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Cheryl C. Nichols

Howard University School of Law, cherylnichols1@mac.com

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Mutual Recognition Based on Substituted Compliance: An Integral Component of the SEC's Mandate

Cheryl Nichols¹

I. Introduction

The U.S. Securities and Exchange Commission (“SEC”) must utilize mutual recognition based on substituted compliance to maintain American preeminence in the global securities market. In fact, mutual recognition based on substituted compliance facilitates the SEC’s ability to fulfill its statutory mandate-- to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.² Currently, all US investors may have access to foreign exchanges in the global securities market without the protection of the U.S. federal securities laws; at a minimum, the SEC must take action to fulfill the first prong of its statutory mandate--to protect investors. In addition, maintaining efficient markets and facilitating capital formation requires that U.S. securities markets remain competitive in the U.S. and the global securities market. This means that business as usual is no longer a viable option for the SEC (follow U.S. rules only or no access to U.S. securities markets) because other markets in the global securities market are becoming more attractive due to increasing investor protections, greater transparency and liquidity, and decreasing transaction costs. These changes in the global securities market require the SEC to amend its oversight of the U.S. securities markets to incorporate mutual recognition based on substituted compliance. This means assessing the regulatory comparability of foreign securities regulatory frameworks and providing exemptions based on such assessments. The SEC seriously began a conversation about mutual recognition based on substituted compliance with the publication of an article written by the Director and Senior Counsel of its Office of International Affairs (OIA), Ethiopia Tafara, and Robert J. Peterson, respectively, entitled *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*.³ In this article, Tafara and Peterson sketch a broad picture of how such a

¹ Associate Professor of Law, Howard University School of Law. J.D., Georgia State University; M.B.A., University of Miami. The author wishes to thank the following people for their invaluable assistance in writing this article: Andrew Gavil, Professor of Law, Howard University School of Law, and her research assistant Anthony Hays.

² The SEC, What We Do, available at <http://www.sec.gov/about/whatwedo.shtml> See also, SEC, 2004-2009 STRATEGIC PLAN 4, available at <http://sec.gov/about/secstratplan0409.pdf>.

³ 48 Harv. Int’l L.J. 31 (Winter 2007). Yes, the Tafara and Peterson article included the usual SEC deniability statement-- “The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any SEC employee or Commissioner. This Article expresses the authors' views and does not necessarily reflect those of the Commission, the Commissioners, or other members of the staff.” 48 Harv. Int’l L.J. 31, 68, FN1.

regulatory framework might be designed and identify this new regulatory model as substituted compliance (“Substituted Compliance”).⁴ Tafara and Peterson assert that the goal of Substituted Compliance is to “...directly benefit U.S. investors by providing them with greater investment opportunities at lower costs, while offering them greater protections against cross-border fraud than they currently have. At the same time, capital formation in the United States would be strengthened by increasing competition among financial service providers in the U.S. market.”⁵ Tafara and Peterson base their assertions on key assumptions enumerated in their article:

- (1) U.S. investors (retail and institutional) actively seek to invest in foreign securities and would benefit from lower transaction costs and additional information about the level of protection different jurisdictions offer investors.
- (2) U.S. investors would benefit from increased competition in the market for financial services.
- (3) U.S. investors are capable of assessing risks in non-U.S. jurisdictions with conceptually similar regulatory frameworks provided the [SEC] has robust regulatory oversight and enforcement-sharing agreements in place.⁶

Tafara and Peterson asserts that if these key assumptions are correct, Substituted Compliance “...offers investors greater choice at less cost and builds an alliance of jurisdictions committed to high standards of investor protection, thus providing U.S. investors with benefits that greatly exceed the risks.”⁷ In the author’s opinion, the primary benefit of mutual recognition based on substituted compliance is the building of an alliance of jurisdictions because US preeminence in the global securities market is most likely to be maintained by building such an alliance of jurisdictions. The SEC can no longer afford to stand alone and require all participants in the global securities market to comply with its rules to access the U.S. securities markets because of the increasing investor protection, efficiency, fairness, and transparency in the global securities market. It is conceivable that in the near future, without such alliances with other like-minded countries, it may be impossible to maintain US preeminence in the global securities market. Now, there are viable alternatives to investors and market participants in the global securities market, other than the U.S. securities markets. These viable alternatives to investors and market participants in the global securities market include London, Tokyo, and Japan. In addition, China’s securities markets are growing and changes to its regulatory framework will likely make it a more viable competitor in the global securities market. In essence, the SEC seems to have recognized that, in the near future, it will no longer be able to dictate to the global securities market and is seeking to maintain US

⁴ 48 Harv. Int’l L.J. at 32. Apparently, this term became unacceptable subsequent to the publication of the Tafara and Peterson article and now the term mutual recognition (based on substituted compliance) is being used instead in SEC publications. This article uses the terms mutual recognition and Substituted Compliance interchangeably.

⁵ 48 Harv. Int’l L.J. at 56

⁶ 48 Harv. Int’l L.J. at 68

⁷ 48 Harv. Int’l L.J. at 68

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preeminence by creating alliances with securities regulators in foreign countries with deep securities markets and comparable regulatory frameworks.

In March 2008, the SEC announced that it would begin to consider mutual recognition based on substituted compliance arrangements with its regulatory counterparts in other countries.⁸ The SEC began negotiating with Australia and also intends to pursue mutual recognition arrangements with the European Commission and the Committee of European Securities Regulators.⁹ In May 2008, the SEC announced that it was negotiating a process agreement with four Canadian securities regulators for a U.S.-Canada mutual recognition based on substituted compliance arrangement.¹⁰ The purpose of this process agreement is to create a framework to implement mutual recognition based on substituted compliance with the four Canadian provinces in which the majority of securities transactions occur--Ontario, Quebec, British Columbia, and Alberta.¹¹ It is appropriate that the U.S. should begin this process with Canada because it has had a formalized ongoing relationship with certain Canadian provinces regarding enforcement, there are significant cross-border transactions between the U.S. and Canada,¹² and mutual recognition based on substituted compliance already exists in the form of Nasdaq Canada operating in the provinces of Quebec and British Columbia. Nasdaq Canada, an affiliate of the U.S.-based and regulated Nasdaq Stock Market, has provided direct access to all Nasdaq Stock Market listed securities to Canadian investors through computer terminals installed in certain Canadian broker/dealers. Specifically, it has allowed a foreign exchange--regulated by its home country regulator (the SEC)--to access all Canadian investors *within the borders* of Quebec and British Columbia.¹³

This article proposes that Tafara and Peterson's Substituted Compliance model is a viable method of maintaining US preeminence in the global securities market, without violating the SEC's statutory mandate. The viability of Substituted Compliance is demonstrated by analyzing a comparable regulatory model constructed to establish Nasdaq Canada. Nasdaq Canada is essentially a mutual recognition regulatory system based on substituted compliance. Nasdaq Canada allowed a foreign trading screen--the Nasdaq Stock Market in the US--direct access to all investors in the Canadian provinces

⁸ SEC, News and Public Statements, available at <http://www.sec.gov/news/press/2008/2008-98.htm> (last visited May 29, 2008).

⁹ The SEC, News and Public Statements, available at <http://www.sec.gov/news/press/2008/2008-98.htm> (last visited May 29, 2008).

¹⁰ The SEC, News and Public Statements, available at <http://www.sec.gov/news/press/2008/2008-98.htm> (last visited May 29, 2008).

¹¹ The SEC, News and Public Statements, available at <http://www.sec.gov/news/press/2008/2008-98.htm> (last visited May 29, 2008).

¹² "Since 1988, Canadian securities regulators and the [SEC] have had formal mechanisms in place to assist each other in enforcement investigations. Since 1990, the [SEC] and Canada's securities regulators have participated in the Multi-Jurisdictional Disclosure System that permits issuers in the United States and Canada to use the same disclosure forms when selling securities in each other's markets." The SEC, News and Public Statements, available at <http://www.sec.gov/news/press/2008/2008-98.htm> (last visited May 29, 2008).

¹³ Department of Finance Canada, Canada's Financial Services Sector, available at http://www.fin.gc.ca/toce/2005/cansec05_e.html.

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of Quebec and British Columbia; Nasdaq Canada was regulated primarily by the SEC with some regulatory oversight by the securities commissions in Quebec and British Columbia. In essence, the securities commissions of Quebec and British Columbia conducted a comparability assessment and determined that they could meet their statutory mandates by allowing the SEC to be the primary regulator of Nasdaq Canada, even though the U.S. securities markets regulatory framework was not exactly the same as the securities regulatory frameworks of Quebec and British Columbia. Accordingly, a hybrid model of mutual recognition based on substituted compliance is recommended. This hybrid model (“MRSC”) relies primarily on the framework and key assessment criteria described in Tafara and Peterson’s Substituted Compliance model with certain structural modifications from the Nasdaq Canada model. MRSC, however, focuses exclusively on assessing the regulatory comparability of foreign exchanges; it expressly excludes regulatory comparability assessment of members of a foreign exchange. MRSC is designed to allow the SEC to assess regulatory comparability for foreign exchanges effectively.

This article focuses on the part of Substituted Compliance, which allows foreign exchanges direct access to all U.S. investors. That is, allowing foreign exchanges direct access to U.S. investors *within* the U.S. *without registering with the SEC*. It will not consider the part of Substituted Compliance that allows foreign broker/dealers to access U.S. investors inside the U.S. without registering with the SEC.

Section II of this article provides a summary description of the global securities market with an emphasis on the regulatory framework for national stock exchanges required to register with the SEC using the Nasdaq Stock Market as an example. Section III of this article analyzes U.S. investor access to the global securities market and the Substituted Compliance model proposed by Tafara and Peterson; it also demonstrates that Nasdaq Canada is indeed a model of mutual recognition based on substituted compliance. Lastly, Section III proposes a hybrid model—MRSC—for use by the SEC in assessing the comparability of the regulatory frameworks of foreign exchanges. Section IV concludes by recommending that the SEC use MRSC, with respect to foreign exchanges, to begin to build alliances between the U.S. and like-minded countries to maintain US preeminence in the global securities market.

II. The Global Securities Market and the Regulation of National Exchanges in the U.S. Securities Markets

The global securities market consists of domestic securities markets throughout the world that are intertwined and interconnected using advanced technology. Today, advanced technology facilitates cross-border capital flows quickly anywhere in the world. Increasingly domestic securities markets, such as the U.S. securities markets, are being integrated into the global securities market resulting in “competing, international combinations of stock exchanges” allowing investors “to trade any stock, any time, anywhere in a linked forum.”¹⁴ Moreover, the global securities market “...is leading to a

¹⁴ 3D Harold S. Bloomenthal & Samuel Wolff, Securities and Federal Corporate Law §23:34, at 23-73 (2d

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growing number of companies wishing to raise capital in more than one country [and] [i]nvestors ... looking at integrated, or interconnected, international markets in order to maximiz[e] their return and spread their capital risk.”¹⁵ Moreover, “[m]ultinational securities firms now conduct business around the world and around the clock. Exchanges and trading systems also operate on a cross-border basis.”¹⁶

Growing competition in the global securities market has forced the two largest U.S. exchanges to upgrade and expand their trading systems. The New York Stock Exchange (“NYSE”) and the Nasdaq Stock Market sought strategic combinations designed to increase their competitiveness in the global securities market. The NYSE combined with Euronext¹⁷ creating a holding company, NYSE Euronext, which brought together “six cash equities exchanges in five countries and six derivatives exchanges.”¹⁸ NYSE Euronext operates the NYSE as a wholly-owned subsidiary, which is registered with the SEC as a national securities exchange under § 6 of the Securities Exchange Act of 1934 (“Exchange Act”).¹⁹ The Nasdaq Stock Market combined with the OMX Nordic exchanges to create a holding company, Nasdaq OMX Group, Inc. (Nasdaq OMX), which operates the Nasdaq Stock Market²⁰ as a wholly-owned subsidiary. The Nasdaq Stock Market is registered with the SEC as a national securities exchange pursuant to § 6 of the Exchange Act. In addition, Nasdaq OMX brought together sixty (60) clients in fifty (50) countries world-wide, including significant financial market centers such as Hong Kong, Singapore, and Australia. Moreover, both parent holding companies for the NYSE and the Nasdaq Stock Market are publicly traded Delaware corporations, which facilitates greater access to capital to fund further competitive efforts in the global securities market.

Currently, U.S. securities markets are preeminent in the global securities market. U.S. preeminence is based, in part, on the liquidity, transparency, and lower cost of

ed. 2006).

¹⁵ Federation of European Securities Exchanges, The Federation, <http://www.fese.be/federation/index.htm> (last visited Jul. 30, 2008); *see also*, Reena Aggarwal, *Demutualization and Corporate Governance of Stock Exchanges*, 15 J. Applied Corp. Fin. 105-13, (2002).

¹⁶ Wise Persons’ Committee to Review the Structure of Securities Regulation in Canada, It’s Time--WPC Final Report 2 (2003) available at http://www.wise-averties.ca/main_en.html (last visited July 2008).

¹⁷ In fact, prior to its combination with Euronext in December 2006, the NYSE was forced to change its business model from an exclusively auction style market to a hybrid market--auction and electronic market--by merging with Archipelago Exchange, a fully electronic exchange. Press release, NYSE, 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>. The NYSE's CEO determined that the merger was necessary because publicly held exchanges in “London, Frankfurt, Toronto and Sydney [were] aggressively competing to expand their reach...” and market share in the global securities market. Press Release, NYSE, 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.

¹⁸ NYSE Euronext Merger, NYSE Euronext available at:

<http://www.nyse.com/about/newsevents/1149243292355.html> (last visited May 29, 2007).

¹⁹ 15 U.S.C. § 78f.

²⁰ Nasdaq Stock Market is incorporated under Delaware corporations law as Nasdaq Stock Market LLC.

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capital of its securities markets.²¹ A key contributing factor to U.S. preeminence is its large retail investor class.²² The U.S. securities markets have the largest retail investor class in the world.²³ This large pool of retail investors provides access to greater amounts of capital than those countries with a smaller retail investor class. Another key contributing factor to U.S. preeminence is its competitive securities regulatory framework. The U.S. securities markets regulatory framework engenders confidence among investors and market participants²⁴ alike that they will be treated fairly in dealings in the U.S. securities markets.²⁵ In fact, other domestic securities markets in the global securities markets have adopted US-style regulatory frameworks which have allowed them to become more competitive in the global securities market. Domestic securities markets in London, Europe, parts of Asia, and the Middle East "...increasingly offer 'American'-style expertise and deep pools of international investors."²⁶ Such markets are also enhancing their regulatory frameworks in many cases to mimic U.S.-style regulation (both pre-SOX and post-SOX), but with less litigation risks.²⁷ To no one's surprise, this

²¹ There are no other securities markets "...with the size, liquidity, and depth of the...[U.S. securities markets]..." Speech by Commissioner Paul S. Atkins U.S. Securities and Exchange Commission, Conference co-sponsored by the American Enterprise Institute and the Brookings Institution Washington, D.C., April 20, 2007: *Is Excessive Regulation and Litigation Eroding U.S. Financial Competitiveness?* In 2005, the U.S. share of global stock market activity was approximately 50 percent. Interim Report of the Committee on Capital Markets Regulation, 2 (Nov. 30, 2006). The U.S. share of global stock market activity was higher in 2000 at 60 percent at "the peak of the U.S. dot.com bubble. Id. Also, "...[financial firms headquartered in the [U.S.] top the league tables in mergers and acquisitions, as well as equity and debt capital-raising...." Sustaining New York's and the US' Global Financial Services Leadership 38 (Jan. 18, 2007), http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NYREPORT%20FINAL.pdf [hereinafter McKinsey Report].

²² A retail investor is "[a] person who buys or sells securities for his or her own account. A retail investor is also referred to as an individual investor. See, FINRA Glossary, available at: <http://www.finra.org/Resources/Glossary/p011041>, (last visited July 22 2008).

²³ Between 1983 and 2005, the number of retail investors in the U.S. increased from 15.9 million to 56.9 million. Speech by SEC Commissioner: Remarks Before the ABA Section of International Law by Commissioner Annette L. Nazareth, U.S. Securities and Exchange Commission, Fairmont Hotel, Washington, D.C., May 4, 2007.

²⁴ "... [R]evenues generated by investment banking and sales and trading activities are still larger in the United States than anywhere else." *Interim Report of the Committee on Capital Markets Regulation*, 2 (Nov. 30, 2006). US revenues totaled \$109 billion (45 percent of the global total) versus Europe's \$98 billion (40 percent)." Id.

²⁵ According to Commissioner Annette L. Nazareth ("Commissioner Nazareth"), our securities regulatory framework is "...a key factor in earning the confidence of investors and fueling the growth of ..." the U.S. securities markets. Furthermore, Commissioner Nazareth states that, "[t]here are three key components of our regulatory framework as set out by Congress. We are charged with protecting investors, maintaining fair, orderly and efficient markets, and facilitating capital formation. Virtually all that we do at the Securities and Exchange Commission, and all that we mandate others who we regulate to do, are in furtherance of these three important goals." Speech by SEC Commissioner: Remarks Before the ABA Section of International Law by Commissioner Annette L. Nazareth, U.S. Securities and Exchange Commission, Fairmont Hotel, Washington, D.C., May 4, 2007.

²⁶ City Journal, Wall Street Worries New York should heed (some of) McKinsey's suggestions, by Nicole Gelinas (Jan. 22, 2007), <http://www.city-journal.org/html/eon2007-01-22ng.html>

²⁷ The New York Times, Business Section, Bush Aides and Business Meet on Shift in Regulation, Stephen Labaton (Mar. 13, 2007). According to Chairman Cox, other countries are adopting some of provisions

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has lead to a bit of “hand-wringing” by the U.S. securities industry that U.S. securities markets are becoming less competitive in the global securities market because its regulatory framework is too onerous. The Committee on Capital Markets Regulation (“CCMR”) contends that the competitiveness of U.S. securities markets has begun to decline in the global securities market because more new equity capital is being raised outside the U.S.²⁸ In its most recent report, the CCMR stated that from 2003-2005, U.S. market share of all global initial public offerings (“IPOs”) was approximately 25 percent, 14 percent, and 6 percent, respectively. Moreover, twenty-four of the twenty-five largest global IPOs in 2005 and nine of the ten largest global IPOs in 2006 occurred outside of the U.S.²⁹ Finally, the CCMR report stated that “... where foreign companies are cross-listed on U.S. and foreign markets, particularly those from developed countries, their principal trading volume is increasingly located in their home market.”³⁰ However, the author contends that this merely means that issuers and other market participants have more choices when accessing securities markets in which to raise capital. Even the SEC asserts that, the “growth of capital markets outside the U.S. [is] a natural consequence of economic growth and market maturation elsewhere.”³¹ The adoption of more U.S.-style securities regulatory frameworks has facilitated an increase in the liquidity, depth, and transparency of other domestic securities markets in the global securities markets. Accordingly, such securities markets have become more attractive to market participants and investors alike. In fact, U.S. - style regulation is very similar to the regulatory framework supported by a majority of the largest domestic securities regulatory authorities in the global securities market; this securities regulatory framework is best set forth in the *Objectives and Principles of Securities Regulation* published by the International Organization of Securities Regulatory Commissions (“IOSCO”).³² IOSCO has approximately 180 members including the U.S., Germany, Japan, China, Great Britain, and Canada. Its members regulate more than ninety percent of the world’s

SOX in their securities regulatory frameworks. Chairman Cox asserts that “... [c]ompetitiveness is driven by far more than ease of doing business — it’s driven by the integrity of the market and investor confidence. That’s America’s sterling competitive edge.” Speech by SEC Chairman: Remarks to the U.S. Chamber of Commerce’s First Annual Capital Markets Summit: Securing America’s Competitiveness by Chairman Christopher Cox, U.S. Securities and Exchange Commission, Washington, D.C., March 14, 2007.

²⁸ The Committee on Capital Markets Regulation interim report published on November 30, 2006 (“CCMR Report”), CCMR provides further support for its contention that there “a competitiveness shift away from” the U.S. “... by focusing on where [non-U.S. issuers] that were issuing internationally decided to place their first issuances when raising capital outside their home markets.” In 2000, 50 percent of global IPOs conducted by non-U.S. issuers were in the U.S. securities market. In 2005, only 5% of such global IPOs were conducted in the U.S. securities markets. *Id.*

²⁹ Interim Report of the Committee on Capital Markets Regulation, Executive Summary 30 (Nov. 30, 2006).

³⁰ *Id.*

³¹ Speech by SEC Commissioner: SEC Regulation Outside the United States by Commissioner Roel C. Campos, U.S. Securities and Exchange Commission, London, England, March 8, 2007.

³² IOSCO, *Objectives and Principles of Securities Regulation*, IOSCO Pub. Doc. 154 (May 2003), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCO154.pdf>.

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securities markets.³³ Its mission is to promote cooperation and provide expertise to set standards for securities regulatory frameworks in the global securities market.³⁴

IOSCO's *Objectives and Principles of Securities Regulation* (OPSR) represents a consensus among domestic securities regulators of a competitive securities regulatory framework in the global securities market. Essentially, OPSR serves as a model for domestic securities regulators to construct the type of securities regulatory framework that facilitates fair, efficient, and transparent markets within the global securities market. The OPSR is based on three objectives implemented by adhering to thirty principles of securities regulation grouped into eight categories.³⁵ 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.³⁶ Effective investor protection requires, among other things, that issuers and other market participants disclose material information about their investment products and services and that the regulatory framework is designed with a view towards prohibiting manipulative or fraudulent practices in the securities market.³⁷ Ensuring fair, efficient, and transparent securities markets requires, among other things, that market participants perceive the ability to compete fairly and that a comprehensive system of inspection, surveillance, and compliance programs exists to support this perception.³⁸ Reducing systemic risk requires, at a minimum, laws and procedures specifying minimum capital requirements and adequate operations controls for market intermediaries as well as the establishment of efficient and accurate procedures for clearing and settling securities transactions.³⁹

The securities regulatory framework of the U.S. securities markets achieves the three objectives of the IOSCO model for effective competition in the global securities market.⁴⁰ Moreover the IOSCO model allows the SEC to achieve its legislative mandate—to administer and enforce the federal securities laws in order to protect investors, and to

³³ See, IOSCO, Historical Background, <http://www.iosco.org/about/index.cfm?section=history> (last visited ?). Other members include Australia, China, France, and Russia.

³⁴ IOSCO 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.” IOSCO, General Information, <http://www.iosco.org/about/> (last visited Jul. 3, 2005).

³⁵ IOSCO Pub. Doc. 154 at i-iii. The categories are principles relating to the regulator for self-regulation; the enforcement of securities regulation, cooperation in regulation, issuers, collective investment schemes (e.g., mutual funds), market intermediaries (e.g., broker/dealers); and the secondary market (e.g., exchanges, alternative trading systems, and clearing and settlement).

³⁶ *Id.* at i.

³⁷ IOSCO Pub. Doc. 154 at 6-7, 12.

³⁸ IOSCO Pub. Doc. 154 at 5.

³⁹ IOSCO Pub. Doc. 154 at 6-7.

⁴⁰ For a detailed comparison of the regulatory framework of the U.S. securities markets with the IOSCO model, see, Nichols, Cheryl, THE IMPORTANCE OF SELECTIVE FEDERAL PREEMPTION IN THE U.S. SECURITIES REGULATORY FRAMEWORK: A LESSON FROM CANADA, OUR NEIGHBOR TO THE NORTH, Chapman Law Review Vol. 10, No. 2, pp.466-489.

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maintain fair, honest, and efficient markets.”⁴¹ A brief overview of the regulatory framework of the U.S. securities markets follows, with an emphasis on the regulatory framework for national exchanges registered with the SEC.

