPORT ON UNIFORMITY OF 1997, *supra* note 123, at 1–2.

¹³³ 15 U.S.C. § 77c.

¹³⁴ 15 U.S.C. § 77d.

¹³⁵ 15 U.S.C. § 77c(b).

¹³⁶ This exempting authority is granted to the Commission in § 3(b) of the Securities Act, *id.*, and to define the phrase “not involving any public offering” in § 4(2) of the Securities Act. 15 U.S.C. § 77d(2).

¹³⁷ Under Rule 504, 17 C.F.R. § 230.504(b)(2) (2006), exemption is limited to \$1 million or less and does not require specific disclosures or filings except as required under the anti-fraud provisions of the federal securities laws. However, Regulation D of the Securities Act requires issuers using the Rule 504 exemption to file notice with the Commission within fifteen days after the first sale of securities. § 230.503(a).

¹³⁸ Rule 505, 17 C.F.R. § 230.505, provides an exemption from registration for specified purchasers. Rule 505 does not require specific disclosures for sales of securities to “accredited investors,” but certain disclosures must be made to non-accredited investors.

1001,¹⁴⁰ Regulation A (mini-registration),¹⁴¹ and § 4(2) of the Securities Act, which exempts transactions “not involving a public offering” from the registration requirements of § 5 of the Securities Act. Rule 506 describes transactions that are not considered to involve a public offering of securities, i.e., that are private placements. The type of disclosures, if any, required in private placements depends upon the circumstances of the particular transaction.¹⁴²

The Commission also regulates key market participants in the U.S. securities markets including securities exchanges, OTC markets, brokers, dealers, investment advisers, and investment companies (e.g., mutual funds).¹⁴³ There were approximately 5191 broker-dealers,¹⁴⁴ 15,300 investment companies,¹⁴⁵ and 8302 investment advisers¹⁴⁶ participating in U.S. securities markets in 2004.

a. How the Commission Performs its Regulatory Duties in the U.S. Securities Markets

The Commission performs many of its regulatory responsibilities through its staff. Focusing on selective federal preemption, the primary divisions of the Commission include the Division of Corporation Finance (CorpFin), the Division of Market Regulation (MarketReg), the Division of Investment Manage-

§ 230.502(b). Offerings using the Rule 505 exemption are subject to the anti-fraud provisions of the federal securities laws.

¹³⁹ Rule 701, 17 C.F.R. § 230.701, provides an exemption from § 5, 15 U.S.C. § 77e, which lists registration requirements for employee compensation plans by non-public companies. Although there are no specific disclosure requirements, offerings made pursuant to Rule 701 are subject to the anti-fraud provisions of the federal securities laws.

¹⁴⁰ Rule 1001, 17 C.F.R. § 230.1001, provides an exemption from registration, which is coordinated with the exemption from registration with California.

¹⁴¹ 15 U.S.C. § 77d(2). The Regulation A exemption, 17 C.F.R. §§ 230.251–.263, requires the issuer to file an offering statement containing required disclosures including, but not limited to, unaudited financial statements. Securities may not be sold under this exemption until the Commission has qualified the issuer’s offering statement.

¹⁴² Rule 506, 17 C.F.R. § 230.506. However, the Rule 506 exemption does require the issuer to file a notice with the Commission within fifteen days after the first sale of securities. § 230.503(a).

¹⁴³ SEC, *Investor’s Advocate*, *supra* note 119; SEC, Over-the-Counter Markets, <http://www.sec.gov/divisions/marketreg/mrotc.shtml> (last visited Sept. 20, 2006).

¹⁴⁴ THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., 2004 YEAR IN REVIEW at Our 2004 Performance (2005), *available at* http://www.nasd.com/web/groups/corp_comm/documents/home_page/nasdw_014279.pdf.

¹⁴⁵ INVESTMENT COMPANY INSTITUTE, 2005 INVESTMENT COMPANY FACT BOOK 9 (45th ed. 2005), *available at* http://www.ici.org/factbook/05_fb_sec1.html#fund_sponsors. This number is for the period 2004 and includes mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts.

¹⁴⁶ INVESTMENT ADVISOR ASSOCIATION, EVOLUTION RESOLUTION: A PROFILE OF THE INVESTMENT ADVISORY PROFESSION 3 (2005), *available at* http://www.icaa.org/public/evolution_revolution-2005.pdf This number is for the period 2004; in 2005, investment advisers registered with the Commission totaled 8,614.

ment (IM), the Division of Enforcement (Enforcement), the Office of Administrative Law Judges (ALJ), the Office of the Chief Accountant (Chief Accountant), the Office of Compliance Inspections and Examinations (OCIE), and the Office of International Affairs (OIA).¹⁴⁷ CorpFin reviews disclosure documents required under the federal securities laws in the primary securities market¹⁴⁸ including registration statements filed in connection with new issues and follow-on offerings, annual (10-K) and quarterly (10-Q) filings, proxy materials, tender offers, and mergers and acquisitions. It also prepares administrative interpretations of the Securities Act, the Exchange Act, and the Trust Indenture Act of 1939 (Trust Indenture Act) regarding securities traded in the primary securities market. With respect to rules and regulations promulgated pursuant to federal securities laws, CorpFin drafts and recommends rules and regulations to implement the Securities Act, the Exchange Act and the Trust Indenture Act.¹⁴⁹ In addition, CorpFin, in cooperation with the Chief Accountant, monitors the accounting profession with an emphasis on standards promulgated by the Financial Accounting Standards Board (FASB),¹⁵⁰ one of several entities responsible for developing Generally Accepted Accounting Principles (GAAP).¹⁵¹

MarketReg regulates and establishes standards for key market participants in the U.S. securities markets, including SROs,

¹⁴⁷ See the Commission's website for a listing of all offices and divisions along with a discussion of their responsibilities. SEC, *supra* note 8.

¹⁴⁸ See generally SEC, Division of Corporation Finance, <http://www.sec.gov/divisions/corpin.shtml> (last visited Oct. 4, 2006). The primary securities market is regulated under the Securities Act, which governs activities related to new issues, including initial public offerings or IPOs.

¹⁴⁹ Administrative interpretations are sometimes issued in the form of no-action letters, which are letters issued in response to public requests of whether a particular course of action or transaction would violate the Securities Act, the Exchange Act, or the Trust Indenture Act. Specifically, the CorpFin staff writes a letter stating whether it would or would not recommend that the Commission take action against the issuer for engaging in the practice and/or transaction. CorpFin also provides informal guidance by giving its interpretation of applicable securities regulations and advice on compliance with applicable disclosure requirements to registrants, prospective registrants and the public. SEC, *Investor's Advocate*, *supra* note 119.

¹⁵⁰ *Id.* FASB was established in 1973 and is a private organization that establishes standards of financial accounting and reporting in the U.S. FASB standards are recognized by the Commission and the American Institute of Certified Public Accountants. FINANCIAL ACCOUNTING STANDARDS BOARD, FACTS ABOUT FASB 1 (2005), available at http://www.fasb.org/facts/facts_about_fasb.pdf.

¹⁵¹ GAAP represents uniform minimum standards of, and guidelines for, financial accounting and reporting. American Institute of Certified Public Accountants, Glossary of Terms, Acronyms, and Abbreviations, <http://www.aicpa.org/members/glossary/g.htm> (last visited Oct. 4, 2006). It is comprised of standards, interpretations, opinions and bulletins used to prepare financial statements for companies whose securities are publicly-traded in U.S. securities markets. Federal Accounting Standards Advisory Board, Generally Accepted Accounting Principles, <http://www.fasab.gov/accepted.html> (last visited Oct. 3, 2006).

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 421

brokers, and dealers. Its duties include reviewing SRO proposed new rules or changes to existing SRO rules submitted to the Commission for approval. MarketReg is also responsible for implementing and monitoring the Commission's financial integrity program for brokers and dealers.¹⁵² Like CorpFin, MarketReg issues no-action letters in response to public requests about whether a particular course of action or transaction would violate federal securities laws. Unlike CorpFin, MarketReg is responsible for surveillance of the actual trading of securities in U.S. securities markets. It also monitors the activities of the Securities Investor Protection Corporation (SIPC), a non-profit, private corporation that insures customer accounts of broker-dealers in the event of insolvency.¹⁵³

IM monitors the activities of entities and individuals regulated under the Investment Advisers Act and the Investment Company Act, including mutual funds, UITs,¹⁵⁴ ETFs,¹⁵⁵ variable insurance products,¹⁵⁶ and federally registered investment advisers.¹⁵⁷ IM regulatory activities include interpreting the laws and

¹⁵² SEC, *Investor's Advocate*, *supra* note 119. The financial integrity program requires broker-dealers to make and keep certain books and records, which allow the Commission to determine, among other things, whether brokers/dealers have sufficient net capital to avoid insolvency. Exchange Act, 17 C.F.R. § 240.17a-3 (2005).

¹⁵³ SEC, No Action Letters, <http://www.sec.gov/answers/noaction.htm> (last visited Oct. 6, 2006); SEC, *Investor's Advocate*, *supra* note 119.

¹⁵⁴ A UIT is:

[a] trust, registered with the SEC under the Investment Company Act of 1940, in which a fixed portfolio of income-producing securities are purchased and held to maturity. This type of investment vehicle is commonly used with municipal bonds. Each unit usually costs \$1,000 and is sold by brokers to investors for an average load of 4% which is included in the per share price.

TIAA-CREF Brokerage Services, Investment Glossary, http://www.tiaa-crefbrokerage.com/invest_glosry_UUnd.htm (last visited Oct. 6, 2006).

¹⁵⁵ ETFs

are open-ended registered investment companies under the Investment Company Act of 1940, which have received certain exemptive relief from the SEC to allow secondary market trading in the ETF shares. ETFs are index-based products, in that each ETF holds a portfolio of securities that is intended to provide investment results that, before fees and expenses, generally correspond to the price and yield performance of the underlying benchmark index.

American Stock Exchange, ETFs Glossary, <http://www.amex.com/etf/Glossary/Gloss.htm>.

¹⁵⁶ For example, variable annuities and variable life insurance—variable annuities are life insurance annuity contracts that consist of an underlying securities portfolio that fluctuates based on the value of the securities. The goal is to provide periodic payments at a specified time (usually retirement). Accordingly, it is important that the value of the annuity is preserved to meet periodic payment requirements. Periodic payments may change based on the market value of the underlying securities portfolio, or may be fixed at some minimum level based on portfolio appreciation. TIAA-CREF Brokerage Services, Investment Glossary, http://www.tiaa-crefbrokerage.com/invest_glosry_V.htm (last visited Oct. 6, 2006).

¹⁵⁷ SEC, Division of Investment Management, <http://www.sec.gov/divisions/investment.shtml> (last visited Oct. 6, 2006). Federal Registration requires that the investment adviser have assets under management in excess of \$25 million. Investment

regulations under the Investment Advisers Act and the Investment Company Act for the public and for divisions within the Commission (e.g., Enforcement). IM is also responsible for drafting new rules and amendments to existing rules on behalf of the Commission pursuant to the Investment Advisers Act and the Investment Company Act. Like CorpFin and MarketReg, IM issues no-action letters in response to requests from regulated individuals, entities, and the public about the Investment Advisers Act and the Investment Company Act.¹⁵⁸ In addition, IM participates in audits of registered individuals and entities and the examination of annual and periodic reports of persons and entities regulated under the Investment Advisers Act and the Investment Company Act, reviews reports such persons and entities must file with the Commission, and proposes new rules and amends existing rules, which it must submit to the Commission for approval.

Enforcement investigates¹⁵⁹ possible violations of federal securities and recommends to the Commission whether those investigated should be prosecuted civilly in federal courts and/or administrative proceedings.¹⁶⁰ Investigatory and prosecutorial activities also include settlement negotiations on behalf of the Commission.¹⁶¹ If those prosecuted are found to have violated federal securities laws, available remedies in the federal courts

Advisers Act of 1940, 15 U.S.C. § 80b-3a (2000).

¹⁵⁸ SEC, *Investor's Advocate*, *supra* note 119; SEC, Division of Investment Management, <http://www.sec.gov/divisions/investment.shtml> (last visited Oct. 6, 2006).

¹⁵⁹ Investigations conducted by Enforcement are private. This means that the Commission is prohibited from disclosing that an investigation has commenced. It is the job of Enforcement to collect sufficient information during an investigation to recommend to the Commission that it initiate a civil action or an administrative proceeding. Enforcement obtains information by, among other things, interviewing witnesses, examining the books and records of regulated entities, and reviewing trading data. Enforcement, acting on behalf of the Commission, may compel regulated individuals and entities to produce information it requires to conduct its investigation. However, the Commission must issue a formal order of investigation to obtain such information from non-regulated individuals, including officers and directors of companies whose securities are publicly traded. SEC, *Investor's Advocate*, *supra* note 119.

¹⁶⁰ Administrative proceedings initiated by the staff on behalf of the Commission begin with the issuance of an Order Instituting Proceedings (OIP) issued by the Secretary of the Commission. 17 C.F.R. § 201.141 (2005). An administrative law judge (ALJ), compensated by, but not appointed by, the Commission presides over the hearing and evaluates evidence presented by Enforcement and respondents. The ALJ issues an initial decision subsequent to the hearing that contains findings of fact, conclusions of law, and recommended sanctions. Both Enforcement and respondents have a right to appeal the ALJ's decision, or a portion thereof, to the full Commission. The Commission's review of the ALJ's decision is de novo, and it may affirm, reverse, or remand the ALJ's decision in full or in part. Administrative sanctions include cease and desist orders, suspension or revocation of broker-dealer and investment adviser registrations, censures, bars from association with the securities industry, payment of civil monetary penalties, and disgorgement (return of ill-gotten gains). Both Enforcement and respondent have a right to appeal the Commission's final order to the appropriate U.S. District Court of Appeals. SEC, *Investor's Advocate*, *supra* note 119.

¹⁶¹ SEC, *Investor's Advocate*, *supra* note 119.

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 423

include injunctions, civil penalties, disgorgement of illegal profits, or barring or suspending individuals from acting as corporate officers of companies whose securities are publicly-traded.¹⁶² Available sanctions in administrative proceedings include cease and desist orders, disgorgement of ill-gotten gains,¹⁶³ civil penalties, and the revocation or suspension of the licenses authorizing regulated entities and their employees to participate in the U.S. securities industry.

The Commission determines whether to authorize Enforcement to bring a civil action, an administrative proceeding, or both, based on several factors. These factors include “the seriousness of the wrongdoing, the technical nature of the [case], tactical considerations, and the type of sanction or relief [sought].”¹⁶⁴

For example, only the Commission is authorized to bar regulated entities such as brokerage firms from participating in the securities industry. Accordingly, the Commission might initiate an administrative proceeding to revoke the registration of the brokerage firm, which means the firm can no longer engage in a securities business in the U.S. securities markets.

Although the Commission only has civil enforcement authority, it may, and frequently does, make referrals and provide assistance to the U.S. Attorney’s Office and state securities enforcement authorities that do have criminal enforcement authority under federal and state securities laws, respectively,¹⁶⁵ against those serving as directors and officers for companies whose securities are publicly traded.¹⁶⁶ In 2002, the Commission, through its Enforcement staff, brought 598 enforcement actions.¹⁶⁷

The Chief Accountant advises the Commission about accounting and auditing matters and collaborates with domestic and international accounting and auditing standards-setting private sector entities, e.g., the American Institute of Certified Public Accountants (AICPA). It also cooperates closely with the Pub-

¹⁶² SEC, About the Division of Enforcement, <http://www.sec.gov/divisions/enforce/about.htm> (last visited Oct. 6, 2006).

¹⁶³ When the Commission obtains disgorgement of ill-gotten gains, i.e., money obtained by defendants from their illegal conduct, this does not mean that such funds are automatically returned to individual investors who have been defrauded. “The Commission’s mandate is to protect investors,” not to act on behalf of individual investors. *Id.*

¹⁶⁴ SEC, *Investor’s Advocate*, *supra* note 119.

¹⁶⁵ *Id.*

¹⁶⁶ The Commission may bar a person from acting as an officer or director by filing an action in federal district court. *Id.*

¹⁶⁷ GPRA, *supra* note 16, at 26. Typical actions included insider trading, accounting fraud, and providing false or misleading information about securities and/or securities transactions. SEC, *Investor’s Advocate*, *supra* note 119.

lic Company Accounting Oversight Board.¹⁶⁸ In addition, the Chief Accountant consults with Commission staff (e.g., CorpFin staff), registrants, and others about the application of accounting standards and financial disclosure requirements under federal securities laws. It may also refer matters to Enforcement if it obtains information indicating possible violations of federal securities laws.

OCIE is responsible for the Commission's examination program for registered SROs, broker-dealers, transfer agents, clearing agencies, investment companies, and investment advisers. The Commission's examination program consists of inspections designed to assess compliance with federal securities laws, to detect violations of federal securities laws, and to inform the Commission of new developments, including products and technologies, in the securities industry.¹⁶⁹

OIA's primary purpose is to reach out to members of the global securities market "to promote cooperation and assistance and to encourage the adoption of high regulatory standards worldwide."¹⁷⁰ According to the Commission, OIA's activities are essential to furthering its interests in the global securities market,¹⁷¹ and include negotiating information-sharing protocols in connection with enforcement cases, providing technical assistance concerning the operation and regulation of securities markets to various countries, and participating in international organizations (e.g., IOSCO) and meetings.¹⁷² For example, OIA assists Enforcement in obtaining and evaluating information needed from other countries to prosecute violations of the U.S. securities laws.

As currently staffed and funded, it would be impossible for the Commission to perform its regulatory responsibilities for the U.S. securities markets single-handedly. Accordingly, the Exchange Act authorizes the Commission, as primary regulator, to delegate the performance of certain of its regulatory responsibilities to SROs. SROs must register with the Commission under §§ 6 and 19(a) of the Exchange Act¹⁷³ and are subject to oversight by the Commission. To qualify for registration with the Commis-

¹⁶⁸ SEC, *Investor's Advocate*, *supra* note 119. More detailed information is available at Public Company Accounting Oversight Board (PCAOB), <http://www.pcaob.org> (last visited Oct. 6, 2006).

¹⁶⁹ SEC, *Investor's Advocate*, *supra* note 119.

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

¹⁷² *Id.*

¹⁷³ 15 U.S.C. § 78f(a) (2000). Section 78s(a) authorizes the Commission to effectively shut down an aberrant registered national securities exchange by revoking its registration with the Commission.

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 425

sion, the SRO must evidence that it has the capacity to regulate its members and their associated persons with a view towards ensuring compliance with applicable securities laws and the rules promulgated hereunder, as well as ensuring compliance with its own rules.¹⁷⁴ SROs are statutorily required to police their members by conditioning membership on compliance with applicable securities laws (including state securities laws);¹⁷⁵ SRO policing efforts must include the imposition of sanctions on its members for violations of applicable securities laws (federal and state) and its own rules. The largest and the most active SROs are the NASD and the NYSE.¹⁷⁶ Specifically, the Commission delegates much of its responsibility for performing examinations of market participants' books and records to SROs which have more resources to perform such examinations on a regular basis (once per year). Generally, examinations of books and records are conducted to ensure that market participants are complying with federal securities laws and to protect investors by determining whether market participants have sufficient capital to support their activities in the marketplace. Examinations of the sales practices of market participants facilitates investor protection by determining whether market participants are making misrepresentations of, and/or omitting to state, material facts in connection with the offer, sale, and purchase of securities in U.S. securities markets. However, despite delegation of certain of its regulatory duties to SROs, the Commission remains ultimately responsible for ensuring that market participants comply with federal securities laws.

¹⁷⁴ § 78f(b)(1).

¹⁷⁵ Section 78f(c)(1) provides that only registered broker-dealers and their associated persons may be members of a national securities exchange, such as the NYSE. See § 78f(c)(2) for a description of factors national securities exchanges consider in denying membership to broker-dealers. Institutional investor membership is prohibited.

¹⁷⁶ FITCH RISK MANAGEMENT, REVIEW OF SIPC RISK PROFILE AND PRACTICES: THE MJK CLEARING EVENT, THE SECURITIES LENDING EXPOSURE, RISK MANAGEMENT PRACTICES AND CAPITAL REQUIREMENTS 24 (2003) ("The two most prominent SROs are the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE)."). NASD Member Firms totaled 5111 in 2005. NASD, NASD Statistics, http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_010990 (last visited Oct. 6, 2006). NASDAQ and NYSE are exchanges. 15 U.S.C. § 78c(a)(1) (2000), defines an exchange as

[A]ny 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 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 market place and the market facilities maintained by such exchange.

For a list of securities exchanges currently registered with the Commission, see SEC, Self-Regulatory Organization (SRO) Rulemaking and National Market System (NMS), <http://www.sec.gov/rules/sro.shtml> (last visited Oct. 6, 2006).

2. State Regulation of U.S. Securities Markets

The state regulatory framework, like the federal regulatory framework, is comprised of a state securities regulatory authority (SSRA)¹⁷⁷ that regulates, within its borders, the issuance and trading of securities; the activities of market participants; and, until 1996, the financial integrity (operations and capital requirements) and sales practices of brokers, dealers, investment advisers, and investment companies. SSRAs are responsible for enforcing state securities laws passed by state legislatures. SSRA regulatory activities include licensing investment professionals and securities firms within their respective jurisdictions, examining broker-dealer and investment adviser firms to confirm compliance with state securities laws, reviewing state offerings not subject to federal securities laws, and educating investors.

The state securities registration process differs from the federal securities registration process because a majority of states regulate securities offerings based on merit reviews rather than, or along with, full disclosure; only a minority of states include full disclosure in their securities registration process. Registration based on merit review means that SSRAs must determine the *fairness* of prospective offerings to investors. The definition of fairness varies from state to state. The merit review process is designed to “prevent promotion of fraudulent or inequitable” securities offerings.¹⁷⁸

Like federal securities laws, state securities laws include exemptions from registration requirements based on the type of securities and the securities transaction. Types of securities that are exempt from state registration requirements include securities issued by banks or savings institutions and by certain reli-

¹⁷⁷ Eleven SSRAs are appointed by their respective Secretaries of State, others by their respective Governors, five are under the jurisdiction of their state’s Attorney General, and the remaining SSRAs operate under the auspices of their respective state banking or financial institutions, or commerce departments. *The Role of State Securities Regulators in Protecting Investors: Hearing on Efforts to Enforce Securities Laws, Investment Adviser Registration and Licensing, State Investigations into Mutual Fund Industry Abuses, and Investor Education Programs Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. 34 (2005) [hereinafter *Role of State Securities Regulators*] (statement of Ralph A. Lambiase, Director, Division of Securities Connecticut Department of Banking; President, NASAA).

¹⁷⁸ In merit reviews, SSRAs determine the fairness of the offering by considering, among other factors, whether the offering: (1) limits sales of stock to insiders and promoters and at a significantly discounted price; (2) Requires repayment of insider loans before the offering is conducted; (3) Ensures that material transactions are from unaffiliated third parties and are ratified by a majority of the issuer’s independent board members; (4) Demonstrates that the issuer’s net income in the past fiscal year is sufficient to cover fixed charges, preferred stock dividends, and redemption requirements of any preferred stock being offered; and (5) Prohibits unequal voting rights without allowing preferential dividends or liquidation provisions in exchange for accepting unequal voting rights. SEC, REPORT ON UNIFORMITY OF 1997, *supra* note 123, at 7–8.

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 427

gious and charitable organizations. Securities transactions that are exempt from state registration requirements include the offer or sale of a security issued to specified purchasers;¹⁷⁹ any transaction in which there is an offer to not more than ten persons in the state during any twelve month period under certain conditions; and any transaction in which there is an offer to existing security holders of the issuer, if certain conditions are met.¹⁸⁰ Moreover, most states have limited offering exemptions from their registration requirements based on such factors as the number of offerees or purchasers, the dollar amount of the offering, or a combination of the two.¹⁸¹

State securities laws, although closely following the regulatory framework set out in federal securities laws, are tailored to fit the requirements of the local marketplace. State securities laws were, and continue to be, different in each state.¹⁸² To address the issue of uniformity, or lack thereof, in the state registration process, forty-eight states have adopted (with modifications) the Uniform Securities Act of 1956 (Uniform Act)¹⁸³ drafted by the National Conference of Commissioners on Uniform State Laws (NCCUSL).¹⁸⁴ SSRAs have attempted to decrease the cost

¹⁷⁹ Specified purchasers include banks, savings institutions, and institutional buyers. *Id.* at 9.

¹⁸⁰ Required conditions include advance notice to the state securities commission. *Id.* at 9–10.

¹⁸¹ *Id.* at 10.

¹⁸² Prior to 1996, all issuers were required to comply with state securities laws of all states. *Id.* at 1. Inevitably, this process raised the cost of capital unnecessarily.

¹⁸³ New York and California have not adopted the Uniform Act. Uniform Law Commissioners, A Few Facts About the Uniform Securities Act (2002), http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-usa.asp (last visited Feb. 9, 2007). Originally, the Uniform Act was drafted in 1956 and was adopted, with modifications, in 37 jurisdictions. It was revised in 1985 and 2002; the Uniform Act of 2002 does not conflict with current federal securities laws and has been adopted by Hawaii, Idaho, Iowa, Kansas, Maine, Minnesota, Missouri, Oklahoma, South Carolina, South Dakota, Vermont, and the U.S. Virgin Islands; it has been endorsed by NASAA, the Securities Industry Association, the NYSE, the NASD, and the Investment Counsel Association of America, and is approved by the American Bar Association. Uniform Securities Act Organization, <http://www.uniformsecuritiesact.org/usa/DesktopDefault.aspx> (last visited Oct. 11, 2006). Regarding registration, the Uniform Act provides for registration of state offerings by notification, coordination and qualification. Registration by notification requires the issuer to make only a notice filing with the SSRA. UNIFORM SECURITIES ACT § 302, 7C U.L.A. 74 (2006). Registration by coordination enables the issuer's state registration statement to become effective when its federal registration statement is declared effective by the Commission. § 303, 7C U.L.A. 81. Registration by qualification means that the state securities authority will conduct a full review of the issuer's prospective offering within its jurisdiction. Generally, registration by qualification is used when the issuer is exempt from registration under the Securities Act but not under state securities laws. § 304, 7C U.L.A. 84.

¹⁸⁴ Uniform Law Commissioners, Frequently Asked Questions about NCCUSL, <http://www.nccusl.org/nccusl/DesktopDefault.aspx?tabindex=5&tabid=61> (last visited Oct. 11, 2006). The NCCUSL consists of lawyers, judges and law professors, who are appointed by states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. It

of capital by adopting the Uniform Act and working together to regulate multi-state offerings under the auspices of the North American Securities Administrators Association.

a. North American Securities Administrators Association (NASAA)

The North American Securities Administrators Association (NASAA) is a *voluntary* umbrella organization representing state and provincial securities regulators in North America. Established in 1919, NASAA consists of the SRAs in the U.S., Canada, and Mexico.¹⁸⁵ NASAA's organizational structure includes a board of directors, standing committees, an executive director, and staff responsible for daily operations.¹⁸⁶ Similar to the Commission, NASAA's standing committees¹⁸⁷ are comprised of five sections—Broker-Dealer,¹⁸⁸ Corporation Finance,¹⁸⁹ Enforcement,¹⁹⁰ Investment Adviser,¹⁹¹ and Investor Education.¹⁹²

drafts uniform and model laws in topical areas of the law which would benefit from uniformity. Uniform Law Commissioners, About NCCUSL, <http://www.nccusl.org/nccusl/DesktopDefault.aspx?tabindex=0&tabid=9> (last visited Oct. 11, 2006).

¹⁸⁵ North American Securities Administrators Association [NASAA], About NASAA, http://www.nasaa.org/About_NASAA/ (last visited Oct. 11, 2006). Canadian membership includes its thirteen provinces and territories of British Columbia, Yukon, Northwest Territories, Nunavut, Quebec, Newfoundland & Labrador, Nova Scotia, New Brunswick, Ontario, Prince Edward Island, Manitoba, Saskatchewan, and Alberta. Canada does not have a federal securities regulator. NASAA, Director of Securities Laws & Regulations, http://www.nasaa.org/industry_regulatory_resources/Directory_of_Securities_Laws_Regulations/ (last visited Oct. 11, 2006).

