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# Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?

Roberta S. Karmel\*

## Introduction

Securities industry self-regulatory organizations (“SROs”) began as private sector membership organizations of securities industry professionals. They set standards of conduct for their members and disciplined errant members. Securities industry SROs existed before the federal securities laws were enacted in 1933 and 1934, and important concepts of federal law were taken from SRO regulation and became an added layer of regulation on top of SRO regulation.<sup>1</sup> Over the last seventy-five years, SROs have grown in membership and become more powerful organizations, but they also have become integrated into the scheme of federal statutory regulation, and now operate subject to Securities and Exchange Commission (“SEC”) oversight of all of their activities. Moreover, as SROs have proliferated, some new SROs have been created by amendments to the securities laws. They are thus a peculiar mix of private sector self-regulation and delegated governmental regulation.

This article addresses the questions of whether, and to what extent, securities industry SROs have become government agencies, and whether, and to what extent, they should be subject to constitutional and statutory controls on government agencies, focusing principally on the Financial Industry Regulatory

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<sup>1</sup> See *Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW. 1487, 1489-1510 (2002).

Agency ("FINRA"), a new entity which combined the National Association of Securities Dealers, Inc. ("NASD") and the member regulatory functions of NYSE Group, Inc. ("NYSE").<sup>2</sup> The cases addressing these issues are contradictory, and generally not based on any overriding constitutional law principles. In some areas, the courts have just stated that an SRO is exercising delegated governmental power. In other areas, the courts have stated that an SRO is a private membership organization. Sometimes, courts have distinguished between the commercial and regulatory functions of SROs, in order to draw lines separating the laws applicable to government agencies from those applicable to private sector organizations. However, it should be noted at the outset that FINRA, unlike a stock exchange, has no commercial activities. The author's conclusion is that categorizing FINRA as a government agency, at this time, would not necessarily be useful, since FINRA is able to operate with more flexibility than a government agency, but when FINRA is exercising investigative and disciplinary functions it should be treated like a government agency. Furthermore, to the extent practicable FINRA should operate according to transparency standards applicable to government agencies.

The stated purpose for the consolidation of the NASD and NYSE's regulatory arm is to bring more efficiency to securities industry regulatory efforts by creating a single rule book for broker-dealers. FINRA was designed as a monopoly SRO under the active and direct oversight of the SEC.<sup>3</sup> Although both the NASD and the NYSE have long histories as SROs, subject to increasingly pervasive and statutorily based SEC regulation, the creation of FINRA poses a question long lurking in the structure and operation of the NASD: was the NASD for all practical purposes a government agency, and if so, what are the constitutional and administrative law ramifications of such a conclusion for its new incarnation, FINRA?

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<sup>2</sup> See Susanne Craig, *Deals and Dealmakers: For the NASD, Goodbye SIRA – Kay-Syrah Sira-- Street's Securities Cop Renames Itself After Flap; A Muslim Connection*, WALL ST. J., July 13, 2007, at C2. PressRelease, FINRA , *NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority-FINRA; FINRA Commences Operations as the Securities Industry's Largest Non-Governmental Regulatory Organization*, available at <http://www.finra.org/PressRoom/newsReleases/2007NewsReleases/PO36329>.

<sup>3</sup> The SEC approved a rule to amend the NASD By-Laws to accomplish this merger in Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc., Exchange Act Release No. 56145 (July 26, 2007) [hereinafter SEC FINRA Approval].

Both the NASD and the NYSE began as voluntary organizations of broker-dealers. Thereafter, the SEC obtained statutory authority to oversee their activities pursuant to the Securities Exchange Act of 1934 ("Exchange Act").<sup>4</sup> From the enactment of that statute until the present, Congress and the SEC have struggled to convert SROs from "private clubs" to public bodies, frequently exploiting scandals to impose governance reforms on exchanges and the NASD.<sup>5</sup> In 1983, every broker-dealer registered with the SEC became required by statute to become a member of the NASD.<sup>6</sup>