B. US REGULATORY FRAMEWORK FOR REGISTERED EXCHANGES

The US securities regulatory framework is administered and enforced by the SEC in accordance with the U.S. federal securities laws.⁴² The SEC is also authorized to promulgate rules to implement the regulatory framework prescribed in the federal securities laws.⁴³ The federal securities laws consist of the Securities Act of 1933 (“Securities Act”),⁴⁴ the Exchange Act,⁴⁵ the Trust Indenture Act of 1939 (“Trust Act”),⁴⁶ the Investment Advisers Act of 1940,⁴⁷ and the Investment Company Act of 1940.⁴⁸ In particular, the Exchange Act authorizes the SEC to register, regulate, and oversee market participants in the secondary market, including self-regulatory organizations (“SROs”)⁴⁹ or exchanges such as the Nasdaq Stock Market.⁵⁰ The federal securities laws are based on the principle of full disclosure of all material non-public information⁵¹ required by a reasonable investor to make an informed investment decision; according to the SEC:

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

⁴¹ Government Performance and Results Act (GPRA) 2004 Annual Performance Plan and 2002 Annual Performance Report 16, available at http://www.sec.gov/about/gpra2004_2002.pdf.

⁴² the SEC was established pursuant to § 4 of the Exchange Act.

⁴³ 15 U.S.C. § 78d. The SEC’s enforcement activities are confined to civil and administrative proceedings. It is not authorized to bring criminal actions to enforce the federal securities laws. Only the Office of the U.S. attorney is authorized to bring criminal actions under the federal securities laws. SEC, About the Division of Enforcement, <http://www.sec.gov/divisions/enforce/about.htm>

⁴⁴ 15 U.S.C. §§ 77a-77aa. 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.

⁴⁵ 15 U.S.C. §§ 78a-78nn. The Exchange Act prohibits fraud in the purchase and sale of securities in the secondary market.

⁴⁶ 15 U.S.C. § 77ddd et seq. The Trust Indenture Act of 1939 requires the preparation of a formal agreement between the issuer of bonds and the bondholder (a trust indenture) to conform to certain standards before such securities are offered for sale to the public.

⁴⁷ 15 U.S.C. § 80b-1 et seq. The Investment Advisers Act of 1940 regulates the conduct and operations of investment advisers. In general it requires certain investment advisers to register with the SEC if they are compensated for advising others about securities investments. Generally, investment advisers with at least \$25 million of assets under management must register with the SEC.

⁴⁸ 15 U.S.C. § 80a-1. The Investment Company Act of 1940 regulates the organization and operation of investment companies, e.g. mutual funds and other companies that invest, reinvest, and trade in securities and that offer their own securities to the public.

⁴⁹ Section 3(a)(26) of the Exchange Act defines the term “self-regulatory organization” as any national securities exchange, registered securities association, or registered clearing agency, or (solely for purposes of sections 78s(b), 78s(c), and 78w(b) of this title) the Municipal Securities Rulemaking Board established by section 78o-4 of the Exchange Act. 15 U.S.C.A § 78c(a)(26).

⁵⁰ SEC, The Laws that Govern the Securities Industry, <http://www.sec.gov/about/laws.shtml>.

⁵¹ U.S. v. Mooney, 425 F.3d 1093, 1096, C.A.B. (Minn.), 2005, October 10, 2005.

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

People who sell and trade securities--brokers, dealers, and *exchanges*--- must treat investors fairly and honestly, putting investors' interests first. (*emphasis added*).⁵²

Accordingly, the SEC promotes full disclosure of non-public material information 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 ("OTC") market; and 3) the operations and sales practices of market participants.⁵³

The SEC conducts many of its regulatory responsibilities through its staff. SEC staff in three divisions are primarily responsible for regulating exchanges in the U.S. securities markets. Staff in the Division of Trading and Markets,⁵⁴ among other duties, regulate and set standards for key market participants including exchanges and other SROs. Trading and Markets staff duties include reviewing SRO proposed new rules or changes to existing rules submitted to the SEC for approval. They also conduct surveillance of the actual trading of securities in the U.S. securities markets. The Office of Compliance Inspections and Examinations ("OCIE") conducts the SEC's examination program for, among other entities, registered exchanges and other SROs. The SEC's examination program consists of inspections designed to assess compliance with, and to detect violations of, the federal securities laws and to inform the SEC of new developments, including products and technologies, in the securities industry.⁵⁵ The Division of Enforcement is responsible for investigating possible violations of federal securities laws and recommending to the SEC whether those investigated should be prosecuted in federal civil courts and/or in administrative proceedings conducted by the SEC.⁵⁶

The Exchange Act authorizes the SEC to delegate the performance of certain of its regulatory responsibilities to SROs. As currently staffed and funded, it would be impossible for the SEC to perform its regulatory responsibilities effectively. SROs must register with the SEC under §§ 6,⁵⁷ 15A,⁵⁸ and 19(a)⁵⁹ of the Exchange Act and are

⁵² See, the SEC, Investor's Advocate, <http://www.sec.gov/about/whatwedo.shtml> .

⁵³ Nichols, 10 Chap. L. Rev. at 417.

⁵⁴ Division of Trading and Markets: Exchanges, Other Markets, Broker-Dealers, Clearing Agencies, Transfer Agents, and NRSROs (Nationally Recognized Statistical Rating Organizations). SEC, available at <http://www.sec.gov/divisions/marketreg.shtml>

⁵⁵ 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)

⁵⁶ Id.

⁵⁷ 15 U.S.C.A. § 78f.

⁵⁸ 15 U.S.C.A. § 780-3

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subject to oversight by the SEC. To qualify for registration with the SEC, the SRO must show 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 of the SRO itself.⁶⁰ SROs are statutorily required to police their members by conditioning membership on compliance with applicable securities laws;⁶¹ SRO policing efforts must include the imposition of sanctions against its members for violations of applicable securities laws and the SROs own rules.

Prior to July 2007, the largest and most active SROs were the National Association of Securities Dealers, Inc. (“NASD”) and the NYSE. The NASD was the only national securities association registered with the SEC pursuant to § 15A of the Exchange Act performing the duties of an SRO. The NYSE was the largest registered exchange performing SRO duties on behalf of the SEC. At this time, the Nasdaq Stock Market did not perform SRO duties on behalf of the SEC because it was not registered with the SEC as a national exchange; it was a wholly-owned subsidiary of the NASD and the NASD performed SEC delegated SRO responsibilities with respect to the Nasdaq Stock Market. In July 2007, the Financial Industry Regulatory Authority (“FINRA”) was formed by the consolidation of the NASD and the member regulation, enforcement and arbitration functions of the NYSE. FINRA is now the primary non-governmental regulator of securities broker/dealers doing business with the public in the U.S.; it also performs regulatory functions with respect to membership in the Nasdaq Stock Market. FINRA, a Delaware corporation, wholly owns the following subsidiaries: FINRA Regulation, Inc. (FINRA REG), FINRA Dispute Resolution, Inc. (FINRA DR) and FINRA Investor Education Foundation (“the Foundation”). FINRA REG was formerly named NASD Regulation, Inc (“NASDR”).⁶² In August 2006, the Nasdaq Stock Market began operating as a national securities exchange registered with the SEC for securities listed on the Nasdaq Stock Market; on February 12, 2007, the Nasdaq Stock Market became operational as a registered national exchange for securities not listed on the Nasdaq Stock Market.⁶³

⁵⁹ 15 U.S.C. § 78s(a).

⁶⁰ 15 U.S.C. § 78f(b)(1).

⁶¹ 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 Nasdaq Stock Market.

⁶² see FINRA 2007 annual Report, Notes to Consolidated Financial Statements, Note 1, p. 29. See also, FINRA web site at

<http://www.finra.org/AboutFINRA/CorporateInformation/index.htm>

⁶³ The Nasdaq Stock Market is now Nasdaq Stock Market LLC, a wholly-owned subsidiary of Nasdaq OMX Group, Inc. (Nasdaq OMX). Nasdaq OMX is a holding company incorporated in Delaware and combined the operations of Nasdaq Stock Market, Inc. and the OMX Nordic exchanges. Nasdaq OMX “...offers trading across multiple asset classes, including equities, derivatives, debt, commodities, structured products and ETFs.” See, Nasdaq OMX, available at: <http://ir.nasdaqomx.com>, last visited May 28, 2008. This article excludes coverage of broker/dealer’s owned Nasdaq Stock Market LLC’s that provide broker/dealer services; these broker/dealers are registered with SEC, DC, Puerto Rico, and all 50 states. Nasdaq Stock Market, Inc. 2006 Annual Report, p.23.

An overview of the Nasdaq Stock Market's regulatory duties is necessary to understand the complexity and significance of mutual recognition based on substituted compliance with respect to exchanges. The Nasdaq Stock Market was selected for analysis because it is one of the two largest exchanges in the U.S. securities markets, it has the longest history using an electronic based trading platform, and, most importantly, it initiated its program to become a dominate player in the global securities market (using an electronic based trading platform) apparently before the NYSE even considered the idea.⁶⁴

1. Regulatory Framework of the Nasdaq Stock Market

The Nasdaq Stock Market, an exchange registered with the SEC, is organized to carry out the purposes of the Exchange Act.⁶⁵ This means that it must regulate its members and the activities of listed issuers. Accordingly, the Nasdaq Stock Market must adopt and enforce rules designed to prevent fraudulent and manipulative acts and practices, to protect investors and the public interest, to facilitate transactions in securities, and to foster cooperation with persons engaged in settlement of securities transactions. All Nasdaq Stock Market rules must be approved by the SEC prior to adoption and enforcement by the Nasdaq Stock Market.⁶⁶ As an SRO, the Nasdaq Stock Market also has the authority to discipline or sanction its members and listed issuers for violations of its rules. Sanctions against members include expulsion, suspension, limitation of activities and operations, fine, censure, and being barred from the securities industry.⁶⁷ Sanctions against listed issuers include de-listing.⁶⁸

The Nasdaq Stock Market also conducts a for-profit business, in addition to its SRO responsibilities. The Nasdaq Stock Market's for-profit business provides services to market participants and is divided into two segments ---Market Services and Issuer Services.⁶⁹ The Market Services segment provides a transaction-based platform to

⁶⁴ In June 2000, the Nasdaq Stock Market conducted the first phase of a private placement to raise proceeds to respond to technological advances and the increasing globalization of securities markets. See, the Nasdaq Stock Market 2002 Annual Report (Form 10-K), at F-7 (Mar. 28, 2002). The second phase of the private placement was completed in January 2001 raising a total of \$326 million. From 2000 until 2001, the Nasdaq Stock Market created stand-alone stock exchanges in Canada, Japan, and Europe. See, the Nasdaq Stock Market, 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>. However, the severe down-turn in the securities market in 2000 combined with the Nasdaq Stock Market's poor economic performance in 2002 halted its global aspirations. By 2003, the Nasdaq Stock Market was forced to close all of its stand-alone stock exchanges, except Nasdaq Canada.

⁶⁵ Section 6(b)(1) of the Exchange Act, 15 U.S.C. 78f(b)(1).

⁶⁶ Nasdaq Stock Market, Inc. 2006 Annual Report, p. 11.

⁶⁷ Section 6(b)(6) of the Exchange Act, 15 U.S.C. 78f(b)(6).

⁶⁸ See, Nasdaq Stock Market IM-4800.

⁶⁹ First Amended Limited Liability Company Agreement of the Nasdaq Stock Market LLC, section 7. Purposes.

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facilitate trade execution for the Nasdaq Stock Market's customers.⁷⁰ It also sells quote and trade information to market participants and data vendors for securities listed on the Nasdaq Stock Market.⁷¹ The Issuer Services segment includes The Nasdaq Stock Market's securities listings business and its financial products business.⁷² The Nasdaq Stock Market's financial products include ETFs⁷³ based on Nasdaq Stock Market Indexes such as QQQ, an ETF based on the Nasdaq-100 Index.⁷⁴

The Nasdaq Stock Market recognizes that its SRO obligations and its responsibility to operate a for-profit business may create conflicts of interest.⁷⁵ The Nasdaq Stock Market's statutory mandate as an SRO is to ensure compliance with applicable securities laws and its own rules. However, it also has to remain competitive and profitable as an exchange. The Nasdaq Stock Market has attempted to ameliorate its conflicts of interest by outsourcing many of its regulatory functions as an SRO to FINRA.⁷⁶ However, the Nasdaq Stock Market recognizes that the interests of these two roles are not always in conflict because "...failure by [the Nasdaq Stock Market] to diligently and fairly regulate ...to enforce the rules... to maintain a fair and orderly trading marketplace, to detect and correct aberrant market activity or to otherwise fulfill [its] regulatory obligations could significantly harm [its] reputation, prompt [SEC] scrutiny and adversely affect [its] business and reputation."⁷⁷

Also, the Nasdaq Stock Market must implement certain corporate governance requirements. Its board of directors must establish certain committees, including a Regulatory Oversight Committee (ROC).⁷⁸ The ROC must be composed solely of independent directors,⁷⁹ and is charged with overseeing the adequacy and effectiveness of

⁷⁰ Nasdaq Stock Market 2006 Annual Report, p. 9.

⁷¹ Nasdaq Stock Market 2006 Annual Report, p. 9.

⁷² The Issuer Services segment also encompasses Nasdaq's insurance business and shareholder and newswire services. Nasdaq Stock Market 2006 Annual Report, p. 9.

⁷³ ETFs or exchange-traded funds are securities that track an index and represent a basket of stocks like an index fund, but trade like a stock on an exchange, thus experiencing price changes throughout the day as it is bought and sold. <http://financial-dictionary.thefreedictionary.com/Exchange-Traded+Fund+-+ETF>

⁷⁴ Nasdaq Stock Market 2006 Annual Report, p. 9.

⁷⁵ Nasdaq Stock Market 2006 Annual Report, p. 34.

⁷⁶ Regulatory services provided by FINRA include arbitration and mediation program for resolution of customer, member firm employee, and Nasdaq member-to-member disputes; initiation of the disciplinary process once a potential violation may have occurred; examinations of member broker/dealers; investigation of suspicious activity in quoting and trading on the Nasdaq Stock Market; review of compliance by member broker/dealers with the rules and regulations applicable to trading on the Nasdaq Stock market; and review and approval of new member broker/dealer applications. Nasdaq Stock Market 2006 Annual Report, p. 25.

⁷⁷ Nasdaq Stock Market 2006 Annual Report, p. 34.

⁷⁸ Article III of the Nasdaq By-Laws, sec. 5(e).

⁷⁹ Nasdaq Rule 4200(a)(15) defines an independent director as " a person other than an executive officer or employee of the company or any other individual having a relationship which, in the opinion of the issuer's

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the Nasdaq Stock Market's regulatory responsibilities delegated by the SEC. The ROC's duties must include reviewing the Nasdaq Stock Market's regulatory budget and assessing the adequacy of resources available in the budget for regulatory activities; assessing the Nasdaq Stock Market's regulatory plan and performance; meeting regularly with the Nasdaq Stock Market's Chief Regulatory Officer ("CRO")⁸⁰ in executive session; and being informed about the compensation, promotion, or termination of the CRO and the basis for such actions.

a. Membership in the Nasdaq Stock Market⁸¹

Broker/dealers must obtain membership in the Nasdaq Stock Market in order to execute transactions on the Nasdaq Stock Market. Broker/dealers are eligible for membership, while their associated persons⁸² or representatives⁸³ must register with the Nasdaq Stock Market.⁸⁴ In addition, broker/dealer membership requires the broker/dealer to be a member of FINRA.⁸⁵

The Nasdaq Stock Market membership process begins with the submission of an application,⁸⁶ which includes the broker/dealer's most current Uniform Application for

board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director...." This rule also expressly identifies directors who *would not be* considered independent. See, Article III of the Nasdaq By-Laws, sec. 5(e).

⁸⁰ The Nasdaq Stock Market's CRO must be an executive vice president, senior vice president, or general counsel of the brokerage firm. In addition, the CRO must have general supervisory authority over the Nasdaq Stock Market's regulatory operations, including overseeing the its surveillance, examination, and enforcement functions and administering regulatory services agreements with other SROs to which the Nasdaq Stock Market is a party, e.g. FINRA. See Nasdaq Stock Market, LLC By-laws, Article IV. Officers, Agents, and Employees, Section 7.

⁸¹ Nasdaq Stock Market has contracted with FINRA REG (formerly NASDR) to perform certain membership, disciplinary, and enforcement functions; however, the Nasdaq Stock Market retains legal liability for the performance of its regulatory responsibilities as an SRO pursuant to § 6 of the Exchange Act. See, Nasdaq Stock Rules 9001, 1001, and 10001. See also, Nasdaq Stock Market Rule 0130.

⁸² Nasdaq Stock Market Rule 1011(b). The term "associated person" means any partner, officer, director, or branch manager of a Nasdaq Stock Market member (or person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such Nasdaq Stock Market member, or any employee of a Nasdaq Stock Market member, except that any person associated with a Nasdaq Stock Market member whose functions are solely clerical or ministerial shall not be included in the meaning of the term "associated person."

⁸³ Nasdaq Stock Market Rule 1011(k). The term "representative" means an associated person of a registered broker/dealer, including assistant officers other than principals, who is engaged in the investment banking or securities business of the Nasdaq Stock Market member including the functions of supervision, solicitation or conduct of business in securities, or who is engaged in the training of persons associated with a broker/dealer for any of these functions. As provided in [Rule 1031](#), all representatives of Nasdaq Stock Market members are required to register with the Nasdaq Stock Market, and representatives that are so registered are referred to as "registered representatives."

⁸⁴ In addition, each branch office of a member brokerage firm must also be registered with the Nasdaq Stock Market. See, Nasdaq Stock Market Rule 1012(j).

⁸⁵ See, Nasdaq Stock Market Rules 1002(e) and 1014(a)(15). Member broker/dealers must obtain membership in, and their associated persons (including partners, officers, directors, branch managers, department supervisors, and salespersons) must register with, FINRA.

⁸⁶ In the form prescribed in Nasdaq Stock Market Rule 1013(a)(1).

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Broker/Dealer Registration (“Form BD”).⁸⁷ The Form BD is used by broker/dealers to register with the SEC and to obtain membership in FINRA.⁸⁸ Among other things, the Nasdaq Stock Market uses Form BD to determine whether the broker/dealer, and its associated persons, have all licenses and registrations required by applicable regulatory authorities and Nasdaq Stock Market Rules. The Form BD also contains any disciplinary information about the broker/dealer and its associated persons.

The membership application process requires the broker/dealer to submit current, audited financial statements. Also, the broker/dealer must submit a description of any material changes in its financial condition subsequent to the date on which its financial statements were prepared.⁸⁹ Audited financial information is used, among other things, to determine whether the broker/dealer has the financial capacity to maintain, at least, the statutory minimum level of net capital required to support its proposed business activities on the Nasdaq Stock Market.⁹⁰

The broker/dealer must submit a business continuity plan. The business continuity plan must describe the communications and operational systems the broker/dealer uses to conduct business, as well as the procedures employed to ensure business continuity in the event of an emergency or significant business disruption.⁹¹ The broker/dealer must also address its relationships with other broker/dealers and counterparties as well as its ability to meet existing customer obligations.⁹² Although, the Nasdaq Stock Market stresses that business continuity plans must be flexible, it specifies minimum requirements for such plans, which include: (1) data backup and recovery (hard copy and electronic); (2) financial and operational assessments; (3) alternate communications between the broker/dealer and its employees; (4) alternate physical location of employees; (5) critical business constituent, bank, and counter-party impact; (6) regulatory reporting; and (7) communications with regulators.⁹³

The broker/dealer must submit copies of any disciplinary actions taken against it by regulatory authorities. Specifically, this includes decisions made, or orders issued, by federal and state regulatory authorities and SROs against a broker/dealer and

⁸⁷ Nasdaq Stock Market Rule 1013(a)(1)(A).

⁸⁸ All data collected in the FORM BD is maintained on the Central Registration Depository (“CRD”). The CRD is a computerized system administered by FINRA, which acts a data base for the employment, qualification, and disciplinary histories for brokerage firms and for more than 600,000 securities industry professionals who deal with the public. FINRA web site located at <http://www.finra.org/Resources/Glossary/P010878>

⁸⁹ Nasdaq Stock Market Rule 1013(a)(1)(E).

⁹⁰ Rule 15c3-1 of the Exchange Act, 17 C.F.R. § 240.15c3-1, requires broker/dealers to have sufficient capital to support their business activities. See also, Nasdaq Stock Market’s Guidance for Submitting Supplemental Information in connection with its membership application process. See, Nasdaq Stock Market, available at <http://classic.nasdaqtrader.com/trader/er/suppguidance.pdf>

⁹¹ Nasdaq Stock Market Rule 1013(a)(H).

⁹² Nasdaq Stock Market Rule 3510 and FINRA Rule 3510(a).

⁹³ Nasdaq Stock Market Rule 3510.

its associated persons for registration or licensing denial.⁹⁴ In addition, the broker/dealer must disclose whether it or its associated persons have been investigated or been the subject of any disciplinary proceeding by any securities regulatory authority, domestic or foreign, that have not been reported to FINRA.⁹⁵ In addition, the broker/dealer must disclose whether its direct owners and executive officers have been, in the last ten years, or are currently, the subject of any investigation or disciplinary proceeding by federal and state regulatory authorities and SROs.⁹⁶ The Nasdaq Stock Market uses this information to determine whether the broker/dealer, among other things, is capable of observing "... high standards of commercial honor and just and equitable principles of trade."⁹⁷

Nasdaq Stock Market requires the submission of detailed information regarding clearance and settlement arrangements to ensure that the broker/dealer's operational infrastructure is sufficient to support its business activities.⁹⁸ Clearance and settlement occur at the conclusion of a securities transaction and ensure that buyers receive securities purchased and corresponding sellers receive cash for securities sold.⁹⁹ Nasdaq Stock Market Rule 4618 requires all member broker/dealers to clear and settle through a registered clearing agency¹⁰⁰ using a continuous net settlement system.¹⁰¹ For example, National Securities Clearing Corporation (NSCC)¹⁰² is a registered clearing agency,

⁹⁴ Disclosure of any sanctions imposed is also required.

⁹⁵ Nasdaq Stock Market Rule 1013(a)(1)(J). See also, Nasdaq Guidance for Submitting Supplemental Information on NASDAQ's web site located at <http://www.nasdaqtrader.com/content/AdministrationSupport/AgreementsTrading/suppguidance.pdf>.

⁹⁶ Nasdaq Stock Market Rule 1013(a)(1)(K). See also, Nasdaq Guidance for Submitting Supplemental Information on NASDAQ's web site located at <http://www.nasdaqtrader.com/content/AdministrationSupport/AgreementsTrading/suppguidance.pdf>

⁹⁷ Nasdaq Stock Market Rule 2110.

⁹⁸ Nasdaq Stock Market Rule 1013(a)(1)(L). Ensuring that applicants meet this requirement also helps to reduce systemic market risk in the U.S. securities markets.

⁹⁹ FINRA glossary, available at <http://www.finra.org/Resources/Glossary/P010878> and <http://www.finra.org/Resources/Glossary/p011153>

¹⁰⁰ Clearing agencies must register with the SEC pursuant to § 17A(b)(3) of the Exchange Act, 15 U.S.C. § 17aa(b), and Rule 17Ab2-1, 17 C.F.R. § 240.17Ab2-1, promulgated thereunder. A clearing agency is defined in § 3(a)(23) of the Exchange Act as "... any person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities or who provides facilities for comparison of data respecting the terms of settlement of securities transactions, to reduce the number of settlements of securities transactions, or for the allocation of securities settlement responsibilities."

¹⁰¹ Nasdaq Stock Market Rule 4618 allows brokerage firms to comply with its provisions by direct participation, use of direct clearing services, or by entering into a correspondent clearing arrangement with another member brokerage firm that clears trades through a registered clearing agency using a continuous net settlement system. However, paragraph (b) of Nasdaq Rule 4618 allows Nasdaq-listed securities to be settled ex-clearing (clearing and settling otherwise than through a designated clearing agency) if both parties to the transaction agree.