¹⁸⁶ NASAA is headquartered in Washington, D.C. and its departments include legal, finance, government affairs, communications, investor education, and membership services. See generally NASAA, About NASAA, http://www.nasaa.org/About_NASAA/ (last visited Oct. 11, 2006).

¹⁸⁷ NASAA, Sections & Project Groups, http://www.nasaa.org/About_NASAA_Sections_Project_Groups/ (last visited Oct. 11, 2006).

¹⁸⁸ Project groups of the Broker-Dealer Section include Continuing Education, Exams Advisory, Market and Regulatory Policy and Review, Operations, Arbitration, and Variable Annuities. NASAA, Sections & Project Groups: Broker-Dealer Section, http://www.nasaa.org/about_nasaa/nasaa_sections_project_groups/345.cfm (last visited Oct. 11, 2006).

¹⁸⁹ Project groups in the Corporation Finance section include Corporation Finance Policy, Direct Participation Programs Policy (e.g., limited partnerships), Franchise and Business Opportunities, Shareholder Rights, Small Business/Limited Offerings, Small Business Capital Formation, and Coordinated Interpretations. NASAA, Sections & Project Groups: Corporation Finance Section, http://www.nasaa.org/about_nasaa/nasaa_sections_project_groups/346.cfm (last visited Oct. 11, 2006).

¹⁹⁰ Project groups in the Enforcement section include Attorney/Investigator Training, Enforcement Technology, Enforcement Trends, Litigation Forum, Special Project Development & Coordination, and Viaticals & Life Settlements. NASAA, Securities & Project Groups, Enforcement Section, http://www.nasaa.org/about_nasaa/nasaa_sections_project_groups/347.cfm (last visited Oct. 11, 2006).

¹⁹¹ Project groups in the Investment Adviser section include Operations, Regulatory Policy & Review, Training, and Zones. NASAA, Securities & Project Groups, Investment Adviser Section, http://www.nasaa.org/about_nasaa/nasaa_sections_project_groups/348.cfm (last visited Oct. 11, 2006).

¹⁹² Project groups in the Investor Education section include affinity and ethnic-based

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 429

NASAA's Enforcement committee coordinates enforcement efforts for multi-state or multi-jurisdictional frauds by facilitating information sharing and attempting to allocate efficiently the enforcement efforts of its membership. The Enforcement committee serves as a liaison, on behalf of NASAA membership, to federal agencies (particularly the Commission) and SROs. The Enforcement committee also attempts to identify fraud and enforcement trends in the various jurisdictions of its members. For the reporting period 2002–2003, SSRAs “filed a total of 2,964 administrative, civil, and criminal enforcement actions; assessed \$822,315,470 of monetary fines or penalties; collected \$660,109,508 in restitution, rescission, and disgorgement and sentenced criminals to over 717 years of incarceration.”¹⁹³

NASAA has adopted several programs over the years in an attempt to harmonize state securities laws. These efforts include the Uniform Limited Offering Exemption (ULOE) in 1983 to facilitate uniformity regarding registering securities offerings; the Coordinated Equity Review (CER) program; and the Small Company Offering Registration (SCOR) program. However, compliance with such programs is strictly voluntary. ULOE provides a state exemption for offerings that are exempt under Rules 505 and 506 of Regulation D of the Securities Act.¹⁹⁴ SCOR provides a lead state examiner for multi-state offerings required by relatively smaller issuers, such as microbreweries, small banks, and technology startups.¹⁹⁵ CER targets relatively larger multi-state offerings, e.g., securities that trade on the NASDAQ Smallcap market or the OTC Bulletin Board.

Most importantly, NASAA members have additional responsibilities other than securities regulation within their jurisdictions. For example, the responsibility for enforcing the securities laws of the State of New York resides with its State Attorney

outreach, online trading awareness, senior outreach, and youth outreach. NASAA, Securities & Project Groups, Investor Education Section, http://www.nasaa.org/about_nasaa/nasaa_sections__project_groups/349.cfm (last visited Sept. 9, 2006).

¹⁹³ These statistics were compiled by NASAA with over 70 percent of its 52 members responding. *Role of State Securities Regulators*, *supra* note 177, at 40 (prepared statement of Joseph P. Borg, Director, Alabama Securities Commission & Chairman of the Enforcement Section of NASAA).

¹⁹⁴ See ROSA MARIA MOLLER, SECURITIES REGULATIONS AND THEIR EFFECTS ON SMALL BUSINESSES 32 (2000) *available at* <http://www.library.ca.gov/crb/00/04/00-005.pdf>; NASAA, Statement on Public Offerings, http://www.nasaa.org/Issues__Answers/Legislative_Activity/Testimony/684.cfm (last visited Sept. 9, 2006). Offerings under Regulation D of the Securities Act are limited offerings that are exempt from the registration requirements of § 5 of the Securities Act. Regulation D exemption requirements are contained in Rules 501–08, which contain requirements to qualify for Regulation D's limited offering exemptions from registration. 17 C.F.R. §§ 230.501–230.508 (2006).

¹⁹⁵ See NASAA, Statement on Public Offerings, http://www.nasaa.org/Issues__Answers/Legislative_Activity/Testimony/684.cfm (last visited Sept. 9, 2006).

General (AG). However, the AG is divided into five major divisions with corresponding bureaus. There are four case-specific divisions: Appeals and Opinions,¹⁹⁶ Criminal Prosecutions,¹⁹⁷ State Counsel,¹⁹⁸ and Public Advocacy; plus a separate Regional Offices Division.¹⁹⁹ There is also a Division of Administration that provides budget, personnel, operations, and technology services for the Attorney General.²⁰⁰ The Investor Protection Bureau is responsible for enforcing and administering the State of New York's securities laws and operates under the auspices of the Division of Public Advocacy (Public Advocacy). Public Advocacy was established to defend and protect the public interest in New York courts. Public Advocacy is comprised of ten bureaus, and in addition to enforcing the State of New York's securities laws, it also enforces its health care laws, environmental laws, laws that prevent trade restraint, laws that protect charitable donors and beneficiaries, and laws that prohibit discrimination. Moreover, the AG's recommended budget for the fiscal year 2005–06 of \$214 million must be shared by all divisions and the corresponding bureaus.²⁰¹ Unlike the Commission, SSRAs rarely have the luxury of focusing exclusively on monitoring and enforcing state securities laws.

As a member of IOSCO, NASAA also participates in the global securities market by exchanging views with international criminal law and regulatory sectors focused on combating investment fraud, and by identifying ways of coordinating enforcement efforts when investigating and prosecuting securities fraud that has crossed international borders.²⁰²

Finally, cooperation between the Commission and SSRAs is mandated under § 19(d) of the Exchange Act. Accordingly,

¹⁹⁶ The Division of Appeals and Opinions handles appellate litigation in both the State of New York and Federal courts. In addition, it drafts opinions which interpret State of New York laws for New York State agencies and municipalities. Office of NYS Attorney General Eliot Spitzer, Tour the Attorney General's Office, <http://www.oag.state.ny.us/tour/tour.html> (last visited Sept. 11, 2006).

¹⁹⁷ The Criminal Prosecutions Division investigates and prosecutes criminal cases including, but not limited to, Medicaid fraud, auto insurance fraud, white collar and organized crime occurring in New York State. *Id.*

¹⁹⁸ The Division of State Counsel provides counsel and representation in legal proceedings involving New York State agencies, the Governor, other New York State officials and the New York State Legislature. *Id.*

¹⁹⁹ The Regional Offices program provides mini-satellite offices in New York State to provide access to the programs and services of the AG and to provide cost-effective representation for New York agencies in all New York State and Federal courts. *See id.*

²⁰⁰ NEW YORK STATE DEPARTMENT OF LAW, 2001 ANNUAL REPORT 29 (2002).

²⁰¹ Assemb. B. 550, 2005 Leg., 228th Legis. Sess. (N.Y. 2005), available at <http://www.budget.state.ny.us/archive/fy0506archive/fy0506appropbills/ppgg.pdf>.

²⁰² *Role of State Securities Regulators*, *supra* note 177, at 37 (statement of Ralph A. Lambiase, Director, Division of Securities Connecticut Department of Banking; President, NASAA).

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 431

NASAA and the Commission co-sponsor an annual Conference on Federal-State Securities Regulation (Conference). At the Conference, participants in working groups focus on regulatory topics such as corporation finance, broker-dealer sales practices, investment advisers, investor education, and enforcement.²⁰³

Against this setting, a movement towards federal preemption in the U.S. securities markets began, in earnest, with the passage of the National Securities Markets Improvement Act of 1996 (NSMIA).²⁰⁴

3. Selective Federal Preemption in the Securities Regulatory Framework

This section identifies significant legislative action endorsing selective federal preemption from 1996 to the present. 1996 was chosen because Congress passed legislation that clearly demonstrated its support for selective federal preemption in the securities regulatory framework. The chart below summarizes legislation signifying Congress's intent to use selective federal preemption in the securities regulatory framework.

²⁰³ Press Release, SEC, SEC, NASAA to Co-Sponsor Conference on Federal-State Securities Regulation (Apr. 5, 2004), *available at* <http://www.sec.gov/news/press/2004-46.htm>.

²⁰⁴ Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.) (1996).

| <u>Name</u> | <u>Purpose</u> | <u>Citation</u> |
|--|---|--|
| National Securities Markets Improvement Act of 1996 Oct. 11, 1996 | To modernize and rationalize the regulatory framework of the U.S. Securities Markets including, but not limited to, the respective responsibilities of Federal and State governmental authorities | Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.) (1996). |
| Securities Litigation Uniform Standards Act of 1998 Nov. 3, 1998 | To prevent certain state private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the Private Securities Litigation Reform Act of 1995 | Pub. L. No. 105-353, § 1, 112 Stat. 3227 (1998). |
| Sarbanes-Oxley Act of 2002 Jul. 30, 2002 | “To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.” | Pub. L. No. 107-204, 116 Stat. 745 (2002). |
| The Securities Fraud Deterrence and Investor Restitution Act of 2004 | Although never passed, this was an attempt to further curtail state regulatory authority in the U.S. securities markets and was described as a bill “[t]o enhance the authority of the [Commission] to investigate, punish, and deter securities laws violations, and to improve its ability to return funds to defrauded investors, and for other purposes.” | H.R. 2179, 108th Cong. (2d Sess. 2004); H.R. REP. NO. 108-475, pt. 1 (2004). |

a. The National Securities Markets Improvement Act of 1996

According to President Clinton, the NSMIA represented the most significant overhaul of the regulatory framework for the U.S. securities markets in decades. NSMIA would

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 433

enhance capital formation and the competitiveness of the American economy by eliminating regulatory overlap between the States and the Federal Government. . . . [The] bill achieve[d] the difficult task of improving the efficiency of the financial markets without compromising investor protections. . . . [It] will more efficiently divide responsibility for regulation between the Federal and State governments. The [Commission] will be charged with responsibility for activities in the national markets, such as regulation of securities listed on the national exchanges and mutual funds, as well as large investment advisors.²⁰⁵ States will have responsibility for smaller issues and investment advisors²⁰⁶ with smaller portfolios, while retaining their authority to take enforcement actions against fraudulent conduct in all situations. . . . These changes will all enhance our national capital markets, helping to create and nurture new businesses and new jobs, and enhancing the returns of both businesses and investors.²⁰⁷

NSMIA was designed to facilitate the development of national securities markets and to reduce the costs and burdens of duplicative regulation. NSMIA increased the use of selective federal preemption by

designating the Federal government as the exclusive regulator of national offerings of securities[;] repealing anti-competitive restrictions on entities from whom brokers may borrow; requiring the consideration of efficiency, competition, and capital formation whenever the [Commission] makes a public interest determination in its rulemaking; providing for streamlining and coordinating of examinations of broker-dealers by [SROs]; significantly reducing regulatory burdens on the mutual fund industry; [and] simplifying and reducing ineffective and anticompetitive restrictions imposed by the Investment Company Act.²⁰⁸

NSMIA also empowered the Commission to exercise wide-ranging, exemptive authority. The Commission's exemptive authority allows it, by rule or regulation, to exempt any person, security, or transaction from any requirement under federal securities laws.²⁰⁹ Congress contended that such exemptive authority was needed to ensure sufficient flexibility to respond quickly to changes in the U.S. securities industry.²¹⁰ However, the Commission's exemptive authority must be exercised to promote effi-

²⁰⁵ Large investment advisers are investment advisers with more than \$25 million in assets under management. SEC, Investment Advisors: What You Need to Know Before Choosing One, <http://sec.gov/investor/pubs/invadvisors.htm> (last visited Sept. 26, 2006).

²⁰⁶ Smaller investment advisers are investment advisers with \$25 million or less under management. *Id.*

²⁰⁷ Statement on Signing the National Securities Markets Improvement Act of 1996, 2 PUB. PAPERS 1812 (Oct. 11, 1996).

²⁰⁸ H.R. REP. NO. 104-622, at 16 (1996).

²⁰⁹ 15 U.S.C. § 77z-3 (2000). The Commission may exercise its exemptive authority conditionally or unconditionally. *See also* H.R. REP. NO. 104-622, at 58 (1996).

²¹⁰ H.R. REP. NO. 104-622, at 38 (1996).

ciency, competition, and capital formation as well as the public interest and investor protection.²¹¹ Accordingly, the Commission must analyze the potential costs and benefits of a particular proposed rule.²¹²

(1) Increased Use of Selective Federal Preemption in Securities Registration

NSMIA facilitates the creation of national securities markets and the reduction of the cost of regulation by prohibiting state regulation of offerings of “covered securities” or “conditionally covered securities.” Covered securities²¹³ include the following:

1. Securities listed, including securities authorized for listing, on the NYSE, the AMEX, and the NASDAQ-NMS;²¹⁴
2. Securities of the same issuer that are equal in seniority or senior to the security listed on the NYSE, AMEX, or NASDAQ-NMS;²¹⁵
3. Securities issued by investment companies registered with the Commission;²¹⁶
4. Sales of securities in items 1 and 2 to qualified purchasers;²¹⁷

²¹¹ *Id.* Congress also intended that the Commission raise the permissible amount of offering exemptions under § 3(b) of the Securities Act from \$5 million to \$10 million, including, but not limited to, increasing the exemption amount under offerings for certain employee benefit plans, and small public offerings under Regulation A of the Securities Act. *Id.* However, this broad grant of exemptive authority is not valid with respect to § 15C of the Exchange Act and to the definitions listed in § 3(a)(42)–(45) of the Exchange Act, which govern government securities dealers. Section 105(b) of NSMIA allows the Commission to act by issuing an order with respect to the Exchange Act to facilitate individual exemptive requests; the Commission is authorized to establish procedures and circumstances that determine whether it will issue an exemptive order. *Id.*

²¹² In addition, Congress requires a rigorous cost and benefits analysis in connection with its review of major rules promulgated by the Commission under the Small Business Regulatory Enforcement Fairness Act of 1996. *Id.* at 39.

²¹³ The Securities Amendments Act of 1996 generally exempts from state registration requirements those securities listed on major stock exchanges, e.g., NASDAQ (National Market System only) or NYSE. *Id.* at 57–58.

²¹⁴ This includes discretionary authority for the Commission to identify securities listed on other exchanges or trading systems that are similar to the NYSE, AMEX, or NASDAQ-NMS. Congress’s intent is to require the Commission to monitor listing requirements of exchanges on which covered securities are listed to ensure compliance with applicable federal securities laws. *Id.* at 30.

²¹⁵ This provision covers securities other than equities, for example, the issuer’s debt securities. *Id.*

²¹⁶ 15 U.S.C. § 77r(b) (2000). The NASD also conducts examinations of investment companies registered with the Commission that are also its members; this includes approximately ninety percent of investment companies. The NASD’s examination includes, but is not limited to, a review of the sales literature and advertising materials. H.R. REP. NO. 104-622, at 31 (1996).

²¹⁷ § 77r(b)(3). This section contemplates that the Commission will define a “qualified purchaser,” which would include purchasers of mortgaged-backed securities, asset-backed securities, other structured securities, and securities issued in connection with project financings. H.R. REP. NO. 104-622, at 31. Generally, Congress believes that “qualified” purchasers are sophisticated investors, capable of protecting themselves in a manner that renders regulation by State authorities unnecessary.” *Id.* Congress’s intent was that

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 435

5. Secondary market trading transactions that are exempt from the registration requirements under §§ 4(1), 4(3) and 4(4) of the Securities Act;²¹⁸
6. Securities exempt from registration pursuant to § 3(a) of the Securities Act;²¹⁹
7. Securities sold in private transactions pursuant to § 4(2) of the Securities Act, if offered or sold in accordance with a rule or regulation promulgated by the Commission in accordance with § 4(2) of the Securities Act.²²⁰

Conditionally covered securities²²¹ include registered securities offerings by issuers with total assets exceeding \$10 million²²² with two years of audited financial statements ending before the filing of a registration statement with the Commission. However, securities offerings in which a person²²³ has been statutorily disqualified²²⁴ are subject to both federal and state regulation. The effect of NSMIA's increased use of selective federal preemption is to impose one set of rules for securities that are, or will be, traded on a national basis.²²⁵ For example, SSRAs may not perform merit reviews of offerings involving covered or conditionally covered securities.

The states' authority to bring enforcement actions under their securities laws prohibiting fraud and deceit in connection with any securities offering and securities transaction is specifically preserved under NSMIA.²²⁶ Such enforcement actions

these types of structured offerings be regulated exclusively by the Federal government and apply to all offerings, both registered or exempt from registration under the Securities Act. *Id.* at 32.

²¹⁸ § 77r(b)(4). The issuer must be reporting under the Exchange Act, or is exempt from the reporting requirements under the Exchange Act. H.R. REP. NO. 104-622, at 32.

²¹⁹ Section 3(a) exempts securities if they are: a) securities of non-profit and similar entities described in § 3(a)(4); b) intrastate offerings under § 3(a)(11)(i); and c) municipal securities as defined in § 3(a)(2). H.R. REP. NO. 104-622, at 32.

²²⁰ *Id.*

²²¹ A conditionally covered security also includes a security that will be a covered security upon completion of the transaction. Offerings involving securities that have been plagued by high levels of fraud will continue to be regulated by state securities authorities, i.e., regulation of such securities is not preempted under federal securities laws. These securities offerings include securities issued by blank check companies, partnerships, limited liability companies, direct participation investment programs, penny stock companies, and roll-up transactions. *Id.* at 32–33.

²²² Total assets may be measured after the transaction is completed. *Id.* at 32.

²²³ Person includes associated persons of broker-dealers. *Id.* at 33.

²²⁴ A person is statutorily disqualified when she is barred from associating with a broker-dealer and/or an investment adviser or investment company. Such a person is effectively excluded from participating in the U.S. securities industry. Section 39(a)(39) of the Exchange Act authorizes the Commission to exempt statutorily disqualified persons, thus exempting the securities offering from state regulation. *See* H.R. REP. NO. 104-622, at 33.

²²⁵ 15 U.S.C. § 77r(a) (2000).

²²⁶ § 77r(c)(1).

would include cases involving broker-dealer sales practices in which misrepresentations and/or omissions of material facts occur. However, Congress asserted that “[NSMIA] preempts authority that would allow the States to employ the regulatory authority they retain to reconstruct in a different form the regulatory regime for covered securities that Section 18 [of NSMIA] has preempted.”²²⁷ Moreover, NSMIA did not reduce the revenue stream to states by eliminating state registration requirements for securities offerings and transactions involving covered or conditionally covered securities; states may still require notice filings and fees in connection with securities offerings and securities transactions made within their borders.²²⁸ They may suspend securities offerings and securities transactions within their borders if the issuer fails to make a filing and/or pay a fee required under state law.²²⁹

(2) Selective Federal Preemption and Broker-Dealer Financial Responsibility

NSMIA preempts state laws imposing financial responsibility and reporting requirements on broker-dealers and associated persons of broker-dealers. Specifically, selective federal preemption applies to regulation of capital, margin, books and records, bonding, and recordkeeping requirements.²³⁰ However, state securities laws continue to apply to broker-dealer sales practices involving fraud in the offer, sale, and purchase of securities traded within the jurisdiction of each state; accordingly, SSRAs maintain the ability to initiate enforcement actions involving fraud. In addition, broker-dealers and their associated persons must still register and pay filing fees in each state. Again, although some state regulatory powers have been preempted by federal securities laws, states continue to receive revenue from

²²⁷ H.R. REP. NO. 104-622, at 34.

²²⁸ § 77r(c)(2)(B).

²²⁹ § 77r(c)(3). States also have the authority to request any registration documents filed with the Commission in order to compute the required fee. H.R. REP. NO. 104-622, at 35. Offering documents “include any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security.” *Id.*

²³⁰ Associated persons may effect transactions for existing customers in states in which they are not registered. This exemption from state registration requires that the associated person “must not be ineligible to register in the [state in which the transaction occurs] for any reason[;] must be registered with the NASD and with at least one [state;] must be associated with a broker-dealer that is registered in the [state] in which the transaction is effected”; permissible transactions are those executed for an “existing customer . . . while that customer is temporarily away from home”; and transactions executed for an existing customer while the associated person is awaiting a response to his/her application for licensing in the state. However, the associated person cannot execute more than ten transactions under this provision in states in which the associated person is not licensed. H.R. REP. NO. 104-622, at 36–37.

state filing and registration fees.

(3) Selective Federal Preemption and the Regulation of Investment Companies and Investment Advisers

NSMIA imposed selective federal preemption by amending the registration provisions of the Investment Company Act (ICA) with a view towards reducing unnecessary regulatory costs and procedural burdens. Investment companies (e.g., mutual funds) were permitted to register an indefinite number of securities on an annual basis. Regulatory costs were reduced significantly because investment companies were permitted to file one registration per year rather than filing a registration statement for each offering of its securities within a one-year period.²³¹

NSMIA authorized the Commission to require investment companies to make and keep certain books and records in addition to those necessary to prepare their financial statements.²³² This expansion of the Commission's authority was designed to facilitate examinations to determine whether investment companies and related entities were complying with federal securities laws. The Commission's expanded authority does not extend to an investment company adviser, unless it is a majority-owned subsidiary of a registered investment company.²³³ Finally, NSMIA left to the states the job of regulating investment advisers with assets of less than or equal to \$25 million; however, investment advisers with less than or equal to \$25 million under management may continue to register with the Commission if they so choose.

b. The Securities Litigation Uniform Standards Act of 1998 Increased the Use of Selective Federal Preemption

Selective federal preemption in the regulatory framework of U.S. securities markets continued with the passage of the Securities Litigation Uniform Standards Act of 1998 (SLUSA).²³⁴ SLUSA established uniform national rules for securities class ac-

²³¹ Fees for such registration statements are based on the aggregate sales price of securities sold during the investment company's fiscal year. Failure to meet the annual filing deadline and to pay the requisite fee subjects the investment company to the payment of interest based on the amount due at a rate established by the Secretary of Treasury under the Debt Collection Act of 1982. *Id.* at 44; *see also* 15 U.S.C. § 80a-24(f).

²³² H.R. REP. NO. 104-622, at 47. Previously, the Commission could only require investment companies to make and keep records necessary to prepare their financial statements. *Id.*

²³³ *Id.*

²³⁴ H.R. REP. NO. 1689, at 4-5 (1997). SLUSA amended § 28(b) of the Exchange Act.

tion lawsuits involving covered securities.²³⁵ Its effect was to require class action lawsuits alleging certain categories of securities fraud²³⁶ and involving covered securities to be filed in federal court under federal securities laws.²³⁷ According to Congress, SLUSA was needed to close a loophole used by the private securities bar to avoid the provisions of the Private Securities Litigation Reform Act of 1995 (PSLRA).²³⁸ PSLRA was passed to eliminate “vexatious litigation that was draining value from the shareholders and employees of public companies.”²³⁹ However, according to a report and statistical analysis of securities class actions lawsuits (Report)²⁴⁰ commissioned by Congress to assess the effectiveness of the implementation of the PSLRA, the private securities bar seemingly avoided the more stringent requirements of securities fraud cases under federal securities laws by filing class actions in state courts under state securities laws. The Report suggested

that the level of class action securities fraud litigation has declined by about a third in federal courts, but that there has been an almost equal increase in the level of state court activity, largely as a result of a “substitution effect” whereby plaintiffs resort to state court to avoid the new, more stringent requirements of federal cases. There has also been an increase in parallel litigation between state and federal courts in an apparent effort to avoid the federal discovery stay or other provisions of [PSLRA]. This increase in state activity has the potential not only to undermine the intent of [PSLRA], but to increase the overall cost of litigation to the extent that [PSLRA] encourages the filing of

²³⁵ H.R. REP. NO. 105-803, at 13 (1998) (Conf. Rep.) (noting class actions relating to a covered security are “defined by section 18(b) of the Securities Act of 1933, which was added” with the passage of NSMIA). Again, selective federal preemption focuses on securities that are traded nationally in the U.S. securities markets.

²³⁶ Specifically, securities fraud consists of misrepresentations, omissions, deception, or manipulation in connection with the purchase or sale of a covered security. *Id.* at 7.

²³⁷ SLUSA amended § 16 of the Securities Act and § 28 of the Exchange Act to limit class actions involving covered securities, i.e., covered class actions. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227, 3227 (1998).

²³⁸ H.R. REP. NO. 105-803, at 13–15 (1998) (Conf. Rep.). *See also, e.g.*, Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 290–91 (1998). PSLRA was passed despite being vetoed by President Clinton. H.R. REP. NO. 105-640, at 9 (1998).

²³⁹ H.R. REP. NO. 105-640, at 9 (1998); *see also* H.R. REP. NO. 104-369, at 31–32 (1995) (Conf. Rep.). Unfortunately, under the PSLRA, the private securities bar could still determine and select the most favorable state forum in which to file a securities class action. Because the issuer’s security was traded nationally, the plaintiff’s attorney’s selection could result in forcing shareholders and defendants to travel great distances in order to litigate securities class actions. Moreover, different plaintiffs and classes could file competing securities class actions in the same or different states forcing the issuer to litigate more than one securities class action case simultaneously. Most of these issues were resolved under SLUSA.

²⁴⁰ *See* Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year’s Experience* (John M. Olin Program in Law and Econ., Working Paper No. 140, 1997).

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 439

parallel claims.

....

... [The Commission] called the shift of securities fraud cases from Federal to State court “potentially the most significant development in securities litigation” since passage of [PSLRA].

... [P]laintiffs’ lawyers have sought to circumvent [PSLRA’s] provisions by exploiting differences between Federal and State laws by filing frivolous and speculative lawsuits in State court, where essentially none of [PSLRA’s] procedural or substantive protections against abusive suits are available.²⁴¹

Specifically, SLUSA prohibited securities class actions involving covered or conditionally covered securities (covered class actions) from being filed in state courts by defining covered class actions as:

- any single lawsuit in which damages are sought on behalf of more than fifty persons²⁴² or prospective class members with common questions of law or fact;²⁴³ or
- any single lawsuit brought on behalf of one or more unnamed parties seeking to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated; and
- any group of lawsuits filed in or pending in the same court, involving common questions of law or fact, brought on behalf of more than fifty persons, which are joined, consolidated, or otherwise proceed as a single action.²⁴⁴

SLUSA was drafted to include *mass actions*²⁴⁵ and to authorize federal courts “to stay discovery in any state court action if deemed to aid in the federal court’s jurisdiction.”²⁴⁶

²⁴¹ H.R.Rep. No. 105-640, at 10 (1998) (Conf. Rep.) (quoting Grundfest & Perino, *supra* note 240). PSLRA contained a heightened pleading standard, which required plaintiffs’ complaints to state specific grounds for their claims. In addition, all motions had to be resolved before conducting discovery. *Id.* at 45.

²⁴² Corporations, investment companies, pension plans, partnerships, or other entities are treated as one person, if the entity was not organized solely for the purpose of participating in a class action involving covered securities. 9 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 4169 (3d ed. 2004).

²⁴³ *Id.* at 4168. Common questions of law or fact must predominate over any questions affecting only individual persons or members. However, it is not necessary under SLUSA to prove individual reliance of all class members on the common questions of fact. *See id.*

²⁴⁴ *Id.* at 4168–69. Individual plaintiffs bringing bona fide actions will not be prohibited solely because more than fifty persons commence actions in the same state court against a single defendant or issuer. *Id.* at 4170.