Exchanges and the NASD long served two functions. They were marketplaces for the trading of securities and regulators of their markets and their members. As marketplaces, they engaged in fixing commissions and spreads until these anti-competitive practices were banned by the SEC.<sup>7</sup> These anti-competitive, but long permitted activities, gave SRO members the incentive to remain members of exchanges and the NASD and to uphold just and equitable principles of trade. As regulators, they adopted rules, which can have the force of federal law,<sup>8</sup> and disciplined member firms and their associated members. These rules covered the handling of transactions in the markets, requirements relating to the internal operations of member firms and rules of fair practice for dealing with customers.<sup>9</sup> In addition, they operated arbitration facilities for disputes between member firms and their employees and between member firms and their customers.<sup>10</sup>

Recently, the NYSE and the NASD separated their market and regulatory functions into separate entities. Now that the broker-dealer regulatory functions of the NYSE and NASD have merged, the monopoly status of FINRA strengthens its

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<sup>4</sup> 15 U.S.C. § 78a *et seq.* (2000).

<sup>5</sup> See also Norman S. Poser, *The Stock Exchanges of the United States and Europe: Automation, Globalization, and Consolidation*, 22 U. PA. J. INT'L ECON. L. 497, 516 (2001). See generally Roberta S. Karmel, *Turning Seats Into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 HASTINGS L.J. 367, 403-09 (2002).

<sup>6</sup> Exchange Act § 15(b)(8), 15 U.S.C. § 78o(b)(8) (Supp. II 2002). There is an exemption for broker-dealers doing business exclusively on a stock exchange. See Pub. L. No. 98-38, § 3(a), 97 Stat. 206 (1983). With the merger of the NASD and NYSE Regulation, Inc., this exemption will no longer be relevant as such broker-dealers were NYSE members.

<sup>7</sup> See *Credit Suisse Sec. (USA) v. Billing*, 127 S. Ct. 2383 (2007). See also Poser, *supra* note 6, at 510-11.

<sup>8</sup> *Credit Suisse First Boston Corp. v. Grunwald*, 400 F.3d 1119 (9th Cir. 2005).

<sup>9</sup> See THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* (5th ed. 2005), at §§ 14.1[3].

<sup>10</sup> See *id.* at § 15.

role as a regulator of broker-dealers. In connection with these developments, the SEC exercised greater plenary power over the governance structure of the SROs. Over the years, the NYSE and the NASD have been treated as private sector business organizations for certain purposes, and as government or quasi-government entities for other purposes. Is FINRA, now organized and recognized, and functioning only as a regulator under the aegis of the SEC, a government regulator? And if so, what are the implications of such a determination? These questions need to be examined in the context of similar questions being raised with regard to a new securities industry regulator, the Public Company Accounting Oversight Board ("PCAOB"), which was structured, in theory, as neither an SRO nor a government agency, and which has been challenged as an unconstitutional organization.<sup>11</sup>

Regardless of whether the PCAOB should properly be categorized as a government regulator, a self-regulator, or neither, it is unlikely that the courts will decide that the NASD, which operated for almost seventy years as an SRO, has somehow become an unconstitutional government agency now that it has become FINRA. Nevertheless, its increasing government-like functions and operations raise the question of what checks and balances and due process procedures are necessary for such an SRO to have constitutional law accountability and administrative law legitimacy. This article will address several important aspects of FINRA's functions and legal status which raise the following issues: first, FINRA's immunity from suit; second, the right of persons under FINRA investigation to claim their privilege against self-incrimination under the Fifth Amendment; third, the role of FINRA as manager of broker-dealer arbitration facilities; fourth, the due process rights of persons prosecuted by FINRA; and fifth, FINRA's role with respect to anti-trust and preemption issues.