¹⁰² NSCC is a wholly-owned subsidiary of the Depository Trust & Clearing Corporation (DTCC); DTCC was established in 1999 to consolidate the operations of NSCC and the Depository Trust Corporation ("DTC"), now has five subsidiaries (including NSCC), and is owned by its principal customers operating on an at-cost basis. See DTCC, available at: <http://www.dtcc.com/downloads/about/US%20Model%20for%20Clearing%20and%20Settlement.pdf>, pp. 1-3. Increasingly, DTCC, through subsidiaries such as NSCC, is providing services to the global financial services industry. Id. at 8. DTCC and its subsidiaries are registered with and regulated by the SEC. Id.

which clears and settles for broker/dealers using its Continuous Net Settlement (CNS) system. CNS reduces or nets the total buy and sell obligations "...for a given security into one net position...[and] simultaneously consolidate[s] all debits and credits from these net positions in all securities into one final net money position for each broker/dealer."¹⁰³ CNS acts to reduce, significantly, the total number of financial obligations requiring settlement,¹⁰⁴ thus reducing overall transaction execution costs. In addition, NSCC provides a guarantee that a trade will be completed.¹⁰⁵

Broker/dealers must submit a description of their proposed trading activities on the Nasdaq Stock Market.¹⁰⁶ This means that a broker/dealer must identify the types of securities it will trade; whether it will be a market maker¹⁰⁷, an order entry firm¹⁰⁸, and/or engage in block trading¹⁰⁹ activities; also, the broker/dealer must indicate the extent to which it intends to conduct such activities as a member of other SROs. Broker/dealers that intend to operate as market makers on the Nasdaq Stock Market must provide information regarding the sources and amounts of net capital.¹¹⁰ Broker/dealers acting as market makers must have sufficient net capital to effect transactions in reasonable quantities for securities in which they provide published quotations (ask/bid prices).¹¹¹ Also, order entry broker/dealers and those engaging in block trading must adhere to

¹⁰³ NSCC describes its CNS service as "...an automated book-entry accounting system that centralizes the settlement of compared security transactions and maintains an orderly flow of security and money balances." NSCC also reports executed trades to U.S. and national exchanges. See, NSCC web site at <http://www.nsc.com/clearance/index.html>

¹⁰⁴ See NSCC, available at <http://www.nsc.com/clearandset.html>

¹⁰⁵ See NSCC, available at <http://www.nsc.com/clearandset.html>

¹⁰⁶ Nasdaq Stock Market Rule 1013(a)(1)(D).

¹⁰⁷ Section 3(a)(38) of the Exchange Act, 15 USC §78c(a)(23), defines the term market maker as "...any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis."

¹⁰⁸ An order-entry broker/dealer enters orders for execution and anonymous display. See Nasdaq Stock Market, available at <http://www.nasdaqtrader.com/Trader.aspx?id=OrderEntryProcess>. Nasdaq Stock Market order-entry firms must register with the Nasdaq Stock Market and are permitted to access the inside bid and ask, individual market maker quotes for each security traded on the Nasdaq Stock Market, enter orders in all Nasdaq Stock Market automated services, view daily statistical and index-related information, and view share-and dollar-volume leaders, net gainers, and losers. Id. Order entry firms cannot input quotes into the Nasdaq Stock Market trading platform as do market maker firms.

¹⁰⁹ A block trade is a securities transaction that involves the purchase or sale of 10,000 shares or more. See, FINRA Glossary, available at <http://www.finra.org/Resources/Glossary/P010868>

¹¹⁰ Nasdaq Stock Market Rule 1013(a)(1)(M).

¹¹¹ Exchange Act Rule 15c3-1(b)(8). Also, a broker/dealer must include a list of persons conducting its market making and other trading activities along with a list of the persons responsible for supervising such persons. See, Nasdaq Stock Market Rule 1013(a)(1)(P). In addition, all supervisors or principals must be appropriately licensed and each broker/dealer with twenty-five or more registered persons must have two supervisors or principals, and at least one of the two supervisors must be a registered principal qualified to act as a Financial and Operations Principal (FINOP). Nasdaq Stock Market Rule 1013(a)(1)(P).

minimum net capital requirements.¹¹² Correlating levels of net capital with the business activities conducted by broker/dealers is designed to maintain systemic risk at an appropriate level in the U.S. securities markets.¹¹³

The broker/dealer must submit a copy of its written supervisory procedures (WSPs).¹¹⁴ The Nasdaq Stock Market requires member broker/dealers to establish, maintain, and enforce a supervisory system that is reasonably designed to achieve compliance with, and to detect violations of, applicable securities laws and regulations, and Nasdaq Stock Market rules.¹¹⁵ The broker/dealer's supervisory system must be tailored to the types of business activities in which it engages. WSPs must designate a person qualified to supervise¹¹⁶ each type of business activity.¹¹⁷ Accordingly, WSPs must specifically identify subordinates to whom supervisors are assigned.¹¹⁸ They must also designate an Office of Supervisory Jurisdiction (OSJ) at each location performing specified activities.¹¹⁹ The designation of OSJs is designed to ensure adequate supervision of the broker/dealers registered representatives and other associated persons conducting business for the broker/dealer at remote locations. In addition, WSPs must contain procedures to conduct and document annual interviews at which compliance matters, relevant to the broker/dealer's types of business activities, are discussed with each registered representative and registered principal (supervisor).¹²⁰

¹¹² However minimum net capital requirements for order entry broker/dealers are much less than market making broker/dealers because order entry firms do not, among other things, make markets in specified securities.

¹¹³ This portion of the Nasdaq Stock Market's membership application process is designed to ascertain whether the broker/dealer has the ability to maintain net capital in excess of the minimum requirements enumerated in Exchange Act Rule 15c3-1.

¹¹⁴ Nasdaq Stock Market Rule 1013(a)(1)(O).

¹¹⁵ Nasdaq Stock Market Rule 3010 and FINRA Rule 3010(a).

¹¹⁶ FINRA Rule 3010(a)(6) requires "...reasonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities."

¹¹⁷ FINRA Rule 3010(a)(2); Nasdaq Stock Market Rule 3010.

¹¹⁸ FINRA Rule 3010(a)(5); Nasdaq Stock Market Rule 3010.

¹¹⁹ FINRA Rule 3010(g)(1) defines an OSJ as "... any office of a member at which one or more of the following functions take place:

- (A) order execution and/or market making;
- (A) structuring of public offerings or private placements;
- (A) maintaining custody of customers' funds and/or securities;
- (A) final acceptance (approval) of new accounts on behalf of the member;
- (A) review and endorsement of customer orders...;
- (A) final approval of advertising or sales literature for use by persons associated with the member, pursuant to [NASD] Rule 2210(b)(1) [requires supervisory approval of advertisements, sales literature and independently prepared reprints communicated to the public], except for an office that solely conducts final approval of research reports; or
- (A) responsibility for supervising the activities of persons associated with the member at one or more other branch offices of the member.

¹²⁰ FINRA Rule 3010(a)(7). broker/dealers that employ registered persons previously employed by a disciplined brokerage firm must enforce special supervisory procedures for supervising the telemarketing activities of all their registered persons.

In addition, WSPs must contain procedures to conduct internal inspections of the broker/dealer's business activities. Internal inspections must be conducted, at least, annually¹²¹ and must be designed to facilitate the detection of violations of applicable securities laws and Nasdaq Stock Market rules.¹²² Internal inspections, at a minimum, must include reviews of customer accounts for the purpose of detecting and preventing "...irregularities or abuses."¹²³ Most importantly, internal inspections must be conducted by supervising associated persons with minimal conflicts of interest with the registered representatives and associated persons working in a particular office.¹²⁴

WSPs must include procedures for reviewing all transactions and correspondence between its registered representatives and the public.¹²⁵ All transactions between the broker/dealer's registered representatives and its public customers must be reviewed and approved by a qualified supervisor or registered principal.¹²⁶ All correspondence (including electronic correspondence) between the broker/dealer's registered representatives and its customers must be reviewed and approved prior to distribution.¹²⁷ Correspondence and transactions review is designed, among other things, to identify and resolve customer complaints in accordance with applicable securities laws and Nasdaq Stock Market rules.¹²⁸

Finally, the broker/dealer must submit a description of its control system. Specifically, one or more principals must be designated to test and verify the procedures contained in the WSPs and to amend it as necessary, based on the results of the testing and verification process.¹²⁹ Nasdaq Stock Market uses the supervisory control system to ensure that review and supervision of "... customer account activity conducted by [the broker/dealer's] branch office managers, sales managers, regional or district sales managers, or any person performing a similar supervisory function..."¹³⁰ is adequate.¹³¹

¹²¹ FINRA Rule 3010(c). OSJs must be inspected annually. however, branch offices [See, FINRA Rule 3010(g)(2)] without supervisory responsibilities and non-branch offices may be inspected every three years. FINRA Rule 3010(c)(1)

¹²² See, FINRA IM-3010-1.

¹²³ FINRA Rule 3010(c)(1).

¹²⁴ Accordingly, internal inspections cannot be conducted by "...any person within [an] office who has supervisory responsibilities or by an individual who is directly or indirectly supervised by such person(s)." NASD Rule 3010(c)(3).

¹²⁵ FINRA Rule 3010(d).

¹²⁶ FINRA Rule 3010(d)(1).

¹²⁷ All incoming and outgoing correspondence must be created in accordance with Exchange Act Rule 17a-3, 17 C.F.R. § 240.17a-3, and maintained in accordance with Exchange Act Rule 17a-4, 17 C.F.R. § 240.17a-4.

¹²⁸ If the brokerage firm's WSPs do not require review and approval of all incoming and outgoing correspondence prior to distribution to the public, it must include procedures for "...the education and training of associated persons as to the firm's procedures governing correspondence; documentation of such education and training; and surveillance and follow-up to ensure that such procedures are implemented and adhered to. FINRA Rule 3010(d)(2).

¹²⁹ Nasdaq Stock Market Rule 3012.

¹³⁰ FINRA Rule 3012(a)(2).

¹³¹ FINRA Rule 3012(a)(1). FINRA Rule 3012 contains conflicts of interest provisions that are similar to FINRA Rule 3010 along with an exception for broker/dealers with limited resources.

(1) Registration of Principals and Registered Representatives

Nasdaq Stock Market membership requires two basic levels of registration and qualification for management and sales personnel of broker/dealers— principals and registered representatives, respectively. Generally, Principals are associated persons actively engaged in management or supervision¹³² and must register by passing exams appropriate to the functions performed at their respective broker/dealers.¹³³ An associated person cannot take a qualification examination to be registered as a principal unless he or she has already passed a qualification examination for registration with the Nasdaq Stock Market as a registered representative.¹³⁴ However, registration with the Nasdaq Stock Market is not required for representatives who are regulated by certain foreign securities regulatory authorities. Representatives approved to conduct business pursuant to the requirements of the Financial Services Authority in the United Kingdom are permitted to conduct business on the Nasdaq Stock Market, as a General Securities Representative, if they pass the Modified General Securities Representative Qualification Examination administered by FINRA.¹³⁵ Representatives regulated by any Canadian Stock Exchange, or by any securities regulator of any Canadian province or territory, or by the Investment Dealers Association of Canada are permitted to trade on the Nasdaq Stock Market if they complete a Canadian Securities Institute training course *and* pass the Canadian General Securities Representative Examination.¹³⁶ Representatives regulated by any Japanese stock exchange or Japanese Securities Dealers Association are permitted to trade on the Nasdaq Stock Market if they pass the Japanese General Securities Registered Representative Examination.¹³⁷ However, all such representatives are prohibited from trading in municipal securities.¹³⁸

2. Discipline and Oversight of Nasdaq Stock Market Members

As an SRO, the Nasdaq Stock Market must ensure that its members comply with

¹³² For example, (1) sole proprietors; (2) officers; (3) partners; (4) managers of OSJs; and (5) directors of corporations.

¹³³ See, Nasdaq Stock Market Rule 1021(b) and NASD Rule 1021(b). Nasdaq Stock Market categories include General Securities Principal, Limited Principal-Financial and Operations; Limited Principal—Introducing Broker/Dealer Financial and Operations, and Limited Principal—General Securities Sales Supervisor. Nasdaq Rule 1022. Other prerequisite exams for taking the principal qualification exams are available at Nasdaq Stock Market, <http://www.finra.org/RegistrationQualifications/MemberFirms/HowtoBecomeaMember/FormsAdditionalDocuments/p009856>.

¹³⁴ See Nasdaq Stock Market Rule 1022(a)(1); FINRA Rule 1022(a)(1).

¹³⁵ See Nasdaq Stock Market Rule 1032(a)(2)(B).

¹³⁶ Nasdaq Stock Market Rule 1032(a)(2)(C).

¹³⁷ Nasdaq Stock Market Rule 1032(a)(2)(D).

¹³⁸ Nasdaq Stock Market Rule 1032(a)(2)(B), Nasdaq Rule 1032(a)(2)(C); Nasdaq Rule 1032(a)(2)(D), respectively. Municipal securities are defined in § 3(a)(29) of the Exchange Act and include bonds issued by states, cities, counties, and towns to fund public capital projects like roads, schools, and sanitation facilities.

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the federal securities laws and its own rules.¹³⁹ Specifically, this means that the Nasdaq Stock Market is authorized to conduct investigations, issue complaints, conduct examinations, and initiate disciplinary proceedings with respect to its members and their associated persons.¹⁴⁰ Nasdaq Stock Market members and their associated persons must provide any information needed to conduct investigations or disciplinary proceedings, or risk losing their Nasdaq Stock Market membership and registration, respectively.¹⁴¹ In addition, the Nasdaq Stock Market can also request such information from its members and their associated persons to assist both domestic and foreign regulators (including SROs), if the domestic or foreign regulator has contracted with the Nasdaq Stock Market to exchange information and to provide assistance for regulatory purposes, such as market surveillance, investigation, and enforcement.¹⁴² Moreover, Nasdaq Stock Market members must automatically submit certain trading data.¹⁴³ This trading data is used by MarketWatch, an automated market surveillance system designed to investigate and prevent abusive, manipulative, or illegal trading practices.¹⁴⁴ If the Nasdaq Stock Market determines that its members, or their associated persons, have violated federal securities laws or its own rules, sanctions may be imposed.¹⁴⁵ Sanctions imposed against members and their associated persons include fines;¹⁴⁶ cancellation of membership; revocation of registration; suspension; and temporary or permanent cease and desist orders.¹⁴⁷ Members cannot employ an associated person whose registration has been suspended or revoked by an order of the Nasdaq Stock Market or the SEC.¹⁴⁸ Associated persons who have been barred from association with any Nasdaq Stock Market member cannot be

¹³⁹ The Nasdaq Stock Market's disciplinary and oversight programs must be consistent with §§ 6(b)(6) and 6(b)(7) of the Exchange Act. 15 U.S.C. § 78(b)(6) and (7). 15 U.S.C. § 78(b)(1). Nasdaq Regulation supervises and administers the Nasdaq Stock Market's regulatory functions including the administration of regulatory services agreements with other SROs. Nasdaq Stock Market Rule 0120(j). As previously noted, Nasdaq Stock Market entered into the Regulatory Contract with FINRA to perform certain regulatory functions. Accordingly, "...Nasdaq [Stock Market] rules that refer to Nasdaq Regulation, Nasdaq Regulation staff, Nasdaq staff, and Nasdaq departments should be understood as also referring to FINRA staff, FINRA Regulation, Inc. staff and FINRA departments acting on behalf of the Nasdaq Stock Market pursuant to the Regulatory Contract." Nasdaq Stock Market Rules 8001 and 9001.

¹⁴⁰ Nasdaq Stock Market Rule 8210.

¹⁴¹ Nasdaq Stock Market Rule 8210(c). Members and their associated persons are also required to testify, under oath or affirmation in any Nasdaq investigation, complaint, examination, or proceeding. Nasdaq Stock Market Rule 8210(a)(1).

¹⁴² Nasdaq Stock Market Rule 8210(b).

¹⁴³ Nasdaq Stock Market Rule 8211. Requested trading data includes transaction date, the security's identifying symbol, number of shares or quantity of securities purchased or sold in the transaction, transaction price, account number, market center where the transaction was executed, and customer name.

¹⁴⁴ See, Nasdaq Stock Market, available at http://www.nasdaq.com/about/Marketwatch_FAQ.stm, (last visited June 10, 2008).

¹⁴⁵ Disciplinary information, including complaints, decisions, and sanctions are released to the public and qualified in accordance with Nasdaq Stock Market IM-8310-3.

¹⁴⁶ Failure to pay fines and other monetary assessments ordered by the Nasdaq Stock Market may result in summary cancellation of membership or revocation of the registration of a member's associated person. See, Nasdaq Stock Market Rule 8320.

¹⁴⁷ See, Nasdaq Stock Market Rule 9290.

¹⁴⁸ See, Nasdaq Stock Market IM-8310-1

employed in any capacity, including clerical or ministerial capacities.¹⁴⁹

The Nasdaq Stock Market can only impose sanctions in disciplinary proceedings initiated and conducted pursuant to its Code of Procedure (Code).¹⁵⁰ Generally, any disciplinary proceeding must include an opportunity for a hearing at which the member or associated person must be entitled to present relevant evidence that violations of Nasdaq Stock Market Rules and/or the federal securities laws have not been committed.¹⁵¹ Disciplinary proceedings must set forth specific charges; send notification of the proceeding; and maintain a record. Decisions and orders must consist of a statement, which describes the violative conduct; identifies the rule, regulation or statutory provision that allegedly has been violated; the basis for any findings made; and the sanction imposed.¹⁵² Members and their associated persons may be represented by counsel, themselves, or another non-lawyer during disciplinary proceedings.¹⁵³ In addition, except as counsel or a witness, Nasdaq Stock Market staff involved in initiating and prosecuting the disciplinary proceeding are prohibited from communicating with, or participating in the decision of, the Adjudicator¹⁵⁴ of a particular disciplinary proceeding.¹⁵⁵

Disciplinary proceedings that include a hearing are conducted by Adjudicators or hearing officers.¹⁵⁶ Hearings may be conducted by one hearing officer¹⁵⁷ or a panel composed of one hearing officer and two panelists appointed by Nasdaq Stock Market's

¹⁴⁹ Nasdaq Stock Market IM-8310-1.

¹⁵⁰ Nasdaq Stock Market's Code of Procedure ("the Code") is contained in its Rule 9000 Series. The Code is also used in proceedings for obtaining relief from the Nasdaq Stock Market's membership eligibility requirements. Nasdaq Stock Market Rule 9110(a). The federal rules of evidence do not apply in Nasdaq Stock Market disciplinary proceedings (Nasdaq Stock Market Rule 9145(a)) and motion practice is permitted. Nasdaq Stock Market Rule 9146.

¹⁵¹ Nasdaq Stock Market Rule 9110(b).

¹⁵² Nasdaq Stock Market Rule 9110(b).

¹⁵³ Nasdaq Stock Market Rule 9141. Non-lawyers include a member of a partnership representing the partnership or a bona fide officer of a corporation, trust, or association representing such entities.

¹⁵⁴ the term Adjudicator is defined in Nasdaq Stock Market Rule 9120(a)

(a) "Adjudicator"

The term "Adjudicator" means:

(1) a body, board, committee, group, or natural person that presides over a proceeding and renders a decision;

(2) a body, board, committee, group, or natural person that presides over a proceeding and renders a recommended or proposed decision which is acted upon by an Adjudicator described in (1); or

(3) a natural person who serves on a body, board, committee, or group described in (1) or (2).

The term includes a Review Subcommittee as defined in paragraph (cc), a Subcommittee as defined in paragraph (ee), an Extended Proceeding Committee as defined in paragraph (n), and a Statutory Disqualification Committee as defined in paragraph (dd).

¹⁵⁵ Waiver of this requirement is available under certain circumstances. See, Nasdaq Stock Market Rule 9144.

¹⁵⁶ A hearing officer is an attorney appointed by the Chief Hearing Officer to act in an adjudicative roll in disciplinary proceedings conducted under the Nasdaq Rule 9000 Series. Nasdaq Rule 9120(r).

¹⁵⁷ See, Nasdaq Stock Market Rule 9120(s).

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Office of Hearing Officers.¹⁵⁸ Hearing officers have the authority “...to do all things necessary and appropriate to discharge...” their duties.¹⁵⁹ Panelists must be associated persons or retired associated persons of a Nasdaq Stock Market member.¹⁶⁰

Decisions issued by hearing officers or hearing panels may be appealed before they become the final disciplinary action of the Nasdaq Stock Market.¹⁶¹ The decision may first be appealed to the Nasdaq Review Council.¹⁶² Generally, such an appeal means a stay of the decision until the Nasdaq Review Council issues its decision.¹⁶³ The Nasdaq Review Council must appoint a subcommittee to consider all decisions appealed or called for review. The purpose of the subcommittee is to review the record, hear oral arguments (if a hearing is held), and to consider new evidence (if appropriate)¹⁶⁴ in order to make a recommendation to the Nasdaq Review Council.¹⁶⁵ In its decision, the Nasdaq Review Council may affirm, dismiss, modify, reverse, or remand, with instructions, the initial decision issued by the hearing officer or hearing panel.¹⁶⁶ The decision of the Nasdaq Review Council must be submitted to the Nasdaq Stock Market Board of Directors (“Nasdaq Board”) and becomes the final disciplinary action by Nasdaq Stock Market if the Nasdaq Board determines not to review the decision.¹⁶⁷ Nasdaq Board review of the decision issued by the Nasdaq Review Council is discretionary. The Nasdaq Board may affirm, modify, reverse, or remand with instructions; it also has the authority to increase or decrease sanctions imposed in the decision of the Nasdaq Review Council. If the Nasdaq Board does not remand with instructions, its decision becomes the final disciplinary action of the Nasdaq Stock Market. Final disciplinary actions of the Nasdaq Stock Market may be appealed to the SEC.¹⁶⁸

¹⁵⁸ Nasdaq Stock Market Rule 9231(b). Nasdaq Stock Market Rule 9120(y) defines the term “Office of Hearing Officers” as the Office of Hearing Officers of FINRA REG, acting on behalf of Nasdaq pursuant to the Regulatory Contract.

¹⁵⁹ See, Nasdaq Stock Market Rule 9235.

¹⁶⁰ Such persons must have served on the Nasdaq Review Council; on a disciplinary subcommittee of the Nasdaq Review Council; as a Nasdaq Director, (but not currently serving); or on FINRA’s National Adjudicatory Council. Nasdaq Stock Market Rule 9231(b).

¹⁶¹ Generally there is no interlocutory review of an Adjudicator’s ruling or order except when a party or his attorney is sanctioned for contemptuous conduct and excluded from the disciplinary proceeding. Nasdaq Stock Market Rule 9148.

¹⁶² Also, the Nasdaq Review Council can initiate a review of the adjudicator’s decision within 45 days of the date the decision was issued. Nasdaq Stock Market Rule 9312(a).

¹⁶³ Nasdaq Stock Market Rule 9310(b). However, there is no stay if the adjudicator’s decision imposes a permanent cease and desist order.

¹⁶⁴ The Nasdaq Review Council or its subcommittee may order the production of new evidence. Nasdaq Stock Market Rule 9346(f).

¹⁶⁵ Nasdaq Stock Market Rule 9331(b). The subcommittee must have at least two members and the members must be former members of the Nasdaq Review Council or former Nasdaq Stock Market Directors. See Nasdaq Stock Market Rule 9331(a). See also, Nasdaq Stock Market Rule 9345.

¹⁶⁶ Nasdaq Stock Market Rule 9348. See also, Nasdaq Stock Market Rule 9349.

¹⁶⁷ Nasdaq Stock Market Rule 9349(c).

¹⁶⁸ Exchange Act Rule 19d-1(c)(1). See also, Nasdaq Stock Market Rule 9351. Application to the SEC for review stays any sanctions imposed by the Nasdaq Stock Market, except the imposition of a bar or an expulsion from the securities industry. Nasdaq Stock Market Rule 9370.