²⁴⁵ Mass actions involve many plaintiffs, have high settlement value, and “may be abused by lawyers who seek to evade [SLUSA].” *Id.*

²⁴⁶ THOMAS LEE HAZEN, *FEDERAL SECURITIES LAW* 85–86 (2d ed. 2003). *See, e.g., In re Bankamerica Corp. Sec. Litig.*, 95 F. Supp. 2d 1044, 1049 (E.D. Mo. 2000) (staying state court class action that “threaten[ed] the orderly conduct of the federal case,” which represented more than twenty-six times the dollar amount in claims than the state court proceeding that was stayed).

SLUSA prohibits securities class actions based on state statutory or common law in any state or federal court, if it alleges misrepresentations and/or omissions of material facts or the use of any manipulative or deceptive device in connection with the offer, sale, or purchase of a covered, or conditionally covered, security. Such securities class actions could not be filed in state court under state or federal securities laws.²⁴⁷ In this case, the use of selective federal preemption means that nationally traded securities can only be subject to federal securities laws, not varying state securities laws; such uniformity facilitates a reduction in the cost of regulation.

c. Sarbanes-Oxley Act of 2002 (SOX) and Selective Federal Preemption

SOX increased the use of selective federal preemption in the regulatory framework of the U.S. securities markets. Areas traditionally regulated by states were now partially regulated under federal securities laws. Specifically, SOX set (1) minimum standards of professional conduct, including non-industry regulation, for accountants performing audits of companies whose securities are publicly traded; and (2) more stringent Commission regulation of the corporate governance of companies whose securities are publicly traded.

(1) Regulation of Accountant Conduct and Selective Federal Preemption

SOX uses selective federal preemption to establish a regulatory framework for accounting firms that conduct audits of companies' required filings with the Commission. Prior to the enactment of SOX, the fragmentation of the regulatory framework governing the accounting profession conducting audits of such companies adversely impacted effective regulation of the accounting profession *and* the usefulness of information obtained from such audits. Accordingly, a reliable regulatory framework for the accounting firms, who are responsible for ensuring that material information provided by such companies is correct, is an essential component of competing successfully in the global securities

²⁴⁷ 15 U.S.C. § 77p(b)–(e). SLUSA excludes certain types of class actions and state court actions. State jurisdiction is preserved with respect to actions brought pursuant to the law of the state where the issuer is incorporated, and actions brought by a state, or on behalf of a state, in which the plaintiffs are named and are authorized by a state to participate in the class action. Essentially, SLUSA preserves SSRA power to continue investigatory and enforcement activities. Shareholder derivative class actions brought on behalf of a corporation or issuer are also excluded under SLUSA. Certain state law fiduciary claims against officers, directors, or control persons primarily based on misrepresentations in connection with tender offers, mergers, and other such transactions are not precluded by SLUSA. *See id.*

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 441

market. In congressional hearings conducted by the Senate Committee on Banking, Housing, and Urban Affairs to consider “the effectiveness of the accounting regulatory oversight system,” it was determined that

The profession’s combination of public oversight and voluntary self-regulation is extensive, Byzantine, and insufficient. The Panel found that the current system of governance lacks sufficient public representation, suffers from divergent views among its members as to the profession’s priorities, implements a disciplinary system that is slow and ineffective, lacks efficient communication among its various entities and with the [Commission], and lacks unified leadership and oversight.²⁴⁸

Under SOX, companies filing with the Commission can only retain accounting firms registered with the Public Company Accounting Oversight Board (PCAOB)²⁴⁹ to conduct audits of their financial statements.²⁵⁰ PCAOB, subject to Commission oversight,²⁵¹ has broad power to establish and adopt standards for auditing, quality control, and ethics for accounting firms conducting audits for companies whose securities are publicly traded.²⁵² PCAOB’s powers include the authority to conduct inspections and investigations and to impose sanctions.²⁵³ All final decisions

²⁴⁸ S. REP. NO. 107-205, at 2, 5 (2002) (quoting testimony of Shaun O’Malley, Chairman, 2000 Public Oversight Board Panel on Audit Effectiveness and former Chairman, Price Waterhouse LLP, before the Committee on Mar. 6, 2002).

²⁴⁹ 15 U.S.C.A. § 7212(a) (2006). PCAOB has authority only with respect to audits of companies whose securities are publicly traded. It has no jurisdiction over the work of accountants auditing other companies, i.e., companies whose securities are *not* publicly traded. § 7211(a).

²⁵⁰ Registered accounting firms must also file a report annually to update all required information. In addition, registration and annual fees are assessed to cover the cost of processing and reviewing applications and annual reports. S. REP. NO. 107-205, at 8. Accounting firms must register with PCAOB in order to be eligible to conduct audits of public companies. Accordingly, suspension or revocation of an accounting firm’s registration means that it can no longer engage in the practice of auditing publicly traded companies. *Id.* at 7.

²⁵¹ See Sarbanes-Oxley Act of 2002 § 107(a), 15 U.S.C.A. § 7217(a) (2006). PCAOB has rulemaking authority, but all rules, auditing standards, and its budget must be submitted to the Commission before becoming effective. § 7217(b). The Commission must also hear appeals of PCAOB’s disciplinary actions and negative inspection reports. § 7217(c).

²⁵² S. REP. NO. 107-205, at 8. However, SOX authorizes PCAOB to rely on professional groups of accountants or one or more advisory groups of practicing accountants or other interested parties as long as such parties meet SOX’s statutory tests. *Id.*

²⁵³ *Id.* at 9–11. PCAOB final inspection reports are sent to the Commission and applicable accountancy boards routinely. They are also made public. Accounting firms are allowed twelve months to correct problems uncovered during PCAOB inspections. Sanctions available for violations of applicable provisions of SOX include revoking or suspending the accounting firm’s registration, barring individuals associated with registered accounting firms from association with their current firm as well as any other accounting firm, imposing civil monetary penalties, mandatory participation in professional education or training programs, and censure. Revoking an accounting firm’s registration with PCAOB or barring an individual from association with a registered accounting firm may only be imposed if the violation was committed intentionally, knowingly, recklessly, or

issued and sanctions imposed by PCAOB may be appealed to the Commission.

Most importantly with respect to the global securities market, PCAOB also has jurisdiction over public accounting firms organized outside of the U.S. that prepare audited financial statements for issuers trading in the U.S. securities markets.²⁵⁴ However, PCAOB has exemptive authority, i.e., it may determine that the role of the foreign accounting firm is sufficiently *de minimis* to avoid SOX's registration requirement.²⁵⁵ Whether this requirement diminishes the competitiveness of the U.S. securities markets in the global securities market remains to be seen.

(2) Corporate Governance and Selective Federal Preemption

SOX, using selective federal preemption, regulates in an area of corporate law traditionally reserved to state incorporation laws—corporate governance. Among other things, SOX places particular emphasis on issuer audit committees. Under SOX, audit committees are directly responsible for the oversight, compensation, and appointment of the accounting firm hired to conduct an audit of the issuer's books, records, and procedures. In addition, auditors are required to report directly to the audit committee.²⁵⁶ SOX was designed to increase the independence of the audit committee, given its importance as the first line of defense for ensuring the accuracy of financial disclosures required under federal securities laws.²⁵⁷ Accordingly, SOX prohibits the payment of consulting fees to audit committee members by the issuer, and prevents audit committee members from being affiliated persons of the issuer or its subsidiaries.²⁵⁸ SOX also re-

peated negligence. PCAOB is authorized to impose sanctions for failure reasonably to supervise a partner or employee. Liability for failure to reasonably supervise a partner or employee is based on similar standards used with respect to broker-dealer under § 15(b)(4) of the Exchange Act. SOX also contains a similar safe harbor, i.e., the accounting firm may avoid liability by showing that it has written internal control procedures designed with a view towards preventing violations of applicable provisions of SOX and that its internal control procedures were implemented and monitored for effectiveness. *Id.*

²⁵⁴ See 15 U.S.C.A. § 7216(a). Congress "believes that there should be no difference in treatment of a public company's auditors under [SOX] simply because of a particular auditor's place of operation. Otherwise, a significant loophole in the protection offered U.S. investors would be built into the statutory system." S. REP. NO. 107-205, at 11.

²⁵⁵ See 15 U.S.C.A. § 7216(c).

²⁵⁶ §§ 78j-1(k)(1), (m)(2).

²⁵⁷ S. REP. NO. 107-205, at 14.

²⁵⁸ 15 U.S.C.A. § 78j-1(m)(3). See also S. REP. NO. 107-205, at 24 ("Former SEC Chairman Arthur Levitt testified that 'as a listing condition, stock exchanges should require at least a majority of company boards to meet a strict definition of independence,' including barring audit committee members from accepting consulting fees from the company.").

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 443

quires the audit committee to establish and implement procedures for protecting whistleblowers, including allowing employees to anonymously report concerns about accounting or auditing matters.²⁵⁹ Finally, the issuer must pay for independent counsel and/or other advisers that audit committee members determine are needed to perform their responsibilities as audit committee members.²⁶⁰

Corporate governance reforms under SOX include additional inroads on state preeminence in matters of corporate governance. Section 302 of SOX requires the Chief Executive Officer (CEO) and the Chief Financial Officer (CFO) to certify that the information contained in annual and quarterly reports filed with the Commission is accurate. Accordingly, the signatures of the CEO and the CFO are required on such reports to evidence certification. Section 303 of SOX prohibits any officer or director from taking any action to fraudulently influence accounting firms engaged in conducting audits of companies required to file with the Commission.²⁶¹ Finally, § 404 of SOX requires that each annual report contain a written assessment of a company's internal controls for ensuring accurate financial reporting.

d. H.R. 2179 and Selective Federal Preemption

The most recent significant attempt to increase selective federal preemption in the U.S. securities markets regulatory framework is The Securities Fraud Deterrence and Investor Restitution Act of 2004 (H.R. 2179).²⁶² H.R. 2179 was designed in part to preempt state laws that interfered with the Commission's ability "to investigate and deter fraud, levy and collect fines and disgorgement [sic] funds, and provide for a significant increase in money available for return to injured investors."²⁶³ Introduced on May 21, 2003, H.R. 2179²⁶⁴ proposed to preempt state securities laws by, among other things,

- Allowing states to place funds obtained from successfully prosecuted fraud cases in an investor restitution fund administered and distributed by the Commission, even if the Commission was not a party to the agreement or settlement which was the source of such

²⁵⁹ 15 U.S.C.A. § 78j-1(m)(4).

²⁶⁰ § 78j-1(m)(5)–(6). *See also* S. REP. NO. 107-205, at 25.

²⁶¹ 15 U.S.C.A. §§ 7241–42. SOX also mandates the adoption of codes of conduct for an issuer's senior officials and disclosure of the terms of such codes of conduct on Form 8K. Any change in, or waiver of, the provisions of such codes must be disclosed to the public immediately. § 7264; *see also* § 7262.

²⁶² H.R. 2179, 108th Cong. (2d Sess. 2004). H.R. 2179 expressly preserves the right of states' securities regulations to bring fraud cases in their respective jurisdictions. H.R. REP. NO. 108-475, pt. 1, at 50 (2004).

²⁶³ H.R. REP. NO. 108-475, pt. 1, at 12.

²⁶⁴ H.R. 2179 was introduced by Representatives Baker, Oxley, Tiberi, Ose and Kelly.

funds.²⁶⁵

- Continuing the Commission's prohibition of state regulation of capital, margin, books and records, disclosure, and disclosure of conflict of interest requirements for brokers, dealers, municipal securities dealers, government securities brokers or government securities dealers.²⁶⁶
- Preempting state or local laws exempting property from foreclosure or forced sale to satisfy judgments obtained by the Commission in connection with its enforcement activities.²⁶⁷ It would preempt state laws that allow properties otherwise covered by state homestead exemptions to be seized by the Commission.
- Establishing that the Central Registration Depository (CRD) and the Investment Adviser Registration Depository (IARD) are operated on behalf of the Commission.²⁶⁸

However, it is clear that H.R. 2179 was not designed to completely eliminate SSRAs in the securities regulatory framework. Its purpose seems to be to increase selective federal preemption in an area Congress deemed to be "weak areas" in the securities regulatory framework. Also, H.R. 2179 requires the Commission to cooperate with NASAA "to produce . . . a joint study on strengthening the working relationship between State and Federal securities regulators."²⁶⁹

²⁶⁵ H.R. REP. NO. 108-475, pt. 1, at 8. The Congressional Committee stresses that states are not required to deposit disgorgement and/or civil penalties in the Commission controlled fund. In addition, this fund would be used only for the purpose of making restitution payments to investors. *Id.* However, such funds are, in many cases, used to cover the costs of state enforcement actions.

²⁶⁶ Proposed Amendment to H.R. 2179, 108th Cong. (2003) (offered by Rep. Baker). However, this section of H.R. 2179 requires the Commission to consult with SSRAs in order to evaluate whether requirements established under this section of H.R. 2179 are adequate. *Id.*

²⁶⁷ H.R. REP. NO. 108-475, pt. 1, at 2. However, Representative Harris offered an amendment that would exempt such property from a judgment or order obtained by the Commission if its aggregate value did not exceed \$125,000 and it was acquired more than 1215 days prior to the Commission's judgment or order. *See* Proposed Amendment to H.R. 2179, 108th Cong. (2003) (offered by Rep. Harris). Subsequently, Representative Harris offered an amendment to her amendment that would require that such property "constitutes or is derived from" proceeds obtained in violation of securities laws and after "payment of debts." Proposed Amendment to the Amendment in the Nature of a Substitute to H.R. 2179, 108th Cong. (2003) (offered by Rep. Harris). Representative Hensarling also offered an amendment that would limit waiver of state homestead exemptions subject to Commission judgments or orders to an aggregate value of \$125,000 after the payment of debts. Amendment to the Amendment in the Nature of a Substitute to H.R. 2179, 108th Cong. (2003) (offered by Rep. Hensarling).

²⁶⁸ *See* H.R. REP. NO. 108-475, pt. 1, at 30. There is an ongoing dispute as to the ownership of the CRD. This section states that such public disclosure programs are under the authority of the Commission, not the states. NASAA, representing the SSRAs, also asserts ownership of the CRD. NASAA, CRD & IARD, http://www.nasaa.org/Industry_Regulatory_Resources/CRD_IARD/ (last visited Oct. 14, 2006).

²⁶⁹ H.R. REP. NO. 108-475, pt. 1, at 28.

IV. CANADIAN REGULATORY FRAMEWORK

A. Overview

Unlike the U.S., Canada does not, nor is it able to, use selective federal preemption in its securities regulatory framework. Canada does not have federal securities laws directly regulating securities markets throughout the country. Moreover, it does not have any entity at the federal level whose sole mission is to ensure a uniform securities regulatory framework, require provincial compliance with such a securities regulatory framework, and represent Canada in the global securities market. Instead, Canada's securities regulatory framework consists of thirteen provincial²⁷⁰ securities regulators and several SROs. Each province has its own SRA, whose jurisdiction does not extend beyond its borders.²⁷¹ Furthermore, although provincial securities laws are based on similar principles and objectives, the implementation of provincial securities laws, inevitably, is inconsistent.²⁷²

The only organization charged with harmonizing the various provincial securities laws and their implementation is the Canadian Securities Administrators (CSA). This is problematic because, like NASAA, the CSA is a voluntary membership organization. Accordingly, provincial compliance with CSA initiatives and policy recommendations is not statutorily mandated. SRAs may choose to follow all, a portion, or none of CSA's harmonization recommendations.

1. Canadian Securities Administrators

The CSA was established in an attempt to bring some uniformity to a very fragmented regulatory framework. Like its counterpart in the U.S.—NASAA—CSA members are the thirteen SRAs responsible for securities regulation in Canada's provinces and territories. The CSA "is an informal body that functions through meetings among its members. . . . [and does not

²⁷⁰ The term province in this article is meant to include Canada's territories, the Yukon Territory, Northwest Territories, and Government of Nunavut.

²⁷¹ The provincial securities regulators are: British Columbia Securities Commission (BCSC); Alberta Securities Commission (ASC); Saskatchewan Financial Services Commission (SFSC); Manitoba Securities Commission (MSC); Ontario Securities Commission (OSC); Commission des Valeurs Mobilières du Québec (CVMQ); New Brunswick Securities Administration Branch (NBSAB); Nova Scotia Securities Commission (NSSC); Prince Edward Island Securities Office (Office of the Attorney General) (PEISO); Securities Commission of Newfoundland and Labrador (SCNL); Registrar of Securities (Community Services), Government of the Yukon Territory (RSYT); Registrar of Securities (Department of Justice), Government of the Northwest Territories (RSNT); and Registrar of Securities (Department of Justice), Government of Nunavut (RSN). WISE PERSONS' COMMITTEE, *supra* note 31, at 15.

²⁷² *Id.*

have] binding authority over the securities regulators regarding policy development or enforcement activities, and is *funded by each of its members on a voluntary basis*.²⁷³ Although created in 1937, it was not until 2003 that the CSA created a Policy Coordination Committee (PCC) to “oversee the implementation of the CSA’s strategic plan²⁷⁴ and ongoing policy and rule development.”²⁷⁵ Despite its limitations, the CSA has focused on harmonizing the various securities laws of its members. Some of its initiatives include:

- National instruments and national policies—The development and implementation of 25 national instruments and 24 national policies covering key areas such as prospectus requirements, mutual funds regulation, rights offerings, take-over bids, registration issues and marketplace operations.
- Mutual Reliance Review System (MRRS)²⁷⁶—A system in which one securities regulator is designated as the “principal regulator” on which other jurisdictions rely for analysis and review of filings and exemptive relief applications.
- System for Electronic Document Analysis and Retrieval (SEDAR)—A web-based system that facilitates the electronic filing of securities information as required by provincial and territorial regulators and that provides public access to most disclosure documents filed by reporting issuers. [SEDAR was established in 1997.]
- System for Electronic Disclosure by Insiders (SEDI)—A web-based system that facilitates the filing and public viewing of reports on

²⁷³ *Id.* (emphasis added).

²⁷⁴ Canadian Securities Administrators, CSA Structure, http://www.csa-acvm.ca/html_CSA/about.html#structure (last visited Feb. 10, 2007). CSA’s strategic plan includes focusing on three areas to make Canada’s securities regulatory framework globally competitive: “[1.] innovative, responsive and flexible policy-making, focused on significant threats to investors and market integrity; [2.] coordinated and streamlined administrative and regulatory operations; and [3.] strategic, firm and fair enforcement.” CANADIAN SECURITIES ADMINISTRATORS STRATEGIC OBJECTIVES at 2, 4 (2005), available at http://www.csa-acvm.ca/pdfs/CSA_Strategic_Objectives_Feb2005_ENG.pdf.

²⁷⁵ WISE PERSONS’ COMMITTEE, *supra* note 31, at 16. PCC has six members appointed for two-year terms. The first members are the chairs of the BSC, ASC, MSC, OSC, CVMQ and NSSC. The CSA also elects its chair and vice-chair for two-year terms. *Id.*

²⁷⁶ *Id.* at 17.

[I]f an issuer wishes to issue securities by way of a prospectus in more than one jurisdiction in Canada, the MRRS allows the issuer to deal with one principal regulator (usually the regulator in the jurisdiction where the issuer’s head office is located) rather than with each of the regulators in the jurisdictions in which the securities are being offered. Staff of the principal regulator provide comments to the issuer on behalf of all of the commissions and make recommendations. The issuer then receives a single decision document from the principal regulator.

However, because participation in MRRS is voluntary, SRAs are free to withdraw from the system at any time and to deal directly with the issuer. Accordingly, market participants must be prepared to deal with the individual SRA securities acts and regulations at all times and there is no reduction in filing fees nor in fees paid to attorneys, accountants, and investment bankers. *Id.*

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 447

securities trading by insiders of reporting issuers.

- National Registration Database (NRD)—A web-based system that permits dealers and advisers to file registration forms electronically.²⁷⁷
- USL Project—A project with the goal of developing uniform securities legislation and uniform rules for adoption by each jurisdiction in Canada.²⁷⁸

However, it cannot be emphasized too strongly that compliance with CSA initiatives is entirely *voluntary*. There are no federal or provincial securities laws that require SRAs to comply with CSA initiatives. Like Canada's securities regulatory framework, the level of participation in CSA initiatives is quite fragmented. SEDAR, created in 1997, enjoys the highest level of participation by the thirteen SRAs. All Canadian public companies and mutual funds are generally required to file their documents in SEDAR. However, filing requirements differ based on which SRA has primary jurisdiction.²⁷⁹ SEDAR is operated by CDS Limited,²⁸⁰ which is regulated by the SRAs in Ontario and Quebec along with the Bank of Canada. SEDAR maintains working and reporting relationships with Canada's remaining SRAs.²⁸¹

Moreover, Canada's attempts at facilitating a uniform secu-

²⁷⁷ The NRD was launched by the CSA and the Investment Dealers Association of Canada on March 31, 2003. "Generally, an individual or company whose business is trading, underwriting or advising with respect to securities is required to register annually with one or more provincial securities regulators." Currently, all thirteen SRAs participate in NRD. However, Quebec did not participate until January 2005. See generally National Registration Database Information, http://www.nrd-info.ca/home_index.jsp (last visited Oct. 26, 2006).

²⁷⁸ WISE PERSONS' COMMITTEE, *supra* note 31, at 16.

²⁷⁹ *Id.* at 35. System for Electronic Document Analysis and Retrieval, Background on SEDAR, http://www.sedar.com/sedar/background_on_sedar_en.htm. See also National Instrument 13-101 System for Electronic Document Analysis and Retrieval (SEDAR) (2004) (Can.), available at <http://ftp.spsc.gov.sk.ca/scripts/ssc/files/nat-inst/13-101niamendedasof-mar30-04.pdf>.

²⁸⁰ System for Electronic Document Analysis and Retrieval, Background on SEDAR, http://www.sedar.com/sedar/background_on_sedar_en.htm (last visited Oct. 26, 2006). CDS Limited is owned by certain Canadian chartered banks, the Toronto Exchange, and the Investment Dealers Association of Canada. Canadian Depository for Securities Limited, CDS Is ..., <http://www.cds.ca/cdshome.nsf/Main-E?OpenFrameSet> (last visited Oct. 26, 2006). The IDA regulates its members based on authority delegated by Canada's thirteen provinces and territories.

²⁸¹ The Office of the Superintendent of Financial Institutions (OSFI) is also actively involved in the Canadian regulatory structure. OSFI supervises and regulates all Canadian banks, federally incorporated or registered trust and loan companies, insurance companies, cooperative credit associations, fraternal benefit societies and pension plans. OSFI has offices in Ottawa, Montreal, Toronto and Vancouver. See Treasury Board of Canada Secretariat, Office of the Superintendent of Financial Institutions Canada: DPR 2000-2001 § 2.3 Role, Responsibilities, and Organization, http://www.tbs-sct.gc.ca/rma/dpr/00-01/OSFI00dpr/osfi0001dpr01_e.asp (follow "2.3 Role, Responsibilities, and Organization" hyperlink) (last visited Oct. 14, 2006).

rities regulatory framework may be undermined at any time if an SRA decides that it is no longer in its best interest to participate in the CSA or to comply with CSA initiatives. The CSA is also subject to an interruption of funding since contributions by its members are voluntary and are taken from the individual SRA budgets of its members.

Like the U.S., Canada's securities regulatory framework includes a fund to protect investors in the event that an investment dealer becomes insolvent. The Canadian Investor Protection Fund (CIPF) is sponsored by the Investment Dealers Association, the Montreal Exchange, and the TSX Group of Companies.²⁸² Investment dealers are automatically enrolled in CIPF if they are members of one of CIPF's sponsoring SROs. The CSA and sponsoring SROs supervise the activities of the CIPF with respect to the financial condition of its members.²⁸³ Although the applicable SRO is responsible for conducting examinations of investment dealers operating within its jurisdiction, CIPF is authorized to conduct annual reviews and evaluations of each SRO's examination activities to ensure compliance with CIPF Minimum Standards. Eligible customer accounts are covered up to a maximum of \$1 million for losses of securities, commodity and futures contracts, segregated insurance funds and cash.²⁸⁴

2. Investment Dealers Association of Canada (IDA)

The IDA is Canada's largest SRO and is authorized under the securities acts of all thirteen SRAs to regulate the activities of Canadian investment dealers. The IDA also serves as an industry representative for its members.²⁸⁵ In its representative role, the IDA is responsible for ensuring that its members' perspectives are considered in the formulation of national policies,

²⁸² See Canadian Investor Protection Fund, Welcome to CIPF: About CIPF, http://www.cipf.ca/c_home.htm (last visited Oct. 14, 2006).

²⁸³ CIPF activities include, among other things, establishing and reviewing national standards for capital adequacy and liquidity, financial reporting, accounting records, internal control, segregation of customers' fully and partly paid securities, and insurance. CANADIAN INVESTOR PROTECTION FUND ANNUAL REPORT TO INVESTORS 2 (2003), available at http://www.cipf.ca/look_images/03reportsumm/cipf%20ar03.pdf.

²⁸⁴ *Id.*; Canadian Investor Protection Fund, Explore CIPF Coverage: Coverage Limits and Policies, http://www.cipf.ca/c_explore_coverage.htm (last visited Oct. 14, 2006). The maximum amount of customer loss due to an insolvent member firm is calculated by "taking into account both the delivery of any available securities, commodity and futures contracts, segregated insurance funds and cash to which the customer is entitled and the distribution of any assets of the insolvent Member firm, less any amounts owed by the customer to the Member." Most investors will have two accounts eligible for coverage—a general account and a retirement account; each is eligible for \$1 million coverage. If there is more than one general account, they are combined into one account for coverage purposes. Retirement accounts are treated similarly. See *id.*

²⁸⁵ Investment Dealers Association of Canada, About the IDA: Roles and Responsibilities, http://www.ida.ca/About/Roles_en.asp (last visited Oct. 14, 2006).

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 449

rules, practices and standards governing Canada's securities industry.²⁸⁶ The IDA is overseen or supervised by SRAs and the CIPF.²⁸⁷ SRAs delegate their supervisory responsibilities of the IDA to the CSA. CSA performs its oversight responsibilities through its regulatory oversight group by reviewing and/or approving all rule changes proposed by the IDA and conducting periodic operational reviews. As previously noted, CIPF reviews and evaluates the IDA's regulatory activities to ensure compliance with CIPF Minimum Standards.²⁸⁸

The IDA conducts inspections and audits of its members²⁸⁹ and requires all members to maintain risk adjusted capital greater than zero at all times; if risk adjusted capital falls below zero, the member must notify the IDA's senior vice president of member regulation.²⁹⁰ However, similar to the NASD in the U.S., the IDA requires varying levels of risk adjusted capital above zero based on the type of business activities conducted by the member firm.²⁹¹

Similar to the NASD, the IDA mandates the education of its members' employees, investor education, and cooperation with governments in developing financial legislation in the public interest.²⁹² The education of its members' employees includes administering exams for licensing to demonstrate proficiency requirements to carry on certain types of securities activities. IDA membership requires members (and their employees) to submit to IDA examinations and investigations to ensure compliance with its bylaws, regulations, rulings or policies; any applicable securities laws of provincial and territorial securities commis-

²⁸⁶ *Id.*

²⁸⁷ Investment Dealers Association of Canada, Membership: Member Regulatory Process, http://www.ida.ca/Membership/MembRegProc_en.asp (last visited Oct. 14, 2006). Many member firms are members of more than one SRO and, to prevent duplication, each firm selects one particular SRO for audit purposes. See CANADIAN INVESTOR PROTECTION FUND ANNUAL REPORT TO INVESTORS, *supra* note 283, at 2. The IDA has recently taken over the audit jurisdictions of The Toronto Stock Exchange (TSX) and the Canadian Venture Exchange. Press Release, Investment Dealers Association of Canada & Canadian Venture Exchange, IDA and CDNX Announce Member Regulation Transfer to the IDA (Jan. 4, 2000), available at http://www.ida.ca/Files/Media/MediaRelease/General/MRG200001040_en.pdf.

²⁸⁸ Investment Dealers Association of Canada, Membership: Member Regulatory Process, *supra* note 287. The CIPF review includes receipt of all Monthly Financial Reports, Joint Regulatory Financial Questionnaires, and field examinations.

²⁸⁹ IDA's inspections and audits include, but are not limited to, the financial status of the firm, an annual audit by external auditors, a sales and compliance review, and a credit practices review. *Id.*

²⁹⁰ IDA By-Law 17.1 Minimum Capital, Conduct of Business and Insurance, in IDA RULE BOOK, <http://www.ida.ca> (follow "English" hyperlink; then follow "Rule Book" hyperlink) [hereinafter IDA RULE BOOK].