Part II of this article will set forth the constitutional issues inherent in FINRA's status as an SRO in the context of its history under the Exchange Act, which has been repeatedly amended to grant the SEC more control of SROs. This analysis is

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<sup>11</sup> See *Free Ent. Fund v. Pub. Co. Accounting Oversight Bd.*, 2008 U.S. App. LEXIS 18029 (D.C. Cir. Aug. 22, 2008). The district court assumed the PCAOB was a government regulator and addressed Appointments Clause issues, as did the circuit court. In 1975, Congress created the Securities Investment Protection Corporation ("SIPC"), as a broker-dealer membership corporation, and specified that it shall not be "an agency or establishment of the United States Government." Pub. L. 91-958, 84 Stat. 1636, § 3 (1975), 15 U.S.C. § 78ccc (2000). The PCAOB regulates accountants who file documents with the SEC. SIPC is an insurer of funds and securities in broker-dealer customer accounts.

related to the Appointments Clause issues which have been raised with respect to the governance of the PCAOB, but unlike the PCAOB, FINRA's directors are not directly appointed by the SEC. Part III will discuss cases addressing the NASD's or NYSE's immunity from suit for their regulatory decisions and functions, the right of persons under NASD investigation to claim deprivation of their Fifth Amendment rights, and the status of NASD arbitration facilities. Part IV will discuss the constitutional and administrative due process rights of persons subject to FINRA investigations and enforcement actions and FINRA rule-making, and inquire whether further rights should be accorded to persons who are SRO members. Part V will discuss the status of SRO rules in cases posing preemption and antitrust issues. The article will conclude that as long as the securities industry, rather than the SEC, controls the governance of FINRA and the selection of its Board of Governors, FINRA will not be a government entity, but since FINRA will be exercising delegated governmental functions with regard to discipline and rule-making, fundamental constitutional and administrative law protections should be afforded to persons affected by these activities.

Each of these issues could probably generate an article on its own, so to some extent this article will be speculative and hopefully will spark further work by the author and by others. These are difficult and important issues that go to the heart of the legitimacy of the administrative state in which we live and work, at a time when governmental functions are being continually privatized or outsourced. Such outsourcing raises constitutional accountability issues, which in the case of FINRA become a question of whether FINRA should be accountable to its members, who are forced to join by federal statute, or to the general public. Furthermore, if FINRA has indeed become a public organization, what distinguishes it from a government agency?

## **I. Factors for Determining Whether FINRA Should Be Considered a Government Agency**

### **A. The Constitutional Framework**

In theory, the government cannot delegate its power to a private standard setting body, but there have been no cases striking down legislation on non-

delegation grounds since the mid-1930s.<sup>12</sup> Although some academics have argued for a resuscitation of the non-delegation doctrine,<sup>13</sup> the Supreme Court has preferred to invoke the separation of powers doctrine or other principles when non-delegation has been invoked.<sup>14</sup> Generally courts have upheld legislation delegating governmental power to administrative agencies on the ground that an intelligible principle is laid down in the statute for the agency to follow.<sup>15</sup>

The problem of a delegation by an agency, which is itself exercising delegated powers, to a private standard setting body like FINRA further confounds the question of whether the private body either is exercising delegated governmental power or is, indeed, a government entity. Yet, such privatization of governmental functions has become increasingly common.<sup>16</sup> There are two basic analyses pursuant to which FINRA might be considered to be either a government agency or a private body exercising delegated governmental power. These are the public entity and the state action doctrines.

Because the U.S. Constitution applies to the government, private entities generally are not liable for infringing constitutional protections of individuals. Nevertheless, private entities and individuals are required to comply with constitutional imperatives if they are acting as the state. This is sometimes referred to as the public entity doctrine, which emanates from *Lebron v. National Railroad Passenger Corp.*<sup>17</sup> in which the Court ruled that Amtrak was a public entity or the Government itself for constitutional purposes, even though Congress declared that it

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<sup>12</sup> See *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935); *Panama Ref. Co. v. Ryan*, 293 U.S. 388 (1935). See also *Clinton v. City of New York*, 524 U.S. 417, 484-91 (1998) (Breyer, J., dissenting).

<sup>13</sup> See STEPHEN G. BREYER ET AL., *ADMINISTRATIVE LAW AND REGULATORY POLICY* 67-68 (6th ed. 2006). Other scholars have argued to the contrary. *Id.*

<sup>14</sup> See, e.g., *Clinton*, 524 U.S. 417; *Mistretta v. United States*, 488 U.S. 361, 371-80 (1989) (Scalia, J., dissenting); *INS v. Chadha*, 462 U.S. 919 (1983). See also Steven G. Calabresi, *The Centrality of Clinton v. City of New York*, 99 NW. U. L. REV. 77, 85-86 (2004). See also *Free Ent. Fund v. Pub. Co. Accounting Oversight Bd.*, 2008 U.S. App. LEXIS 18029 (D.C. Cir. Aug. 22, 2008) (Kavanaugh, J., dissenting), at 53-54.