Disciplinary proceedings also include membership eligibility proceedings. Membership eligibility proceedings are conducted to determine whether a person, subject to statutory disqualification,¹⁶⁹ can become or remain an associated person of a Nasdaq Stock Market member.¹⁷⁰ Also, disciplinary proceedings are used to obtain relief from eligibility or qualification requirements for Nasdaq Stock Market members and their associated persons.¹⁷¹ For example, in cases in which statutorily disqualified persons are deemed eligible for Nasdaq Stock Market membership, they are usually admitted pursuant to heightened supervisory plans established in accordance with Exchange Act Rule 19h-1.¹⁷² If the application for Nasdaq Stock Market membership is denied, the appellate process is the same as described in the preceding paragraph.¹⁷³

As previously noted, the Nasdaq Stock Market's SRO responsibilities extend both to membership and transactions executed by its members and their associated persons and issuers listing their securities on the Nasdaq Stock Market. Accordingly, an overview of the Nasdaq Stock Market's regulatory framework concerning the execution of transactions on its trading platform is helpful in assessing regulatory comparability.

3. The Nasdaq Market Center¹⁷⁴

The Nasdaq Stock Market regulates and operates the Nasdaq Market Center ("NMC"), its automated trading system for order execution and trade reporting.¹⁷⁵ The NMC allows market participants to enter orders, quotes, and report trades on a single platform for securities listed on the Nasdaq Stock Market ("Nasdaq-listed securities"), securities listed on other exchanges, and securities traded in the OTC market.¹⁷⁶ Trading access by market participants to the NMC requires registration as a Nasdaq Market Maker, Nasdaq ECN, or Order Entry firm.¹⁷⁷ These Nasdaq Stock Market Rules are

¹⁶⁹ The term statutory disqualified includes a member who has been expelled or suspended and an associated person of a member who has been barred or suspended from a domestic or foreign SRO or whose registration has been revoked by the SEC or a foreign financial regulatory authority. Nasdaq Stock Market, LLC, By-Laws, Article I(dd). See also § 3(a)(39) and §15(b)(4) (B),(C), (D) and (H) of the Exchange Act.

¹⁷⁰ Nasdaq Stock Market Rule 9521(a).

¹⁷¹ Nasdaq Stock Market Rule 9521(a).

¹⁷² See, Nasdaq Stock Market Rule 9523 describing the Nasdaq Stock Market's approval process for heightened supervision plans submitted to the SEC for approval pursuant to Exchange Act Rule 19h-1.

¹⁷³ See Nasdaq Stock Market Rules 9524 and 9525.

¹⁷⁴ The provisions of Nasdaq Stock Market Rule 11000 Series relating to clearance and settlement will apply to Nasdaq Market Center transactions only in unusual circumstances in which trades are settled ex-clearing, i.e. actually through the Nasdaq Market Center. Normally, Nasdaq Stock Market membership requires members to contract with a registered national clearing agency for clearance and settlement of transactions executed on the Nasdaq Stock Market.

¹⁷⁵ The NMC consists of SuperMontage, CAES, Intermarket, and the Automated Confirmation Transaction Service SM (ACT SM). See, Nasdaq Stock Market, available at http://www.nasdaq.com/newsroom/news/pr2004/ne_section04_026.html.

¹⁷⁶ Reuters.com available at <http://www.reuters.com/finance/stocks/companyProfile?symbol=NDAQ.O>, last visited June 12, 2008.

¹⁷⁷ See section II.B.1, p. 21 of this article.

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designed to facilitate transparency and efficiency in the U.S. securities markets--one of Nasdaq Stock Market's SEC-delegated SRO responsibilities.

The NMC must display orders and quotes entered into its system in compliance with Nasdaq Stock Market Rules. This means that the NMC is required to time stamp orders to determine the time ranking and processing of the order.¹⁷⁸ In addition, all orders directed, or permitted to be routed, to other market centers must be displayed to all members.¹⁷⁹ Quotes and orders available for execution must be displayed through the NMC's System Book Feed.¹⁸⁰ The NMC must also display the aggregate size of all quotes and orders at the best price to buy and sell; however, if the aggregate size is less than one round lot, the aggregate size must be displayed in the System Book Feed.¹⁸¹ In addition, discretionary orders¹⁸² must not be displayed but must be made available for execution when there is a contra-side trading interest.¹⁸³ Non-displayed orders have lower priority than equally priced displayed orders because they are not displayed in the NMC, regardless of time stamp.¹⁸⁴ Finally, the NMC must meet ITS¹⁸⁵ Trade-Through Compliance and Locked or Crossed Markets requirements.¹⁸⁶ An example of the NMC on an electronic trading screen is provided below.

¹⁷⁸ Nasdaq Stock Market Rule 4756(a)(2). Orders can be entered into Nasdaq trading system from 7:00 am until 8:00 pm, Eastern Time. Id. Order processing is governed by Nasdaq Stock Market Rule 4757, which describes an order execution algorithm.

¹⁷⁹ Nasdaq Stock Market Rule 4755(3). Intermarket Sweep Orders must be executed exclusively within the Nasdaq Stock Market's trading system in compliance with Regulation NMS. Nasdaq Stock Market Rule 4755(4). Intermarket Sweep Orders are limit orders as defined in Nasdaq Stock Market Rule 6000(b).

¹⁸⁰ Nasdaq Stock Market Rule 4751(i) defines the term System Book Feed as a data feed for all eligible securities trading in the Nasdaq Trading System.

¹⁸¹ Nasdaq Stock Market Rule 4756(c)(2). Reserve size is not required to be display but must be accessible (see Nasdaq Stock Market Rule 4757).

¹⁸² Nasdaq Stock Market Rule 4751(f)(1) defines a discretionary order as an order that is displayed on the Nasdaq System showing price and size along with a non-displayed discretionary price range at which the entering party is also willing to buy or sell.

¹⁸³ Nasdaq Stock Market Rule 4756(c)(3)(B). discretionary orders must be executed in accordance with Nasdaq Stock Market Rules 4751(f) 4757.

¹⁸⁴ Nasdaq Stock Market Rule 4756(c)(3)(C).

¹⁸⁵ The ITS is a communications network system that links electronically the Non-Nasdaq Stock Markets and the Nasdaq Stock Market pursuant to the ITS plan which requires competing exchange markets to submit bids and offers for the purpose of choosing the best market for a given transaction as required under § 11A(a)(3)(B) of the Exchange Act and Rule 608 promulgated thereunder.

¹⁸⁶ Nasdaq Stock Market Rule 4756(c)(3)(D). If, upon entry and non-eligible for routing, a displayed order in an exchange-listed security would lock or cross the market, it will be converted into a non-displayed order. The same would occur for displayed orders that would lock or cross the market or cause a trade-through violation; subsequently, the order would be re-priced to the current low offer or best bid, whichever would be applicable. Both of these types of non-displayed orders would be canceled if the market moved through the price of the order after the order was accepted. Nasdaq Stock Market Rule 4756(c)(3)(D)

Spread

Every Market Maker must register to trade a stock with both a bid and offer price. In 1997, ECNs were also included as market participants.

BID PRICE	ASK PRICE
POSITION TO BUY	POSITION TO SELL
MM1.....25	25.25.....MM4
MM2.....24.875	25.5.....ECN1
MM3.....24.875	25.5.....MM3
ECN1.....24.875	25.5.....MM2
MM4.....24.875	25.5.....MM1

Market Marker 1 has positioned itself to buy stock.



Spread

All trades on Nasdaq are required to be executed at the best displayed price or better (when trade size \leq displayed size).

BID PRICE	ASK PRICE
MM1.....25	25.25.....MM4
MM2.....24.875	25.5.....ECN1
MM3.....24.875	25.5.....MM3
ECN1.....24.875	25.5.....MM2
MM4.....24.875	25.5.....MM1



¹⁸⁷ The Nasdaq Stock Market, Market_Structure, PowerPoint Presentation, Slides 20-21, on file with the author.

a. Listing Requirements

The Nasdaq Stock Market must maintain listing requirements for issuers seeking to list their securities that are designed to comply with the the federal securities laws and its own rules.¹⁸⁸ Nasdaq uses quantitative and qualitative criteria to meet its statutory mandate. These criteria are different with respect to whether the issuer is seeking to list on the Nasdaq Global Select Market, the Nasdaq Global Market, or the Nasdaq Capital Market. The Nasdaq Global Select Market has the most stringent criteria while the Nasdaq Capital Market has the least stringent criteria. This allows the Nasdaq Stock Market to seek to list a wide range of issuers but still meet its statutory mandate. For analytical purposes, this article will review listing requirements in the Nasdaq Rule 4300 Series (the Nasdaq Capital Market) which applies to securities of domestic or Canadian issuers and non-Canadian foreign securities and american depository receipts.¹⁸⁹ In addition, although various types of securities may be listed on the Nasdaq Stock Market, this discussion is confined to the listing of common stock only.¹⁹⁰

Quantitative criteria under the Nasdaq Stock Market Rule 4300 Series includes financial and liquidity requirements which differ depending on whether the issuer is initially listing or is seeking to maintain its listing. Financial requirements are based on pre-tax earnings, cash flows, market capitalization, revenue, bid price, and the number of market makers. They are divided into three standards, which allows for some flexibility for the issuer in meeting the financial requirements. The following tables enumerating quantitative initial and continued listing requirements for domestic and Canadian issuers for common stock only on the Nasdaq Capital Market was prepared by the Nasdaq Stock Market. Table 1 contains initial listing standards and Table 2 contains continued or maintenance listing standards.¹⁹¹

INITIAL LISTING

Companies must meet all of the criteria under at least one of the three standards below.

¹⁸⁸ Sections 6 and 19(a) of the Exchange Act, 15 U.S.C. §§ 78f and 78s(a).

¹⁸⁹ See Nasdaq Stock Market Rules 4310 and 4320, respectively. The irony of the application of the same rules for both U.S. and Canadian issuers is not lost on the author. However, this is only one part of the securities regulatory framework and does not evidence regulatory comparability with the entire U.S. securities regulatory framework.

¹⁹⁰ Listing requirements for other types of securities are contained in Nasdaq Stock Market Rules 4426(e), 4426(f), 4450 and 4420.

¹⁹¹ See, Nasdaq Stock Market, Listing Fees and Standards, available at: http://www.nasdaq.com/about/nasdaq_listing_req_fees.pdf.

NASDAQ Capital Market Listing Requirements

Requirements	Standard 1	Standard 2¹	Standard 3	Marketplace Rules²
Stockholders' equity	\$5 million	\$4 million	\$4 million	4310(c)(2) 4320(e)(2)
Market value of publicly held shares	\$15 million	\$15 million	\$5 Million	4310(c)(2) 4320(e)(2)
Operating history	2 years	N/A	N/A	4310(c)(2) 4320(e)(2)
Market value of listed securities ³	N/A	\$50 million	N/A	4310(c)(2) 4320(e)(2)
Net income from continuing operations (in the latest fiscal year or in two of the last three fiscal years)	N/A	N/A	\$750,000	4310(c)(2) 4320(e)(2)
Publicly held shares ⁴	1 million	1 million	1 million	4310(c)(7) 4320(e)(5)
Bid price	\$4	\$4	\$4	4310(c)(4) 4320(e)(2)
Shareholders (round lot holders) ⁵	300	300	300	4310(c)(6) 4320(e)(4)
Market makers ⁶	3	3	3	4310(c)(1) 4320(e)(1)
Corporate governance	Yes	Yes	Yes	4350, 4351, and 4360

¹ Seasoned companies (those companies already listed or quoted on another marketplace) qualifying only under the market value of listed securities requirement must meet the market value of listed securities and the bid price requirements for 90 consecutive trading days prior to applying for listing.

² Marketplace Rule 4310 is applicable to domestic (U.S.) and Canadian securities. Marketplace Rule 4320 is applicable to non-U.S. securities other than Canadian securities

³ Under Marketplace Rule 4200(a)(20), listed securities is defined as "securities listed on NASDAQ or another national securities exchange".

⁴ Publicly held shares is defined as total shares outstanding, less any shares held by officers, directors or beneficial owners of 10% or more. In the case of ADRs, for initial inclusion only, at least 400,000 shall be issued.

⁵ Round lot holders are shareholders of 100 shares or more. The number of beneficial holders are considered in addition to holders of record.

⁶ An electronic communications network (ECN) is not considered a market maker for the purpose of these rules.

CONTINUED LISTING

Companies must meet all of the criteria under at least one of the three standards below.

NASDAQ Capital Market Continued Listing Requirements

Requirements	Standard 1	Standard 2	Standard 3	Marketplace Rules ¹
Stockholders' equity	\$2.5 million	N/A	N/A	4310(c)(3) 4320(e)(2)
Market value of listed securities ²	N/A	\$35 million	N/A	4310(c)(3) 4320(e)(2)
Net income from continuing operations (in the latest fiscal year or in two of the last three fiscal years)	N/A	N/A	\$500,000	4310(c)(3) 4320(e)(2)
Publicly held shares ³	500000	500000	500000	4310(c)(7) 4320(e)(5)
Market value of publicly held securities	\$1 million	\$1 million	\$1 million	4310(c)(7) 4320(e)(5)

Requirements	Standard 1	Standard 2	Standard 3	Marketplace Rules ¹
Bid Price	\$1	\$1	\$1	4310(c)(4) 4320(e)(2)
Public Holders ⁴	300	300	300	4310(c)(6) 4320(e)(4)
Market makers ⁵	2	2	2	4310(c)(1) 4320(e)(1)
Corporate governance	Yes	Yes	Yes	4350, 4351 and 4360

¹ Marketplace Rule 4310 is applicable to domestic (U.S.) and Canadian securities. Marketplace Rule 4320 is applicable to non-U.S. securities other than Canadian securities.

² Under Marketplace Rule 4200(a)(20), listed securities is defined as "securities listed on NASDAQ or another national securities exchange"

³ Publicly held shares is defined as total shares outstanding, less any shares held by officers, directors or beneficial owners of 10% or more.

⁴ Public holders of a security include both beneficial holders and holders of record, but does not include any holder, who is, directly or indirectly, an executive officer, director, or the beneficial holder of more than 10% of the total shares outstanding.

⁵ An electronic communications network (ECN) is not considered a market maker for the purpose of these rules.

(1) Corporate Governance

Corporate governance listing requirements apply to all issuers seeking to list on the Nasdaq Stock Market.¹⁹² Corporate governance rules address several categories including: (a) distribution of annual and interim reports; (2) independent directors; (3) audit committees; (4) shareholder meetings; (5) Quorum; (6) solicitation of proxies; (7) conflicts of interest; (8) shareholder approval; (9) stockholder voting rights; (8) and codes of conduct. However, foreign private issuers are permitted to follow their home country corporate governance rules if they disclose, in annual reports filed with the SEC, which corporate governance rules their home country regulators do not follow and describe the alternative (comparable) practices permitted by their home country regulators.¹⁹³ In addition, the foreign private issuer must submit a written statement to Nasdaq Stock Market from an independent counsel in it's home country certifying that the issuer's non-compliant practices are not prohibited by its home regulator.¹⁹⁴ Essentially, Nasdaq Stock Market listing requirements already incorporate some of the comparability assessments suggested under the Substituted Compliance model proposed by Tafara and Peterson. However, foreign private issuers must comply with Nasdaq Stock Market corporate governance provisions that require: (1) disclosure of an auditor's opinion

¹⁹² Nasdaq Stock Market corporate governance rules are enumerated in Nasdaq Stock Market Rules 4350, 4351, and 4360.

¹⁹³ Nasdaq Stock Market Rule 4350(a)(1).

¹⁹⁴ Nasdaq Stock Market IM-4350-6.

expressing doubt about the issuer's ability to continue as a going concern;¹⁹⁵ (2) execution of the Nasdaq Stock Market Listing Agreement;¹⁹⁶ (3) prompt notification after an issuer's executive officer¹⁹⁷ becomes aware of any material noncompliance with Nasdaq Stock Market corporate governance provisions;¹⁹⁸ (4) the issuer to have an audit committee with the specific responsibilities and the authority necessary to comply with the provisions of Nasdaq Stock Market Rule 4350(d)(3);¹⁹⁹ and (5) all members of the issuer's audit committee to be independent directors.²⁰⁰

(a) Distribution of Annual and Interim Reports

Issuers listing on Nasdaq must distribute audited financial statements to their shareholders annually.²⁰¹ If the issuer's audited financial statements contain a qualified opinion (e.g. doubt as to the issuer's ability to continue as a going concern), it must notify the public by distributing a press release; however, the press release must be reviewed by Nasdaq MarketWatch and distributed to the public within 7 calendar days following the filing of its audited financial statements containing the qualified opinion with the SEC.²⁰² Issuers required to file quarterly financial reports with the SEC must also provide copies of such reports to the Nasdaq Stock Market.²⁰³ In addition, a foreign private issuer must issue a press release containing an interim balance sheet and income statement at the end of its second quarter.²⁰⁴

(b) Board Independence

The majority of the board of directors of issuers listed on the Nasdaq Stock Market must be independent.²⁰⁵ Moreover, the Nasdaq Stock Market asserts that

¹⁹⁵ Nasdaq Stock Market Rule 4350(b)(1)(B). See also, Nasdaq Stock Market IM-4350-6.

¹⁹⁶ Nasdaq Stock Market Rule 4350(j). See also, Nasdaq Stock Market IM-4350-6.

¹⁹⁷ The term executive officer means an issuer's president, principal financial officer, principal accounting officer (or controller); any vice-president of an issuer's business unit, division or function (e.g., administration); any officer of the issuer who performs a material, policy-making function; any other person who performs material, policy-making functions for the issuer; and officers of the issuer's parent or subsidiary that perform material policy-making functions for the issuer. Exchange Act Rule 16a-1(f); Nasdaq Stock Market IM-4350-4.

¹⁹⁸ Nasdaq Stock Market Rule 4350(m). See also, Nasdaq Stock Market IM-4350-6.

¹⁹⁹ Nasdaq Stock Market Rule 4350(d)(3). See also, Nasdaq Stock Market IM-4350-6.

²⁰⁰ See, Nasdaq Stock Market Rule 4350(d)(2)(A)(ii). See also, Nasdaq Stock Market IM-4350-6 and Exchange Act Rule 10A-3(b)(1).

²⁰¹ Nasdaq Stock Market Rule 4350(b)(1)(A). An issuer posting its audited financial statements on its website must, simultaneously, issue a press release stating that its audited financial statements have been filed with the SEC, are available on its website, provide its website address, and tell investors that a free, hard copy is available upon request.

²⁰² Nasdaq Stock Market Rule 4350(b)(1)(B).

²⁰³ These quarterly financial reports must include, among other things, a statement of operating results containing "any substantial items of an unusual or nonrecurring nature and net income before and after estimated federal income taxes or net income and the amount of estimated federal taxes." Nasdaq Stock Market Rules 4350(b)(2) and (3).

²⁰⁴ Nasdaq Stock Market Rule 4350(b)(4). Also, this financial information must be submitted to the SEC.

²⁰⁵ Nasdaq Stock Market Rule 4350(c)(1).

requiring a majority of independent directors "...guard[s] against conflict[s] of interest ...[and] empowers [independent] directors to carry out more effectively..."²⁰⁶ their oversight responsibilities. However, there is no empirical basis for this assertion.²⁰⁷ Nasdaq Rule 4200(a)(15) defines an independent director as "...a person other than an executive officer or employee of the company or any other individual having a relationship which, in the opinion of the issuer's board of directors, would interfere with the exercise of independent judgement in carrying out the responsibilities of a director."²⁰⁸ This definition is very broad. Family members²⁰⁹ of employees and any director or family member who is a current partner of the issuer's outside auditor who worked on the issuer's audit in the past three years are expressly excluded under this definition.²¹⁰ Finally, independent directors must conduct regularly scheduled meetings that only independent directors are permitted to attend, i.e., "executive sessions." Nasdaq Stock Market asserts that "[r]egularly scheduled executive sessions encourage and enhance communication among independent directors."²¹¹

(c) Committees of the Board of Directors

The compensation of the issuer's chief executive officer (CEO), and all other executive officers, must be determined by a majority of independent directors, or a compensation committee of the board of directors composed *only* of independent directors. Moreover, Nasdaq Stock Market qualitative listing requirements expressly prohibit the presence of the CEO even in the room where deliberations take place regarding his compensation.²¹² The Nasdaq Stock Market asserts that this requirement "...is intended to provide flexibility for an issuer to choose an appropriate board structure and to reduce resource burdens, while ensuring independent director control of compensation decisions."²¹³ However, a very limited exception to these requirements is available under exceptional circumstances, and only for a very limited time period—two years.²¹⁴ When the compensation committee consists of three (3) or more directors, a non-independent director may be appointed if the board of directors determines that this non-independent director is "required by the best interest of the company and its shareholders."²¹⁵ The non-independent director cannot be a current officer, employee, or family member of an officer or employee. In addition, the nature of the relationship of the non-independent director to the issuer and the reasons for his appointment must be disclosed in the issuer's proxy statement (or quarterly report) filed with the SEC for its

²⁰⁶ Nasdaq Stock Market IM-3450-4.

²⁰⁷ Jeffery D. Bauman, Elliott J. Weiss and Alan R. Palmiter, *Corporations: Law and Policy, Materials and Problems*, 6th (American Casebook Series).

²⁰⁸ Nasdaq Stock Market Rule 4350(a)(15).

²⁰⁹ Family member means a person's spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person's home. Nasdaq Stock Market Rule 4200(a)(14).

²¹⁰ See, Nasdaq Stock Market Rule 4200(a)(15)(C)-(F).

²¹¹ Nasdaq Stock Market IM-4350-4.

²¹² Nasdaq Stock Market Rule 4350(c)(3)(A).

²¹³ Nasdaq Stock Market IM-4350-4.

²¹⁴ Nasdaq Stock Market Rule 4350(c)(3)(C).

²¹⁵ Nasdaq Stock Market Rule 4350(c)(3)(C).

next annual shareholder meeting.²¹⁶ This limited exception regarding independence also applies to the nomination of directors.²¹⁷

Nominees serving on the issuers board of directors must be selected (or recommended to the full board for their selection) by a majority of independent directors or a nominations committee composed solely of independent directors.²¹⁸ According to the Nasdaq Stock Market, requiring that director nominees be selected by independent directors provides independent director oversight of the process for selecting director nominees for shareholder vote.²¹⁹ Accordingly, “[e]ach issuer must certify that it has adopted a formal written charter or board resolution...addressing the nominations process...”²²⁰ However, there are two significant exceptions to the requirement of independent director oversight of the nominations process: (1) no independent director oversight is required if the issuer is required to adhere to another director nomination process, which is inconsistent with Nasdaq Stock Market qualitative listing requirements *and* the non-Nasdaq Stock Market director nomination process pre-dates the Nasdaq Stock Market’s independent director oversight rule²²¹ and (2) controlled companies (more than 50% of the voting power is held by an individual, group or another company) are exempt from the Nasdaq Stock Market independent director oversight rule along with the requirement that the majority of the issuer’s board of directors be independent.²²²

The audit committee is one of the most significant committees under the qualitative listing requirements of the Nasdaq Stock Market because it is the first line of defense for ensuring the accuracy and transparency of the issuer’s financial condition. The primary goal of the audit committee is to ensure accurate disclosure of the issuer’s financial condition, which relies heavily on audit services provided by an outside accounting firm.²²³ Accordingly, the audit committee is directly responsible for appointing, compensating, retaining and overseeing the work of the issuer’s public accounting firm.²²⁴ This means that the public accounting firm must report directly to the audit committee.²²⁵ The audit committee is also responsible for conducting appropriate review and oversight of all related party transactions for potential conflicts of interest on an ongoing basis.²²⁶ At a minimum, the audit committee must be authorized to act with

²¹⁶ Nasdaq Stock Market Rule 4350(c)(3)(C).