²⁹¹ *Id.*

²⁹² See, e.g., IDA Policy 6 Proficiency and Education, in IDA RULE BOOK, *supra* note 290.

sions; and the bylaws, rules, regulations and policies of any SRO.²⁹³ Examinations and investigations may be initiated by complaints to the IDA, at the direction of the IDA's board of directors, the request of an SRA, or by any information the IDA receives about a member's and/or its employee's conduct, business, or affairs.²⁹⁴ In addition, the IDA requires its members to disclose their financial condition and other information to their clients²⁹⁵ upon request.²⁹⁶

IDA members, similar to their U.S. NASD counterparts, must participate in or become a member of an arbitration program or organization to resolve disputes between its members and their clients.²⁹⁷ At the request of a client, IDA members must agree to submit the dispute to binding arbitration.²⁹⁸ Moreover, the arbitration program is separate and independent of the securities industry. In addition, each IDA member must participate in an ombudsperson service approved by the IDA's board of directors.²⁹⁹ Upon request by a client, any dispute with an IDA member must be submitted to the ombudsperson service.³⁰⁰ The ombudsperson service determines whether the dispute is eligible for resolution using its services. IDA members are bound by the rules, procedures and standards of the ombudsperson service, but the ombudsperson's recommendations are non-binding on each participant.³⁰¹ Finally, all decisions made by the IDA in performing its regulatory functions may be reviewed, upon request, by any SRA with jurisdiction.³⁰²

3. The Mutual Fund Dealers Association of Canada (MFDA)

The MFDA³⁰³ was established as a not-for-profit federal cor-

²⁹³ *Id.* at By-Law 19.1 Examinations and Investigations.

²⁹⁴ *Id.* at By-Law 19.2 Examinations and Investigations.

²⁹⁵ The term "client" is defined as any person "who has had a transaction with a Member within one year of the day on which a request for a statement of financial condition is made." *Id.* at IDA Regulation 1400.1 Disclosure to Clients of Members' Financial Condition and Other Information.

²⁹⁶ The required disclosure of the member's financial condition generally contains the member's balance sheet and income statement; disclosure of notes to member's financial statements (if applicable) is not required. *Id.*

²⁹⁷ The arbitration program or organization must be approved by the IDA's board of directors. *Id.* at By-Law 37.1 Alternative Dispute Resolution.

²⁹⁸ *Id.*

²⁹⁹ *Id.* at By-Law 37.2 Alternative Dispute Resolution.

³⁰⁰ *Id.*

³⁰¹ *Id.*

³⁰² *Id.* at By-Law 33.1 Review by Securities Commissions.

³⁰³ The MFDA is governed by a board of directors currently with twelve members; the board members are from the public and the industry, such as the IFIC. Mutual Fund Dealers Association of Canada [MFDA], Board of Directors, <http://www.mfda.ca/about/boardOfDirectors.html> (last visited Sept. 8, 2006).

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 451

poration in June 1998 to act as an SRO for the distribution side of Canada's mutual fund industry,³⁰⁴ i.e., it is responsible for regulating all sales of mutual funds by its members. Specifically, MFDA's regulatory activities include monitoring the operations, standards of practice, and business conduct of its members.³⁰⁵ In addition, the MFDA is not responsible for regulating the activities of Canadian mutual fund dealers who are already members of an SRO, e.g., IDA mutual fund dealers will continue to be regulated by the IDA.³⁰⁶ The MFDA is authorized to conduct disciplinary proceedings and to impose fines, suspensions or loss of registration.³⁰⁷ MFDA's rules and bylaws are based on provincial and territorial statutory requirements, recommendations of the MFDA board of directors and industry committees,³⁰⁸ current industry practices, standards of similar SROs, and requirements of SRAs.³⁰⁹ However, MFDA membership is only required in five of Canada's thirteen provinces: Ontario,³¹⁰ British Columbia,³¹¹

³⁰⁴ MFDA, Our Role, <http://www.mfda.ca/> (last visited Sept. 8, 2006). Participants in Canada's mutual fund industry include independent dealers, fund companies, banks/trust companies, and insurance companies. See *Profile of the Mutual Fund Dealer Industry*, MFDA IN TRANSITION (MFDA, Toronto, Ontario), Aug. 1999, at 2.

³⁰⁵ MFDA, About the MFDA, <http://www.mfda.ca/about/aboutMFDA.html> (last visited Sept. 8, 2006). The MFDA regulates the operations, standards of practice and business conduct of its members. *Id.* It has 176 members and over 69,000 mutual fund salespersons. *Id.* It does not regulate mutual funds or mutual fund manufacturers. Brochure from MFDA of Canada, Information for Investors, available at http://www.mfda.ca/investors/brochure/MFDA_brochure.pdf. The term "mutual fund manufacturers" is used to describe the entity that actually creates the mutual fund itself; this entity is separate from an entity involved exclusively in the distribution of mutual funds. Provincial and territorial securities commissions regulate mutual funds and mutual fund manufacturers. *Finally, Some Mutual Fund Investor Protection* [sic], THE FUND OBSERVER (Canadian-FundWatch.com), Nov. 2004, at 3, available at <http://www.canadianfundwatch.com/modules.pdf?noredirect=1&name=News&file=article&sid=88>.

³⁰⁶ *You were asking...*, MFDA IN TRANSITION (MFDA, Toronto, Ontario), Dec. 1998, at 8.

³⁰⁷ *Id.*

³⁰⁸ The five industry committees were comprised of volunteers from the mutual fund industry, the staff of the MFDA, the Investment Funds Institute of Canada (IFIC), the IDA, and the OSC. *MFDA Applies for Recognition as SRO*, MFDA IN TRANSITION (MFDA, Toronto, Ontario), Jan. 2000, at 1.

³⁰⁹ The MFDA performs its regulatory responsibilities through five policy committees: (1) the Distribution Structures Committee; (2) the Sales Compliance and Practices Committee; (3) the Proficiency and Continuing Education Committee; (4) the Capital, Insurance and Investor Protection Fund Committee; and (5) the Books, Records, and Administration Committee. *Id.*

³¹⁰ Ontario recognized the MFDA as an SRO in February, 2001. MFDA, SRO Recognition, <http://www.mfda.ca/about/recognition.html> (last visited Oct. 25, 2006). The OSC did not initiate compliance examinations of mutual fund dealers until 1996. See *Mutual Fund Dealer Compliance Issues: a Regulatory Perspective*, MFDA IN TRANSITION (MFDA, Toronto, Ontario), Apr. 1999, at 2; Canada Department of Finance, Canada's Securities Industry at 9, http://www.fin.gc.ca/toce/2005/cansec05_e.html (follow "Adobe Acrobat Version" hyperlink) (last visited Sept. 8, 2006) [hereinafter Canada Dep't of Fin.].

³¹¹ British Columbia recognized the MFDA as an SRO in February, 2001. Canada Dep't of Fin., *supra* note 310, at 9; MFDA, SRO Recognition, *supra* note 309.

Saskatchewan,³¹² Alberta,³¹³ and Nova Scotia.³¹⁴

4. Market Regulation Services, Inc. (RS)

RS, a joint initiative of the TSX Group³¹⁵ and the IDA, is the independent regulation services provider for Canadian equity markets.³¹⁶ However, it is only recognized in five of Canada's thirteen provinces: Ontario, Quebec, Alberta, Manitoba, and British Columbia. RS monitors real-time trading operations and market-related activities of market participants in Canadian equity markets only in provinces in which SRAs have recognized it as an SRO. Accordingly, RS acts as an SRO only for the following trading systems and exchanges: TSX, TSX Venture Exchange (TSX V), Bloomberg Tradebook Canada Company (Bloomberg), Canadian Trading and Quotation System (CNQ), Liquidnet Canada Inc. (Liquidnet), and Market Securities, Inc. (BlockBook).³¹⁷

As an SRO, RS implements and administers Canada's Universal Market Integrity Rules (UMIR). UMIR and its companion policies were designed to facilitate universal rules for regulating equities trading on exchanges.³¹⁸ They were written by securities

³¹² Saskatchewan recognized the MFDA as an SRO on February 13, 2001. *Id.*

³¹³ Alberta recognized the MFDA as an SRO on April 10, 2001. *Id.*

³¹⁴ Canada Dep't of Fin., *supra* note 310, at 9. Nova Scotia recognized the MFDA as an SRO in November, 2001. *Id.*; MFDA, SRO Recognition, *supra* note 309.

³¹⁵ The TSX Group includes the TSX and the TSX V. The TSX and TSX V outsourced its compliance responsibilities when the TSX demutualized to compete with ATSS entering the Canadian securities markets. Market Regulation Services Inc., Frequently Asked Questions, <http://www.rs.ca> (follow "About RS" hyperlink; then follow "Frequently Asked Questions" hyperlink) (last visited Sept. 10, 2006).

³¹⁶ *Id.* RS was formed on March 1, 2002, by combining the previous in-house surveillance, trade desk compliance, investigation and enforcement functions of the TSX and the TSX V. Market Regulation Services Inc., Our History, <http://www.rs.ca> (follow "About RS" hyperlink; then follow "Our History" hyperlink) (last visited Sept. 10, 2006). RS recognizes the importance of the global securities market and is a member of the Intermarket Surveillance Group (ISG). ISG is an international committee of representatives from thirty-one exchanges around the world. Market Regulation Services Inc., Special Initiatives, <http://www.rs.ca> (follow "About RS" hyperlink; then follow "Special Initiatives" hyperlink) (last visited Sept. 10, 2006). *See also* Market Regulation Services Inc., Recognition Orders, <http://www.rs.ca> (follow "Market Policy" hyperlink; then follow "Recognition Orders" hyperlink) (last visited Oct. 25, 2006).

³¹⁷ Market Regulation Services Inc., Frequently Asked Questions, *supra* note 315. TSX is Canada's senior equities market and consists of a broad cross-section of Canadian issuers. TSX V is Canada's public venture equity market. CNQ is Canada's small cap market. Bloomberg Tradebook is an ATS that facilitates Canadian institution investors' trading in equity and fixed income securities domestically and internationally. Liquidnet Canada Inc. allows Canadian institutional investors to trade U.S. stocks directly and anonymously with other U.S. and European institutional investors; it bypasses both exchanges and brokers. BlockBook is a block trading network for equities traded in the Canadian securities markets. It also provides anonymous size and value while monitoring trading on the network. Market Regulation Services Inc., The Marketplaces We Regulate, <http://www.rs.ca> (follow "About RS" hyperlink; then follow "The Marketplaces We Regulate" hyperlink) (last visited Sept. 10, 2006).

³¹⁸ Prior to the creation of RS, each exchange regulated equities trading using its own set of trading rules. Generally, each exchange's trading rules were different. RS uses

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 453

industry representatives, legal and compliance officers, exchanges, trade association representatives, and provincial SRAs.³¹⁹

RS is also charged with market surveillance, with a view toward preventing violations of applicable securities laws and SRO rules and regulations. This includes the authority to issue trading halts.³²⁰ RS may initiate preliminary investigations based on its market surveillance activities. If, during a preliminary investigation, RS determines that wrongful conduct has been committed by an entity over which it has no jurisdiction, it may forward information from its preliminary investigation to the appropriate provincial SRA. If RS does have jurisdiction over the prospective wrongdoer, the matter is referred to its Investigations & Enforcement staff for possible enforcement³²¹ action.³²² If RS determines that violations have occurred that warrant disciplinary action, the action may be settled or referred to a hearing panel for a contested hearing.³²³ A Disciplinary Notice is issued and published if the hearing panel determines that a violation has occurred.³²⁴ Final RS decisions may be appealed to the appropriate

UMIR to regulate various trading practices including manipulative or deceptive methods of trading, short selling, front running, best execution obligations, order entry, and order exposure. UMIR “[1] applies equally to each class of marketplace participants[; 2] cannot be circumvented by directing trading activity to another marketplace[; 3] applies to trading of all forms of listed or quoted securities[; and 4] incorporates exceptions to the rules to accommodate the workings of an individual marketplace or ATS.” Market Regulation Services Inc., Universal Market Integrity Rules (UMIR), <http://www.rs.ca> (follow “Market Policy” hyperlink; then follow “Universal Market Integrity Rules” hyperlink) (last visited Sept. 10, 2006).

³¹⁹ UMIR is updated by its Rules Advisory Committee comprised of representatives from the following entities: Barristers and Solicitors, Billy de Lavery; National Bank Financial; RBC Dominion Securities, Inc.; RS; BMO Nesbitt Burns, Inc.; Investors Groups; TSX Group Inc.; Bloomberg Tradebook Canada Company; Canaccord Capital; TD Securities Inc.; and CNQ. Market Regulation Services Inc., Board & Advisory Committees, <http://www.rs.ca> (follow “About RS” hyperlink; then follow “Board & Advisory Committees” hyperlink) (last visited Sept. 10, 2006).

³²⁰ Generally trading halts are issued “in anticipation of a material news announcement by [a particular] company.” Trading halts may also be initiated by a listed company or SRA. Market Regulation Services Inc., Timely Disclosure, <http://www.rs.ca/> (follow “Surveillance” hyperlink; then follow “Timely Disclosure” hyperlink) (last visited Sept. 10, 2006).

³²¹ Enforcement is the process used by RS to determine whether to proceed with disciplinary action against regulated persons. Market Regulation Services Inc., Our Role, <http://www.rs.ca/> (follow “Enforcement” hyperlink) (last visited Sept. 10, 2006).

³²² Market Regulation Services Inc., Trading Analysis, <http://www.rs.ca/> (follow “Surveillance” hyperlink; then follow “Trading Analysis” hyperlink) (last visited Sept. 10, 2006).

³²³ Hearing panels consist of at least one member in good standing of Canada’s national bar association (the Law Society), two members of the securities industry, and a current or former director, officer, or employee of an investment dealer or trading organization. Market Regulation Services Inc., Contested Hearing Decisions, <http://www.rs.ca> (follow “Enforcement” hyperlink; then follow “Contested Hearing Decisions” hyperlink) (last visited Sept. 10, 2006).

³²⁴ The hearing panel’s decision is also made public and such decisions may be re-

SRA.³²⁵

SRAs using RS's services oversee its self-regulatory activities. While some SRAs may perform adequate oversight, others may not have the resources and/or political will to conduct adequate oversight of RS.³²⁶

5. The Canadian Public Accountability Board (CPAB)

Canada's fragmented regulatory framework limits the efficacy of the CPAB, which was established in July 2002 to oversee accounting firms auditing Canadian issuers.³²⁷ CSA Rule 52-108 requires accounting firms that conduct audits of reporting issuers to register with the CPAB.³²⁸ However, compliance with CSA rules is strictly voluntary. Accordingly, the requirement to register with the CPAB in accordance with CSA Rule 52-108 does not apply to accounting firms in Alberta, British Columbia, and Manitoba.³²⁹ In addition, any provincial regulator or regulatory authority may grant an exemption to the requirements of CSA Rule 52-108.³³⁰ Registered firms are subject to the CPAB's inspection, investigation, and disciplinary procedures.³³¹ Lastly, CPAB also has rulemaking authority which is subject to SRA review prior to implementation.³³²

6. Canadian Securities Industry Reorganizes in 1999 to Enhance Global Competitiveness

The Canadian securities markets were reorganized in late 1999 in order to become more competitive in the global securities market. Canada's major exchanges agreed to restructure along

viewed on RS's website. *Id.*

³²⁵ *Id.*

³²⁶ Market Regulation Services Inc., About RS, <http://www.rs.ca> (follow "About RS" hyperlink) (last visited Feb. 10, 2007). Memorandum of Understanding Regarding Oversight of Market Regulations Inc. (Feb. 15, 2002), available at http://www.osc.gov.on.ca/MarketRegulation/SRO/rs/mou/smou-rs_25-OSCB-896.pdf. See also WISE PERSONS' COMMITTEE, *supra* note 31, at 25.

³²⁷ Canadian Public Accountability Board [CPAB], Background, <http://www.cpab-cerc.ca/> (follow "Who We Are" hyperlink; then follow "Background" hyperlink) (last visited Sept. 10, 2006). The CPAB is organized as a non-profit corporation with an eleven-member board of directors and two member categories—the Council of Governors and the Industry Members. CPAB, Structure, <http://www.cpab-cerc.ca/> (follow "Who We Are" hyperlink; then follow "Structure" hyperlink) (last visited Sept. 10, 2006).

³²⁸ CPAB, Background, *supra* note 327.

³²⁹ See National Instrument 52-108 Auditor Oversight § 1.2(2) (2004) (Can.), available at <http://www.cpab-cerc.ca/412b56fd5a8ab.pdf>.

³³⁰ *Id.* § 4.1.

³³¹ *Id.* §§ 1.1, 3.3(1).

³³² CPAB Article 11 Participating Audit Firms § 11.3 Rules, in BY-LAW NO.1—AMENDED AND RESTATED, <http://www.cpab-cerc.ca> (follow "By-Laws" hyperlink; then follow "CPAB By-Law No. 1" hyperlink) (last visited Sept. 10, 2006).

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 455

lines of market specialization.³³³ The reorganization was:

intended to enhance the efficiency of the trading facilities and services of [Canadian] Exchanges, create new opportunities for the Canadian market-place and improve the competitive position of the Canadian securities industry in the context of the globalization of the securities . . . markets and technological developments . . . [and] to eliminate fragmentation of the Canadian market for exchange-traded securities . . . , avoid duplication of services and leverage the strengths of each Exchange through specialization.³³⁴

After the 1999 reorganization, the TSE (now the TSX and part of the TSX Group) became the only exchange for trading senior equities. The CDN, which became the CDNX,³³⁵ was solely responsible for trading junior equities, and was merged into the TSX Group in 2001. It was then renamed the TSX Venture Exchange (TSX V). In 2002, the TSX demutualized and became the first exchange in North America whose shares were publicly traded.³³⁶ The ME took over all Canadian trading in derivatives.³³⁷ The Table below highlights the changes brought about as a result of the reorganization³³⁸:

³³³ At that time, Canada's major exchanges included the Alberta Stock Exchange (ASE), the Montreal Exchange (ME), the Toronto Stock Exchange (TSE), the Canadian Venture Exchange (CDNX), and the Vancouver Stock Exchange (VSE). Canada Dep't of Fin., *supra* note 310, at 1.

³³⁴ Memorandum of Agreement Between the Alberta Stock Exchange, the Montreal Exchange, the Toronto Stock Exchange (both for itself and on behalf of the Canadian Dealing Network Inc.) and Vancouver Stock Exchange §§ 1.2.–1.3. (Mar. 15, 1999), *available at* http://www.m-x.ca/f_publications_en/restructuring.pdf [hereinafter Memorandum of Agreement].

³³⁵ CDNX was created through a merger of the VSE (Vancouver) and ASE (Alberta), and later Winnipeg stock exchanges. Canada Dep't of Fin., *supra* note 310, at 1; *see also* Market Regulation Services Inc., *The Marketplaces We Regulate*, *supra* note 317.

³³⁶ Canada Dep't of Fin., *supra* note 310, at 5.

³³⁷ *Id.* at 1.

³³⁸ Memorandum of Agreement, *supra* note 334.

| <u>Exchange</u> | <u>Activities After 1999</u> | <u>Activities Before 1999</u> |
|---|---|--|
| Montreal Exchange (ME) | All exchange-traded derivative products, comprising (without limitation) any type of option and futures contracts, including options and futures on index participation units. | Derivatives and equities, including equities inter-listed with the TSX. |
| Toronto Stock Exchange (TSE) (renamed TSX) | All senior securities, other than exchange-traded derivatives products including (without limitation) stocks, rights, convertible debentures, trust and limited partnership units, warrants, bonds and mutual fund securities and other products commonly traded on the cash market, including index participation units. Senior securities means the securities of all issuers that qualify for listing on the TSX. | Equities, junior and senior, including equities inter-listed with ME. |
| Alberta Stock Exchange (ASE) and the Vancouver Stock Exchange (VSE) | All junior securities, other than exchange-traded derivatives products, defined as the securities of all other issuers, including (without limitation) stocks, rights, convertible debentures, trust and limited partnership units, warrants, bonds and mutual fund securities and other products commonly traded on the cash market, including junior securities under participation units. For greater clarity, current ME issuers that do not qualify for transfer to the TSX will be transferred to the ASE/VSE (and not Canadian Dealing Network, Inc. (CDN)). | Equities, junior and senior, some inter-listing between the VSE and the ASE. |
| Transfers | TSX will transfer CDN to the VSE and the ASE; TSX will transfer OM (the Nordic Exchange) to the ME; TSX will transfer to ME the shares held by TSX in Canadian Derivatives Clearing Corporation; ME will transfer to TSX the shares held by ME in the Canadian Depository for Securities Ltd. | |

7. Organization of the Canadian Securities Industry After 1999

Currently, Canada's major exchanges are TSX in the province of Ontario, and ME (listing primarily derivatives) in the province of Quebec. TSX, although ranked among the top seven exchanges in the world, measured by market capitalization of domestic issuers, still remains significantly below those exchanges ranked above it.³³⁹ However, many Canadian businesses list on U.S. securities markets.³⁴⁰

Interlistings generally raise the profile of issuers in the global market, and trading volumes for these issuers' shares often increase across all markets. . . . To capture a greater proportion of trading in securities of issuers that are listed on other markets, particularly those in the U.S., the TSX Group recently extended trading in U.S. dollars to 16 securities listed on the Toronto Stock Exchange, with additional securities to be added in the future. [Moreover, t]o address changes brought on by technology and globalization, the [Canadian] securities industry has been taking steps to improve foreign market access for Canadian issuers and investors. A number of Canadian securities firms, particularly those owned by banks, are building a global platform through the acquisition of foreign businesses operating in niche markets such as discount brokerages, wealth management and investment banking.³⁴¹

To increase global competitiveness, Canada's federal government "announced a coordinated national enforcement approach to strengthen the investigation and prosecution of serious corporate fraud and market illegality" in 2003.³⁴² In support of this initiative, the provinces of Ontario and Quebec enhanced enforcement in their securities regulatory frameworks. Each province passed legislation that increased penalties and expanded the investigative powers of their respective SRAs. This coordinated national enforcement approach was designed to develop "a proposed regime that will give investors in the secondary market a simpler procedure to sue companies, directors, officers, underwriters and experts that make misleading or untrue statements, or fail to give full and timely information."³⁴³

³³⁹ Market capitalization of domestic companies at the end of 2003 for the top exchanges in the global securities market are, in billions of U.S. dollars: (1) NYSE \$11,329; (2) Tokyo Stock Exchange \$2,953; (3) The NASDAQ Stock Market \$2,844; (4) London Stock Exchange \$2,460; (5) Euronext \$2,076; (6) Deutsche Börse (German Exchange) \$1,079; and (7) TSX Group \$889. The ME is also a member of the GLOBEX Alliance (GLOBEX). GLOBEX is an international electronic trading network for derivatives products. The ME's membership in GLOBEX "provides Canadian derivatives investors access to international markets." *Id.* at 6-7.

³⁴⁰ In 2003, 184 Canadian issuers were interlisted on U.S. exchanges. *Id.* at 8.

³⁴¹ *Id.*

³⁴² *Id.* at 9.

³⁴³ *Id.*

Other initiatives designed to strengthen Canada's securities regulatory framework include the IDA's new rules to promote the independence of research analysts employed by securities firms.³⁴⁴ In addition, the Canadian securities regulatory framework includes the Canadian Depository for Securities Limited (CDS), which acts as a securities depository, clearing, and settlement mechanism for Canada's securities markets.³⁴⁵ CDS also facilitates access to the global securities market; it settles cross-border transactions with the U.S. securities markets and has custodial relationships with, among others, the Depository Trust Company in the U.S., Japan Securities Settlement & Custody, Inc., and Euroclear France.³⁴⁶ CDS is regulated by the SRAs in Ontario and Quebec along with the Bank of Canada; CDS also works with the CSA and the Office of the Superintendent of Financial Institutions. For example, CDS operates SEDAR on behalf of the CSA.³⁴⁷

8. The Securities Regulatory Framework in Quebec

a. Commission des Valeurs Mobilières du Québec (CVMQ)/Autorité des marchés financiers (AMF)

On February 1, 2004, Quebec reorganized its securities regulatory framework. The purpose of the reorganization was to separate the administrative functions from the quasi-tribunal functions of Quebec's existing SRA.³⁴⁸ Market participants in Quebec's securities industry "complained that the hearings of commissions do not have the appearance of fairness because, from the outside, the commissioners seem to be passing judgment on their own decisions."³⁴⁹ The AMF, the entity emerging after the combination, is authorized to regulate the securities markets in Quebec by, among other activities, ensuring that issuers and other financial sector market participants meet their obligations, protecting investors, regulating the information that issuers must disclose to investors, and supervising the regulation of se-

³⁴⁴ The CSA has proposed corporate governance guidelines and related disclosure requirements designed to replace TSX corporate governance guidelines. *Id.* at 9–10.

³⁴⁵ The Canadian Depository for Securities Limited Homepage, <http://www.cds.ca/> (last visited Sept. 10, 2006).

³⁴⁶ *Id.*

³⁴⁷ *Id.* See also The System for Electronic Documents Analysis and Retrieval Homepage, <http://www.sedar.com> (last visited Sept. 10, 2006).

³⁴⁸ Quebec's existing SRA was combined with certain other financial sectors in Quebec to form a new regulator for Quebec's financial sector, the Autorité des marchés financiers (AMF). Autorité des marchés financiers [AMF], History, <http://www.lautorite.qc.ca/accueil.en.html> (follow "About Us" hyperlink; then follow "History" hyperlink) (last visited Sept. 10, 2006).

³⁴⁹ Jean-Marie Gagnon, *Do We Need a National Regulator?: No: A Single Market Umpire for the Whole Country Would Be More Easily "Captured" by Big Business, Argues Laval University Professor*, GLOBE AND MAIL (Toronto), Jan. 28, 2004, at A13.

curities professionals.³⁵⁰

Quebec's primary SRO is the Bourse de Montréal (the Montreal Exchange, or ME), which regulates derivative trading³⁵¹ and investment dealers in Quebec; it offers clearing services through its wholly-owned corporation, Canadian Derivatives Clearing Corporation (CDCC).³⁵² It also provides educational services about the derivatives market to both institutional and retail investors through its Derivatives Institute.³⁵³ Members of the ME approved demutualization on September 25, 2000, and the ME became a for-profit company.³⁵⁴ It also closed its trading floor and began using only an electronic trading platform, SAM, to trade derivatives.³⁵⁵

(1) Quebec's Approval of NASDAQ Canada Diminishes Canada's Efforts to Compete in the Global Securities Market

Canada's inability to use selective federal preemption in its regulatory framework allowed Quebec to disrupt its attempt to reorganize its securities market to compete in the global securities market. On November 21, 2000, Quebec began trading equity securities by allowing the NASDAQ Stock Market, Inc. (NASDAQ U.S.) to establish NASDAQ Canada.³⁵⁶ NASDAQ Canada provides direct access to all NASDAQ U.S. listed securities, which means that equity trading is no longer confined to the province of Ontario. Moreover, NASDAQ Canada represents a de

³⁵⁰ AMF, Industry Sectors, <http://www.lautorite.qc.ca/accueil.en.html> (follow "About Us" hyperlink; then follow "Industry Sectors" hyperlink) (last visited Sept. 10, 2006).

³⁵¹ As part of the 1999 reorganization of Canada's securities markets, ME, on October 1, 2001, ceased trading junior equity listings. See Montreal Exchange [ME], Our Mission, <http://www.m-x.ca/> (follow "About Us—Mission" hyperlink) (last visited Sept. 10, 2006); Canada Dep't of Fin., *supra* note 310, at 5; ME, Historical Highlights, <http://www.m-x.ca/> (follow "About Us—Historical highlights" hyperlink) (last visited Sept. 10, 2006).

³⁵² ME, Profile Overview, http://www.m-x.ca/profil_bref_en.php (last visited Sept. 16, 2006). The CDCC is the issuer, clearinghouse and guarantor of derivative contracts traded on the ME. It also provides clearing services to other exchanges and partners. CDCC, a for-profit company, has provided these services since 1975. ME, THREE-MONTH CANADIAN BANKERS' ACCEPTANCE FUTURES (2001), *available at* http://www.m-x.ca/f_publications_en/bax_en.pdf.