²¹⁷ See, Nasdaq Stock Market Rule 4350(c)(4)(C),

²¹⁸ Nasdaq Stock Market Rule 4350(c)(4).

²¹⁹ See, Nasdaq Stock Market IM-4350-4.

²²⁰ Nasdaq Stock Market Rule 4350(c)(4)(B).

²²¹ Nasdaq Stock Market Rule 4350(c)(4)(E).

²²² However, controlled companies are not exempt from the requirements of Nasdaq Stock Market Rule 4350(c)(2), which requires regularly scheduled executive sessions for independent directors. Nasdaq Stock Market Rule 4350(c)(5).

²²³ Nasdaq Stock Market IM-4350-4.

²²⁴ See, Exchange Act Rule 10A-3(c)

²²⁵ Rule 10A-3(b)(2), 17 C.F.R. § 240.10A-3(b)(2).

²²⁶ Nasdaq Stock Market Rule 4350(h). the term related party transaction means transactions with “related persons,” which include the company’s directors, director nominees, executive officers, 5% shareholders, and their respective immediate family members. See, Regulation S-K, item 404.

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respect to: (1) retaining and oversighting registered public accounting firms on behalf of the issuer;²²⁷ (2) entertaining complaints concerning accounting, internal accounting control or auditing matters;²²⁸ (3) engaging advisors to conduct audit committee activities, effectively;²²⁹ and (4) funding audit committee activities, as determined, *solely*, by the audit committee.²³⁰

The audit committee must be composed of at least three independent directors. Each audit committee member must meet independence standards set out in Nasdaq Stock Market Rule 4200(a)(15) *and* Exchange Rule 10A-3(b)(1).²³¹ This means that each member of the audit committee must be independent²³² and cannot accept, directly or indirectly, any consulting, advisory, or other compensatory fee from the issuer or any of its subsidiaries.²³³ In addition, if an audit committee member serves on the board of directors of both the listed issuer and its affiliate, he may qualify as independent as long as he only receives compensation for service on the board of directors and board committees of the listed issuer and its affiliate.²³⁴

Nasdaq's qualitative listing standards also specify additional requirements for audit committee members. An audit committee member cannot have participated in the preparation of the issuer's financial statements during the past three (3) years. Moreover, audit committee members must be able to read and understand fundamental financial statements, *and* each issuer must certify that at least one member of its audit committee has employment experience in finance or accounting, professional certification in accounting, or "comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities."²³⁵ However, a very limited exception to these requirements is available under exceptional

²²⁷ Accounting firms that audit public companies for the purpose of protecting investors and the public interest must register with the Public Company Accounting Oversight Board ("PCAOB"). PCAOB is a private-sector, nonprofit corporation established under the Sarbanes-Oxley Act of 2002. Its mission is to facilitate the preparation of informative, fair, and independent audit reports of publicly-traded companies. PCAOB, available at <http://www.pcaob.org/>.

²²⁸ With respect to the issuer's employees, the audit committee must establish procedures to allow confidential, anonymous submission of concerns about questionable accounting or auditing matters. Nasdaq Stock Market Rule 4350(d)(3).

²²⁹ See, Exchange Act Rule 10A-3(b)(4), 17 C.F.R. § 240.10A-3(b)(4).

²³⁰ This includes necessary or appropriate, ordinary administrative expenses. Rule 10A-3(b)(5), 17 C.F.R. § 240.10A-3(b)(5).

²³¹ The requirements in Exchange Act Rule 10A-3(b)(1) are subject to the exemptions in Exchange Act Rule 10A-3(c). There are exemptions from the independence requirements for audit committee members specified in Exchange Act Rule 10A-3(b)(1)(ii) for foreign private issuers.

²³² However, Rule 10A-3(b)(1)(i) permits a listed issuer that is one of two dual holding companies to designate one audit committee for both companies as long as each member of the audit committee is also a member of the board of directors of at least one of the dual holding companies.

²³³ Such compensation does not include payment for service on the issuer's board of directors or board committees. Exchange Act Rule 10A-3(b)(1)(ii)(A).

²³⁴ Exchange Act Rule 10A-3(b)(1)(iv)(B)

²³⁵ Nasdaq Stock Market Rule 4350(d)(2)(A).

circumstances, and only for a very limited time period—two years.²³⁶ One audit committee member who is not independent under Nasdaq Rule 4200(a)(15), but meets the criteria in § 10A(m) of the Exchange Act²³⁷ may be appointed if the board of directors determines that this non-independent director is “required by the best interest of the company and its shareholders.”²³⁸

(d) Shareholders

Nasdaq Stock Market qualitative listing standards include provisions for shareholder rights. A shareholder meeting of the holders of the issuer’s listed common stock or voting preferred stock must occur annually.²³⁹ The purpose of the annual shareholder meeting is to allow shareholders to discuss the issuer’s affairs with management and to elect directors, if provided for in the issuer’s governing documents²⁴⁰

Issuers must also solicit and provide proxy statements for all shareholder meetings. Copies of proxy solicitations must be provided to the Nasdaq Stock Market.²⁴¹ A quorum (at least 33 1/3% of outstanding voting stock) must be present at any meeting in which shareholder approval is required of the issuer’s proposed action.²⁴² Nasdaq Stock Market’s primary goal is to provide a voice for existing shareholders when issuer compensation actions may result in dilution of their interests.²⁴³ Shareholder approval²⁴⁴ is required when a stock option, purchase plan, or other equity compensation is made or materially amended for officers, directors, employees or consultants.²⁴⁵ A material amendment of a compensation plan includes a material increase in the number of shares to be issued; a material expansion of the class of participants eligible to participate; and

²³⁶ Nasdaq Stock Market Rule 4350(d)(2)(B).

²³⁷ Section 10A(m) of the Exchange Act does not allow the audit committee member to receive compensation for any consulting, advisory, or other compensatory fee from the issuer; also, the audit committee member cannot be an affiliated person of the issuer or any subsidiary of the issuer. § 10A(m)(3), 15 U.S.C. § 78.

²³⁸ Nasdaq Stock Market Rule 4350(d)(2)(B). The non-independent director cannot be a current officer, employee, or family member of an officer or employee. Also, the nature of the relationship of the non-independent director to the issuer and the reasons for his appointment to the audit committee must be disclosed in the issuer’s proxy statement (or quarterly report) filed with the SEC for its next annual shareholder meeting. Nasdaq Stock Market Rule 4350(d)(2)(B).

²³⁹ Nasdaq Stock Market Rule 4350(e).

²⁴⁰ Nasdaq Stock Market IM-4350-8.

²⁴¹ Nasdaq Stock Market Rule 4350(g). This requirement includes e-proxy provisions under the Exchange Act Rules.

²⁴² Nasdaq Stock Market Rule 4350(f). Where a shareholder vote is required, the minimum vote required for approval must be a majority of the total votes cast at the meeting considering the proposal. Nasdaq Stock Market Rule 4350(i)(6).

²⁴³ Nasdaq Stock Market IM-4350-5.

²⁴⁴ Shareholder approval is not required, if issuance of shares is part of a court-approved reorganization pursuant to federal bankruptcy laws or comparable foreign laws. Nasdaq Stock Market Rule 4350(i)(7).

²⁴⁵ This does not include certain types of securities specified in Nasdaq IM-4350-5. Also excluded are issuances for the purpose of inducing prospective employees to enter into employment with the issuer; however, the material terms of such inducements must be disclosed in a press release by the issuer regarding its reliance on this exemption. Nasdaq Stock Market Rule 4350(i)(1)(A).

an expansion in the types of options or awards.²⁴⁶ If a compensation plan allows a specific action without shareholder approval, this is permitted, as long as it does not contain a formula for automatic increases in shares available,²⁴⁷ or for automatic grants of shares tied to a dollar-based formula and the term does not exceed ten (10) years.²⁴⁸ Other instances requiring shareholder approval include when the issuance of shares will result in a change of control of the issuer²⁴⁹ or when the potential issuance of the issuer's outstanding common stock, or securities convertible into common stock,²⁵⁰ to acquire a company could result in a material dilution of voting power for the issuer's existing shareholders.²⁵¹

In addition, , Nasdaq Stock Market qualitative listing requirements contain a voting rights policy that prohibits the issuance of securities that would restrict or have a disparate impact on the voting rights of existing shareholders of the issuer's common stock registered pursuant to § 12 of the Exchange Act.²⁵² Examples of the prohibited conduct include issuance of super-voting stock, the adoption of capped voting rights plans,²⁵³ or the issuance of stock with voting rights less than the per share voting rights of existing common stock shareholders through an exchange offer.²⁵⁴ The voting rights policy specifically addresses dual class structures; consultation with the Nasdaq Stock Market; and past voting activities. Issuers with dual class structures cannot issue supra-voting stock, but there is a grandfather clause, which allows issuers that already have supra-voting stock to issue additional shares of their existing class of supra-voting stock.²⁵⁵ Violation of the Nasdaq Stock Market's voting rights policy results in the delisting of the issuer's securities.²⁵⁶ With respect to private foreign issuers, the Nasdaq Stock Market will accept compliance with the voting rights policy of the foreign private

²⁴⁶ See Nasdaq Stock Market IM-4350-5 items (1)-(4)

²⁴⁷ This is an example of an evergreen formula in a compensation plan. Nasdaq Stock Market IM-4350-5.

²⁴⁸ A compensation plan, which requires that grants are made using treasury or repurchased shares, are permitted only after obtaining shareholder approval. Nasdaq Stock Market IM-4350-5.

²⁴⁹ Nasdaq Stock Market Rule 4350(i)(1)(B).

²⁵⁰ This terms refers only to shares actually issued and outstanding. Unissued shares reserved for issuance upon conversion of securities or upon exercise of options or warrants will not be regarded as outstanding. Nasdaq Stock Market Rule 4350(i)(3).

²⁵¹ Voting power means the aggregate number of votes, which may be cast by holders of those securities outstanding, which entitle the holders to vote generally on all matters submitted to the issuer's shareholders for a vote. Nasdaq Stock Market Rule 4350(i)(4). Dilution is material when the issuer's common stock (or voting power) upon issuance represents at least 20% of the voting power outstanding before the issuance of common stock needed to acquire another company. Nasdaq Stock Market Rule 4350(i)(1)(C).

²⁵² Nasdaq Stock Market Rule 4351.

²⁵³ Share caps are used to prevent issuances of 20% or more of an issuer's common stock or 20% or more of the issuer's voting power outstanding before the transaction; such issuances would violate Nasdaq Stock Market Rule 4350(i), which requires a shareholder vote for such issuances. In addition, share caps structured with an alternative outcome based upon whether shareholder approval is obtained have been deemed to violate Nasdaq Stock Market Rule 4350(i). Specifically, the Nasdaq Stock Market asserts that "...if the terms of a transaction can change based upon the outcome of the shareholder vote, no shares may be issued prior to the approval of the shareholders..." Nasdaq Stock Market IM-4350-2.

²⁵⁴ Nasdaq Stock Market Rule 4351.

²⁵⁵ Nasdaq Stock Market IM-4351.

²⁵⁶ Nasdaq Stock Market IM-4351

issuer's home regulator, if it is comparable. However, Nasdaq Stock Market will not waive compliance with its voting rights policy for foreign private issuers. Finally, shareholders cannot otherwise agree to permit the issuer to violate or avoid the Nasdaq Stock Market's voting rights policy.²⁵⁷

(e) Other Nasdaq Stock Market Qualitative Listing Requirements

Nasdaq Stock Market qualitative listing requirements include other corporate governance provisions. Issuers must adopt and maintain a code of conduct for its directors, officers, and employees. This code of conduct must comply with the code of ethics described in § 406(c) of SOX and regulations and rules promulgated thereunder.²⁵⁸ The issuer must establish an enforcement mechanism to monitor and maintain its code of conduct; any waivers provided to directors, officers, and employees must be approved by the issuer's board of directors and disclosed in the issuer's Form 8-K filed with the SEC. This waiver procedure also applies to foreign private issuers.²⁵⁹

Finally, The Nasdaq Stock Market has discretionary authority to list or de-list an issuer even if it meets all of its qualitative and quantitative listing requirements. This discretionary authority is based on concern for the public interest.²⁶⁰ The Nasdaq Stock Market's discretionary authority is significant because it facilitates the Nasdaq Stock Market's ability to achieve its statutorily delegated mandate, i.e., "... to maintain the quality of and public confidence in its market, to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect investors and the public interest."²⁶¹ Accordingly, the Nasdaq Stock Market is authorized to impose additional or more stringent listing criteria, if necessary to fulfill its mandate.²⁶² In the exercise of its discretionary authority, the Nasdaq Stock Market may consider various factors including whether a person associated with the issuer has a

²⁵⁷ Nasdaq Stock Market IM-4350-1

²⁵⁸ Section 406(c) of SOX defines the term code of ethics as

such standards as are reasonably necessary to promote -

(1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;

(2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer; and

(3) compliance with applicable governmental rules and regulations.

§ 406(b) of SOX also requires public disclosure of any material changes to the issuer's code of conduct.

²⁵⁹ Nasdaq Stock Market Rule 4350(n).

²⁶⁰ See, Nasdaq Stock Market Rules 4300 and 4400.

²⁶¹ Nasdaq Stock Market Rule 4300.

²⁶² However, Nasdaq cannot use its discretionary authority to grant exemptions or exceptions from the listing criteria enumerated in its applicable rules. Nasdaq Stock Market IM-4300.

regulatory disciplinary history and whether remedial measures²⁶³ implemented by the issuer can ameliorate public interest concerns.²⁶⁴

III. Analysis

A. US investor access to Foreign Exchanges Under the Current US Securities Markets Regulatory Framework

US investors—retail,²⁶⁵ institutional,²⁶⁶ and major institutional²⁶⁷—can access foreign exchanges under the existing regulatory framework of the U.S. securities markets. Access is gained directly and indirectly by routing investor orders:

[a.] ...from the U.S. investor to the foreign exchange through a foreign broker-dealer;

[b] ...from the U.S. investor to the foreign exchange through a U.S. broker-dealer that then transmits the order to a foreign broker-dealer; or

[c] ...from the U.S. investor to the foreign exchange through a U.S. broker-dealer that is a member of that exchange (*using a trading screen placed in the United States*), without routing the order through a foreign broker-dealer²⁶⁸

²⁶³ Appropriate remedial measures include the person's resignation from officer and director positions, divestiture of stock holdings, termination of contracts between the issuer and the person, and establishment of a voting trust for the person's shares. Nasdaq Stock Market IM-4300.

²⁶⁴ Nasdaq Stock Market also reviews prior conduct and/or corporate actions by the issuer in determining whether the use of its discretionary authority is appropriate under the circumstances.

²⁶⁵ FINRA defines the term retail investor as an individual investor--- "[a] person who buys or sells securities for his or her own account. The individual investor is also called a retail investor or retail shareholder." FINRA, <http://www.finra.org/Resources/Glossary/p011041>, (last visited July 22 2008).

²⁶⁶ The term U.S. institutional investor is defined in Exchange Act Rule 15a-6(b)(7), 17 C.F.R. § 240.15a-6(b)(7), as "...a person that is:

(i) An investment company registered with the SEC under section 8 of the Investment Company Act of 1940; or

(ii) A bank, savings and loan association, insurance company, business development company, small business investment company, or employee benefit plan defined in Rule 501(a)(1) of Regulation D under the Securities Act of 1933 (17 CFR 230.501(a)(1)); a private business development company defined in Rule 501(a)(2) (17 CFR 230.501(a)(2)); an organization described in section 501(c)(3) of the Internal Revenue Code, as defined in Rule 501(a)(3) (17 CFR 230.501(a)(3)); or a trust defined in Rule 501(a)(7) (17 CFR 230.501(a)(7))."

²⁶⁷ The term major U.S. institutional investor is defined in Exchange Act Rule 15a-6(b)(4), 17 C.F.R. § 240.15a-6(b)(4), as "...a person that is:

(i) A U.S. institutional investor that has, or has under management, total assets in excess of \$100 million; provided, however, that for purposes of determining the total assets of an investment company under this rule, the investment company may include the assets of any family of investment companies of which it is a part; or

(ii) An investment adviser registered with the SEC under section 203 of the Investment Advisers Act of 1940 that has total assets under management in excess of \$100 million."

²⁶⁸ Howell E. Jackson, Andreas M. Fleckner & Mark Gurevich, FOREIGN TRADING SCREENS IN THE UNITED STATES, Discussion Paper No. 549, The Harvard John M. Olin Discussion Paper Series, available at: http://www.law.harvard.edu/programs/olin_center/, p.22.

Routing orders from a U.S. investor to a foreign exchange through a foreign broker-dealer located outside the U.S. allows direct, unregulated access to a foreign exchange by a U.S. investor.

U.S. Investor-----Foreign Broker/Dealer-----Foreign Exchange
Located Outside the U.S. Located Outside
the U.S.

The SEC does not regulate the foreign broker-dealer located outside of the U.S., but U.S. investors can open accounts at foreign broker-dealers located in their home countries on an unsolicited basis,²⁶⁹ if the laws of the foreign country permit them to do so. This means that U.S. investors can effect transactions in securities that are not subject to SEC regulation (disclosure and reporting requirements), thus stymieing the SEC's investor protection mandate. Technology (especially the Internet) has made it much easier for U.S. investors to find and open accounts with foreign broker/dealers in other countries that are not subject to the regulatory framework of the U.S. securities market.²⁷⁰ Again, this method of obtaining direct access to foreign exchanges is available to all U.S. investors, including investors who need protection the most--investors with minimal investing skills and knowledge, i.e., generally retail investors.²⁷¹ However, U.S. institutional and major U.S. institutional investors ("institutional investors") have greater access to foreign exchanges because many simply open a branch in the country in which they wish to do business and deal directly with the foreign exchange on its own soil. Moreover, institutional investors are allowed to receive directly (in the U.S.) various services from foreign broker-dealers, e.g., research reports and trade execution, as long as the foreign broker-dealer does not solicit an order.

Routing orders from the U.S. investor to the foreign exchange through a U.S. broker-dealer that then transmits the order to a foreign broker-dealer located in a foreign country permits indirect access for U.S. investors to the foreign exchange located in that same foreign country, but at a higher cost. The U.S. investor must pay two broker-dealers for trade execution instead of one.

U.S. Investor----U.S. Broker/Dealer----Foreign Broker/Dealer----Foreign Exchange

²⁶⁹ Exchange Act Rule 15a-6(a)(1), 17 C.F.R. § 240.15a-6(a)(1).

²⁷⁰ Howell E. Jackson, Andreas M. Fleckner & Mark Gurevich, FOREIGN TRADING SCREENS IN THE UNITED STATES, Discussion Paper No. 549, The Harvard John M. Olin Discussion Paper Series, available at: http://www.law.harvard.edu/programs/olin_center/, p. 24. See also, S. Eric Wang, Investing Abroad: Regulation S and U.S. Retail Investment in Foreign Securities, 10 U. Miami Bus. L. Rev. 329, 249 (2002).

²⁷¹ Howell E. Jackson, Andreas M. Fleckner & Mark Gurevich, FOREIGN TRADING SCREENS IN THE UNITED STATES, Discussion Paper No. 549, The Harvard John M. Olin Discussion Paper Series, available at: http://www.law.harvard.edu/programs/olin_center/, p.24.

Located in the U.S.	Located in a Foreign Country	Located in the Same Foreign Country as the Foreign Broker/ Dealer
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Although the U.S. broker-dealer is subject to regulation by the SEC, the foreign broker-dealer located in a foreign country is not.²⁷² Higher execution costs may not be an issue if the U.S. broker-dealer has a foreign branch or affiliate located in the same country as the foreign exchange; however, U.S. broker-dealers that do not have affiliates in foreign countries must find and pay a foreign broker-dealer located in that particular country to execute trades on the foreign exchange. Accordingly, U.S. investors with accounts at U.S. broker-dealers without foreign affiliates located in the same country as the foreign exchange must pay higher execution costs.²⁷³ Notably, the SEC’s investor protection mission is somewhat hindered because the US investor is dealing with a foreign broker-dealer, a foreign exchange and a foreign issuer not subject to the SEC’s reporting and disclosure requirements under the U.S. securities regulatory framework. In this scenario, the SEC cannot fulfill, at a minimum, the first prong of its statutory mandate--the protection of investors. Instead, it must rely on the foreign regulator and the rules of the foreign exchange to protect U.S. investors without assessing whether protections provided by the foreign regulator are comparable to investor protections contained in the U.S. securities regulatory framework.

Routing the order from the U.S. investor to the foreign exchange through a U.S. broker/dealer that is a member of that exchange (*using a trading screen placed in the United States*), without routing the order through a foreign broker-dealer would provide direct access to all types of U.S. investors without higher execution costs.

U.S. Investor-----U.S. Broker/Dealer <----> Foreign Exchange				
<table border="0"> <tr> <td style="text-align: center;">Located in the U.S.</td> <td style="text-align: center;">Located in the U.S.</td> </tr> <tr> <td style="text-align: center;">With Foreign Trading Screen</td> <td style="text-align: center;">VIA Trading Screen</td> </tr> </table>	Located in the U.S.	Located in the U.S.	With Foreign Trading Screen	VIA Trading Screen
Located in the U.S.	Located in the U.S.			
With Foreign Trading Screen	VIA Trading Screen			

In theory, both retail and institutional investors would have the same, lower cost, access to the foreign exchange because the U.S. broker/dealer would be a member of the foreign exchange located *within* the U.S. However, “Unfettered access of this sort

²⁷² Howell E. Jackson, Andreas M. Fleckner & Mark Gurevich, FOREIGN TRADING SCREENS IN THE UNITED STATES, Discussion Paper No. 549, The Harvard John M. Olin Discussion Paper Series, available at: http://www.law.harvard.edu/programs/olin_center/, p.25.

²⁷³ For broker/dealer firms without foreign, off-shore affiliates “...[o]rder routing procedures are somewhat more complicated.... These firms will need to route their orders to an unaffiliated foreign broker-dealer, perhaps one associated with a major U.S. trading firm or perhaps one operating only overseas.” Howell E. Jackson, Andreas M. Fleckner & Mark Gurevich, FOREIGN TRADING SCREENS IN THE UNITED STATES, Discussion Paper No. 549, The Harvard John M. Olin Discussion Paper Series available at: http://www.law.harvard.edu/programs/olin_center/, p.25.

is what the [SEC] has been unwilling to authorize....(aside from the Tradepoint²⁷⁴), and this trading channel is therefore not available to U.S. investors."²⁷⁵ Notably, this is what the SEC is now proposing to at least consider in its discussions of mutual recognition based on the Substituted Compliance model described by Tafara and Roberson. Under the model described by Tafara and Peterson, the SEC would rely on the foreign exchange and its foreign home regulator, primarily, to ensure investor protection mandated under the regulatory framework of the U.S. securities markets.

Given these access scenarios for U.S. investors to foreign exchanges, SEC action to fulfill its investor protection mandate may be almost too late. Continuing advances in technology may allow all U.S. investors to access foreign exchanges at a reasonable cost through foreign broker/dealers located in their home countries. This means that the SEC can't fulfill its investor protection mandate because it has no jurisdiction over the foreign broker/dealer or the foreign exchange to which U.S. investors have access and thus minimal ability to protect U.S. investors. The one entity that seems hurt the most in this scenario is the small, regional broker/dealer that does not have access to foreign exchanges located in other countries through their own affiliates located in such foreign countries; this means that they must pay a higher cost—and require their customers, who are most likely to be retail investors, to shoulder this cost—to access foreign exchanges located outside the U.S. for their customers. Again, the Tafara and Peterson Substituted Compliance model focuses on resolving the SEC's diminishing ability to fulfill the first prong of its statutory mandate--investor protection; advances in technology have made it possible for U.S. investors to access domestic securities markets in foreign countries, and the SEC must act in order to protect U.S. investors.

B. Substituted Compliance--Tafara and Peterson's Proposed International Framework²⁷⁶

²⁷⁴ In 1999, Tradepoint Financial Networks plc (Tradepoint), a U.K. screen-based electronic market for securities listed on the London Stock Exchange ("LSE"), was exempted from registration as an exchange by the SEC using the low volume exemption under § 5(2) of the Exchange Act, 15 U.S.C. § 78e(2) (2007). The exemption was granted with the following conditions: (1) average daily dollar value of trades with a U.S. broker/dealer member must be \$40 million or less, measured quarterly; (2) global average daily volume must be 10% or less of the average daily volume of the LSE, measured quarterly; (3) retail investors were only allowed to trade securities that were registered under the Exchange Act; and (4) Bid and offers could only be made to qualified institutional investors, international investors, and non-U.S. persons. *See*, Securities and Exchange Commission, Release No. 34-41199, International Series Release No. 1189 (File No. 10-126): Tradepoint Financial Networks plc; Order Granting Limited Volume Exemption From Registration as an Exchange Under Section 5 of the Securities Exchange Act (March 22, 1999), 64 Fed. Reg. 14,953, note 31, 14,957 (1999) [hereinafter:Tradepoint Release].

²⁷⁵ Howell E. Jackson, Andreas M. Fleckner & Mark Gurevich, FOREIGN TRADING SCREENS IN THE UNITED STATES, Discussion Paper No. 549, The Harvard John M. Olin Discussion Paper Series: http://www.law.harvard.edu/programs/olin_center/, p.25.

²⁷⁶ Substituted Compliance as set forth by Tafara and Peterson includes allowing foreign broker/dealers direct access to retail investors in the U.S. *See*, Ethiopis Tafara and Robert Peterson, A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework, 48 Harv. L.J. 31 (Winter 2007)

The Substituted Compliance regulatory framework (“Substituted Compliance”) would authorize the SEC to use its exemptive authority to permit foreign exchanges (using trading screens) to access US investors *inside* the US *without registering with the SEC*. This also means that the issuers listed on such foreign exchanges would not be registered with the SEC.²⁷⁷ Exemption from registration with the SEC would be based on the SEC’s determination that the foreign exchange is already subject to a comparable regulatory framework in its home country. Essentially, the SEC would have determined that allowing the foreign regulator to be the primary regulator of a foreign exchange operating inside the U.S., would not violate its legislative mandate--to protect investors; maintain fair orderly, and efficient markets; and facilitate capital formation.²⁷⁸ However, the SEC would retain jurisdiction over the foreign exchange with respect to investigating and enforcing the anti-fraud provisions of the federal securities laws. Also, the SEC would not be responsible for enforcing the securities laws of the foreign regulator primarily responsible for regulating the foreign exchange. Tafara and Peterson assert that the SEC’s exemptive authority is sufficient to allow access by foreign exchanges without requiring any material amendments to the federal securities laws.²⁷⁹

As proposed, Substituted Compliance would not adversely impact the competitiveness of U.S. exchanges required to register with the SEC pursuant to § 6 of the Exchange Act. Foreign exchanges would only be permitted to offer exclusively foreign-listed securities to U.S. investors inside the U.S. This means that securities listed on registered national securities exchanges in the U.S. could not be offered on a foreign exchange operating inside the U.S. The foreign exchange would only be permitted to offer securities listed on U.S. exchanges, if it registered with the SEC pursuant to § 6 of the Exchange Act. This framework facilitates a level playing field for exchanges registered in the U.S., which are subject to the prudential requirements and enforcement regime of the U.S. securities markets regulatory framework.

Substituted Compliance consists of two parts and would be implemented in a four step process. The two parts are : (1)exemption requirements and (2) regulatory preconditions. Part one outlines exemption requirements specific to the exchange seeking the exemption. Part Two sets forth a set of regulatory preconditions that must exist in the securities regulatory framework of the foreign exchange’s home country. With respect to implementation of the two parts, there is some overlap. Exemption requirements and regulatory preconditions must be established before the SEC can use its exemptive authority. Exemption requirements and regulatory preconditions are designed to ensure that the SEC’s legislative mandate is not compromised by exempting foreign exchanges from registration with the SEC pursuant to § 6 of the Exchange Act. The SEC

[Hereinafter Tafara and Peterson]. This article will only address requirements for allowing foreign exchanges to access U.S. retail investors, directly inside the U.S.

²⁷⁷ Tafara and Peterson, p. 27.

²⁷⁸ The SEC, 2004-2009 STRATEGIC PLAN 4, available at [http:// sec.gov/about/secstratplan0409.pdf](http://sec.gov/about/secstratplan0409.pdf).

²⁷⁹ Tafara and Peterson, p. 52.

determines whether the exchange has met its exemption requirements and the existence of the required preconditions in its home country securities regulatory framework by using a four step process:²⁸⁰

1. A petition from the foreign exchange to the SEC seeking an exemption from registration;
2. A discussion between the SEC and the foreign securities regulator with primary regulatory and oversight responsibility for the foreign exchange (designated as the home country regulator);
3. A dialogue between the SEC and the foreign stock exchange, which would include agreement to the SEC's jurisdiction and to service of process with regard to the anti-fraud provisions of the federal securities laws; and
4. Public notice and comment and subsequent SEC deliberation before determining whether to approve the petition for exemption by issuing a SEC order.

1. Steps 1 and 2 of the Process: Regulatory Comparability of Foreign Home Jurisdiction

Substituted Compliance begins with a petition to the SEC by the foreign exchange seeking an exemption from registration under § 6 of the Exchange Act. Next, the SEC would conduct an assessment of regulatory comparability with respect to the foreign exchange's home country regulator, i.e., the overall securities regulatory framework governing the exchange's activities in its home country. Regulatory comparability must include, at a minimum, comparability with the SEC's legislative mandate--to protect investors; maintain competitive, orderly, fair, and efficient market; and promote capital formation in the US. This assessment of regulatory comparability would help the SEC to determine appropriate regulatory preconditions to allow access to the U.S. securities markets by the foreign exchange. Substituted Compliance anticipates that the regulatory preconditions might be memorialized in a bilateral arrangement with the SEC and "...possibly legally supported by a treaty between the United States and the foreign government. Such a treaty would help cement an alliance of like-minded regulators committed to working together to provide for high quality investor protections and regulatory standards."²⁸¹

Also, step two of the process is based on bilateral discussions and negotiations. This means that the SEC evaluates and determines regulatory comparability in discussions with one country at a time. Substituted Compliance identifies this process as "...a bilateral regulatory mechanism..."²⁸² Tafara and Roberston contend that this bilateral regulatory mechanism would allow the SEC, among other things, "... to maintain

²⁸⁰ Substituted Compliance does not distinguish between exchanges and broker/dealers although they are regulated differently; exchanges generally have self-regulatory responsibilities along with their market activities.

²⁸¹ Tafara and Peterson, p.26

²⁸² Tafara and Peterson, p.28.

a substantial degree of de facto prudential oversight over foreign entities [such as exchanges] in its jurisdiction by negotiating the terms of foreign access.”²⁸³ Accordingly, discussion topics regarding comparability would include: 1. the exchange’s trading rules, 2. prudential requirements regarding the exchange (e.g.), 3. examinations of the exchange’s operations, 4. the exchange’s review processes for corporate filers, and, 5. “the enforcement capabilities and philosophies” of the home country regulator.²⁸⁴ In addition, Substituted Compliance recognizes that adjustments to the securities regulatory frameworks of both the SEC and the foreign home country regulator might be required to ensure an effective regulatory framework overall. Substituted Compliance envisions that memorialization of discussions and negotiations between the SEC and the home country regulator will include a framework for sharing information about enforcement activities and inspection reports; conducting joint inspections; and cooperating at the prudential oversight level.²⁸⁵

Substituted Compliance recommends that certain key criteria be used to assess the regulatory comparability of the foreign exchange’s home securities regulatory framework. Key assessment criteria include: 1. regulatory oversight of the foreign exchange by the home country regulator; 2. issuer requirements, 3. general legal and enforcement comparability, 4. reciprocity, and 5. supervisory and enforcement Memoranda of Understanding (“MOU”).²⁸⁶

a. Regulatory Oversight of the Foreign Exchange by the Home Country Regulator

Assessment of the home country regulator’s oversight of the foreign exchange is a key assessment criteria in determining appropriate regulatory preconditions. Tafara and Peterson assert that such an assessment should, at least, include an overall analysis of material differences between the SEC and the home country regulator. Specifically, this might include an evaluation of the two regulatory frameworks’ exchange registration requirements; statutory and SRO authority; if and how, the exchange and its members are licensed by the home country regulator; how investor funds are protected from misappropriation and misapplication; whether the foreign exchange is subject to recordkeeping, reporting, and electronic audit trail requirements by the home country regulator; whether the foreign exchange is subject to corporate governance requirements, including an internal control system; the comparability of the foreign exchange’s rules for trading on the exchange; and the comparability of the foreign exchange’s rule approval process.²⁸⁷

b. Issuer Requirements of the Home Country Regulator

²⁸³ Tafara and Peterson, p. 29.

²⁸⁴ Tafara and Peterson, p. 31.

²⁸⁵ Tafara and Peterson, p. 31.

²⁸⁶ Tafara and Peterson, p. 33.

²⁸⁷ Tafara and Peterson, p.33

The home country regulator comparability assessment must include an evaluation of issuer requirements. This would necessarily include an evaluation of the foreign exchange's listing requirements for issuers. Tafara and Peterson suggest that this comparability assessment should include, at a minimum, listing requirements pertaining to financial and non-financial statement disclosure requirements, the resiliency of accounting standards; the adequacy of local auditing standards, and the adequacy of auditor oversight controls. In addition, Tafara and Peterson recommend a comparability assessment of laws and regulations designed to ensure that issuer disclosures required by the foreign exchange are accurate and complete. Specifically, this would include a comparability assessment of corporate governance and internal control system requirements, director independence requirements, and laws and regulations designed to protect shareholders.²⁸⁸ A comparability assessment of issuer requirements must include at least these criteria to avoid mistaking a similarity in language, for a similarity in enforcement and regulatory philosophies with the home country regulator of the foreign exchange.

c. General Law and Enforcement in the Home Country of the Foreign Exchange

Comparability assessment would also include an evaluation of the general enforcement powers and philosophy of the home country regulator. Tafara and Peterson suggest various factors that might be considered in assessing such comparability including adoption, implementation, and adequate enforcement of the OECD Convention Against Bribery of Foreign Public Officials in International Business Transactions;²⁸⁹ certification that the home country regulator is not subject to constraints with respect to providing information to the the SEC regarding the Foreign Corrupt Practices Act; and implementation of applicable IOSCO regulatory principles with respect to the overall regulatory framework in the foreign exchange's home country. Tafara and Peterson also suggest an evaluation of whether shareholder remedies are comparable.

d. Reciprocity Between the SEC and the Home Country Regulator

Reciprocity appears to be non-negotiable under Substituted Compliance. U. S. registered exchanges regulated by the SEC must be allowed to engage in comparable activities in the foreign exchange's home country. In fact, Tafara and Peterson assert that ...

reciprocity would likely have to be the cornerstone of any [SEC] international framework to help ensure that the framework is politically acceptable in the United States and that competition is not a one-way street. Reciprocity is also essential for the [SEC] to fulfill its legislative mandate under the [National Securities Market Improvement Act] to promote the competitiveness of the U.S.

²⁸⁸ Tafara and Peterson, p. 34.

²⁸⁹ This OECD document was adopted on November 21, 1997 by OECD Member countries and five non-member countries, Argentina, Brazil, Bulgaria, Chile and the Slovak Republic to combat bribery of foreign public officials in international business transactions. OECD, available at http://www.oecd.org/document/21/0,3343,en_2649_34859_2017813_1_1_1_1,00.html

capital market and those firms and institutions accessing it.²⁹⁰

Finally, reciprocity might also apply to remedies available to investors in resolving disputes regarding their securities transactions. This would allow the investor, U.S. and foreign, to choose the forum in which to resolve disputes--in the U.S. or the home country of the foreign exchange.²⁹¹ However, this is probably more unlikely because this would assume that there are private rights of action under the securities regulatory framework of the home country regulator.

e. Supervisory and Enforcement Memoranda of Understanding (“MOU”) with the Home Country Regulator

Supervisory and enforcement MOUs between the SEC and the home country regulator are required to determine regulatory comparability. These written arrangements must provide for enforcement information sharing and prudential regulatory oversight. The purpose of these arrangements is to facilitate the exchange of routine regulatory information to ensure initial and continuing comparability between the U.S. and the home country regulatory regime. Supervisory arrangements would include information sharing with regard to regulatory changes in both the home country and the U.S., risk assessments, reports of inspections of the foreign exchange conducted by its home country regulator,²⁹² and even “informal regulatory concerns that may have an impact on oversight of the exempted exchanges...”²⁹³ Essentially, such arrangements would allow the SEC and the home country regulator to act as meaningful regulatory partners in their oversight of the foreign exchange. Moreover, Tafara and Peterson suggest that the SEC and the home country regulator “...hold periodic regulator-to-regulator staff-level meetings to discuss prudential oversight matters of mutual concern..... [and] meet regularly at senior levels to help ensure that regulatory standards and approaches remain comparable through coordinated interpretations and enforcement approaches.”²⁹⁴

Finally, Substituted Compliance suggests that the SEC will retain broad discretion to determine regulatory comparability with respect to particular elements of the U.S. securities regulatory framework.²⁹⁵ Such broad discretion is needed because the SEC is in the best position to determine whether a particular element of the foreign country regulatory framework, as it is applied, is comparable to the underlying policies and goals of a particular element of the U.S. securities regulatory framework. Also, such broad discretion ensures that, under Substituted Compliance, the SEC has the capacity to

²⁹⁰ Tafara and Peterson, p. 35

²⁹¹ Tafara and Peterson, p. 35

²⁹² Non-public reports of inspection might also include registration and disciplinary information, client identification and beneficial ownership information, and statements from exchange employees.

²⁹³ Tafara and Peterson, p. 36.

²⁹⁴ Tafara and Peterson, p. 63

²⁹⁵ Tafara and Peterson, p.63.

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fulfill its legislative mandate--to protect investors; maintain fair orderly, and efficient markets; and facilitate capital formation.²⁹⁶

2. Step 3 of the Substituted Compliance---Entity-Specific Exemption Requirements

Step three of the implementation process details representations and information that must be submitted by the petitioning foreign exchange directly to the SEC.²⁹⁷ Initially, the foreign exchange must represent to the SEC that it agrees to be subject to the anti-fraud provisions of the U.S. securities laws, including Rule 10b-5 of the Exchange Act; This representation includes agreeing to provide a U.S. service of process agent. This requirement appears to subject the foreign exchange to both private and federal liability as § 10(b) and Rule 10b-5 thereunder provide for private rights of action. The foreign exchange must also agree to provide a disclosure statement²⁹⁸ to U.S. investors making them aware of the risks associated with trading on its facilities because it is not subject to SEC oversight under § 6 of the Exchange Act.²⁹⁹

The petitioning exchange must agree to provide information specific to its operations. Tafara and Peterson recommend that such entity-specific information include affirmations regarding home registration status, disciplinary history (if any), and identification of government entities and SROs with oversight responsibility, both in the foreign exchange's home country regulatory framework and the global securities market. They also suggest obtaining information about the foreign exchange's trading rules, listing requirements, corporate governance practices, and rulemaking procedures and approval process.³⁰⁰ Such information might be provided quarterly, annually, or in a timeframe that makes sense in light of the pace of change in the provisions of applicable laws and rules in the petitioning foreign exchange's home country regulatory framework.

Finally, foreign exchanges receiving an exemption from registration may be sanctioned for failing to provide requested information to the SEC. Sanctions may be imposed for failing to provide requested information as well as failing to provide accurate information. Depending on the severity of the conduct,³⁰¹ the SEC could revoke the foreign entity's exemption from registration with the SEC and any other exemptions it

²⁹⁶ Tafara and Peterson, at 15.

²⁹⁷ Most likely, certain of these exemption requirements could also be characterized as regulatory preconditions. However, for the sake of clarity, the author will use the term exemption requirements when referring to entity-specific requirements for obtaining an exemption from registration with the SEC.

²⁹⁸ The foreign exchange provides this disclosure statement through its members and any other SEC registered or exempt broker/dealers conducting transactions on its facilities. Tafara and Peterson, p. 65

²⁹⁹ Tafara and Peterson, p. 65. Tafara and Peterson also suggest that this disclosure statement to investors: "...note that the laws and regulations that govern the foreign stock exchange may be different from those in the United States, that U.S. investors may not have access to the U.S. courts should a dispute occur, and that U.S. federal securities laws may not apply to the transaction in which they are engaging...." [and] "any choice of law and choice of forum provisions, particularly if those provisions limited U.S. investors to the legal remedies of the foreign jurisdiction."

³⁰⁰ Tafara and Peterson, p. 5.

³⁰¹ Examples of conduct that might constitute a violation of the federal securities laws include failure to provide required information, furnishing inaccurate information, and fraud.

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may have obtained. In the later case, due process requires adequate notice and a hearing. Revocation leaves the foreign exchange with two choices---withdraw from the U.S. securities market or register with the SEC as an exchange under § 6 of the Exchange Act.³⁰²

3. Step Four of the Implementation Process--Public Notice and Comment in the U.S.

Step four of the process requires the SEC to subject its initial determination to grant or deny an exemption from registration to the foreign exchange to public review. This process allows interested members of the public and the securities industry to comment in support or in opposition to the SEC's initial decision before it becomes final. However, comments received by the SEC are not required to be included in the SEC's final determination whether to grant or deny an exemption to the foreign exchange.

4. Other Components of Substituted Compliance

Substituted Compliance calls for an in-depth review of the initial assessment of regulatory comparability, at a minimum, once every five years. The purpose of such a review would be to ascertain whether the determining factors initially relied upon to establish regulatory comparability still remain substantially the same.

C. Nasdaq Canada

1. Background

Nasdaq Canada commenced operations in the Canadian provinces of Quebec and British Columbia in November 2000 and September 2003, respectively. In both provinces, it was established to provide an opportunity for all investors (retail and institutional investors) in Quebec and British Columbia to invest in Canadian IPOs and securities listed on the Nasdaq Stock Market in the U.S.³⁰³ Initially Nasdaq Canada's mission was to create a full-fledged exchange with the ability to compete with all Canadian exchanges that primarily traded equities, beginning in the province of Quebec. Specifically, the Nasdaq Stock Market in the U.S. ("Nasdaq US") planned to establish Nasdaq Canada 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 Nasdaq-listed securities (U.S. and Canadian issuers) in U.S. dollars only. Phase two

³⁰² Registration might not be a real option since it took 6 years for the SEC to declare effective the registration statement of the Nasdaq Stock Market.

³⁰³ Press Release, Nasdaq Stock Market, 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.

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included participation by non-FINRA³⁰⁴ member firms in Canada, trading in both U.S. and Canadian dollars, regulatory oversight by FINRA and Quebec's Securities Regulatory Authority, and listing Canadian companies exclusively on Nasdaq Canada. Phase three would have included linking Nasdaq Canada with Nasdaq US's affiliates in Japan ("Nasdaq Japan") and Europe ("Nasdaq Europe"). Phases two and three were expected to follow depending on the success of phase one.³⁰⁵ However, on September 20, 2003, Nasdaq US was forced to relinquish its plans for the implementation of phases two and three of Nasdaq Canada, in part, because of losses sustained due to the downturn in technology stocks and the global economy; the same losses contributed to Nasdaq US's decision to close other global ventures including Nasdaq Japan and Nasdaq Europe.³⁰⁶ In addition, political conditions in Canada played a significant role in preventing Nasdaq Canada's expansion to other provinces and in establishing phases two and three. Quebec and British Columbia wanted to reestablish equities trading because an overhaul of the Canadian securities market resulted in all equities trading being conducted only in the province of Ontario in the city of Toronto. Creating Nasdaq Canada allowed the return of the more lucrative equities trading business to both provinces.³⁰⁷ Currently, phase one of Nasdaq Canada continues to operate in the provinces of Quebec and British Columbia.³⁰⁸

2. Nasdaq Canada in Quebec

Quebec amended its securities act to allow Nasdaq Canada to be recognized as an SRO and an exchange in Quebec.³⁰⁹ Specifically, the amendment to the Quebec Securities Act ("QSA") expressly authorized Nasdaq US³¹⁰ to operate as an SRO in Quebec and exempted broker/dealers effecting transactions with Nasdaq US from certain

³⁰⁴ Formerly National Association of Securities Dealers, Inc. (NASD) members. *See, supra*, fn. ____.

³⁰⁵ Press Release, Nasdaq Stock Market, NASDAQ Announces the Launch of NASDAQ Canada (Nov. 21, 2000) (on file with author).

³⁰⁶ 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>

³⁰⁷ *See, Cheryl Nichols, The Importance of Selective Federal Preemption in the U.S. Securities Regulatory Framework: A lesson from Canada, Our Neighbor to the North*, Chapman Law Review, Vol. 10, No. 2, p. 391, 454-458 (Winter 2006).

³⁰⁸ Marotte, *supra* note 357, at B5.

³⁰⁹ Nasdaq stock exchange activities in Quebec, An Act respecting, R.S.Q. E-20.1, <http://www.canlii.org/qc/laws/sta/e-20.01/20040210/whole.html>, last visited June 16, 2008. Nasdaq is recognized as an SRO within the meaning of section 169 of the Securities Act (chapter V-1.1) to carry on business in Quebec. s. 1.

³¹⁰ In 2000, The Nasdaq US was a wholly-owned subsidiary of the National Association of Securities Dealers, Inc. (NASD), and the NASD, an SRO registered with the SEC, performed required regulatory duties delegated by the SEC pursuant to § 15A of the Exchange Act. Nasdaq US was a wholly-owned subsidiary of the NASD until December 2005. Nasdaq US, no longer owned by the NASD, registered with the SEC as an exchange but continued to contract with the NASD to perform certain of its statutorily required SRO duties. (see section __, p. __ of this article). In July 2007, the NASD became FINRA by combining its regulatory functions with the enforcement and arbitration functions of the NYSE. FINRA, like its predecessor the NASD, is registered with the SEC as a securities industry association authorized to perform SRO duties. For clarity, the analysis of Nasdaq Canada will use NASD instead of FINRA because FINRA did not exist during the creation and the first eight years of Nasdaq Canada's operations.

provisions of the QSA.³¹¹ Nasdaq US incorporated Nasdaq Canada under the Canada Business Corporation Act as a wholly-owned subsidiary; however, Nasdaq Canada was authorized to operate as an SRO³¹² and an exchange under the QSA only if it complied with the rules of Nasdaq US. Finally, the amendment to the QSA allowed Nasdaq US, with the prior approval of the Quebec Securities SEC, to delegate certain SRO responsibilities to another SRO authorized under the Quebec Securities Act. This was necessary because membership in Nasdaq US required membership in the NASD.³¹³ Essentially, the amendment to the QSA allowed Quebec to rely primarily on the US securities regulatory framework to regulate Nasdaq Canada, i.e., Nasdaq US's home regulator in the US--the SEC. This arrangement is an example of mutual recognition based on substituted compliance; Quebec determined that it could meet the statutory mandate of its securities regulatory framework (protecting investors and ensuring a transparent, competitive, and efficient securities market) because the U.S. securities regulatory framework was comparable.