³⁵³ Financial Advisors Association of Canada, The Derivatives Institute, <http://www.advocis.ca/content/education/CE-prog/CE-derivatives.html> (last visited Sept. 16, 2006). The Derivatives Institute was established by the ME in April 2001 "to understand and use derivative instruments." ME, About Us, http://www.d-x.ca/a_propos_institut_en.php (last visited Sept. 16, 2006); see also RBC Action Direct Inc., Seminars, <http://www.actiondirect.com/RBC:RCq-SI71A8YAAlkFOU/derivatives-institute.html> (last visited Sept. 16, 2006).

³⁵⁴ ME, Historical Highlights, http://www.m-x.ca/qui_histo_en.php.

³⁵⁵ SAM (Montreal Automated System) is the ME's electronic trading platform. *Id.*

³⁵⁶ Press Release, NASDAQ, NASDAQ Concludes Record Share and Dollar Volume Year Composite Index Finishes Lower (Sept. 16, 2006), *available at* http://www.nasdaq.com/newsroom/news/pr2001/ne_section01_022.html; see also Canada Dep't of Fin., *supra* note 310, at 6.

facto reorganization of Canada's securities markets by Quebec and the U.S. Recently, Canada's attempts to reorganize its securities markets to compete in the global securities market were further diminished when British Columbia recognized NASDAQ Canada, again establishing equity trading within its borders.

Quebec amended its securities act to establish NASDAQ Canada.³⁵⁷ The amendment recognized NASDAQ Canada as an SRO for purposes of carrying on business in Quebec; it also recognized NASDAQ Canada's parent, NASDAQ U.S., as an SRO in Quebec. This amendment effectively injected the U.S. securities regulatory framework into the Canadian securities regulatory framework because "[t]he rules of NASDAQ Canada are those of NASDAQ [U.S.], and are overseen by the [U.S.] Securities and Exchange Commission NASDAQ [U.S.] is a subsidiary of the NASD, a registered [SRO] in the [U.S.]" securities regulatory framework.³⁵⁸

NASDAQ Canada began with ten securities firms participating in trading securities listed on NASDAQ U.S. (including Canadian companies) from Montreal, Quebec. Moreover, participating investment dealers are the largest investment dealers in Canada's securities industry.³⁵⁹ Participating investment dealers are able to establish affiliated, wholly-owned Delaware corporations whereby the affiliate operates in Montreal in the same building as its parent company and uses NASDAQ U.S. workstations.³⁶⁰ All affiliates are regulated under U.S. securities laws, which require registration with the Commission and membership in the NASD of affiliates as well as some of their personnel. The affiliate is structured as an order entry firm and, under Quebec law, can have only one institutional client, its parent company.³⁶¹ Moreover, the affiliate must have dually-engaged employees, i.e.,

³⁵⁷ *New Regulatory Structure for the Quebec Financial Sector: Recent Developments—A Supplement to the June 2002 Newsletter*, INFO. (Ogilvy Renault, Quebec), Dec. 2002, at 2, available at <http://www.ogilvyrenault.com/WebControls/GetResource.aspx?id=2067>. Quebec also offered NASDAQ U.S. an incentive package, which included a ten year tax holiday. Bertrand Marotte, *Nasdaq Nixes Plans for Separate Canadian Stock Exchange*, GLOBE AND MAIL (Can.), Sept. 20, 2003, at B5.

³⁵⁸ Simon Romano, Notice and Request for Comments: NASDAQ Canada, Inc. Proposal for Improved Access for B.C. Dealers, at 2 (July 24, 2004) (on file with author).

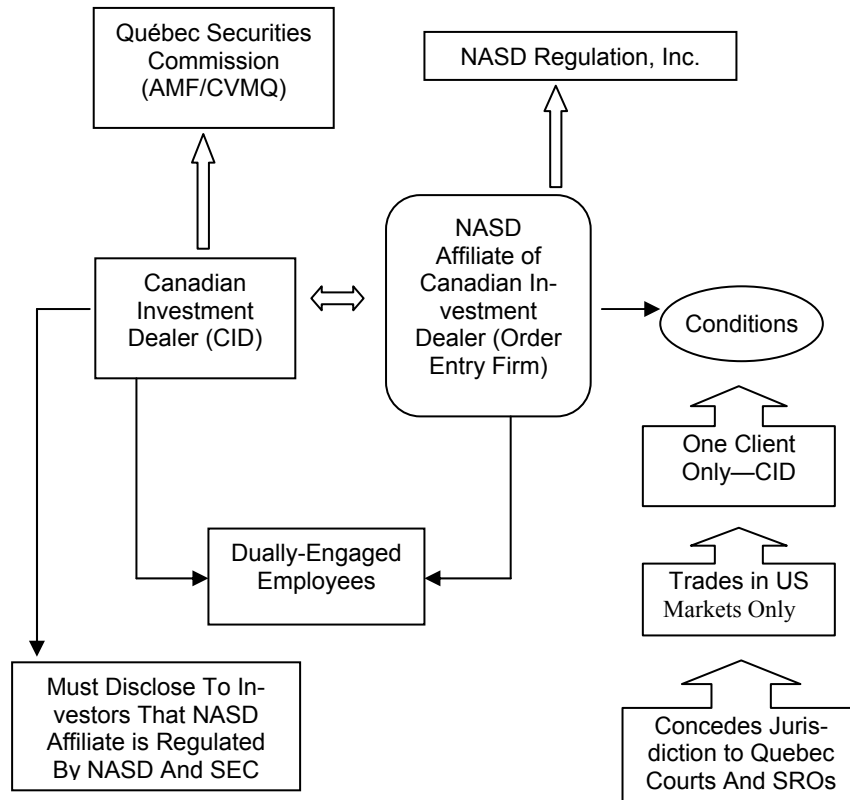
³⁵⁹ The participating investment dealers are BMO Nesbitt Burns, Canaccord, Capital Casgrain & Company, CIBC WorldMarkets Corp., Desjardins, NBC International Inc. (USA), Pictet Overseas, Scotia Capital Markets, TD Securities Inc., Yorkton Capital (USA). Press Release, NASDAQ, Helen Kearns Named President of NASDAQ Canada (May 1, 2001), available at http://www.nasdaq.com/newsroom/news/pr2001/ne_section01_143.html.

³⁶⁰ See *id.* The NASDAQ Workstation II is a computerized trading tool that provides access to all NASDAQ markets for Market Makers (firms that maintain firm bid and offer prices in a given security by standing ready to buy or sell at publicly-quoted prices), brokers, and institutions.

³⁶¹ Romano, *supra* note 358, at 3.

employees who work at the affiliate and the parent company simultaneously.³⁶² This arrangement effectively allows direct regulation under the U.S. securities regulatory framework and indirect regulation by Quebec's securities regulatory framework. Quebec regulates the same employees in connection with their interactions with Canadian investors (institutional and retail) and securities markets.³⁶³

NASDAQ Canada Broker-Dealer Model



³⁶² *Id.* at 10.

³⁶³ Investment dealers and their NASD affiliates must: (1) remain affiliated with a Quebec dealer that is an IDA member in good standing; (2) undertake to the NASD and the Commission that: (i) its NASD affiliate would carry on its business in compliance with applicable NASD requirements; (ii) its NASD affiliate would not have any clients in Quebec (other than its Quebec parent) and would only engage in U.S. transactions; (iii) all trading officers and employees of the NASD affiliate would be dually employed by both the parent investment dealer and its NASD affiliate; and (iv) its NASD affiliate would consent to jurisdiction in any action or proceeding before any court or securities regulatory authority in Quebec, and agree to provide access to and inspection rights to the Commission. *Id.* at 11.

This arrangement benefits Canadian investment dealers

[b]y enabling Canadian dealers to set up U.S. NASD member affiliates on their own premises in Canada, staff them with Canadian employees, utilize existing infrastructure, and supervise them via their existing Canadian compliance operations, etc., the costs of accessing NASDAQ US [sic] should be reduced from those that would apply to either foreign affiliate operations or third party jitney operations.³⁶⁴

At its inception, NASDAQ Canada would be established in three phases. Phase one included opening the NASDAQ Canada office in Montreal, Quebec; launching a NASDAQ Canada website; creating a NASDAQ Canada Index to track the market performance of Canadian issuers listed on NASDAQ U.S.; and trading of all NASDAQ-listed securities in U.S. dollars only. Phases two and three were expected to follow depending on the success of phase one. Phase two included participation by non-NASD member firms in Canada, trading in both U.S. and Canadian dollars, regulatory oversight by NASD and Quebec's SRA, and listing Canadian companies exclusively on NASDAQ Canada. Phase three would include linking NASDAQ Canada with NASDAQ Japan and NASDAQ Europe. According to Frank G. Zarb, the CEO of NASDAQ U.S. in 2000, "Our ultimate goal is linking [NASDAQ] Canada to a global trading platform that will include [NASDAQ] markets in Asia and Europe."³⁶⁵

On September 20, 2003, NASDAQ abandoned its plans to start a new exchange in Canada or to trade Canadian stocks in Canadian dollars, effectively eliminating the possibility of a stand-alone Canadian securities market using NASDAQ U.S.'s trading platform. NASDAQ U.S.'s global expansion strategy was adversely impacted by a downturn in technology stocks and the global economy. According to former NASDAQ Canada president Helen Kearns, "[M]arket conditions have really dictated how quickly [NASDAQ] Canada could roll out and it's been a difficult market."³⁶⁶ These events, among others, resulted in losses for NASDAQ U.S. and the closing of other global ventures including NASDAQ Japan and Europe.³⁶⁷

Phase one of NASDAQ Canada continues to operate in the provinces of Quebec and British Columbia and is NASDAQ U.S.'s

³⁶⁴ *Id.* at 6. Jitney operations include such services as execution, clearing, and settlement of trades performed by U.S. broker-dealers on behalf of Canadian investment dealers.

³⁶⁵ Press Release, NASDAQ, NASDAQ Announces the Launch of NASDAQ Canada (Nov. 21, 2000) (on file with author).

³⁶⁶ Bertrand Marotte, *Canadian Nasdaq on Hold*, GLOBE AND MAIL (Can.), Oct. 28, 2002, at B1; *see also* Marotte, *supra* note 357, at B5.

³⁶⁷ Marotte, *Canadian Nasdaq on Hold*, *supra* note 366; *Nasdaq Europe to Close*, BBC NEWS, June 26, 2003, <http://news.bbc.co.uk/2/hi/business/3024558.stm>.

only successful global venture using this business model. NASDAQ Canada continues to seek expansion to other Canadian provinces including Ontario.³⁶⁸

9. The Ontario Securities Commission Regulates Canada's Premier Securities Markets

The OSC³⁶⁹ administers and enforces securities laws³⁷⁰ in the province of Ontario. Canada's premier securities markets are housed within Ontario's borders. It is managed by a board of directors comprised of members of the OSC or commissioners.³⁷¹ Commissioners are appointed by the Lieutenant Governor in Council for varying terms of five years or less, but may be reappointed by the Lieutenant Governor in Council.³⁷² The OSC must have at least nine but not more than fourteen commissioners, who may serve on a part-time basis.³⁷³ Full-time commissioners are generally full-time executive managers of the OSC and fill the positions of Chair, CEO, and Vice-Chair. The remaining commissioners are part-time and conduct their responsibilities in a non-executive capacity. A quorum requires only two commissioners.³⁷⁴ All commissioners have statutory responsibility for the administration of Ontario's Securities Act. All bylaws passed by the OSC must be approved by Ontario's Minister of Finance.³⁷⁵

OSC commissioners meet to address regulatory policy matters every two weeks, and at least quarterly to conduct non-regulatory matters. The commissioners conduct non-regulatory

³⁶⁸ Marotte, *supra* note 357, at B5.

³⁶⁹ In 1994, Ontario's Securities Act was amended to change the OSC's status from government agency to a Crown Corporation responsible to the Ontario Legislature through the Minister of Finance. In 1997, the OSC was converted to a self-funded Crown Corporation. Ontario Securities Commission [OSC], Governance & Accountability http://www.osc.gov.on.ca/About/Governance/ga_index.jsp (last visited Sept. 18, 2006). According to the OSC, these changes promoted "greater autonomy and independence from the government." FIVE YEAR REVIEW COMMITTEE FINAL REPORT, *supra* note 34, at 61.

³⁷⁰ The OSC is statutorily mandated to administer Ontario's Securities Act and its Commodity Futures Act in order "to provide protection to investors from unfair, improper or fraudulent practices and to foster fair and efficient capital markets and confidence in their integrity." Memorandum of Understanding Between the Minister of Finance of Ontario and the OSC § 1.1.4.A.3 (May 26, 2003), *available at* <http://www.osc.gov.on.ca/> (follow "Policy & Regulation" hyperlink; then follow "Memoranda of Understanding" hyperlink; then follow June 6, 2003 "Memorandum of Understanding" hyperlink) [hereinafter MOU Minister of Finance & OSC].

³⁷¹ OSC, The Commission, http://www.osc.gov.on.ca/About/Governance/ga_the_commission.jsp (last visited Sept. 18, 2006).

³⁷² *Id.*

³⁷³ *Id.*

³⁷⁴ *Id.*; Securities Act, R.S.O. 1990, Ch. S.5 s. 3(11) (2006) (Can.).

³⁷⁵ Ontario Securities Act § 143.3(3) requires the Minister to approve, reject or return the bylaw to the OSC for further consideration within sixty days of delivery. R.S.O. 1990, Ch. S.5 s. 143.3(3).

matters through meetings of its three standing committees: Audit and Finance, Corporate Governance and Nominating, and Compensation.³⁷⁶ All committee members are part-time, non-executive commissioners;³⁷⁷ however, the OSC chairman is an ex officio, non-voting member of the Governance and Nominating Committee.³⁷⁸

OSC regulatory activities include making policy, conducting investigations, and sitting as an administrative tribunal.³⁷⁹ The OSC obtained rulemaking authority as recently as 1995.³⁸⁰ All OSC rules must be submitted to the Ontario Minister of Finance for review and approval.³⁸¹ The rule becomes effective if the Minister of Finance does not reject or return the rule.

Although non-binding, the OSC is statutorily authorized to make policy. Like the OSC's rulemaking process, proposed policies must be published for public comment.³⁸² Although OSC policies may not be prohibitive or mandatory, they inform market participants about, among other topics, the manner in which the OSC may exercise its discretionary authority, the interpretation of Ontario securities law, and OSC practices for conducting its duties under the Ontario Securities Act.

The OSC regulates marketplaces in Ontario, including exchanges, alternative trading systems (ATs), quotation and trade reporting systems, and stock exchanges, by specifying the terms

³⁷⁶ OSC, The Commission, *supra* note 371.

³⁷⁷ *Id.* Part-time members meet under the leadership of the Lead Director, who presides as chair over all meetings of part-time members charged with administering the infrastructure of the OSC. The Lead Director may make recommendations but has no decision-making authority. OSC, Lead Director of the Board of Directors Mandate, http://www.osc.gov.on.ca/About/Governance/ga_lead_director.jsp (last visited Sept. 18, 2006).

³⁷⁸ OSC, The Commission, *supra* note 371. The OSC also has an Adjudicative Committee responsible for evaluating and monitoring the OSC's adjudicative procedures and practices. The Adjudicative Committee has no decision-making authority. See OSC, Adjudicative Committee, http://www.osc.gov.on.ca/About/Governance/ga_adjudicative.jsp (last visited Sept. 18, 2006). The Adjudicative Committee is advised by an Independent Adjudicative Counsel about hearings and related matters; it provides legal research and drafting assistance to the Adjudicative Committee. OSC, Independent Adjudicative Counsel, http://www.osc.gov.on.ca/About/Governance/ga_independent-adj-counsel.jsp (last visited Sept. 18, 2006).

³⁷⁹ OSC, ANNUAL REPORT 2004, at 1 (2004), available at <http://www.osc.gov.on.ca/About/AnnualRpt/2004/com.html>. However, the OSC cannot issue any order under the Ontario Securities Act without a hearing. Securities Act, R.S.O.1990 Ch. S.5 s. 127(4) (2006) (Can.).

³⁸⁰ OSC, Rule-Making in Ontario, http://www.osc.gov.on.ca/Regulation/Rulemaking/rrn_backgrounder.jsp (last visited Sept. 18, 2006). The OSC must publish proposed rules for public comment for a period of at least ninety days. Securities Act, R.S.O. 1990 Ch. S.5 s. 143.2(1)-(4) (2006) (Can.).

³⁸¹ R.S.O. Ch. S.5 s. 143.3.

³⁸² R.S.O. Ch. S.5 s. 143.8(2).

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 465

and conditions under which they can operate in Ontario.³⁸³ The OSC recognizes the TSX and the Canadian Trading and Quotation System (CNQ). The TSX V and the ME have received exemptions from registration in Ontario. It does not recognize NASDAQ Canada. The OSC also recognizes quotation and trade reporting systems (QTRSs). Such QTRSs operate facilities that distribute quotations for the purchase and sale of securities and report such transactions exclusively to registered dealers.³⁸⁴

The Ontario Ministry of Finance and the Ontario Legislature oversee the OSC. The Minister of Finance appoints a statutorily authorized, independent Five Year Review Committee to review securities regulation in Ontario.³⁸⁵

The need for a single securities regulator was identified by the Five Year Review Committee as “the most pressing securities regulation issue in Ontario and across Canada.” We believe strongly that a single securities regulator for Canada is essential in order to effectively protect investors and foster integrity and confidence in our capital markets in an increasingly global marketplace. A single securities regulator will maximize efficiency, take advantage of scale and scope, ensure a level national playing field, and encourage Canadian competitiveness.³⁸⁶

The Five Year Review Committee also recommended the development of securities transfer legislation modeled on revised Article 8 of the U.S. Uniform Commercial Code.³⁸⁷ The OSC must enter into an MOU with the Ontario Minister of Finance every five years.

The OSC also publishes an annual Statement of Priorities and solicits comments from market participants; the Statement of Priorities also compares OSC’s annual performance against the goals enumerated in the previous year’s Statement of Priorities.

³⁸³ Neil Mohindra, *Securities Regulation Market in Canada*, CRITICAL ISSUES BULL. (The Fraser Institute), 2002, at 9; National Instrument 21-101 Marketplace Operation (2004) (Can.), available at <http://ftp.sfsc.gov.sk.ca/scripts/ssc/files/nat-inst/21-101consolidatedmay20-04.pdf>.

³⁸⁴ OSC, Exchanges and Other Marketplaces, http://www.osc.gov.on.ca/MarketRegulation/Marketplaces/mp_index.jsp (last visited Sept. 18, 2006); see also Roel C. Campos, Commissioner, Securities and Exchange Commission, Remarks at New York University Stern: New Challenges in Regulating Financial Markets (Mar. 24, 2006).

³⁸⁵ OSC, *supra* note 379, at 1; OSC, Advisory Committee Legislative Reviews, http://www.osc.gov.on.ca/Regulation/FiveYearReview/fyr_index.jsp (last visited Sept. 18, 2006).

³⁸⁶ David A. Brown, OSC, *Executive Summary, Five Year Review Committee Final Report: Reviewing the Securities Act (Ontario)*, at 1 (Aug. 18, 2004), available at http://www.osc.gov.on.ca/Regulation/FiveYearReview/fyr_20040818_fairness_exec-sum.pdf (last visited Sept. 25, 2006) (citation omitted) (quoting FIVE YEAR REVIEW COMMITTEE FINAL REPORT, *supra* note 34, at 29).

³⁸⁷ *Id.* at 4; see also MOU Minister of Finance & OSC, *supra* note, 370, § 1.1.4.B.10.

ties.³⁸⁸ Market participants are also surveyed to measure the OSC's effectiveness in providing services and meeting obligations to market participants. "The [OSC's] regulatory and adjudicative decisions must be made and be seen by the public to be made in an independent and impartial manner."³⁸⁹

The OSC wants to facilitate "Canadian financial markets that are attractive to domestic and international investors, issuers and intermediaries because they are cost efficient and have integrity."³⁹⁰ It also recognizes that it must address issues in the global regulatory framework to compete successfully domestically as well as internationally; the OSC also asserts that the fragmentation of Canada's securities regulatory framework adversely impacts the competitiveness of Canadian securities markets in the global marketplace:

Financial markets are global. Borders no longer serve as barriers to capital flows. Those seeking to invest and those seeking capital go where they see the opportunity for the best returns for the risks assumed. As capital flows become global, so do the market intermediaries and infrastructure servicing the business. Many of the largest intermediaries are global conglomerates combining banking, insurance and securities services in one entity.³⁹¹

Accordingly, the OSC has determined that it must maintain a globally competitive securities regulatory framework.³⁹² Mostly, the goal is reflected in the OSC's efforts to harmonize its securities laws/regulations with other provinces in Canada as well as internationally, especially with the U.S. securities markets. The OSC has also established an International Affairs Office to ensure that Ontario (through the OSC) is a recognized participant in the shaping of the international securities regulatory framework in an increasingly global securities market.³⁹³

V. ANALYSIS

A. Securities Regulatory Frameworks of the U.S. and Canada: A Comparison with the IOSCO Standard

The securities regulatory frameworks of the U.S. and Canada, to varying degrees, meet the three objectives of the IOSCO

³⁸⁸ See OSC, STATEMENT OF PRIORITIES 2006/2007, at 1-3, 10 (2006), available at http://www.osc.gov.on.ca/About/WhatWeDo/wwd_2006-2007_statement_of_priorities_annual.pdf (last visited Oct. 14, 2006).

³⁸⁹ MOU Minister of Finance & OSC, *supra* note 370, § 1.1.4.B.10.

³⁹⁰ OSC, BUSINESS STRATEGY 2004-2008, at 1, available at http://www.osc.gov.on.ca/About/WhatWeDo/wwd_2004-2008_osc_business_strategy.pdf.

³⁹¹ *Id.* at 2.

³⁹² *Id.*

³⁹³ See OSC, International Affairs, http://www.osc.gov.on.ca/International/int_index.jsp. (last visited Sept. 10, 2006).

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 467

Standard: protecting investors; ensuring fair, efficient, and transparent markets; and dealing with systemic risk.³⁹⁴ However, the U.S. has a greater capacity to achieve the IOSCO Standard because its securities regulatory framework incorporates selective federal preemption. Moreover, Canada's failure to use selective federal preemption in its securities regulatory framework will significantly impair its ability to achieve the IOSCO Standard.

Effective investor protection under the IOSCO Standard requires disclosure of material information to both retail and institutional investors, prohibits manipulative or fraudulent practices in the securities markets, mandates supervision of market intermediaries or operators of exchanges that provide investment services, and prescribes minimum standards for market participants.

1. Investor Protection

- a. Disclosure of Material Information

The U.S. and Canadian³⁹⁵ securities regulatory frameworks require issuers and other market participants to disclose all material information about the issuer's securities in the primary and secondary markets. Both regulatory frameworks are based on the principle of full disclosure of material information, and the definition of material information is substantially the same under both regulatory frameworks. The U.S. securities regulatory framework defines material information from the perspective of the investor's decision to buy or sell the issuer's securities; information is material if it is required by a reasonable investor to make an informed investment decision.³⁹⁶ The province of On-

³⁹⁴ IOSCO Pub. Doc. 154, *supra* note 6, at i.

³⁹⁵ As noted previously, the term "Canadian securities regulatory framework" refers to the provinces of Ontario and Quebec only, because they are the most active in Canada with respect to trading volume and regulatory activity. Describing and analyzing all thirteen provinces and territories would expand significantly the length and adversely impact the thesis of this article.

³⁹⁶ Accordingly, the disclosure of material information by an issuer accessing the primary market includes a description of the issuer, its organization, the terms of its particular offering, and independently audited financial statements. Securities Act, 15 U.S.C. § 77g(b)(1) (2000). In the secondary market, §§ 12–14 of the Exchange Act require continuous disclosure from an issuer or reporting company required to register under these provisions. §§ 78l–78n. A reporting company includes a company with a class of securities listed on a national securities exchange (§ 78l(b)); a company with assets in excess of \$10 million and equity securities held by at least 500 persons (§ 78l(g) and Rule 12g-1, 17 C.F.R. § 240.12g-1(2006)); and a company with a Securities Act registration statement that has been declared effective by the Commission (§ 78l). Required disclosures in the secondary market include an extensive description of the reporting company's business, audited financial statements for its fiscal year, management's discussion and analysis of the issuer's performance and financial position, and any material events. *See* 15 U.S.C. §§ 78m, 78j-1; 17 C.F.R. § 228.303; *see also* *Basic Inc. v. Levinson*, 485 U.S. 224,

tario's securities regulatory framework defines material information from the perspective of the effect of information on the value or price of the issuer's securities, i.e., information is material if it could reasonably be expected to significantly affect the market price or value of the issuer's securities.³⁹⁷ The province of Quebec's securities regulatory framework, similar to that of the U.S., defines material information from the perspective of the investor; information is material if a reasonable investor's decision of whether to buy, sell, or hold an issuer's securities is likely to be influenced or changed by the information.³⁹⁸ Ontario, Quebec and the U.S. obtain the requisite disclosure, with minor differences, by requiring issuers to submit material information to a designated regulator. In the U.S., material information in the primary market is obtained in the registration process; continuing disclosure in the secondary market is submitted to the Commission and stored in EDGAR.³⁹⁹ In Ontario and Quebec, material information in their primary markets is obtained in their respective registration processes; continuing disclosure in their secondary markets is submitted to provincial SRAs and stored in SEDAR. Information stored in EDGAR and SEDAR is made available to investors, generally, on the regulator-sponsored websites for EDGAR and SEDAR.⁴⁰⁰

Although full disclosure of material information is required in the securities regulatory frameworks of Ontario and Quebec, the consistency and quality of the implementation of full disclosure of material information is somewhat fragmented. There is no federal securities law mandating full disclosure; each province has its own disclosure requirements embodied in its own securities act. The CSA has attempted to bridge this gap by drafting National Instrument 51-102 (NI 51-102) and MRRS.⁴⁰¹ However,

236 (1988).

³⁹⁷ Securities Act, R.S.O. 1990, ch. S.5 s. 1(1) (2006) (Can.).

³⁹⁸ Securities Act, R.S.Q. ch. V-1.1 s. 73 (2006) (Can.).

³⁹⁹ SEC, Important Information About EDGAR, <http://www.sec.gov/edgar/aboutedgar.htm> (last visited Sept. 10, 2006).

⁴⁰⁰ SEC, Filings & Forms (EDGAR), <http://www.sec.gov/edgar.shtml> (last visited Oct. 14, 2006); SEDAR, http://www.sedar.com/homepage_en.htm (Oct. 14, 2006); *see also* National Instrument 13-101 System for Electronic Document Analysis and Retrieval (SEDAR) (2004) (Can.), *available at* <http://ftp.spsc.gov.sk.ca/scripts/ssc/files/nat-inst/13-101niamendedasof-mar30-04.pdf>. National Instrument 13-101 was adopted by all thirteen provinces, but with one or more changes to the original instrument in certain provinces.

⁴⁰¹ *See*, National Instrument 51-102 Continuous Disclosure Obligations (2004) (Can.), *available at* http://www.osc.gov.on.ca/Regulations/Rulemaking/Current/Part5/rule_51-102-cont-disc-ob.pdf. MRRS designates one principal regulator to review issuer disclosure documents for securities offerings made in more than one province. As previously noted, the provinces do not surrender their jurisdiction or discretion under MRRS and are free at any time to withdraw and deal directly with the issuer. WISE PERSONS' COMMITTEE, *supra* note 31, at 17. Notably, the chief goal of MRRS is not to facilitate uniformity, but to

compliance with NI 51-102 and MRRS is voluntary for all thirteen provinces. Provinces may also adopt portions of NI 51-102 and MRRS. Despite the fact that these measures are designed to facilitate uniformity in the Canadian securities regulatory framework, voluntary compliance, instead of mandating compliance using selective federal preemption, severely undermines this goal. Voluntary compliance means that the issuer must always be prepared to deal with the regulatory framework of each province in which it plans to offer its securities.

b. Prohibition of Manipulative or Fraudulent Practices

Investor protection under the IOSCO Standard also requires the prohibition of manipulative or fraudulent practices in the securities market.⁴⁰² In the U.S., manipulative or fraudulent practices are prohibited under both federal and state securities laws.⁴⁰³ The federal anti-fraud provisions include § 17(a) of the Securities Act, § 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder.⁴⁰⁴ Both provisions prohibit fraud or deceit, and manipulative or deceptive devices or contrivances.⁴⁰⁵ Canada's prohibitions against fraud and manipulation are contained in National Instrument 23-101 (NI 23-101).⁴⁰⁶ However, because selective federal preemption is not included in Canada's securities regulatory framework, making compliance with all or a portion of the provisions of NI 23-101 voluntary, the provinces of Alberta, British Columbia, and Saskatchewan have decided to retain their own rules prohibiting manipulative or fraudulent practices.⁴⁰⁷ This ability to opt out adversely impacts the consistency required to compete successfully in the global securities market.