An analysis of Nasdaq Canada's regulatory structure would be incomplete without a review of its broker/dealer model because of their overlapping regulatory jurisdiction and enforcement activities. Nasdaq Canada began with a membership of the largest ten Canadian broker/dealers in the Canadian securities industry.³¹⁴ These member broker/dealers established affiliated, wholly-owned Delaware corporations whereby the affiliate operated in Montreal in the same building as its parent, the Nasdaq Canada member broker/dealer ("Canadian parent broker/dealer"), and used Nasdaq U.S. workstations or trading screens.³¹⁵ All U.S. incorporated affiliates were regulated under U.S. securities laws, which required that they register with the SEC and become members in the NASD; NASD membership required registration of certain employees of U.S. incorporated affiliates of the Canadian parent broker/dealer ("Quebec NASD Affiliates"). A Quebec NASD Affiliate was structured as an order entry firm and, under the QSA, could have only one institutional client, its Canadian parent broker/dealer.³¹⁶ Moreover, the Quebec NASD Affiliate was required to have dually-engaged employees, i.e., persons who were employed by the Quebec NASD Affiliate and the Canadian parent broker/dealer simultaneously.³¹⁷ The Nasdaq Canada broker/dealer model effectively allowed direct regulation under the U.S. securities regulatory framework and indirect

³¹¹ However, Quebec Securities Commission (the Autorite des marches financiers or AMF) reserved discretionary authority to apply specific provisions of the Quebec Securities Act to such broker/dealers.

³¹² With modifications and amendments considered necessary by Quebec, solely in its discretion.

³¹³ This remains a requirement, currently. Membership in Nasdaq US requires membership in FINRA. Both entities are under the jurisdiction of the SEC.

³¹⁴ 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

³¹⁵ 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.

³¹⁶ Romano, *supra* note 358, at 3.

³¹⁷ *Id.* at 10.

regulation under Quebec's securities regulatory framework. Quebec regulated the same employees of the Quebec NASD Affiliate in connection with their interactions with Canadian investors (institutional and retail) and securities markets. Canadian parent broker/dealers and their Quebec NASD affiliates were required to:

- (1) remain affiliated with a Quebec broker/dealer that is an Investment Dealers Association³¹⁸ member in good standing;
- (2) undertake to the NASD and the Quebec Securities SEC that:
 - a. a Quebec NASD Affiliate would carry on its business in compliance with applicable NASD requirements;
 - b. a Quebec NASD Affiliate would not have any clients in Quebec (other than its Canadian parent broker/dealer) and would only engage in U.S. transactions;
 - c. all trading officers and employees of the Quebec NASD Affiliate would be dually employed by both the Canadian parent broker/dealer and its Quebec NASD Affiliate; and
 - d. the Quebec 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 and inspection rights to the Quebec Securities Commission.³¹⁹

The Nasdaq Canada broker/dealer model also benefited Canadian broker/dealers because, presumably, it reduced the cost of accessing the U.S. securities markets. Cost were reduced because Canadian broker/dealers were permitted to establish Quebec NASD Affiliates in the US, but operate them on their own premises in Canada, staff them with Canadian employees, utilize existing infrastructure, and supervise them via their existing Canadian compliance operations.³²⁰

3. Nasdaq Canada in British Columbia

³¹⁸ Prior to 2007, the Investment Dealers Association of Canada (IDA) was Canada's largest SRO charged with regulating Canada's broker/dealers. Accordingly, it is authorized under the securities acts of Canada's thirteen provinces and territories. Subsequently, the IDA became the Investment Industry Regulatory Organization of Canada ("IIROC") by combining with Market Regulation Services, Inc., a Canadian SRO. IIROC is now Canada's largest SRO charged with regulating Canada's broker/dealers.

³¹⁹ *Id.* at 11.

³²⁰ The author recognizes that Quebec NASD Affiliate model would be most beneficial for smaller broker/dealers in Quebec with insufficient capital to establish, staff, and operate an affiliate broker/dealer in the U.S.

Nasdaq Canada began operating in British Columbia in 2003 in a manner quite similar to its operation in Quebec.³²¹ Nasdaq US and Nasdaq Canada applied for an exemption from the requirement to be recognized as an exchange under § 25 of the Securities Act of British Columbia (BC Securities Act).³²² In 2003, the NASD remained the parent company of Nasdaq US and a national securities association registered with the Commission pursuant to § 15A of the Exchange Act. Also, the NASD continued to provide regulatory services to Nasdaq US required under the Exchange Act.³²³ In addition, Nasdaq Canada has no trading or marketplace operations that are independent of Nasdaq US.³²⁴

The broker/dealer model for NASD affiliates in British Columbia (BC NASD Affiliate) is substantially the same as the Quebec NASD Affiliate. A Canadian broker/dealer who is registered in British Columbia (BC parent broker/dealer) and is a member in good standing with the IDA, was permitted to have a BC NASD Affiliate using dually-engaged employees. The BC NASD Affiliate was a wholly-owned U.S. corporation and exempt from the registration requirements under the BC Securities Act, but "...subject to conditions necessary to protect the integrity of regulation and the market in [British Columbia], such as:

- the [BC] NASD [A]ffiliate must remain affiliated with a [BC parent broker/] dealer that is an IDA member;
- all trading officers and trading employees in [British Columbia] of the [BC] NASD Affiliate must be dually employed by both the [BC parent broker/] dealer and its [BC] NASD Affiliate;
- the [BC] NASD Affiliate must comply with relevant NASD requirements;
- the [BC] NASD Affiliate must not have any clients in [British Columbia] other than its [BC parent broker/] dealer affiliate and accredited investors acting as principal or other clients in respect of which registration is not required, and must only engage in transactions in the U.S.; and

³²¹ According to Simon Romano, general counsel to Nasdaq Canada, Nasdaq Canada was organized and operated in British Columbia in the same manner as in Quebec. However, the author was only able to obtain detailed information about the creation and operation of Nasdaq Canada in British Columbia. The failure to obtain detailed information regarding Quebec was due primarily to the author's inability to speak French and/or to obtain a reliable translator; many of the applicable documents obtained were available only in French.

³²² It was also necessary for Nasdaq US and Nasdaq Canada to apply for exemptions from certain requirements of National Instrument 21-101 (NI 21-101) and National Instrument 23-101 (NI 23-101). 2003 WL 22814272 (B.C. Securities Comm.), 2003 BCSECOM 744 (Nov. 12, 2003).

³²³ See, *Plan of Allocation and Delegation of Functions* (date?), which requires Nasdaq US to obtain the review, ratification or rejection of the NASD board for all actions taken by Nasdaq US.

³²⁴ 2003 WL 22814272 (B.C. Securities Comm.), 2003 BCSECOM 744 (Nov. 12, 2003), ¶ 8

- the [BC] NASD Affiliate must consent to jurisdiction in any action or proceeding before any court or securities regulatory authority in [British Columbia], agree to provide access to its books and records, and give inspection rights to the BCSC.³²⁵

One important difference between Quebec and British Columbia's Nasdaq broker/dealer model is that Quebec NASD Affiliates are only permitted to have a single client--its Quebec parent broker/dealer. BC NASD Affiliates are permitted to have clients other than their BD parent broker/dealers. However, this expansion in Nasdaq Canada's activities comes with additional terms and conditions of operation in British Columbia.

The BCSC required Nasdaq US and Nasdaq Canada to comply with certain terms and conditions to obtain and maintain their exemption from registration under the BC Securities Act. Nasdaq US was required to remain subject to oversight by the SEC and to comply with all applicable provisions of the U.S. securities regulatory framework.³²⁶ Also, Nasdaq US was required to formally acknowledge the jurisdiction of the BCSC with respect to all its activities conducted in British Columbia.³²⁷ Both Nasdaq US and Nasdaq Canada were prohibited from trading any Canadian securities in Canadian dollars.³²⁸ This in effect, preserved the ability of Canadian stock exchanges to compete with US exchanges in their own country. This is important because allowing trading of Canadian securities in Canadian dollars within Canada could create a two-tiered market in which only smaller, and perhaps less financially sound, Canadian issuers not able to meet Nasdaq US listing requirements would trade on Canadian exchanges. In addition, Nasdaq US was required to advise BCSC, if it intended to open an office in British Columbia.³²⁹ This requirement differs from Nasdaq Canada's initial operations in Quebec, because Nasdaq Canada, did have a very small office (only two employees) located in Montreal, Quebec. It is unclear whether this requirement would have an adverse impact on the exemptions from the BC Securities Act obtained by either Nasdaq US or Nasdaq Canada. Both Nasdaq US and Nasdaq Canada were required to file with the BCSC a list of any BC NASD affiliate "... against whom public disciplinary action has been taken[,] or who has been denied access by Nasdaq US in [any] quarter."³³⁰ This requirement provides the BCSC with information needed to take meaningful regulatory action, if necessary, against both the BC NASD Affiliate and its BC parent broker/dealer.

The BCSC expressed specific terms and conditions with respect to access to Nasdaq US and Nasdaq Canada. Nasdaq US was prohibited from providing access to its facilities to BC NASD members that were not either registered in accordance with the BC Securities Act or were exempted from the registration requirements of the BC Securities

³²⁵ British Columbia Securities Commission Weekly Summary

Week Ending June 20, 2003, B.C. Sec. Summ. Issue 06/20/2003, pp. 6-7.

³²⁶ 2003 WL 22814272 (B.C. Securities Comm.), 2003 BCSECOM 744 (Nov. 12, 2003), Appendix A, ¶ 1.

³²⁷ 2003 WL 22814272 (B.C. Securities Comm.), 2003 BCSECOM 744 (Nov. 12, 2003), Appendix A, ¶ 2.

³²⁸ 2003 WL 22814272 (B.C. Securities Comm.), 2003 BCSECOM 744 (Nov. 12, 2003), Appendix A, ¶ 3.

³²⁹ 2003 WL 22814272 (B.C. Securities Comm.), 2003 BCSECOM 744 (Nov. 12, 2003), Appendix A ¶ 4.

³³⁰ source needed.

Act.³³¹ This means that the BCSC retains its jurisdiction and therefore its ability to ensure compliance with applicable requirements of its securities regulatory framework with respect to broker/dealers operating within its jurisdiction; in effect, both the SEC and the BCSC were able to conduct meaningful regulatory oversight of BC NASD Affiliates. With respect to listing and trading operations of Nasdaq US of dually-listed securities (the Canadian security is listed simultaneously on Nasdaq US *and* a Canadian exchange), the BCSC required Nasdaq US to advise of, and to submit the basis for, trading halts, if the dually-listed security was subject to a trading halt in the US, but not in Canada or vice versa.³³² Finally, Nasdaq US and Nasdaq Canada must provide, upon the request of the BCSC:

- (a) any bylaw, rule or other regulatory instrument or policy, or direction, decision, order or ruling made under a bylaw, rule or other regulatory instrument or policy of Nasdaq US, Nasdaq Canada or the NASD;
- (b) the manner in which Nasdaq US carries on business;
- (c) the trading of securities on or through Nasdaq US; and
- (d) issuers, whose securities are listed or quoted on Nasdaq US.³³³

The operation of Nasdaq Canada in Quebec and British Columbia shows that its regulatory framework is sufficiently flexible to address local conditions, which are different in each province. This type of flexibility is needed if this regulatory framework is to be used by securities regulators to allow foreign exchanges to operate in other Canadian provinces or other domestic securities markets in the global securities market.

D. Nasdaq Canada: A Model of Mutual Recognition Based on Substituted Compliance

Nasdaq Canada is a model of mutual recognition based on substituted compliance, which is structured, theoretically, to provide access by foreign exchanges to all Canadian investors *in Canada*. It is substantially the same in concept and philosophy as Tamar and Peterson's Substituted Compliance model, with the exception of two significant differences.³³⁴ The Nasdaq Canada Model recognizes that the regulatory framework of the U.S. securities markets is comparable to the regulatory framework of Quebec and British Columbia; specifically, that relying on the regulatory framework of the U.S. securities markets would allow them to fulfill their legislative mandates---to protect investors and to ensure a transparent, competitive provincial securities market. With this

³³¹ 2003 WL 22814272 (B.C. Securities Comm.), 2003 BCSECOM 744 (Nov. 12, 2003), Appendix A, ¶ 6

³³² 2003 WL 22814272 (B.C. Securities Comm.), 2003 BCSECOM 744 (Nov. 12, 2003), Appendix A, ¶ 7.

³³³ 2003 WL 22814272 (B.C. Securities Comm.), 2003 BCSECOM 744 (Nov. 12, 2003), Appendix A, ¶ 8.

³³⁴ These differences are discussed in section III.E. of this article.

determined, the two provinces only needed to identify the particular requirements and regulatory preconditions needed to ensure that permitting direct access to their investors by a foreign exchange would not diminish the competitiveness of their provincial securities markets.

The Nasdaq Canada and Substituted Compliance models are structured similarly. Both consist of two parts--exemption requirements and regulatory preconditions. Part one for both the Nasdaq Canada and Substituted Compliance models outlines exemption requirements specific to the foreign exchange seeking access to the domestic market. Part two of both models sets forth regulatory preconditions that must exist in the foreign exchange's home country regulatory framework. Under both models, these exemption requirements and regulatory preconditions are designed to ensure that the legislative mandates of the BSCS, Quebec Securities Commission, and the SEC are not compromised. In this context, an important difference between the two models is that Quebec and British Columbia were forced to amend their securities acts to exempt Nasdaq Canada and Nasdaq US from their exchange registration requirements, while the SEC would be able to use its existing exemptive authority. This provides the SEC with the required flexibility to negotiate and implement quickly any decision to allow a particular foreign exchange access to the U.S. securities markets. There was no such mechanism available under the securities acts of British Columbia and Quebec; accordingly, both provinces were forced to amend their securities acts to obtain the required flexibility. Use of the SEC's exemptive authority is a singular benefit of the U.S. securities regulatory framework, which uses selective federal preemption resulting in one voice for the U.S. securities markets. Canada does not have this advantage.³³⁵

The implementation process for both Substituted Compliance and the Nasdaq Canada model, also, are quite similar. Both may begin with a petition or application by the foreign exchange to the SEC, the BCSC, and the Quebec Securities Commission requesting an exemption from exchange registration requirements. Next, the SEC, BCSC, or the Quebec Securities Commission must conduct an assessment of regulatory comparability with respect to the foreign exchange's home country regulator. During this assessment period, both models would facilitate a determination of appropriate regulatory preconditions needed to comply with their legislative mandates. Substituted Compliance anticipates that final determination of regulatory preconditions would be memorialized in bilateral agreements between the SEC and the home country regulator of the foreign exchange; it also suggests that the bilateral agreements be supported by a treaty to "...cement an alliance of like-minded regulators committed to working together to provide for high quality investor protections and regulatory standards."³³⁶ Presumably, the Nasdaq Canada model contains similar bilateral agreements describing regulatory

³³⁵ For an analysis of the use of selective federal preemption in the U.S. securities markets regulatory framework and a Comparison of the U.S. and Canadian regulatory frameworks, See, Cheryl Nichols, *The Importance of Selective Federal Preemption in the U.S. Securities Regulatory Framework: A lesson from Canada, our Neighbor to the North*, *Chapman Law Review*, Vol. 10, No. 2, pp. 415-489 (Winter 2006).

³³⁶ Tafara and Peterson, p.26.

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preconditions for access by Nasdaq Canada to investors in Quebec and British Columbia based on the final orders issued by each province.³³⁷

Both the Nasdaq Canada and Substituted Compliance models utilize a bilateral regulatory mechanism to allow access by foreign exchanges. Quebec and British Columbia each negotiated separately with Nasdaq US.³³⁸ This allowed each province to craft regulatory frameworks specifically designed to meet the conditions existing in their respective provinces, i.e., to effectively control the type of access permitted for foreign exchanges, while preserving their legislative mandates. Substituted Compliance contemplates that the SEC will negotiate with one foreign exchange or country at a time to determine regulatory comparability. This bilateral mechanism reduces the complexity of the regulatory comparability assessment process. Also, this bilateral regulatory mechanism facilitates the crafting of an effective regulatory framework overall because it encourages coordination and cooperation between the SEC and the home country regulator for both prudential oversight and enforcement. For example, the Substituted Compliance model contemplates sharing information about enforcement activities as well as conducting joint inspections and cooperating at the prudential oversight level. Similarly, under the Nasdaq Canada model, sharing information about enforcement activities and cooperating at the prudential oversight level is present because the Nasdaq Canada Model requires Nasdaq Canada to provide information about, among other things: (1) the manner in which Nasdaq US carries on its business; (2) any bylaw, rule, order, or other regulatory instrument or policy of Nasdaq US or Nasdaq Canada; and (3) issuers whose securities are listed or quoted on Nasdaq US.³³⁹

Also, both models assess the comparability of regulatory oversight of the foreign exchange conducted by its home country regulator. Moreover, it appears that many of the same criteria are used under both models to assess comparability. Under Substituted Compliance, the comparability of oversight by the foreign exchange's home country regulator is conducted by analysing, among other factors, the exchange registration requirements of the home country regulator, the statutory and SRO authority of the foreign exchange; whether the foreign exchange and/or its members are licensed by the home country regulator; whether the home country regulator requires the foreign exchange to make and keep records, required to implement certain corporate governance requirements; and the rule approval process of the foreign exchange. The Nasdaq Canada model apparently analyzes similar factors in determining the comparability of oversight conducted by Nasdaq Canada's home country regulator--the SEC. Nasdaq Canada was statutorily authorized to operate as an exchange and SRO in both provinces, only if it complied with the rules of Nasdaq US, which, at the relevant time, was owned and

³³⁷ In fact, bilateral agreements concerning information sharing in enforcement activities in the form of Memoranda of Understanding ("MOU") currently exist between the SEC and the securities commissions of both Quebec and British Columbia. See, Ontario Securities Commission web site at http://www.osc.gov.on.ca/International/imou/imou_20030714_mou-table.pdf.

³³⁸ As previously noted, the bilateral negotiation conducted by Quebec and British Columbia may be a result of the absence of a federal securities regulator, similar to the SEC, in Canada. Nevertheless, each province negotiated separately with Nasdaq Canada.

³³⁹ 2003 WL 22814272 (B.C. Securities Comm.), 2003 BCSECOM 744 (Nov. 12, 2003), Appendix A, ¶ 8.

operated by the NASD--a registered securities association and SRO under the U.S. securities regulatory framework. The NASD required Nasdaq US, and therefore Nasdaq Canada, among other things, to make and keep records of its operations; to ensure that its members were registered with the SEC; to implement certain corporate governance requirements; and to obtain approval from the SEC of the implementation of its rules governing trading on Nasdaq US, and other rights, responsibilities, and activities of the Nasdaq US and its members.

The comparability of overall issuer requirements in the home country of the foreign exchange seeking access is assessed by both models. Both models assess the comparability of issuer requirements by examining the foreign exchange's listing requirements for issuers. They also include an evaluation of whether the home regulatory environment of the foreign exchange facilitates accurate and complete disclosure by issuers. The Nasdaq Canada model conducts this type of assessment by requiring Nasdaq US and Nasdaq Canada to provide information about issuers whose securities are listed on Nasdaq US. This listing information would include information regarding the listing requirement that an issuer's securities must be registered with the SEC in order to qualify for listing on Nasdaq US, and therefore Nasdaq Canada; registration of issuers' securities with the SEC brings to light overall issuer requirements in the U.S. securities markets designed to ensure the completeness and accuracy of information submitted to the foreign exchange by the issuer. The Substituted Compliance model contains substantially similar criteria for assessing issuer requirements in the foreign exchange's home country.

Both models include a review of the general enforcement powers and philosophy of the foreign exchange's home country regulator. In addition, both models appear to rely heavily on IOSCO regulatory principles in evaluating an effective securities regulatory framework, both in the global and domestic securities markets.³⁴⁰ However, neither order implementing the Nasdaq Canada model in British Columbia or Quebec mention relying on the OECD or FCPA in assessing regulatory comparability with respect to the home country regulator's general enforcement powers and philosophy.³⁴¹

Curiously, the Nasdaq Canada model and Substituted Compliance diverge markedly with respect to reciprocity. Substituted Compliance appears to assert that reciprocity is practically non-negotiable, i.e., U.S. exchanges registered with the SEC must be allowed to engage in comparable activities in the home country of the foreign exchange. This was not the case in the Nasdaq Canada Model. Seemingly, Nasdaq Canada was permitted to operate as an exchange and an SRO in British Columbia and Quebec, but that exchanges in both provinces were not allowed to engage in the same activities in the US. This is the one area of the Nasdaq Canada model that is, on its face, disadvantageous to the domestic securities market contemplating allowing direct access to its investors by foreign exchanges. Any model of mutual recognition based on substituted compliance must

³⁴⁰ The US, Quebec, and British Columbia are all members of IOSCO and are members of its technical committee, which is responsible for drafting IOSCO's *Objectives and Principles of Securities Regulation*, May 2003.

³⁴¹ Cite to the order--BC and Quebec

contain a reciprocity. If nothing else, reciprocity facilitates the ability to maintain a competitive position in the global securities market. It seems that this apparent lack of reciprocity was likely facilitated by the lack of a single securities regulator at the federal level in the Canadian securities regulatory framework. Essentially, lack of selective federal preemption in the Canadian securities regulatory framework adversely impacts Canada's ability to present a congruent securities regulatory presence in the global securities market and to negotiate from a position of strength. Accordingly, the US was able to enter the securities markets of Quebec and British Columbia without being required to accord the same access to the U.S. securities markets to foreign exchanges domiciled in Quebec and British Columbia.

The Nasdaq Canada and Substituted Compliance models contain supervisory and enforcement MOUs with the home country regulator. Such written arrangements must be designed to provide enforcement information sharing and to facilitate prudential regulatory oversight. With respect to supervision, both models recommend information sharing between the domestic regulatory authority and the foreign home country regulator about regulatory changes, risk assessments, exchange inspection reports, and informal regulatory concerns that may affect oversight of exempted exchanges. For example, the Nasdaq Canada model requires that Nasdaq Canada and Nasdaq US to provide supervisory information such as changes to Nasdaq by-laws, rules, and policies, changes to NASD by-laws, rules, and policies; and because all three entities are subject of regulation and oversight by the SEC, changes in the laws, rules, regulations, and policies of the SEC. Specifically, the BCSC required Nasdaq US, and therefore Nasdaq Canada, to remain subject to oversight by the SEC and in compliance with all applicable provisions of the U.S. securities regulatory framework.³⁴² Substituted Compliance includes similar criteria and recommends meetings with the staff of the foreign exchange's home regulator to ensure a meaningful regulatory partnership

The foreign exchange must submit information and make representations directly to the domestic regulatory authority from which it is seeking access under both models. The Nasdaq Canada model requires representations from both the foreign exchange and its members, i.e., Nasdaq Canada and BC NASD Affiliates. For example, BC NASD Affiliates must represent that they are affiliated with a BC parent broker/dealer who is registered in British Columbia and a member in good standing with the IDA. It must also represent that it will not have any clients other than its BC parent broker/dealer and accredited investors acting as principals, and that it will only engage in transactions in the U.S. The Nasdaq Canada model requires both the foreign exchange and its members to represent that they consent to jurisdiction in any action or proceeding before any court or the BCSC, and to provide access to its books and records along with inspection rights to the BCSC. In addition, both Nasdaq US and Nasdaq Canada must represent that neither will trade Canadian securities in Canadian dollars. While the information and representations are not exactly the same under the Nasdaq Canada and Substituted

³⁴² 2003 WL 22814272 (B.C. Securities Comm.), 2003 BCSECOM 744 (Nov. 12, 2003), Appendix A, ¶ 1.

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Compliance models, they are similar and have the same goal in this context---to retain sufficient regulatory authority over the foreign exchanges allowed to operate within their borders to fulfill their respective legislative mandates. Finally while the Nasdaq Canada model does not mention sanctions or what rights, if any, the foreign exchange has should the BCSC or the Quebec Securities Commission determine to revoke its exemption because sufficient comparability no longer exists, the Substituted Compliance model, at least, contemplates providing due process should the SEC decide to revoke the foreign exchange's exemption based on insufficient regulatory comparability.

Finally, Both models allow for public notice and comment when determining to issue an order to exempt a foreign exchange from domestic registration requirements. Both Quebec and British Columbia issued their preliminary determination, set a finite period for comments from the public and considered such comments in their deliberations. As previously noted, this is the process used under Substituted Compliance. Allowing public notice and comment allows the SEC to revise, or determine not to issue, an order exempting a foreign exchange from registration based on comments received from interested parties, including investors and other regulatory bodies, within the U.S. securities markets.

E. Significant Differences between Substituted Compliance and the Nasdaq Canada Model

A word about two significant differences between the Nasdaq Canada and Substituted Compliance models. Both models are essentially the same in concept, philosophy, and structure except for the Nasdaq Canada model's (1) seeming omission of reciprocity and (2) the regulation of broker/dealers indirectly by regulating the exchange on which they are members. In point of fact, reciprocity under both models means that each party receives some benefit in exchange for allowing the other direct access to its investors. Because Quebec and British Columbia allowed Nasdaq US direct access to their investors without complying with their securities regulatory framework, one would assume that they would demand the same type of access for exchanges domiciled in their jurisdictions. This was not the case. However, Quebec and British Columbia did receive, from their perspective, a very valuable benefit from permitting Nasdaq US, through its wholly-owned subsidiary, to have direct access to their investors. This benefit was the reemergence of equities trading in both jurisdictions. In 1999, the Canadian securities market determined to reorganize its securities markets in order to compete more effectively in the global securities market. The reorganization relocated all equities trading (one of the most lucrative submarkets in the securities industry) to the province of Ontario. This meant that the provinces of Quebec and British Columbia no longer had equities trading on exchanges domiciled within their jurisdictions. Accordingly, each province lost a very lucrative source of income in the securities business. To combat this loss, first Quebec, and subsequently British Columbia, negotiated with Nasdaq US to again have equities trading within their jurisdictions. This rift between the provinces and the perceived lack of reciprocity by other Canadian provinces, especially Ontario,

eventually stopped the expansion of Nasdaq Canada to other provinces. The four largest securities markets in Canada are located in the provinces of Ontario, Quebec, British Columbia, and Alberta. Expansion of Nasdaq Canada as structured in the provinces of Quebec and British Columbia would have destroyed Canada's major equities trading market--the Toronto Stock Exchange ("TSX") located in Ontario. Without operating in the province of Ontario, Nasdaq Canada could not have achieved its original goal--"...to establish a full-fledged exchange in Canada that would compete for listings..."³⁴³ with all exchanges domiciled in Canada, including the TSX. Accordingly, the Nasdaq Canada model contains reciprocity, but not to the extent required in any mutual recognition based on substituted compliance program that would be initiated by the SEC. Currently, the SEC is negotiating a process to begin discussions of mutual recognition based on substituted compliance with Ontario, Quebec, British Columbia, and Alberta. In all likelihood, this deficit in reciprocity under the Nasdaq Canada model will be corrected.³⁴⁴

There must be reciprocity in any mutual recognition program based on substituted compliance initiated by the SEC. Moreover, reciprocity must be non-negotiable to ensure American preeminence in the global securities market. Reciprocity will facilitate an expansion of the U.S. securities markets with other like-minded countries, which should lead to greater liquidity, depth, and competitiveness while maintaining the SEC's legislative mandate--to protect investors and to ensure a transparent, efficient, and competitive U.S. securities market. In addition, this reciprocity must restrict foreign exchanges accessing U.S. securities to offering investment products that are not available on securities exchanges in the U.S. It is no longer possible in the global securities market, to restrict access to U.S. investors (specifically retail investors) by requiring all market participants to comply, strictly, with the U.S. securities regulatory framework. Investors, broker/dealers, and other market participants now have the choice of investing in other securities markets that are equal to the U.S. with respect to investor protection, transparency, efficiency, and depth, e.g., London, Hong Kong, Tokyo, and, most likely in the near future, China and India. Reciprocity may even facilitate more competition among broker/dealers because it would allow medium and small broker/dealers access to securities on foreign exchanges which were heretofore closed to them due to higher transaction costs. Finally, without reciprocity, mutual recognition based on substituted compliance is politically, a nonstarter.

The Nasdaq Canada model conducts only one assessment of the factors previously discussed to determine regulatory comparability for both exchanges and broker/dealers. This means that under the Nasdaq Canada model, broker/dealers are regulated indirectly by regulating the exchange on which they are members---Nasdaq Canada. Although this article focuses specifically on the part of Substituted Compliance that would allow access to U.S. investors by foreign exchanges, it must be noted that Substituted Compliance requires the regulatory comparability assessment to be conducted twice in the same jurisdiction--once for the foreign exchange and once for the foreign broker/dealer. Perhaps, by studying the Nasdaq Canada model, the Substituted

³⁴³ Find source

³⁴⁴ cite to march 2008 press release

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Compliance model might be able to streamline its process to avoid duplication of resources and unnecessary costs. Moreover, there may be some appreciable benefits in conducting a comparability assessment of the home country regulatory regime simultaneously for the foreign exchange and broker/dealers. Of course, this presumes that the SEC would only exempt broker/dealers and foreign exchanges from the same home country. This assumption is invalid if the SEC determines to exempt broker/dealers from one foreign country and foreign exchanges from a another foreign country.

F. Mutual Recognition Based on Substituted Compliance (MRSC)—A Hybrid Model

A model of mutual recognition based on substituted compliance combining the Substituted Compliance and Nasdaq Canada models would allow the SEC to assess regulatory comparability for foreign exchanges effectively. Such a combination would provide the requisite level of flexibility needed to address circumstances specific to foreign exchanges in various foreign countries. This hybrid model of mutual recognition based on substituted compliance (“MRSC”) relies primarily on the framework and key assessment criteria described in the Substituted Compliance model with certain structural modifications from the Nasdaq Canada model. Accordingly, concepts and elements of each model that are modified or not included in MRSC will be explicitly identified.

MRSC is designed exclusively for the purpose of determining whether the SEC should exempt a foreign exchange from the registration requirements of § 6 of the Exchange Act. Moreover, MRSC expressly prohibits the SEC from exempting foreign broker/dealers from the registration provisions of the federal securities laws. MRSC is based on the assumption that the SEC should proceed cautiously by relinquishing primary regulatory authority over one segment of the operation of U.S. securities markets at a time. Regulation of exchanges and their members in the U.S. securities markets are two integral components of effective regulation in the U.S. securities markets. MRSC encompasses a more prudent approach which relinquishes primary regulatory authority over one component at a time; assesses the effects of this relinquishment; and subsequently, considers whether relinquishment of primary regulatory authority over both components simultaneously is warranted.

MRSC, like both models, consists of the two parts-- (1) exemption requirements and (2) regulatory preconditions. It also uses the Substituted Compliance model’s four step process as a framework for organizing exemption requirements and regulatory preconditions.

1. MRSC--Steps 1 and 2 of the Process: Regulatory Comparability of Foreign Home Jurisdiction

MRSC eliminates Step One of the Substituted Compliance model. The SEC must be proactive in identifying foreign countries that have comparable securities regulatory frameworks. Complacency is not an option in the global securities market given the rapid rate of change and the growing competitiveness of other domestic securities markets such as London, Hong Kong, India, China, and Brazil. American preeminence in the global securities market cannot be maintained and strengthened by waiting for foreign exchanges to petition the SEC for an exemption from its registration requirements.

MRSC retains the concepts in Step Two of the Substituted Compliance model with some modifications based on the Nasdaq Canada model. Discussions between the SEC and the foreign exchange's home country regulator are essential to determine regulatory comparability. MRSC incorporates the bilateral regulatory mechanism included explicitly in the Substituted Compliance model and implicitly in the Nasdaq Canada model. Under MRSC, this bilateral regulatory mechanism would restrict the SEC to engaging in discussions with only one foreign country and/or jurisdiction at a time. Restricting discussions to one foreign country at a time reduces the complexity of the regulatory comparability assessment process. It is much easier to assess the regulatory comparability of a single foreign country than to attempt to assess the regulatory comparability of several countries simultaneously. Moreover, this bilateral regulatory mechanism gives the SEC the flexibility it needs to focus specifically on crafting a regulatory framework that takes account of local regulatory circumstances of the foreign exchange but, most effectively, supports the SEC's ability to fulfill its legislative mandate. In addition, MRSC also requires agreements, resulting from this bilateral regulatory mechanism, to be memorialized using various types of documents including SEC orders and supervisory and enforcement MOUs as described in the Substituted Compliance and Nasdaq models. However, MRSC excludes adoption of a treaty to further strengthen agreements obtained using the bilateral regulatory mechanism.

MRSC utilizes the key criteria identified and described in Step Two of the Substituted Compliance model with modifications based on the Nasdaq Canada model. MRSC explicitly requires that the foreign exchange have statute-based SRO authority and responsibilities comparable to the statute-based SRO authority accorded to Nasdaq Canada under the Nasdaq Canada model. According statute-based SRO authority and responsibilities to the foreign exchange facilitates the home country regulator's ability to conduct effective oversight of the foreign exchange. Effective oversight of the foreign exchange by its home country regulator would include the ability to impose sanctions along with prudential oversight.

MRSC, unlike the Substituted Compliance model, is narrowly focused on the an evaluation of the general enforcement powers and philosophy of the home country regulator utilizing IOSCO principles. MRSC utilizes IOSCO principles to conduct this evaluation because they represent a consensus of securities regulatory authorities in the global securities market of an effective and competitive regulatory framework in the global securities market. This focus on the regulatory framework of the home country regulator is more appropriate because this is the entity upon which the SEC will rely,

primarily, to regulate the foreign exchange. Accordingly, evaluating whether the OECD Convention Against Bribery of Foreign Public Officials in International Business Transactions or the Foreign Corrupt Practices Act has been adopted in the country of the home country regulator is not helpful.

With respect to reciprocity, MRSC and the Substituted Compliance model are in agreement---the SEC could not fulfill its legislative mandate without reciprocity. Moreover, failure to include reciprocity might result in an unfair competitive advantage for the foreign exchange. Specifically, the foreign exchange would have access to the large retail investor class in the U.S. securities markets without being required to register with the SEC, while U.S.-based exchanges required to register with the SEC would not have access to investors in the foreign exchanges' home country. This would mean a direct violation of the SEC's legislative mandate that requires it to facilitate a competitive U.S. securities market both domestically and in the global securities market.

MRSC, like the Substituted compliance model, requires that the SEC be given broad discretion in assessing regulatory comparability. Such broad discretion is crucial to the SEC's ability to assess regulatory comparability and rightly assumes that the SEC is in the best position to make a decision that is in the public interest and that maintains American preeminence in the global securities market.

2. MRSC Step 3---Entity Specific Exemption Requirements

MRSC relies on both models in requiring the foreign exchange to submit information and to make certain representations directly to the SEC. Like the Nasdaq Canada model, the MRSC model requires foreign exchanges *and their members* to submit information and to make representations directly to the SEC. MRSC requires the foreign exchange to submit information specific to its operations of the type identified under the Nasdaq Canada and the Substituted Compliance models, e.g., home registration status, trading rules, corporate governance, and rulemaking approval process. However, the MRSC model specifically requires the exchange to submit the following information routinely, e.g., on a monthly basis; this information is enumerated under the Nasdaq Canada model but must include: (1) proposed, amended, or existing bylaws, rules or other regulatory instrument or policy made under the foreign exchange's rulemaking process, its home country regulator, or any other SRO with oversight authority; (2) the manner in which the foreign exchange conducts its business and any anticipated changes to the foreign exchange's business model; (3) identification of all securities traded on or through the foreign exchange; (4) identification of all issuers whose securities are listed or quoted on the foreign exchange. See TABLE E.3 below. Members of the foreign exchange submit information and make representations to the SEC because, under MRSC, they must be members of FINRA. FINRA membership means that all members of the foreign exchange would be required to register with the SEC and thus, subject to its direct oversight. This would eliminate the need for a separate assessment process for broker/dealers as required under the Substituted Compliance model and would strengthen SEC control over the operation of the foreign exchange with

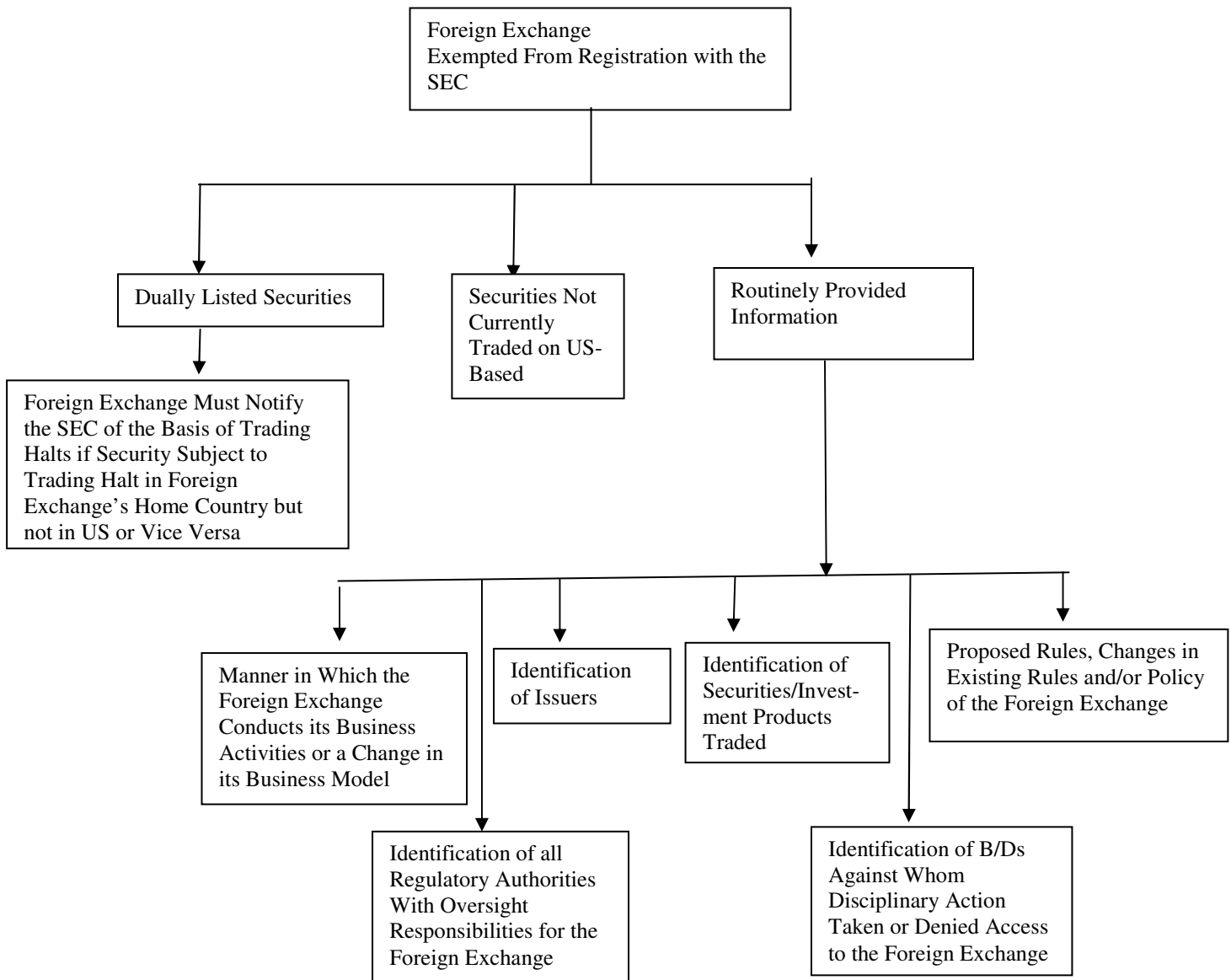
respect to investor protection--especially retail investor protection, i.e., those investors with the least investment knowledge and skills. Moreover, requiring FINRA membership of the foreign exchange's members would facilitate an effective overall regulatory framework of the foreign exchange's activities in the U.S.—a shared regulatory framework between the SEC and the foreign exchange's home country regulator. Also, MRSC does not include the disclosure statement to investors contained in the Substituted Compliance model because investor disputes would be adjudicated under the existing US securities regulatory framework; this dispute resolution mechanism is administered by FINRA and oversighted by the SEC. Finally, requiring FINRA membership of the foreign exchange's members facilitates the SEC's mandate of investor protection and competition in the U.S. securities markets because regional and small broker/dealers would have direct access to foreign exchanges and therefore, their customers, would have an opportunity to increase the diversity in their portfolios by accessing investment products not available on U.S.-based exchanges required to register with the SEC.

MRSC, like the Nasdaq Canada model, provides for trading in dually-listed securities and securities *not traded* on U.S.-based exchanges registered with the SEC. Also like the Nasdaq Canada model, MRSC requires the foreign exchange to notify the SEC if a trading halt in a dually-listed security is initiated in its home country but not in the U.S. and vice versa. Allowing the foreign exchange to trade in dually-listed securities and securities not traded on U.S.-based exchanges registered with the SEC is most likely, the best tool for obtaining reciprocity agreements with foreign exchanges without diminishing the ability of U.S.-based exchanges to compete in the U.S. securities markets. It also facilitates fulfillment of the SEC's legislative mandate to ensure the competitiveness of the U.S. securities markets both domestically and in the global securities market.

MRSC combines elements of both models with respect to SEC jurisdiction over activities conducted by the foreign exchange within the U.S. Like the Substituted Compliance model, MRSC requires the foreign exchange to represent to the SEC that it agrees to be subject to the anti-fraud provisions of the U.S. securities laws and to provide a U.S. service of process agent. MRSC also incorporates the broader requirement in the Nasdaq Canada model that requires the foreign exchange to submit to the jurisdiction of the SEC with respect to its activities conducted in the U.S securities markets. This does not mean that the SEC is the foreign exchange's primary regulator. It simply provides the SEC with the ability to take action, when necessary, to protect the public interest. Accordingly, the foreign exchange must also represent that it will remain subject to oversight by its home regulator and that it will comply with all applicable provisions of its home country regulatory framework.

TABLE E.3

The MRSC Foreign Exchange Requirements



3. MRSC Step 4—Public Notice and Comment

MRSC, like both models, incorporates subjecting the SEC’s determination to exempt a foreign exchange from the registration requirements of § 6 of the Exchange Act to public notice and comment. The public notice and comment is essential to ensure the consideration of all factors essential to identifying appropriate regulatory conditions and exemption requirements. Again, the public notice and comment process allows interested members of the securities industry and other members of the financial members an opportunity to express concerns about the proposed activities of the foreign exchange. Although the SEC is not required to consider such comments in determining which

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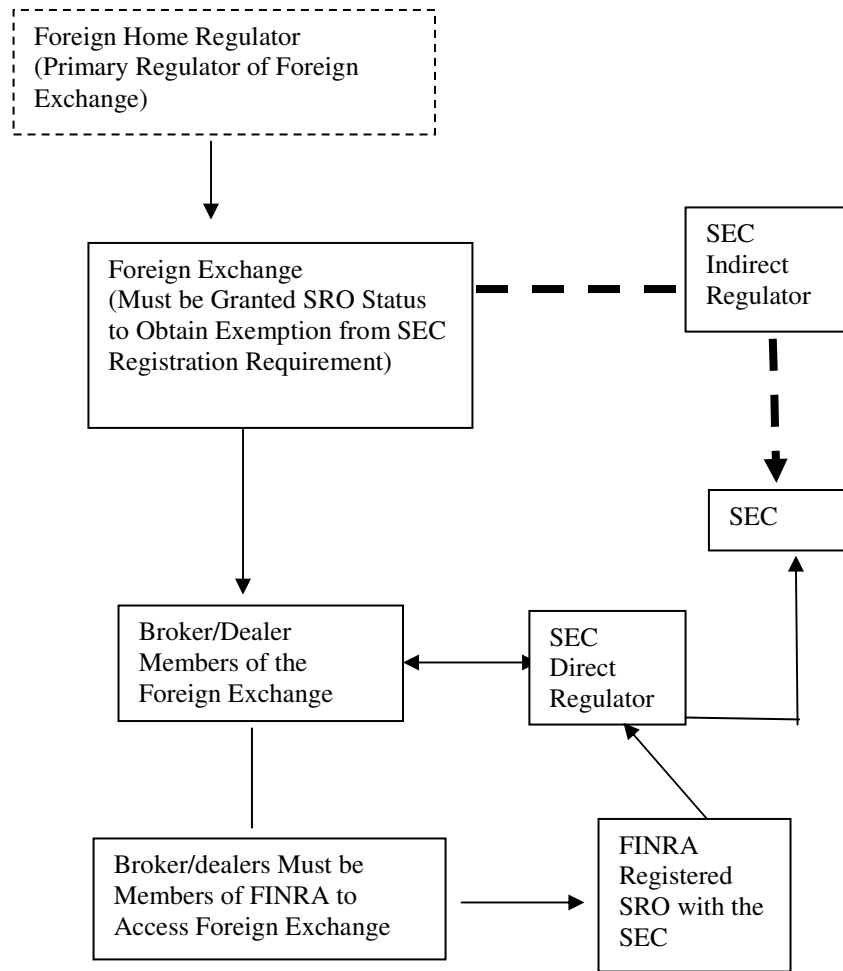
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regulatory preconditions and exemption requirements it will impose upon the foreign exchange, these comments are essential to ensuring that the SEC has considered the widest array of relevant factors in making its decision.

In summary, MRSC is a viable model for initiating mutual reliance based on substituted compliance. It allows the SEC to increase American preeminence in the global securities market by allowing access to foreign exchanges while fulfilling one of the most important prongs of its legislative mandate—investor protection. Specifically, MRSC allows the SEC to maintain sufficient control over market participants (broker/dealers) in direct contact with investors who are most in need of the protections of the federal securities laws—retail investors. Essentially, MRSC provides a safety net to fill unforeseen regulatory gaps. See TABLE E.3.1. If mutual recognition based on substituted compliance is to be successful, MRSC's controlled relinquishment of one primary regulatory tool at a time approach is more likely to succeed. Assessing regulatory comparability is a difficult endeavor. Prudence suggests that the SEC proceed cautiously by first exempting foreign exchanges but maintaining regulatory jurisdiction over the foreign exchange's members. Allowing the home country regulator to be the primary regulator of a foreign-based exchange operating in the U.S. securities markets instead of the SEC is a significant step and departure from our current securities regulatory framework—a regulatory framework which has facilitated American preeminence in the global securities market. Relinquishing both primary regulatory tools (exempting foreign exchanges and their members) simultaneously would not facilitate a meaningful regulatory partnership between the SEC and the home country regulator for effective oversight of the foreign exchange.

TABLE E.3.1
The MRSC Model
Framework



VI. Conclusion

The U.S. can no longer be a regulatory isolationist in the global securities market. It must allow access to foreign based market participants, such as exchanges, without requiring strict compliance with its securities regulatory framework. To continue down this path is unreasonable and too costly for global market participants. Given the continued growth of the global securities market, market participants and investors have other equally viable and acceptable alternatives to U.S. securities markets; currently, viable alternatives include London, Hong Kong, and Tokyo. Accordingly, US preeminence is most likely to be maintained by linking with like-minded countries with

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comparable regulatory frameworks and enforcement philosophies. The SEC's legislative mandate can be fulfilled without requiring every player in the global securities market to play by its rules exclusively. Such exclusivity is no longer a viable option for competing successfully in the global securities market.

Mutual recognition based on substituted compliance is a viable tool for competing successfully in the global securities market. However, changes to our regulatory system should be implemented carefully. MRSC allows the SEC to conduct controlled access to U.S. securities markets by determining the basis on which to allow foreign exchanges direct access to all U.S. investors. It recognizes the two primary regulatory tools in the regulatory framework for exchanges—market operations and membership—and represents a conservative, controlled approach to exempting foreign exchanges from direct SEC oversight by only altering one of these primary regulatory tools at a time. MRSC allows the SEC to maintain sufficient control over market participants (broker/dealers) in direct contact with investors who are most in need of the protections of the federal securities laws—retail investors. U.S. preeminence in the global securities market cannot be maintained without linking like-minded domestic securities markets with the U.S. securities markets. Failure to make proper alliances with like-minded regulators (perhaps those subscribing to IOSCO regulator principles) *is not* a viable path for retaining US preeminence in the global securities market.