In the primary market, U.S. federal anti-fraud provisions do not prohibit stabilization of stock prices when needed. Regulation M of the Exchange Act provides guidelines with respect to

reduce cost of regulation in multi-jurisdictional offerings in Canada. Memorandum of Understanding Regarding Mutual Reliance Review System Between the OSC and Members of the Canadian Securities Administrators (Oct. 28, 1999), available at http://www.albertasecurities.com/dms/2984/7165/7166_1353811_v1_-_MOU-_MRRS_-_in_word.pdf.

⁴⁰² IOSCO Pub. Doc. 154, *supra* note 6, at 5.

⁴⁰³ This is one of the primary areas in the U.S. securities regulatory framework which has not been preempted under NSMIA.

⁴⁰⁴ 15 U.S.C. §§ 77q(a), 78j(b) (2000); 17 C.F.R. § 240.10b-5 (2006). Other anti-fraud provisions under federal securities laws include § 14(e) of the Exchange Act, § 15(e)(1) of the Exchange Act, and § 206 of the Investment Advisers Act of 1940. 15 U.S.C. §§ 78n(e), 78o(e)(1), 80b-6 (2000).

⁴⁰⁵ See 15 U.S.C. §§ 77q, 78j (2000); 17 C.F.R. § 240.10b-5 (2006).

⁴⁰⁶ National Instrument 23-101 Trading Rules § 3.1 (2001) (Can.), available at http://www.rs.ca/en/pdf/National_Instrument_23-101.pdf; Companion Policy to National Instrument 23-101 Trading Rules § 3.1 (2004) (Can.), available at <http://www.spsc.gov.sk.ca/ssc/files/nat-inst/23-101cp-consolidated-may20-04.pdf>.

⁴⁰⁷ National Instrument 23-101 Trading Rules, § 3.1(2).

when and at what price the broker-dealer may enter a stabilizing bid.⁴⁰⁸ However, federal securities laws do prohibit such manipulative or fraudulent practices as free riding,⁴⁰⁹ insider trading,⁴¹⁰ parking,⁴¹¹ wash sales,⁴¹² false and misleading statements during a distribution of securities resulting in the artificial distortion of the market price for investors,⁴¹³ and issuer repurchases designed to manipulate the issuer's stock price.⁴¹⁴ Canada's fraud and manipulation provisions also allow stabilization of stock prices while expressly prohibiting substantially the same type of fraudulent and manipulative conduct under the U.S. securities regulatory framework.⁴¹⁵

Generally, almost every state (including the District of Columbia and the Commonwealth of Puerto Rico) has broadly-worded anti-fraud provisions that apply to all securities issued and/or traded within its borders. Most states have adopted all or some portion of the anti-fraud provisions of the Uniform Securities Act (USA),⁴¹⁶ but not New York and California.⁴¹⁷ Although

⁴⁰⁸ Regulation M, 17 C.F.R. § 242.104 (2005).

⁴⁰⁹ Illegal free riding occurs any time a purchaser of securities does not have the funds to pay for the purchase but rather intends to take a free ride on the securities purchased. See *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967) (holding that a customer ordered stock from his broker with the predetermination of paying for it only if the price increased by the settlement date).

⁴¹⁰ SEC, Insider Trading, <http://www.sec.gov/answers/insider.htm> (last visited Oct. 21, 2006).

Legal insider trading refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security. Insider trading violations may also include "tipping" such information, securities trading by the person "tipped," and securities trading by those who misappropriate such information.

Id.

⁴¹¹ Parking consists of transferring record ownership of a security in order to hide the true identity of the beneficial owner of such security. See *First Montauk Securities Corp.*, Exchange Act Release No. 38,775, 64 SEC Docket 2082 (June 25, 1997).

⁴¹² SEC, Wash Sales, <http://www.sec.gov/answers/wash.htm> (last visited Oct. 21, 2006). Wash sales occur when you buy and sell the same security at the same time or within a short period of time. "Wash sales violate the federal securities laws—Section 9(a)(1)(A) and Rule 10b-5 of the Securities Exchange Act of 1934—if they are done to create the false or misleading appearance of active trading in a security." *Id.*

⁴¹³ 15 U.S.C. § 78i(a) (2000).

⁴¹⁴ *Id.*

⁴¹⁵ Companion Policy to National Instrument 23-101 Trading Rules § 3.1(1)–(4) (2004) (Can.), available at <http://www.spsc.gov.sk.ca/ssc/files/nat-inst/23-101cp-consolidated-may20-04.pdf>.

⁴¹⁶ They are: Alabama, Alaska, Arkansas, Colorado, Connecticut, Delaware, District of Columbia, Guam, Idaho, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Mexico, North Carolina, Oklahoma, Oregon, Pennsylvania, Puerto Rico, Rhode Island, South Carolina, South Dakota, Tennessee, Utah, Vermont, Washington, West Virginia, and Wyoming. LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 73–74 n.114 (3d ed. 1998).

⁴¹⁷ LOUIS LOSS ET AL., *SECURITIES REGULATION* 162, 174 (4th ed. 2006).

Hawaii, Minnesota, New Jersey, and Wisconsin have adopted § 101 of the USA, they have also adopted other anti-fraud provisions.⁴¹⁸ Moreover, even though Arizona, Florida, Georgia, Louisiana, Texas, and Ohio have not adopted the USA, they have substantially adopted the anti-fraud provisions contained in § 101 of the USA.⁴¹⁹ The language of state anti-fraud provisions in states that have adopted the USA generally tracks the language of § 10(b) of the Exchange Act.⁴²⁰ Section 101 of the USA states that

[i]t is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly

(1) to employ any device, scheme, or artifice to defraud,

(2) 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 are made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.⁴²¹

The USA anti-fraud provisions provide for both civil liabilities and criminal penalties. Under § 410 of the USA, there is civil liability for violations of its anti-fraud provisions. However, civil liability is available only to buyers of securities, not sellers.⁴²² Buyers may sue under § 410 or in equity to recover consideration paid plus interest, costs, and reasonable attorneys' fees minus any income generated by the security.⁴²³ Criminal penalties may be imposed under § 409 for willful violations of the USA anti-fraud provisions.⁴²⁴

The USA,⁴²⁵ a voluntary attempt by various SSRAs to achieve consistency in state securities regulation, has failed even in the one area, anti-fraud, in which state action is expressly permitted under selective federal preemption. Although all

⁴¹⁸ LOSS & SELIGMAN, *supra* note 416, at 74.

⁴¹⁹ *Id.* at 74–75 n.116.

⁴²⁰ *Id.*

⁴²¹ UNIFORM SECURITIES ACT § 101 (1956) (current version at UNIFORM SECURITIES ACT § 501, 7C U.L.A. 150 (2006)).

⁴²² *Id.* § 410 (current version at UNIFORM SECURITIES ACT § 509, 7C U.L.A. 162 (2006)). In the author's opinion, the reason for allowing only civil liability for violation of the anti-fraud provisions of the USA is that in each state, both buyers *and* sellers may sue based on state common law and equitable remedies such as fraud and rescission, respectively. In other words, a statute is not needed.

⁴²³ *Id.* § 410(a) (current version at § 509(b)(1), 7C U.L.A. 163 (2006)).

⁴²⁴ *Id.* § 409 (current version at § 508, 7C U.L.A. 158 (2006)). Willful is defined under the USA as “proof that a person acted intentionally in the sense that the person was aware of what he or she was doing.” § 508 cmt. 2, 7C U.L.A. 158 (2006).

⁴²⁵ This description of the Uniform Securities Act of 1956 includes the Revised Uniform Securities Act of 1985 and the 2005 revision.

SSRAs agree with the principle of uniformity as evidenced by the USA, they refuse to adopt voluntarily the USA as drafted even with respect to its anti-fraud provisions. Voluntary compliance under the auspices of NASAA inevitably leads to fragmentation in the securities regulatory framework and its related problems—different laws in each state, different levels of enforcement, varying quality of employee skills and knowledge of applicable securities laws, and increases in the issuer's cost of capital. The CSA, like NASAA, is attempting to achieve consistency in provincial regulation by promulgating a Canadian Uniform Securities Act (CUSA) along with a Securities Administration Act (SAA);⁴²⁶ the drafting of the CUSA and the SAA is the essence of Canada's Uniform Securities Legislation Project (USL Project). However, the USL Project seems doomed to fail from the start because: (1) the provinces are not required to adopt, in whole or in part, the CUSA at its completion; (2) the CSA has already acquiesced to the notion that Quebec requires special (non-uniform) treatment because of its "civil law regime and particular legislative drafting requirements";⁴²⁷ (3) British Columbia was already in the process of streamlining and simplifying its own securities act; and (4) the USL Project allows each province to draft its own SAA.⁴²⁸

Selective federal preemption prevents de facto policy and rulemaking by a single dominant state or province in the securities regulatory framework. The state of New York houses within its borders, arguably, the premier market within the U.S. securities markets—the NYSE. Selective federal preemption prevents New York's SSRA's (the New York Attorney General, currently Eliot Spitzer)⁴²⁹ regulatory activities from having a disproportionate impact on regulatory framework of the U.S. securities markets. This may represent de facto policy and rulemaking in the U.S. securities markets. Moreover, Spitzer's legal mandate is

⁴²⁶ UNIFORM SECURITIES ACT: A LEGISLATIVE PROPOSAL FOR HARMONIZATION OF SECURITIES LAWS: CONSULTATION DRAFT (2003). SAAs must be promulgated by all thirteen provinces and contain the procedural provisions for implementing the USA in each province. The CSA acknowledges that it would be preferable to have uniform procedures, but states that this is too difficult to accomplish. See CANADIAN SECURITIES ADMINISTRATION, UNIFORM SECURITIES LEGISLATION PROJECT: COMMENTARY ON CONSULTATION DRAFTS 14 (2003).

⁴²⁷ CANADIAN SECURITIES ADMINISTRATION, *supra* note 426, at 13.

⁴²⁸ *Id.* at 14.

⁴²⁹ The New York Attorney General is elected for a term of four years and manages over 500 attorneys and over 1800 employees including forensic accounts and scientists. Office of NYS Attorney General Eliot Spitzer, Tour the Attorney General's Office, <http://www.oag.state.ny.us/tour/tour.html> (last visited Oct. 21, 2006). "The Attorney General shall [p]rosecute and defend all actions and proceedings in which the state is interested, and have charge and control of all the legal business of the departments and bureaus of the state . . ." N.Y. EXEC LAW § 63 (2002).

only to protect securities markets within New York's borders. Selective federal preemption prevents domination of the U.S. securities regulatory framework by a single state whose legal mandate is only to protect securities markets within its borders, even if the NYSE is located within its borders. Without the limits imposed by selective federal preemption in the securities regulatory framework, Spitzer's regulatory activities would dominate policy and rulemaking, just as the OSC's regulatory activities dominate policy and rulemaking in the Canadian securities regulatory framework.

(1) The Spitzer Phenomenon⁴³⁰

Spitzer's recent enforcement activities, although laudable, could have affected adversely the competitiveness of the U.S. securities markets in the global securities market. The competitiveness of the U.S. securities markets is weakened when a single SSRA's enforcement activities result in policies and rules that change the securities regulatory framework created by Congress and implemented and monitored by the Commission. In 2002, Spitzer entered into an agreement with Merrill Lynch (the Spitzer Agreement) to settle charges that its investment advice was tainted by conflicts of interest, i.e., securities analysts at Merrill Lynch were not being truthful and fair in public announcements about companies that were Merrill Lynch's investment banking clients.⁴³¹ The Spitzer Agreement, negotiated solely between Spitzer and Merrill Lynch, produced significant reforms in the way in which Merrill Lynch conducted its investment banking activities. The Spitzer Agreement had a signifi-

⁴³⁰ N.Y. EXEC LAW § 63 (2002) (allowing the Attorney General to prosecute violations of New York state laws, as well as violations of federal laws or regulations). Any conduct which violates state or federal law or regulation is actionable under § 63-12. *Id.* § 63-12; *see also* *People v. World Interactive Gaming Corp.*, 714 N.Y.S.2d 844, 848 (1999); *New York v. Feldman*, 210 F. Supp. 2d 294, 300 (S.D.N.Y. 2002). Executive Law § 63-12 provides:

Whenever any person shall engage in repeated fraudulent or illegal acts or otherwise demonstrate persistent fraud or illegality in the carrying on, conducting or transaction of business, the [A]ttorney [G]eneral may apply, in the name of the people of the state of New York, to the supreme court of the state of New York, on notice of five days, for an order enjoining the continuance of such business activity or of any fraudulent or illegal acts, directing restitution and damages and, in an appropriate case, canceling any certificate filed under and by virtue of the provisions of section four hundred forty of the former penal law or section one hundred thirty of the general business law, and the court may award the relief applied for or so much thereof as it may deem proper.

§ 63-12.

⁴³¹ Press Release, Office of New York State Attorney General Eliot Spitzer, Spitzer, Merrill Lynch Reach Unprecedented Agreement to Reform Investment Practices: Merrill Lynch to Pay \$100 Million Penalty (May 21, 2002), *available at* http://www.oag.state.ny.us/press/2002/may/may21a_02.html.

cant impact on all investment banks in the U.S. because Merrill Lynch is the largest securities brokerage firm in the U.S. securities markets, the state of New York, Spitzer's jurisdiction, has Wall Street⁴³² and the NYSE within its borders. Spitzer recognized that his activities resulted in de facto policy and rulemaking for the U.S. securities markets. He stated that "[t]his agreement [between Merrill Lynch and the New York State Attorney General] changes the way Wall Street will operate [by] severing the compensation link between the research and banking divisions [of Merrill Lynch] that tainted investment advice."⁴³³ In fact, Spitzer's settlement with Merrill Lynch was the catalyst for a Global Settlement addressing research analyst conflicts of interest and related issues with the top ten U.S. securities firms in the U.S. securities markets.⁴³⁴ The Global Settlement, negotiated by the Commission with the assistance of Spitzer, the NASD, NASAA, and the NYSE, resulted in, among other things, the promulgation of new rules for research analysts by the Commission.⁴³⁵ However, the Global Settlement would not have occurred without the Commission's statutory power to negotiate, accept, implement, and monitor the Global Settlement. Essentially, the Commission has the statutory authority to impose the Global Settlement on all securities firms participating in the U.S.

⁴³² Wall Street is the heart of the U.S. Financial District and was the first permanent location of the NYSE. NY.com, Financial District, http://www.ny.com/sights/neighborhoods/financial_district.html (last visited Oct. 22, 2006); NYSE Group, Timeline, http://www.nyse.com/about/history/timeline_events.html (last visited Oct. 22, 2006).

⁴³³ Press Release, Office of New York State Attorney General Eliot Spitzer, *supra* note 431. Among other things, Merrill Lynch agreed to sever the link between compensation for analysts and investment banking, prohibit investment banking input in determining analyst compensation, "[c]reate a new investment review committee responsible for approving all research recommendations with strict standards and independence from investment banking and the analysts themselves," "disclose in Merrill Lynch's research reports whether it has received or is entitled to receive any compensation from a covered company over the past 12 months," "pay a \$100 million penalty," and issue a statement of contrition for its failure to address conflicts of interest. *Id.*

⁴³⁴ Bear, Stearns & Co. Inc.; Credit Suisse First Boston LLC; Goldman, Sachs & Co.; J.P. Morgan Securities Inc.; Lehman Brothers Inc.; Merrill Lynch & Co., Inc.; Morgan Stanley & Co., Inc.; Salomon Smith Barney Inc.; UBS Warburg LLC; and U.S. Bancorp Piper Jaffray Inc. Collectively, these firms paid total penalties of almost \$900 million dollars. Press Release, NASD et al., SEC, NY Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement to Reform Investment Practices: \$1.4 Billion Global Settlement Includes Penalties and Funds for Investors (Dec. 20, 2002), *available at* http://www.nasd.com/PressRoom/NewsReleases/2002NewsReleases/NASDW_002864; Press Release, SEC et al., Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Apr. 28, 2003), *available at* <http://www.sec.gov/news/press/2003-54.htm>.

⁴³⁵ The terms of the Global Settlement included a ban on spinning IPOs, an obligation to provide independent research to clients for five years by paying for independent research firms chosen by an independent consultant appointed by regulators, disclosure of analysts' recommendations, ratings, and price target forecasts to the public, and payment of significant monetary penalties by each securities firm. *See* Press Release, NASD et al., *supra* note 434.

securities markets, while Spitzer's authority as an SSRA is only effective in a single state—New York. Selective federal preemption empowers the Commission to bring all necessary parties to the negotiating table and to impose a consistent solution effective against all participants in the U.S. securities regulatory framework. The IOSCO Standard requires consistency in a country's domestic securities regulatory framework to compete successfully in the global securities market. The Commission's comprehensive statutory authority facilitates consistency in the U.S. securities markets and thus is critical to the competitiveness of the U.S. securities markets in the global securities market.

The Office of the New York Attorney General is similar to the OSC in the Canadian securities regulatory framework. Arguably, Canada's premier securities markets (e.g., the TSX) are located in Ontario and, therefore, are regulated by the OSC. Accordingly, the OSC's policy and rulemaking activities, in effect, set policies and rules for the Canadian securities markets even though the OSC's jurisdiction is confined to the province of Ontario. However, unlike the OSC, the impact of Spitzer's activities on the U.S. securities regulatory framework is checked by selective federal preemption, which statutorily mandates that the Commission, a federal regulator, set policy and ensure fair and efficient markets in the U.S. securities regulatory framework. The activities of the OSC have a greater impact on the Canadian securities regulatory framework because its securities regulatory framework does not use selective federal preemption. Unlike the U.S., there is no statutorily authorized federal regulator empowered to set policy and ensure consistency in Canada's securities regulatory framework.

c. Supervision of Market Intermediaries that Provide Investment Services

Investor protection under the IOSCO Standard also requires supervision of market intermediaries or operators of exchanges that provide investment services. Such supervision must incorporate a comprehensive system of inspection and surveillance along with a compliance program. This means that there must also be a comprehensive requirement for establishing and maintaining appropriate records to facilitate monitoring of compliance. In the U.S. securities regulatory framework this is a shared responsibility between the Commission and securities industry SROs.⁴³⁶ The SROs represent the front line of supervision by ensuring regulatory compliance by their members. Although

⁴³⁶ SEC, *Investor's Advocate*, *supra* note 119.

the Commission has delegated much of its inspection and surveillance activities to SROs, it conducts sufficient inspections and surveillance to ensure that the SROs perform their delegated regulatory responsibilities.⁴³⁷ This system of delegation allows the Commission, a relatively small federal agency with respect to human resources and budget, to regulate the largest securities market in the world. If an SRO fails to perform its responsibilities adequately, the Commission has statutory authority to sanction the SRO; the ultimate sanction, of course, is to revoke the SRO's registration under the Exchange Act.⁴³⁸ Revocation of SRO registration means that securities firms would no longer be required to become members, thus eliminating the SRO's statutory authority to regulate its members.

SROs acting as exchanges or trading systems in the OTC market perform their delegated regulatory responsibilities by establishing and enforcing listing standards that issuers must meet to trade their securities on securities exchanges or in the OTC securities market. Also, they must ensure that their members comply with applicable securities laws. SROs perform these requirements by promulgating rules, performing inspections, investigating possible violations of applicable securities laws and SRO rules, and imposing sanctions against members found to have committed such violations.⁴³⁹ Although there are several exchanges throughout the U.S.,⁴⁴⁰ the NYSE is the largest, in part because of its listing requirements.⁴⁴¹ Prior to August 31, 2006, the NYSE was responsible for all SRO responsibilities for exchanges under the Exchange Act. Subsequently, the NYSE delegated certain SRO regulatory responsibilities to the NASD, including examining and enforcing compliance with federal

⁴³⁷ SEC, *The Laws that Govern*, *supra* note 124. Section 5 of the Exchange Act requires every national securities exchange to register with the Commission. 15 U.S.C. § 78e (2000). Section 6(b) of the Exchange Act requires every exchange to promulgate rules that are designed, among other things, to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to provide for appropriate discipline of its members for any violations of the exchange's rules and applicable securities laws. § 78f(b).

⁴³⁸ See §§ 78f(b)(6), 78o-3(b)(7), 78s(d)(3).

⁴³⁹ Regulation of Market Information Fees and Revenues, Exchange Act Release No. 42,208, 71 SEC Docket 496, at IV(A) (Dec. 9, 1999), available at <http://www.sec.gov/rules/concept/34-42208.htm>.

⁴⁴⁰ There are nine securities exchanges registered with the Commission. They are the American Stock Exchange, Boston Stock Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, International Securities Exchange, National Stock Exchange (formerly the Cincinnati Stock Exchange), New York Stock Exchange, Pacific Exchange, and Philadelphia Stock Exchange. U.S. Dep't of Labor, Additional Guidance for Filing Form LM-30, http://www.dol.gov/esa/regs/compliance/olms/LM30_additional.htm (last visited Oct. 22, 2006).

⁴⁴¹ See generally NYSE Group, NYSE Arca Listings, <http://www.nyse.com/about/listed/1155031724207.html> (last visited Oct. 23, 2006).

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 477

securities laws by common members, and enforcing and overseeing NYSE Rules that are substantially similar to NASD Rules.⁴⁴² NASDAQ, the largest OTC market,⁴⁴³ is regulated by the NASD. Like the NYSE, the NASD performs the regulatory functions for issuers listed on NASDAQ, the operation of NASDAQ, and the activities of NASDAQ member securities firms.⁴⁴⁴

SROs regulate their member securities firms primarily by performing inspections and surveillance. Inspections or examinations require the creation and maintenance of certain records by member securities firms.⁴⁴⁵ SRO rules for member firms require that they submit to inspections by the SRO; such inspections are designed to determine and to ensure that member securities firms are complying with all applicable SRO rules and securities laws.⁴⁴⁶ Without the creation and maintenance of such books and records, it would be impossible for SROs (or the Commission for that matter) to perform regulatory responsibilities delegated by the Commission and authorized by statute. Section 17(a) of the Exchange Act, and rules promulgated thereunder, require securities firms to create and maintain records required for inspections conducted by SROs and the Commission.⁴⁴⁷ These

⁴⁴² Program for Allocation of Regulatory Responsibilities Pursuant to Rule 17d-2, Notice of Filing of the Plan for Allocation of Regulatory Responsibilities Between NYSE Arca, Inc. and the National Association of Securities Dealers, Inc., Exchange Act Release No. 54,224, 71 Fed. Reg. 43,823 (July 27, 2006).

⁴⁴³ NASDAQ, 2005 ANNUAL REPORT at NASDAQ's Business in Brief (2006), available at http://files.shareholder.com/downloads/NDAQ/92898776x0x36919/4926252F-A3F3-446A-85D0-AEA84A42CB82/NASDAQ_2005AnnualReport.pdf.

⁴⁴⁴ See National Association of Securities Dealers, NASD Corporate Description: Building Investor Confidence Every Day, <http://www.nasd.com>. The NASD also supervises other OTC markets, such as the OTC Bulletin Board (OTCBB) and the pink sheets. SEC, Over-the-Counter Markets, <http://www.sec.gov/divisions/marketreg/mrotc.shtml> (last visited Oct. 9, 2006). The OTCBB is an electronic inter-dealer quotation system that displays real-time quotes, last-sale prices, and volume information for many OTC securities not quoted on NASDAQ or listed on a national securities exchange; the OTCBB is not a part of NASDAQ. OTC Bulletin Board, Overview and History of the OTCBB, <http://www.otcbb.com/aboutOTCBB/overview.stm>. The Pink Sheets is an electronic inter-dealer quotation system that displays quotes and last-sale information for many OTC securities and does not have listing requirements; securities listed in the Pink Sheets are generally foreign issuers and small, thinly-traded, closely held companies unable to meet the listing requirements of NASDAQ, OTCBB, or the NYSE. Pink Sheets, About the Pink Sheets, <http://www.pinksheets.com/about/index.jsp> (last visited Oct. 9, 2006); Pink Sheets, Frequently Asked Questions, <http://www.pinksheets.com/faq.jsp> (last visited Oct. 9, 2006).

⁴⁴⁵ IOSCO Pub. Doc. 154, *supra* note 6, at i–ii; SEC, 2002 ANNUAL REPORT, at 68, 74–76 (2002), available at <http://www.sec.gov/pdf/annrep02/ar02full.pdf>.

⁴⁴⁶ See, e.g., *One Broker Gone Bad: Punishing the Criminal, Making Victims Whole: Hearing Before the H. Subcomm. on Oversight and Investigations of the H. Comm. On Financial Services*, 107th Cong. 109–115 (2002) (testimony of Daniel M. Sibears, Senior Vice President, Deputy Member Regulation, NASD, Inc.).

⁴⁴⁷ Exchange Act 17 C.F.R. § 240.17a-1(a) (2006). Rule 17a-4 allows securities firms to maintain records electronically if the electronic storage media meets the conditions described in the rule. § 240.17a-4(f). See also Reporting Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, Exchange Act Release No. 38,245, 62 Fed.

records include financial statements prepared in accordance with GAAP⁴⁴⁸ and certain financial and operation reports (commonly known as FOCUS Reports) with the Commission.⁴⁴⁹ Section 17 of the Exchange Act also requires registered exchanges (e.g., the NYSE) to create and maintain sufficient records for effective oversight by the Commission.⁴⁵⁰

Dealers are also required to create and maintain certain books and records to facilitate compliance with the OSA and the QSA⁴⁵¹ in the Canadian securities regulatory framework. Such books and records include blotters or other records of original entry and ledgers reflecting all liabilities, income and expenses, and capital accounts.⁴⁵² OSA and QSA regulations also prescribe the content and time limits of such books and records: they must be maintained “in an accurate and intelligible form” so that they are available “to any person lawfully entitled to examine the re-

Reg. 6443, 6470 (Feb. 5, 1997) (codified at 17 C.F.R. § 240.17a-4(f)) (describing amendment to Rule 17a-4 that will allow broker-dealers to use any electronic storage media that satisfies the other requirements of the Rule); TradeWeb LLC, SEC No-Action Letter, 2003 WL 22220706, at *1 (July 22, 2003) (indicating that the SEC will not enforce any regulations against TradeWeb for using electronic trade confirmation in broker deals).

⁴⁴⁸ Exchange Act, 17 C.F.R. §240.17a-5(c)(2) (2006) (noting that portions of a mandatory audited statement must be “prepared in accordance with generally accepted accounting principles”). GAAP is an acronym for generally accepted accounting principles. Annual financial statements must be filed on a calendar or fiscal year basis and must be audited by an independent public accountant within sixty days after the date of the financial statement. § 240.17a-12(b).

⁴⁴⁹ § 240.17a-5(c)(2). Form X-17A-5 is more commonly known as a FOCUS report. Other required books and records include daily blotters; ledgers reflecting all assets and liabilities, income and expense and capital accounts; separate ledgers itemizing each of the securities firm’s customer’s accounts; ledgers reflecting all long and short positions in each security carried by the securities firm for its own account; a memorandum of each order, whether executed or not; order tickets for each purchase and sale showing price and time (if possible) of execution; copies of confirmations of transactions and notices of other debits and credits sent to the securities firm’s customers; trial balances as proof of money balances in all of the securities firm’s ledger accounts; questionnaires or applications for employment executed by each associated person of the securities firms with, among other things, a complete disciplinary history in the securities industry and any criminal records; and fingerprinting records of the firms associated persons. § 240.17a-3 (giving a complete list of records required to be made and kept.). All records must be created in the form prescribed by Rule 17a-3. *Id.* Records required in Rule 17a-3 must be kept and retained for the periods prescribed in Rule 17a-4. § 240.17a-4(a)–(e). Exchange Act Rule X-17A-5 requires registered securities firms to file FOCUS reports with the Commission. Exchange Act, 17 C.F.R. § 240.17a-5(a)(2). FOCUS Report is an acronym for Financial and Operational Combined Uniform Single Report. The depth and detail required in FOCUS Reports are determined by the business activities of each securities firm. Documents used to prepare FOCUS Reports must be kept three years, the first two years in an easily accessible place. § 240.17a-4(b)(8). FOCUS Reports and other required records may be created and maintained electronically. *See* Order Approving Proposed Rule Change by NASD Regulation, Inc. Relating to the Submission of Information in Electronic Form, Exchange Act Release No. 38,591, 62 Fed. Reg. 26,735, 26,842 (May 9, 1997).

⁴⁵⁰ 17 C.F.R. § 240.17a-1 (2006).

⁴⁵¹ Securities Act, R.S.Q., ch. V-1.1 s. 220 (2006) (Can.).

⁴⁵² Securities Act, R.R.O. 1990, Reg. 1015, s. 113 (2006) (Can.).

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 479

cords.”⁴⁵³ Securities dealers’ books and records are used by SROs and SRAs to regulate the activities of securities dealers in Ontario and Quebec.

The Ontario Securities Act defines an SRO as an entity that represents registrants and is organized for the purpose of regulating the operations and the standards of practice and business conduct of its members and their representatives with a goal of promoting the protection for investors and the public interest.⁴⁵⁴ The OSC is statutorily authorized to recognize SROs.⁴⁵⁵ This means that recognized SROs operating within Ontario are subject to financial examination by the OSC.⁴⁵⁶ Accordingly, SROs in Ontario must make and keep certain financial records and practice and procedure documents for review by the OSC.⁴⁵⁷ If the OSC determines that there have been violations of the Ontario Securities Act, the SRO may be required to provide or amend required disclosure documents.⁴⁵⁸ All SRO rules are subject to OSC approval prior to implementation. However, the absence of selective federal preemption in Canada’s securities regulatory framework makes SRO oversight somewhat convoluted. For example, all RS rules must be approved by all SRAs that have contracted for its services—Ontario, Quebec, Manitoba, Alberta, and British Columbia.⁴⁵⁹ The OSC is the principal regulator, which means that it is responsible for coordinating the review and approval process of all rules proposed by RS. However, RS must file the proposed rule with all five SRAs at the same time and all RS rules must be approved by all five SRAs by agreement of the other four SRAs.⁴⁶⁰ “The [OSC] may . . . make any decision with respect to any by-law, rule, regulation, policy, procedure, interpretation or practice of a recognized self-regulatory organization.”⁴⁶¹ There are currently three SROs recognized by the OSC: the IDA, the MFDA, and RS. Quebec also recognizes three SROs: the IDA, the ME, and the MFDA.

⁴⁵³ Securities Act, R.R.O. 1990, Reg. 1015, s. 113(2)(b) (2006) (Can.).

⁴⁵⁴ Securities Act, R.S.O. 1990, ch. S.5 s. 21.1 (2006) (Can.).

⁴⁵⁵ *Id.* SROs are defined as Market Participants under the Ontario Securities Act, R.S.O. 1990, ch. S.5 s. 1.

⁴⁵⁶ *Id.* s. 12(1).

⁴⁵⁷ *Id.* ss. 19(1), 19(3), and 127; Securities Act, R.R.O. 1990, Reg. 1015, s. 113 (2006) (Can.).

⁴⁵⁸ Securities Act, R.S.O. 1990, ch. S.5 s. 127 (2006) (Can.).

⁴⁵⁹ Memorandum of Understanding Regarding Oversight of Market Regulation Services Inc. Between: Alberta Securities Commission (the ASC) and British Columbia Securities Commission (the BCSC) and Commission des Valeurs Mobilières du Québec (the CVMQ) and Manitoba Securities Commission (the MSC) and Ontario Securities Commission (the OSC) (also referred to collectively as the Commissions) app. A, 25 OSCB 896, 9 (Feb. 15, 2002).

⁴⁶⁰ *Id.*

⁴⁶¹ Securities Act, R.S.O. 1990, ch. S.5 s. 21.1(4) (2006) (Can.).

SROs will not regulate their members with a view towards detecting and preventing violations of applicable securities laws without statutory oversight from a single federal regulator. In 1996, the Commission was forced to institute administrative proceedings against the NASD, in part because it failed to comply with certain of its own rules and to enforce compliance with federal securities laws by securities firms acting as NASDAQ market makers.⁴⁶² NASDAQ market makers engaged in manipulative practices in certain securities traded on NASDAQ in order to increase profits by artificially widening spreads in such transactions.⁴⁶³ Specifically,

[NASDAQ] market makers observed an anticompetitive pricing convention by which most [NASDAQ] stocks were quoted only in even eighths (i.e., \$1/4, \$1/2, \$3/4, 0). The pricing convention resulted in most [NASDAQ] stocks being quoted with a minimum inside spread of \$1/4, thereby increasing the transactions [sic] costs paid by many investors when purchasing or selling those stocks.⁴⁶⁴

This manipulative and anti-competitive pricing convention resulted in wider spreads and was enforced by NASDAQ market makers using harassment.⁴⁶⁵ In addition, the Commission determined that “[t]he NASD was unduly influenced by [NASDAQ] market making firms with respect to rulemaking, the discipli-

⁴⁶² See Report Regarding the NASD and the NASDAQ Market, Exchange Act Release No. 37,542, 62 SEC Docket 1385 (Aug. 8, 1996); Order Instituting Public Proceedings, Making Findings and Imposing Remedial Sanctions Against NASD, Exchange Act Release No. 37,538 (Aug. 8, 1996). The NASD defines a market maker as

[a] firm that maintains a firm bid and offer price in a given security by standing ready to buy or sell at publicly-quoted prices. The [NASDAQ] Stock Market is a decentralized network of competitive Market Makers. Market Makers process orders for their own customers, and for other NASD broker/dealers; all NASD securities are traded through Market Maker firms. Market Makers also will buy securities from issuers for resale to customers or other broker/dealers. About 10 percent of NASD firms are Market Makers; a broker/dealer may become a Market Maker if the firm meets capitalization standards set down by NASD.

NASD, Glossary of Terms: M, http://www.nasd.com/Resources/Glossary/NASDW_011116 (last visited Oct. 9, 2006).

⁴⁶³ See Report Regarding the NASD and the NASDAQ Market, Exchange Act Release No. 37,542, 62 SEC Docket 1385 (Aug. 8, 1996). “Spread” is “[t]he difference between the bid price at which a Market Maker will buy a security, and the ask price at which a Market [M]aker will sell a security.” NASD, Glossary of Terms: S, http://www.nasd.com/Resources/Glossary/NASDW_011153 (last visited Oct. 16, 2006). The “inside spread” is

[t]he difference between the best bid and best ask among all securities is the highest bid and lowest offer being quoted among all of the Market Makers competing in a security. Since the spread is the aggregate of individual Market Maker spreads, it is narrower than an individual dealer spread or quote.

NASD, Glossary of Terms: I, http://www.nasd.com/Resources/Glossary/NASDW_011041 (last visited Oct. 16, 2006).

⁴⁶⁴ See Report Regarding the NASD and the NASDAQ Market, Exchange Act Release No. 37,542, 62 SEC Docket 1385 (Aug. 8, 1996).

⁴⁶⁵ See *id.*

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 481

nary process and the admission of new members.”⁴⁶⁶ The NASD spent more time investigating and bringing disciplinary actions against certain broker-dealers that were “widely disliked” by NASDAQ market makers.⁴⁶⁷

From 1999 through 2003, NYSE specialists engaged in fraudulent and anti-competitive behavior designed to increase their compensation. Specifically, *all* NYSE equity specialist firms engaged in unlawful trading ahead⁴⁶⁸ and interpositioning.⁴⁶⁹

The Commission took swift and decisive action against the abuses uncovered at the NYSE and NASD. It required systemic changes at both the NASD and the NYSE to ensure fair and competitive markets and to eliminate fraudulent practices that adversely impacted the competitiveness, efficiency, and transparency of the U.S. securities markets.⁴⁷⁰ Such comprehensive remedial action was possible because of the existence of the use of selective federal preemption in the securities regulatory framework.

d. Minimum Standards for Market Participants

The IOSCO Standard requires the authorization of market intermediaries to hold themselves out to the public as such. In

⁴⁶⁶ *See id.*

⁴⁶⁷ *See id.*

⁴⁶⁸ NASD Manual Rule 2111(b) (2006).

A member that accepts and holds a market order of its own customer or a customer of another broker-dealer in a [NASDAQ] or exchange-listed security without immediately executing the order is prohibited from trading that security on the same side of the market for its own account, unless it immediately thereafter executes the customer market order up to the size and at the same price at which it traded for its own account or at a better price.

Id.

⁴⁶⁹ Order Instituting Public Administrative Proceedings, Making Findings, Ordering Compliance with Undertakings, and Imposing a Censure and a Cease-and-Desist Order, Exchange Act Release No. 51,524, 85 SEC Docket 517 (Apr. 12, 2005). NASD Manual Rule 2320(b) (2006).

In any transaction for or with a customer, no member or person associated with a member shall interject a third party between the member and the best available market except in cases where the member can demonstrate that to his knowledge at the time of the transaction the total cost or proceeds of the transaction, as confirmed to the member acting for or with the customer, was better than the prevailing inter-dealer market for the security. A member's obligations to his customer are generally not fulfilled when he channels transactions through another broker/dealer or some person in a similar position, unless he can show that by so doing, he reduced the costs of the transactions to the customer.

Id.

⁴⁷⁰ *See* Order Instituting Public Administrative Proceedings, Making Findings, Ordering Compliance with Undertakings, and Imposing a Censure and a Cease-and-Desist Order, Exchange Act Release No. 51,524 (Apr. 12, 2005).

the U.S., this is accomplished primarily through registration of securities firms with the Commission.⁴⁷¹ Registration of securities firms facilitates compliance with applicable securities laws by requiring securities firms to maintain an appropriate level of capital and to abide by a code of business conduct.⁴⁷²

In Canada, the OSC and the CVMQ also monitor the activities of market participants by requiring registration of dealers, underwriters,⁴⁷³ and other market participants. The OSA prohibits trading and otherwise participating in Ontario securities markets unless such person, dealer,⁴⁷⁴ or adviser registers with the OSC as a dealer or an adviser.⁴⁷⁵ Non-trading employees, designated by the Director of the OSC, are not required to register. Unlike the U.S., Ontario allows registration of all advisers seeking to do business within its borders, while the Commission only mandates registration of advisers with greater than \$30 million in assets under management; advisers with less than \$30 million in assets under management must register with the appropriate SSRA.⁴⁷⁶ Similar to Ontario, Quebec requires the registration of dealers and advisers to engage in the securities business within its borders. The definition of dealer, however, is much broader than the OSA or federal securities laws. Section 5(2) of the QSA includes “trading in securities as principal,

⁴⁷¹ Securities Exchange Act of 1934, 15 U.S.C. § 78o (2000). Brokers and dealers doing business in the U.S. securities markets must register with the Commission in a process administered by the NASD. NASD, Glossary of Terms: N, http://www.nasd.com/Resources/Glossary/NASDW_011118 (last visited Oct. 9, 2006).

⁴⁷² Securities Exchange Act of 1934, 15 U.S.C. § 78m (2000). Compliance is facilitated by requiring minimum levels of skill and knowledge, which are monitored by proficiency exams. 15 U.S.C. § 78o (2000).

⁴⁷³ Quebec does not have specific registration requirements for dealers that act as underwriters. *See* Securities Act, R.S.Q., ch. V-1.1 s. 148 (2005) (failing to list underwriters as governed by the statute).

⁴⁷⁴ Dealer registration is divided into ten categories: a broker (trades in the capacity of an agent or principal); a financial intermediary dealer (e.g., a bank, loan corporation, trust corporation, insurance company, credit union); a foreign dealer; an international dealer; an investment dealer (member of the IDA and trades in the capacity of an agent or principal); a limited market dealer; a mutual fund dealer (trades exclusively in shares or units of mutual funds); a scholarship plan dealer (trades exclusively in shares or units of securities of a scholarship or educational plan or trust); a securities dealer; and a security issuer (issuer registering as dealer to distribute its own securities exclusively for its own account. This category is rarely used). *See* Securities Act, R.R.O. 1990, Reg. 1015, s. 98 (2006) (Can.). In addition, SRO membership is required to obtain registration as a broker or investment dealer. *See* SRO Membership—Securities Dealers and Brokers, OSC Rule 31-507 § 1.1 (2006), *available at* http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part3/rule_20000818_31-507_fr.jsp.

⁴⁷⁵ Securities Act, R.S.O. 1990, ch. S.5, s.25(1)(a) (2006). This section also requires registration of the dealer, partners, officers, and employees that perform trading activities such as the purchase and sale of securities. This allows personal liability of individuals for violations of the OSA.

⁴⁷⁶ Investment Advisers Act of 1940, 17 C.F.R. § 275.203A-1 (2006).

whether as his main activity or only as a secondary activity.”⁴⁷⁷ Curiously, persons seeking to register as a dealer or adviser of a mutual fund, a scholarship plan, or an investment contract dealer (and its representative) must register with the AMF in accordance with *An Act Respecting the Distribution of Financial Products and Services (Quebec)* (FP&S Act) instead of the QSA.⁴⁷⁸

Exchange Act Rule 15c3-1 requires securities firms to have specified levels of initial and ongoing capital to meet the current demands of their business activities and to protect customers and creditors from losses in the event of financial failure.⁴⁷⁹ Adequate liquidity must be maintained at all times. Accordingly, minimum net capital requirements vary based on the type of activities engaged in by the securities firms. Minimum net capital is determined by reducing net worth by all assets that cannot be readily converted into cash and by a percentage of the market value of securities and commodities held in the securities firms’ proprietary accounts to reflect market risk.⁴⁸⁰ Certain firm assets are deducted in their entirety from net worth, including real estate, furniture and fixtures, exchange memberships, prepaid rent, insurance and other prepaid expenses, goodwill, and organizational expenses.⁴⁸¹ Unsecured and partly secured receivables and certain insurance claims must also be deducted from the firm’s net worth,⁴⁸² along with undue concentrations of securities.⁴⁸³ Subordinated liabilities, however, may be added back to

⁴⁷⁷ Securities Act, R.S.Q. ch. V-1.1 s. 5(2) (2006) (Can.). In Quebec, there are also categories of dealer registration with a restricted practice instead of an unrestricted practice (standard full-service securities dealers): security issuer (issuers intending to limit their activity to the distribution of their own securities), independent trader (members of recognized stock exchanges trading on their own behalf or on behalf of a dealer), dealer distributing Quebec business investment company (QBIC) shares, debt security dealer (limited to the distribution or sale of debt securities issued by the federal and provincial governments, municipalities and certain other public bodies), and any other category that may be designated by the AMF. See R.S.Q. ch. D-9.2 s. 192.

⁴⁷⁸ An Act Respecting the Distribution of Financial Products and Services, R.S.Q. ch. D-9.2 s. 72 [hereinafter FP&S Act]. However, Quebec did not decide to participate in the web-based National Registration database until January 2005. Press Release, National Registration Database Information, The Autorité des Marchés Financiers (the “AMF”) Has Announced Its Participation in the National Registration Database (NRD) (Sept. 23, 2004), available at <http://www.nrd-info.ca/news/news040923.jsp>.

⁴⁷⁹ Exchange Act, 17 C.F.R. § 240.15c3-1 (2005). The Commission is authorized to ensure that securities firms maintain reserves with respect to customers’ deposits or credit balances and establish minimum financial responsibility requirements for all brokers and dealers. 15 U.S.C. § 78o(c)(3)(A).

⁴⁸⁰ Mid America Fin. Serv., Inc., SEC No-Action Letter, 1982 WL 29920, at *3 (Nov. 8, 1982). These deductions are designated as haircuts. Haircuts are designed to reflect the price volatility, liquidity, and risk inherent in the securities firms’ proprietary accounts. 17 C.F.R. § 240.15c3-1(c)(2)(vi)(A)–(K).

⁴⁸¹ See 17 C.F.R. § 240.15c3-1(c)(2)(iv)(A).

⁴⁸² See 17 C.F.R. § 240.15c3-1(c)(2)(iv)(B)–(E).

⁴⁸³ An undue concentration of a single security means that the securities firm has a relatively large amount of the security in its proprietary account. This circumstance

net worth to determine the firm's minimum net capital requirements.⁴⁸⁴ Financial regulation is also supplemented by the Securities Investor Protection Act of 1970, which established the Securities Investor Protection Corporation (SIPC). SIPC, funded by the securities industry, provides restitution to customers of firms that are no longer financially viable.

The OSC and the CVMQ also require registered dealers to maintain sufficient capital to protect investors in the event of insolvency. The OSC requires dealers to maintain certain capital and insurance requirements.⁴⁸⁵ In Ontario, all dealers (except securities issuers) must maintain minimum capital (designated as free capital). The required amount of free capital is determined by identifying the maximum deductible under any bonding or insurance policy, plus \$25,000⁴⁸⁶ of net free capital⁴⁸⁷ and a varying percentage of adjusted liabilities.⁴⁸⁸ In addition, all dealers (except mutual fund dealers⁴⁸⁹ and security issuers) must have a broker's blanket bond in the amount of \$200,000, or a greater amount if the dealer's directors determine that a greater amount is needed.⁴⁹⁰ The CVMQ requires unrestricted dealers or discount brokers to maintain minimum capital of \$250,000; unrestricted dealers must also have a risk adjusted capital greater than \$0.⁴⁹¹ Introducing brokers must have minimum capital of \$75,000.⁴⁹² Restricted dealers must maintain minimum capital of \$50,000 plus the amount of the deductible under their broker's blanket bond or insurance policy.⁴⁹³ In addition, both unrestricted and restricted dealers must subscribe for insurance or bonding meeting minimum coverage requirements under the QSA and in accordance with applicable SROs.⁴⁹⁴ Mutual fund,

means that the firm's liquidity may be threatened if it has to liquidate a large position quickly because it may not be able to realize the security's full market value.

⁴⁸⁴ See *Mid-America Fin. Serv., Inc.*, 1982 WL 29920, at *3.

⁴⁸⁵ Securities Act, R.R.O. 1990, Reg. 1015 ss. 107-112 (2006) (Can.).

⁴⁸⁶ R.R.O. 1990, Reg. 1015 s. 107.

⁴⁸⁷ Net free capital is defined in Ontario Securities Act R.R.O. 1990, Reg. 1015 s. 96. See also R.R.O. 1990, Reg. 1015 s. 107(1)(a)-(b).

⁴⁸⁸ Adjusted liabilities are defined in R.R.O. 1990, Reg. 1015 s. 96.

⁴⁸⁹ Mutual fund dealers must maintain at least \$50,000 in bonding or insurance for each employee. See R.R.O. 1990, Reg. 1015 s. 108(2)(a), (4).

⁴⁹⁰ However, the OSC Director has discretion to waive or reduce this coverage. See R.R.O. 1990, Reg. 1015 s. 108(1).

⁴⁹¹ Autorité des marchés financiers [AMF] Securities Reg. § 207 (2005). Risk adjusted capital is calculated according to the method prescribed by the ME. In addition, the deductible under the insurance policy (blanket broker's bond), required by AMF Securities Reg. § 213 (2005), must be included in the calculation for risk adjusted capital.

⁴⁹² AMF Securities Reg. § 207.

⁴⁹³ *Id.* §§ 207-208, 213.

⁴⁹⁴ Minimum insurance or bonding coverage requirements for dealers registered in Quebec include: \$500,000 for each category of risks covered for a dealer with an unrestricted practice or for a discount broker; \$200,000 for each category of risks covered by the financial institution bond for an introducing broker; \$100,000, plus \$50,000 for each

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 485

scholarship plan and investment contract dealers must subscribe for professional liability insurance coverage in accordance with the provisions of the FP&S Act; the AMF will not accept a financial institution bond for these categories of dealer.⁴⁹⁵ Finally, like the Commission, compliance by registered dealers and their employees with the applicable securities laws of the OSC and the CVMQ is facilitated by imposing minimum levels of proficiency assessed by examination.⁴⁹⁶

Business conduct rules are enforced and promulgated by SROs, with the approval of the Commission. The NASD's business conduct rules are designed to ensure that securities firms and their employees "observe high standards of commercial honor and just and equitable principles of trade" when dealing with investors and other members of the securities industry.⁴⁹⁷ These rules cover approximately five major categories concerning legal and appropriate business conduct by firms and their employees and associated persons in the securities industry including general standards of commercial honor and principles of trade;⁴⁹⁸ communications with customers and the public;⁴⁹⁹ transactions with customers;⁵⁰⁰ commissions, mark-ups, and charges;⁵⁰¹ special accounts;⁵⁰² securities distributions;⁵⁰³ special products;⁵⁰⁴ responsibilities to other brokers or dealers;⁵⁰⁵ responsibilities relating to associated persons, employees, and others' employees;⁵⁰⁶ and alternative dispute resolution.⁵⁰⁷ The OSC and the CVMQ also require dealers to supervise their registered salespersons, officers, and partners with a view towards ensuring compliance with Ontario and Quebec securities laws and the

employee, for a debt security dealer or a dealer distributing QBIC shares; and \$10,000 for securities advisers. AMF Securities Reg. § 213. Registration requirements for mutual fund, scholarship plan and investment contract dealers are set out in the regulations adopted under the FP&S Act. *See generally* FP&S Act, *supra* note 478.

⁴⁹⁵ AMF Securities Reg. § 213.

⁴⁹⁶ *See* Proficiency Requirements for Registrants, OSC Rule 31-502 § 2.1. These rules detail which industry courses must be completed and the level of previous registration or experience required for each type of registration. The OSC prescribes certain time limits to complete the required exams and courses. OSC Rule 31-502 § 1.2. In addition, professional training requirements for representatives of mutual fund, scholarship plan and investment contract dealers are prescribed in FP&S Act regulations. *See generally* FP&S Act, *supra* note 478.

⁴⁹⁷ NASD Manual Rule 2110 (2006).

⁴⁹⁸ NASD Manual Rule 2100 Series.

⁴⁹⁹ NASD Manual Rule 2200 Series.

⁵⁰⁰ NASD Manual Rule 2300 Series.

⁵⁰¹ NASD Manual Rule 2400 Series.

⁵⁰² NASD Manual Rule 2500 Series.

⁵⁰³ NASD Manual Rule 2700 Series.

⁵⁰⁴ NASD Manual Rule 2800 Series.

⁵⁰⁵ NASD Manual Rule 2900 Series.

⁵⁰⁶ NASD Manual Rule 3000 Series.

⁵⁰⁷ NASD Manual Rule 10300 Series.

terms and conditions imposed by the OSC and the CVMQ for registration in their respective jurisdictions.⁵⁰⁸ Included in the business conduct rules of the NASD is the “Know-Your-Customer” rule.⁵⁰⁹ Although the Know-Your-Customer Rule is not codified in the Exchange Act, it is expressly stated in the OSA and the QSA.⁵¹⁰

Under OSC Rule 31-505, § 1.5 and QSA § 161 a dealer is required to comply with the Know-Your-Client Rule.⁵¹¹ Under this Rule, a dealer is required to ascertain the identity, creditworthiness, and investment needs of its customer before recommending transactions (purchase or sale) in specific securities to the customer.⁵¹² However, this rule is limited because the dealer only has to determine customer creditworthiness if it is financing the customer’s securities transaction. In addition, if the customer has a registered adviser, the dealer is only required to determine the creditworthiness of the registered adviser.⁵¹³ Moreover, there is no obligation to ensure the suitability of the trade if the adviser gives the instruction to execute to the dealer.⁵¹⁴

Selective federal preemption facilitates consistency, and therefore reliability, in the securities regulatory framework. In the U.S., all policy, laws, and rules must be approved by one entity, the Commission. In Canada, although the provinces of Ontario and Quebec dominate Canada’s securities markets, the approval of policy, laws, and rules is a much more arduous process simply because, at least theoretically, all thirteen SRAs must agree. As we have seen, complete agreement is an anomaly.

2. Ensuring that Markets are Fair, Efficient, and Transparent

Under the IOSCO Standard, ensuring fair, efficient, and transparent markets requires regulator approval of exchange and trading system operators and their trading rules. The regu-

⁵⁰⁸ Advisers must also supervise their registered officers and partners in accordance with Ontario and Quebec securities laws and any terms and conditions imposed by the OSC and the CVMQ for registration in their respective jurisdictions. See *In re Dundee Securities Corporation Settlement Agreement*, 26 O.S.C.B. 6070, ¶ 47 (Aug. 8, 2003) (Can.).

⁵⁰⁹ NASD Manual Rule 2310 (2006).

⁵¹⁰ Securities Act, R.S.Q. ch. V-1.1 s. 161 (2006) (Can.).

⁵¹¹ *Id.*; OSC Rule 31-505 § 1.5–1.6 (1998). Section 4.1 of OSC Rule 31-505 permits the OSC Director, in his discretion, to exempt a dealer from complying with the Know-Your-Client Rule. See *In re Fidelity Investments Canada Ltd. and Valspar Inc.*, 25 O.S.C.B. 1069, app. (Feb. 12, 2002) (Can.).

⁵¹² OSC Rule 31-505 §§ 1.5–1.6 (1998).

⁵¹³ However, the dealer must ascertain the creditworthiness of the customer represented by the registered adviser if payment of the account is not guaranteed by the adviser. See OSC Rule 31-505 § 1.6(1)–(2) (1998).

⁵¹⁴ See OSC Rule 31-505 § 1.7 (1998).

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 487

latory structures for exchanges and trading systems in the U.S. and Canada are designed to detect, deter, and penalize market manipulation and other unfair trading practices. Both countries have laws and require SROs to have rules that ensure transparency of trading. Under the IOSCO Standard, transparency is defined “as the degree to which information about trading (both for pre-trade⁵¹⁵ and post-trade⁵¹⁶ information) is made publicly available on a real-time basis.”⁵¹⁷ Also, the IOSCO Standard emphasizes timely access as an integral component of transparency. “Timely access to relevant information about . . . trading allows investors to better look after their own interests and reduces the risk of manipulative or other unfair trading practices.”⁵¹⁸ In the U.S. and Canada, registered national securities exchanges (including ECNs/ATs registered as exchanges) must promulgate rules designed to prevent fraudulent and manipulative acts and practices. Moreover, they must have the capacity to enforce compliance with the rules and regulations of applicable securities laws as well as the exchange’s rules.⁵¹⁹ However, the absence of selective federal preemption in the Canadian securities regulatory framework makes this process less consistent and transparent because there is no national entity with jurisdiction over all thirteen provinces and territories. For example, RS is the SRO responsible for regulating equities trading but is only authorized to regulate equity trading in five of Canada’s thirteen provinces.⁵²⁰ Finally, the admission criteria and procedures for exchanges and trading systems in the U.S. and Canadian securities markets do not unduly favor some market users over others.

3. The Reduction of Systemic Risk

The IOSCO Standard requires merely the reduction of systemic risk because systemic risk is essential to compete successfully in the global securities market. Regulators must manage systemic risk by implementing processes and procedures designed to minimize market disruptions and their impact on the

⁵¹⁵ “Pre-trade information concerns the posting of firm bids and offers [in both quote and order-driven markets] as a means to enable investors to know, with some degree of certainty, whether and at what prices they can deal.” IOSCO Pub. Doc. 154, *supra* note 6, at 6.

⁵¹⁶ “Post-trade information is related to the prices and the volume of all individual transactions actually concluded.” *Id.*

⁵¹⁷ *Id.*

⁵¹⁸ *Id.* at 43.

⁵¹⁹ 15 U.S.C. § 78f(b) (2000); Ontario Securities Act, R.S.O. 1990, ch. S.5 s. 21 (2006); Quebec Securities Act, R.S.Q., ch. V-1.1, s.169 (2006); Alberta Securities Act, R.S.A. 2000, ch. S-4, ss. 62–63 (2006). Transactions on unregistered exchanges are strictly prohibited unless specifically exempted by the Commission upon application of Exchange Act § 5. *See* § 78e.

⁵²⁰ Market Regulation Services Inc., About RS, *supra* note 326.

respective securities markets. Such processes and procedures would include decreasing the risk of financial failure of market intermediaries and its impact on the securities markets,⁵²¹ facilitating adequately supervised clearing and settlement procedures that are accurate and efficient,⁵²² and cooperating and sharing information across jurisdictional boundaries in the global securities market.⁵²³

Both the U.S. and Canada include procedures and processes designed to reduce systemic risk. Both regulatory frameworks have systems in place that reduce the impact of financial failures of market intermediaries, supervised clearing and settlement procedures, and have entered into cooperation and information sharing both inside and outside their respective jurisdictions.⁵²⁴ However, the use of selective federal preemption provides greater flexibility and efficiency with respect to decreasing systemic risk in the U.S. securities regulatory framework. The author concedes that the Commission must consult with various stakeholders in the securities markets before implementing rules for administering federal securities laws. However, after the consultative process is complete, the Commission has the authority, indeed the mandate, to promulgate and to enforce the rules nationwide.⁵²⁵ In Canada, the absence of selective federal preemption makes promulgating rules designed to reduce systemic risk slow and unnecessarily complex. The fragmented Canadian securities regulatory framework, at a minimum, would make cooperation and information sharing in the pursuit of stability more difficult. Moreover, systemic stability cannot be protected in a system in which each SRA is autonomous and there is no federal regulatory authority to consistently facilitate systemic stability in Canada's securities markets. Although all of Canada's SRAs are members of the CSA, membership, and more importantly adoption in whole or in part of CSA national instruments designed to reduce systemic risk, is voluntary. Without federal preemption, there is no single federal regulatory author-

⁵²¹ This means establishing systems and procedures that attempt reasonably "to isolate the risk to the failing institution." This would include specifying minimum capital requirements for market intermediaries and establishing and maintaining various programs for market intermediaries designed to reduce systemic risk. IOSCO Pub. Doc. 154, *supra* note 6, at 6-7.

⁵²² The IOSCO Standard defines clearing and settlement systems as "systems providing the process of presenting and exchanging data or documents in order to calculate the obligations of the participants in the system, to allow for the settlement of these obligations, and the process of transferring funds [and/or] securities." *Id.* at 45.

⁵²³ *Id.* at 7.

⁵²⁴ *See generally id.*

⁵²⁵ *See* SEC, What We Do, <http://www.sec.gov/about/whatwedo.shtml> (last visited Sept. 26, 2006) (noting that the SEC works closely with many other institutions, but remains the primary overseer and regulator of the U.S. securities markets).

ity empowered to set a coherent policy by mandating that all provinces adhere to national instruments promulgated by the CSA. The CSA is comparable to NASAA, where member participation is voluntary and adoption of the Uniform Securities Act is *not* mandatory.

B. The IOSCO Standard for Securities Regulator: Selective Federal Preemption Requires a Federal Securities Regulator

Selective federal preemption combined with a federal securities regulator is required to meet the IOSCO Standard for securities regulator (IOSCO Standard Regulator) in the global securities market.⁵²⁶ Only a regulator at the federal level will have the requisite power to make decisions that bind all securities markets and market participants. The IOSCO Standard Regulator: (1) is operationally independent because it has sufficient and stable funding; (2) is accountable based on public monitoring and judicial review of orders issued in connection with its regulatory activities; (3) is clear, consistent, transparent, and fair in the exercise of its authority and formulation of policy, and considers whether its regulatory activities unnecessarily burden capital formation; (4) actively promotes investor and other market participant education because it recognizes that its regulatory framework is based on disclosure of material facts; (5) uses the assistance of SROs to meet its regulatory functions and responsibilities; (6) has comprehensive enforcement powers; and (7) has the authority to conduct cross-border activities, e.g., to obtain and provide information to its regulatory counterparts in other countries.⁵²⁷

The securities regulators in the U.S. and Canada (specifically Ontario and Quebec) have many of the attributes enumerated in the IOSCO Standard Regulator. The Commission, the OSC, and the AMF/CVMQ have a stable and sufficient source of funding. The Commission's entire budget is funded from fee collection generated by statutorily required filings by market participants. All fees collected are deposited in the U.S. Treasury except the portion used to fund the Commission's budget. Total fees collected are more than sufficient to fund the Commission's budget. In 2003, total fees collected were \$1.076 billion,⁵²⁸ of

⁵²⁶ However, IOSCO contends that "[t]here need not be a single regulator, [and that] [i]n many jurisdictions, the desirable attributes of the regulator . . . are in fact the shared responsibility of two or more government or quasi-government agencies." IOSCO Pub. Doc. 154, *supra* note 6, at 9 n.11.

⁵²⁷ *Id.* at 9–16.

⁵²⁸ 25% was from securities registrations, 74% was from securities transactions, and 1% was from tender offer, merger, and other filings. SEC, ANNUAL REPORT 2003, at 4 (2003), *available at* <http://sec.gov/pdf/annrep03/ar03full.pdf>.

which \$716.4 million was used to fund the Commission. The OSC and AMF/CVMQ are also funded from fees paid by market participants. In 2004, fees collected by the OSC totaled \$76.61 million and expenses totaled \$54.97 million, generating a surplus of \$21.64 million.⁵²⁹ In 2004–05, AMF/CVMQ revenues totaled \$94.7 million with a surplus of \$28.7 million.⁵³⁰ The Commission, the OSC, and the AMF/CVMQ are all publicly monitored and orders issued by the three regulators are subject to judicial review. Each of the three regulators also have education programs for the investing public and securities markets participants. In addition, the Commission, the OSC, and the AMF/CVMQ delegate many of their regulatory functions to SROs under their jurisdictions; SROs performing regulatory functions on behalf of the three regulators are overseen by the applicable regulator.

The U.S., but not Canada, substantially incorporates the IOSCO Standard Regulator attributes of clear and consistent exercise of authority, formulation of policy, and comprehensive enforcement. According to the IOSCO Standard for a securities regulator, these attributes in a securities regulator are required to compete successfully in the global securities market.⁵³¹ The U.S. has established a regulator at the federal level using selective federal preemption to consistently exercise authority, formulate policy, and conduct comprehensive enforcement. This federal regulator, the Commission, is legally authorized to represent and make binding decisions for the U.S. securities markets in the global securities market.⁵³² Each of Canada's thirteen regulators is statutorily empowered to exercise authority, formulate policy, and conduct comprehensive enforcement *only within their respective borders*. Only the CSA purports to represent Canada's thirteen SRAs at the national level, but participation, and adherence to CSA decisions, is purely voluntary.

It is impossible to achieve the IOSCO Regulator Standard without using selective federal preemption implemented by a securities regulator at the federal level. Each of the securities regulators in Canada and the U.S. has substantially the same attributes as those enumerated in the IOSCO Standard for a securities regulator. However, Canada does not have a securities regulator at the federal level to ensure consistency in the exercise of authority, policymaking and enforcement in all thirteen prov-

⁵²⁹ OSC, 2004 MANAGEMENT'S DISCUSSION AND ANALYSIS 2 (2004), available at http://www.osc.gov.on.ca/About/AnnualRpt/rpt_index.jsp (follow "Management's Discussion and Analysis in PDF" hyperlink below the heading "2004").

⁵³⁰ AMF RAPPORT ANNUEL 2004–2005, at 36 (2005) (Can.).

⁵³¹ IOSCO Pub. Doc. 154, *supra* note 6, at i–ii.

⁵³² See SEC, What We Do, *supra* note 525.

inces. Successfully competing in the global securities market requires a regulator at the federal level using selective federal preemption to regulate securities markets. The U.S. understands the importance of a securities regulator at the federal level to maintain its competitive position in the global securities market. Therefore, it consolidates regulatory authority in the Commission, its securities regulator at the federal level, with increasing use of selective federal preemption in its securities regulatory framework.

1. The Absence of Selective Federal Preemption and a Federal Securities Regulator Adversely Impacts Canada's Securities Regulatory Framework

The absence of a federal securities regulator and selective federal preemption causes the location of a securities transaction to be unusually significant in the Canadian securities regulatory framework.

This is because each province only has jurisdiction within its own borders. In Ontario, jurisdiction under the OSA is determined by "whether a person has engaged in 'trading' in a security so as to give rise to the dealer registration requirement in s. 25(1)(a)."⁵³³ Section 25(1)(1) of the OSA defines trade as "any act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of" a sale or purchase of a security.⁵³⁴ This definition is problematic because, frequently, all the components of a securities transaction do not occur in a single province. This means that in each case brought by provincial securities regulators, jurisdiction may be raised as a first defense of the party being sued instead of addressing first whether there has been a violation of the OSA. In addition, factors identified in each province to determine the location of a securities transaction (and thus provincial jurisdiction) may vary considerably. This fact alone would cause inconsistency in the exercise of authority and enforcement as well as make it more difficult to attract capital to Canadian securities markets. In a Quebec case, *Gregory & Co. v. Quebec Securities Commission*, the court determined that a promoter, doing business in Quebec was trading in securities in Quebec even though the promoter mailed bulletins to prospective investors in provinces other than Quebec.⁵³⁵ In *R. v. W. McKenzie Securities Ltd.*, a court in the province of Manitoba determined that an Ontario broker-dealer was trading in se-

⁵³³ 1 VICTOR P. ALBOINI, *SECURITIES LAW AND PRACTICE* § 11.1.5 at 11-28 (2d ed. 1984).

⁵³⁴ The definition also includes an offer to sell. *Id.*

⁵³⁵ *Id.* § 11.1.5 at 11-29 (citing [1961] S.C.R. 584).

curities in Manitoba because it mailed literature and made telephone calls to Manitoba residents.⁵³⁶

In *Gregory*, the promoter had three offices in Quebec and its registration as a broker in Quebec had been revoked for refusing to cease publishing his weekly bulletins. Subsequently, the promoter alleged lack of jurisdiction in Quebec even though his activities included: (1) preparing and printing its bulletin in Quebec; (2) soliciting trades in securities listed on the Montreal Exchange from non-Quebec residents; (3) asserting its ability to execute trades through the Montreal Exchange; (4) accepting payment for trades from non-Quebec residents in its offices in Quebec; and (5) maintaining its bank accounts in Quebec.⁵³⁷ In addition, the shares of companies in which the promoter solicited to non-Quebec residents could only be transferred in Quebec. Trading in securities was found by the court based on the fact that the shares were traded on the Montreal Exchange. The court might not have reached the same result if the company's shares were traded on an exchange located outside of the province of Quebec.

In *McKenzie*, the Manitoba court determined that trading occurred within Manitoba's jurisdiction even though the dealer was registered in Ontario because: (1) the dealer made telephone calls and mailed literature to a Manitoba resident for the purpose of soliciting orders to purchase shares in various companies and (2) the Manitoba resident responded to the broker-dealer's solicitations by agreeing to purchase such shares and paying for his purchase with a check from his bank account maintained at a Manitoba bank and mailing the check to the dealer in Toronto.⁵³⁸ The Court determined that the trade took place at least in part in Manitoba and that

*[t]he Securities Act of Manitoba is not designed to reach out beyond provincial borders and to restrain conduct carried on in other parts of Canada or elsewhere. Its operation is effective within Manitoba, and nowhere else. For a person to become subject to its restraint he must trade in securities in Manitoba. This is not to say that a non-resident of Manitoba can never become subject to the controls of the statute. If the activities of such a non-resident can fairly and properly be construed as constituting trading within the province, then they fall within the purview of the Act.*⁵³⁹

⁵³⁶ *Id.* (citing [1972] S.C.R. 409).

⁵³⁷ *Gregory & Co. v. Quebec Sec. Comm'n*, [1961] S.C.R. 584, 586-89.

⁵³⁸ ALBOINI, *supra* note 533, at 11-30.

⁵³⁹ *Id.* See also *Midland Doherty Ltd. v. Zonailo*, [1982] 36 B.C.L.R. 326, 339 (giving supplementary reasons for judgment); *rev'd on other grounds*, [1983] 43 B.C.L.R. 138 (B.C. Ct. App.); *In re a Company*, June 1968 O.S.C.B. 129, 132 ("[F]urnishing the potential purchaser at his request with a prospectus and an order form" constitutes trading be-

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 493

Moreover, to add to the lack of consistency and clarity, each province has discretion to provide a waiver to persons with respect to determining location of trade under its securities act and applicable case law. In *In the Matter of a Company*, the OSC decided not to impose sanctions based on equitable reasons despite the fact that precedent indicated violations of the OSA requiring the imposition of sanctions.⁵⁴⁰ In *Company*, the OSC alleged that a company, through its three directors, violated the OSA by trading as an issuer and by way of primary distribution in Ontario without an Ontario prospectus. The company was registered in British Columbia and had a British Columbia prospectus. The company's three directors were residents of British Columbia, but one of the directors was formerly a resident of Ontario and was also "known to a number of people in [Ontario] . . . to have brought a mine to success in each of two former ventures. Without solicitation from the company or its directors these people and their friends . . . wrote to the company in Vancouver [British Columbia] requesting a prospectus."⁵⁴¹ Based on advice from the issuer's lawyer, the issuer sent copies of its British Columbia prospectus and a subscription form to the people residing in Ontario, issued shares to the Ontario residents upon receipt of their checks, and completed subscription forms. The OSC determined that the company and its three directors violated the OSA by distributing and trading the company's securities in Ontario without an Ontario registration and prospectus. The OSC held that

by using the Post Office to place the British Columbia prospectus and the order form in the hands of the prospective purchasers in Ontario . . . [the company and its directors had 'traded' in Ontario and] . . . [t]he fact that there was no act of solicitation and the fact that the final acts of sale and issue of the shares took place in British Columbia and not in Ontario . . . is beside the point; furnishing the potential purchaser at his request with a prospectus and an order form were acts done in furtherance of a sale and done in Ontario. [S]ending from outside Ontario and in response to a spontaneous request a prospectus and an order form to a person in Ontario constitutes sufficient dealing in Ontario with members of the Ontario public to call for their protection by the supervisory devices of registration and prospectus filing exercised by the Ontario Securities Commission in pursuance of the Ontario Act.⁵⁴²

In *Company*, the discretion exercised by the OSC in not imposing sanctions despite recognized violations of the OSA ad-

cause such activities are considered "acts done in furtherance of a sale and done in Ontario.")

⁵⁴⁰ *In re a Company*, June 1968 O.S.C.B. at 133.

⁵⁴¹ *Id.* at 130–32.

⁵⁴² *Id.* at 132–33.

versely impacts Canada's securities regulatory framework. Clarity and consistency in enforcement of securities acts are essential to a globally competitive securities market. Such uneven enforcement of the OSA reduces the consistency and clarity of the Canadian securities regulatory framework. It also makes it more difficult for lawyers to advise their clients when they are unsure of whether a particular regulatory requirement might be waived by one of Canada's thirteen provincial securities regulators. Lack of consistency in enforcement of provincial securities laws leads to increased costs to ensure compliance with applicable requirements in the fragmented Canadian securities regulatory framework.

a. NASDAQ Canada⁵⁴³ and the Renegade Province of Quebec

NASDAQ Canada is an excellent example of why selective federal preemption implemented by a securities regulator at the federal level is necessary to compete successfully in the global securities market. NASDAQ Canada was established in response to Canada's reorganization of its securities markets in order to increase its competitiveness in the global securities market. Initially, Canadian SRAs understood that consolidation was required in order to maintain the viability of Canada's securities markets in the global securities market. However, the agreement brokered in 1999 to consolidate Canada's securities market completely disintegrated when the province of Quebec, and subsequently British Columbia, decided to withdraw from the 1999 agreement and allow NASDAQ U.S. to establish NASDAQ Canada in Montreal, Quebec.⁵⁴⁴ As a consequence, the Canadian securities regulatory framework was essentially invaded by the U.S. securities regulatory framework. The U.S., through NASDAQ Canada, now had regulatory control over a portion of Canada's securities markets, and Quebec again had equity trading within the province.

Quebec amended its laws to allow the creation of NASDAQ Canada and provide primary regulatory control of NASDAQ Canada to the U.S. "[NASDAQ] Canada is a recognized [SRO] under Quebec law for purposes of carrying on business in Que-

⁵⁴³ NASDAQ Canada was initially established to become a "standalone Canadian [securities] market on the [NASDAQ] trading platform . . . Phase 2 of [NASDAQ] Canada[] was to have been an ambitious attempt to create an electronic market competing directly with the Toronto Stock Exchange and nascent alternative trading systems." It was going to be "a new exchange in Canada . . . trad[ing] Canadian stocks in Canadian dollars." Marotte, *supra* note 357, at B5.

⁵⁴⁴ NASDAQ Canada's incentive package included a 10-year tax holiday. Marotte, *supra* note 543.

bec. NASDAQ Canada's parent, [NASDAQ U.S.], is similarly recognized as an SRO under Quebec law for purposes of carrying on business in Quebec."⁵⁴⁵ Moreover, "[t]he rules of NASDAQ Canada are those of NASDAQ [U.S.] and are overseen by the [U.S.] Securities and Exchange Commission . . ."⁵⁴⁶ NASDAQ Canada allows the Canadian dealer to have an NASD affiliate incorporated in the U.S. but co-located within the Canadian dealer's office in Quebec. Dually-engaged employees are also permitted, "thus reducing costs and enabling better compliance and regulatory controls."⁵⁴⁷ The Canadian dealer's NASD affiliate must be registered with the Commission and must be a member of the NASD. Accordingly, the Canadian dealer's NASD affiliate is not required to become registered in Quebec nor to become a member of the IDA.⁵⁴⁸ However, the Canadian dealer of the NASD affiliate must remain an IDA member in good standing.⁵⁴⁹ Quebec also attempts indirect regulation of the NASD affiliate by requiring the Canadian dealer to: (a) have dually-engaged employees with its NASD affiliate; (b) require its NASD affiliate to comply with NASD rules and, therefore, with U.S. securities laws, rules, and regulations; (c) require its NASD affiliate to have only exempt clients and to only engage in U.S. transactions; and (d) require its NASD affiliate to consent to the jurisdiction, in any action or proceedings, of any provincial or provincially-recognized SRA in the province.⁵⁵⁰ Apparently, Quebec believes that it has maintained regulatory control by sharing regulatory authority with the U.S. However, this patchwork regulatory framework probably makes the Canadian securities regulatory framework even more difficult to navigate and it may have an anticompetitive effect in the global securities market.

Supporters of NASDAQ Canada contend that the primary benefit of NASDAQ Canada is to allow small to medium broker-

⁵⁴⁵ Romano, *supra* note 358, at 1. NASDAQ Canada was recognized similarly by the province of British Columbia. In both provinces, registered dealers establish affiliates (incorporated in the U.S. but headquartered in the province), as well as the facilities, of the applicable Canadian dealer. As previously discussed, this allowed such affiliates to trade directly through NASDAQ U.S.'s facilities. *Id.* at 3.

⁵⁴⁶ *Id.* at 2. According to Mr. Romano, prior to the establishment of NASDAQ Canada, many Canadian dealers transmitted orders to NASDAQ U.S. indirectly using ECNs, their U.S. broker/dealer affiliates or other U.S. broker-dealers, who then transmitted such orders directly to [NASDAQ] U.S. However, such indirect access methods were "administratively cumbersome." Direct access would "reduce costs, enhance market visibility and transparency for Canadian dealers, . . . reduce customer risk, and [benefit] Canadian capital markets generally." *Id.*

⁵⁴⁷ *Id.* at 3.

⁵⁴⁸ Provided that the NASD affiliate only has clients classified as accredited investors and other clients who do not require Canadian registration (i.e., non-exempt clients) and only execute U.S. transactions. *Id.*

⁵⁴⁹ *Id.*

⁵⁵⁰ *Id.* at 3-4.

dealers to directly, and therefore less expensively, access U.S. capital markets.⁵⁵¹ Unfortunately (or fortunately, according to one's perspective), the Canadian securities marketplace operates next to the largest securities marketplace in the world, therefore making it vulnerable to being gobbled up by the U.S. securities markets, or at least becoming a "branch investment banking" securities market for the U.S. securities markets.

NASDAQ Canada may be the first step in diminishing the relevance of the Canadian securities markets in the global securities market. This diminution of importance would lead to Canada taking a "back seat" on the bus of meaningful participation in shaping the regulatory structure of the global securities market.

C. Selective Federal Preemption Implemented by a Federal Securities Regulator—Lesson Learned

The U.S. and Canada are quite similar in their approaches to the framework for securities regulation; the primary difference is that the U.S. has a single federal regulatory authority, the Commission, to guide policy and to ensure consistency both domestically and in the global securities marketplace. The U.S.'s understanding of the importance of a single federal regulatory authority is reflected in the steady increase in federal preemption in its securities regulatory framework. Given the experiences of our neighbor to the north, increasing federal preemption in the U.S. securities regulatory framework is the better strategy for at least maintaining the competitiveness of securities markets in the global securities marketplace; regulatory power selectively consolidated in a federal regulator, the Commission, enables the U.S. to speak with one voice in the global securities marketplace, craft a coherent policy, and provide consistent enforcement of its securities regulatory framework. This is important from a global perspective because regulatory authorities in the global securities market only need to negotiate with one entity when dealing with the U.S. securities markets. In Canada, they must negotiate with thirteen provinces if they wish to access all Canadian securities markets. This is the primary reason that the Commission reacted so strongly to the actions of New York Attorney General Spitzer. Given the importance of the NYSE, domiciled in Spitzer's jurisdiction, in the overall U.S. securities regulatory framework, actions taken in the state of New York have policy implications for all U.S. securities markets. Although Spitzer is to be applauded for his excellent work, it is not in the best inter-

⁵⁵¹ *Id.* at 3.

2006] *Federal Preemption in U.S. Securities Regulatory Framework* 497

ests of U.S. securities markets to allow one state—New York—to set policies for all U.S. securities markets.⁵⁵² Moreover, market participants, especially issuers, should not be held to a higher standard in one state despite its preeminence in the U.S. securities markets. A domestically and globally competitive securities market must treat substantially similar conduct equally. This means that Spitzer, and any other SSRA, must consult with the Commission to ensure that the U.S. securities markets continue to “speak with one voice” and therefore remain competitive in the global securities market.

Lest I offend my brethren to the north, they, too, realize the importance of selective federal preemption implemented by a federal securities regulator. The Canadian federal government (Ottawa), along with market participants and issuers, recognizes the need for a single federal regulator to compete successfully in the global securities market. Ottawa realizes that Canada’s fragmented securities regulatory framework causes significant transaction delays and the imposition of onerous costs because market participants must deal with thirteen SRAs. Moreover, a senior securities counsel in Canada asserted that “[a]ll other problems pale in comparison to the lack of harmonization” between Canada’s thirteen provinces.⁵⁵³ Moreover,

at the end of the day, [Canada] will still have 13 securities regulators instead of one. International investors, and indeed Canadians, will still be drawn to the clarity of the U.S. regime, over the relative complexity of [Canada’s]. And Canadian public companies will continue to overwhelmingly call for more dramatic reform, to no avail. Only in Canada.⁵⁵⁴

“[I]t is simply not credible to argue that the involvement of multiple regulators that exists [sic] within the CSA can achieve the efficiency of a national securities regulator.”⁵⁵⁵ Under Canada’s securities regulatory framework, “it is not entirely clear who, if anyone, speaks for Canada.”⁵⁵⁶ Moreover, Barbara Stymiest, the CEO of the TSX, echoing the sentiments of the Ontario’s Minister

⁵⁵² Note that New York, like Ontario, houses the largest and most powerful securities markets and exchanges in the nation’s securities markets. See NYC.com, Financial District (Lower Manhattan), http://www.nyc.com/visitor_guide/Financial_District_Lower_Manhattan.75852/editorial.aspx (last visited Oct. 23, 2006) (noting that New York “houses some great economic powerhouses, including the headquarters of major banks, the New York Stock Exchange, [and] the World Financial Center”).

⁵⁵³ REGULATORY BURDEN TASK FORCE, REPORT TO THE ONTARIO SECURITIES COMMISSION 10 (2003), available at http://www.osc.gov.on.ca/About/Governance/Accountability/ga_20031212_rbtfrpt.pdf.

⁵⁵⁴ Michael Den Tandt, *Charest Won’t Want Single Regulator*, GLOBE AND MAIL (Can.), Apr. 17, 2003, at B2.

⁵⁵⁵ FIVE YEAR REVIEW COMMITTEE FINAL REPORT, *supra* note 34, at 37 (quoting comment letter on the Issues List of Torys LLP).

⁵⁵⁶ *Id.*

of Finance, stated that

the current system, fractured as it is, burdens companies with duplicative costs and impairs Canada's stature on the world stage. . . .

. . . .

[Moreover,] Canada must "get its act together" and begin speaking with a unified voice. The U.K. securities watchdog, for instance, refuses to open up trading on its exchanges to Canadian brokerages on a province-by-province basis, while China's regulator has expressed its displeasure at having to negotiate a recent deal with four separate provinces⁵⁵⁷

The author of this article would extend this sentiment one step further. Most likely, Canadian companies would also bypass Canadian capital markets given the proximity of the U.S. securities markets if their securities could be traded in both Canadian and U.S. dollars. In fact, Level II of NASDAQ Canada included allowing users to trade in Canadian companies listed on NASDAQ Canada from either the U.S. or Canada *simultaneously* in either Canadian or U.S. dollars.⁵⁵⁸ If this were to occur, Canadian issuers would probably be sorely tempted to bypass Canadian capital markets altogether.

CONCLUSION

*Federal preemption should be crafted to "clear away some of the regulatory underbrush that adds to the cost of capital[,] without compromising investor protections."*⁵⁵⁹

Selective federal preemption administered by a federal securities regulator is the better regulatory model for competing successfully in the global securities market. Congress apparently understands this, based on the trend of increasing selective federal preemption in the securities regulatory framework of the U.S. securities markets. State authority to bring securities fraud cases should be preserved in the delicate balance of selective federal preemption because state securities regulators have a strong interest in putting away "the bad guys" within their jurisdictions. "Bringing suit for common law fraud in no way interferes with the regulatory mandates of the [federal government] [T]he purpose underlying state common law fraud actions—to deter fraudulent practices—is consistent with federal securities

⁵⁵⁷ Sinclair Stewart & Heather Scofield, *Ottawa to "Act Quickly" to Pave Way for National Securities Watchdog*, GLOBE AND MAIL (Can.), Mar. 24, 2004, at B12.

⁵⁵⁸ Press Release, NASDAQ, Helen Kearns Named President of NASDAQ Canada (May 1, 2001), available at http://www.nasdaq.com/newsroom/news/pr2001/ne_section01_143.html.

⁵⁵⁹ Rachel Witmer, *Legislation: Congress Passes Major Securities Bill; Clinton Expected to Sign It* OMB Says, 28 Sec. Reg. & L. Rep. (BNA) 1211, 1212 (1996).

law . . . as both seek to deter fraud.”⁵⁶⁰ Federal preemption must be carefully used to “‘maintain uniformity and certainty’ in U.S. securities markets so that they may remain ahead of markets ‘in London, Frankfurt, Tokyo or Hong Kong.’”⁵⁶¹ Moreover, allowing the Commission to operate exclusively in certain areas in which it previously shared regulatory authority with state SRAs led to a reduction in cost, complexity, and redundancy.

Federal preemption also supports the flexibility required to compete successfully in the global securities marketplace. Enron, Worldcom, Adelphia, and their ilk dealt a severe blow to investor confidence and the perceived transparency and fairness of U.S. securities markets. Without a regulatory framework incorporating selective federal preemption and a federal securities regulator, the necessarily rapid regulatory response to shore up investor confidence and the perceived fairness and transparency of U.S. securities markets would likely not have occurred. A swift response was necessary to ensure that U.S. securities markets remain the premier markets in the world. A tarnished U.S. securities marketplace could result in foreign investors less likely to invest in U.S. issuers, depriving issuers of an important source of capital. In turn, investors would have less investment opportunities because issuers would be less willing to access capital markets perceived as lacking fairness and transparency.

It is obvious that the principle of cooperation or harmonization of securities laws between state or provincial securities regulators is not feasible. The primary problem is that none of the members of the CSA or NASAA are required to adopt uniform securities laws and regulations that have not been adopted by their legislators. Also, wholesale adoption of the provisions of uniform laws is simply not the norm.

The consequence of not “speaking with one voice” is, at best, becoming irrelevant in setting policy in the regulatory framework for the global securities market.

⁵⁶⁰ *Common Law Fraud Claims Not Preempted By Federal Securities Law, Court Concludes*, 33 Sec. Reg. & L. Rep. (BNA) 1634, 1635 (2001).

⁵⁶¹ Witmer, *Litigation Reform*, *supra* note 3, at 1402.