<sup>15</sup> *J.W. Hampton, Jr. & Co. v. United States*, 276 U.S. 394, 406 (1928); *Yakus v. United States*, 321 U.S. 414 (1944). See, e.g., *Am. Power & Light Co. v. SEC*, 329 U.S. 90 (1946).

<sup>16</sup> See John J. Dilulio, Jr., *Government by Proxy: A Faithful Overview*, 116 HARV. L. REV. 1271 (2002); Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543 (2000); Gillian E. Metzger, *Privatization as Delegation*, 103 COLUM. L. REV. 1367 (2003); Steven J. Schwarcz, *Private Ordering*, 97 NW. U. L. REV. 319 (2002).

<sup>17</sup> 513 U.S. 374 (1995).

would not be an agency of the United States.<sup>18</sup> In order to meet the tests for categorizing a private corporation as a government entity after *Lebron*, courts have required the following:

“[O]nly if (1) the government created the corporate entity by special law, (2) the government created the entity to further governmental objectives, and (3) the government retains permanent authority to appoint a majority of the directors of the corporation will the corporation be deemed a government entity for the purpose of the state action requirement.”<sup>19</sup>

As will be demonstrated below, FINRA is not a governmental entity under this formulation since it was not created by special law and the government will not appoint a majority of its directors. Nevertheless, FINRA could not exist without SEC approval, and the SEC has dictated the composition of its board of governors, although not the persons who will serve on the board. This differentiates FINRA from the PCAOB, which was created by a special statute and whose chairman and directors are appointed by the SEC, and thus may well be a government entity under the *Lebron* analysis.<sup>20</sup>

Another level of analysis with respect to FINRA is whether, since it is funded entirely by assessments on the securities industry, the government has delegated taxing authority to a private body. At least one scholar has argued that the taxing authority should not be delegated, as this is a prerogative of the Congress.<sup>21</sup>

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<sup>18</sup> *Id.* at 391. Previously, in *San Francisco Arts & Athletics, Inc. v. United States Olympic Comm.*, 483 U.S. 522, 543 (1987), the Court held that a committee was not a part of the government required to comply with the Constitution, although it had been chartered by Congress, was regulated by federal law, and was partially federally funded.

<sup>19</sup> *Horvath v. Westport Library Ass'n*, 362 F.3d 147, 153 (2d Cir. 2004), quoting *Hack v. President & Fellows of Yale Coll.*, 237 F.3d 81, 84 (2d Cir. 2000).

<sup>20</sup> See Donna Nagy, *Playing Peekaboo With Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 975 (2005) [hereinafter Nagy]. That the PCAOB is a government entity was essentially conceded in *Free Ent. Fund v. Pub. Co. Accounting Oversight Bd.*, 2007 U.S. Dist. LEXIS 24310 (Mar. 21, 2007), and this issue was not addressed on appeal. SIPC has a board of directors of seven persons, one appointed by the Secretary of the Treasury, one appointed by the Federal Reserve Board, and five by the President with the advice and consent of the Senate. 78 U.S.C. ccc (c) (2000). Yet, the statute creating SIPC specifies that it is not a government agency. See *Horvath*, 362 F.3d 147.

<sup>21</sup> See Ronald J. Krotoszynski, *Reconsidering the Nondelegation Doctrine: Universal Service, the Power to Tax and the Ratification Doctrine*, 80 IND. L. J. 239, 241 (2005). According to



On the other hand, as will be explained below, FINRA did not originate as an agency created by the government, but began as a private organization that was gradually transformed into an agency which exercises governmental functions.

Under the state action doctrine, the courts examine whether the conduct or activities of a private party can be attributed to the government for purposes of constitutional law accountability. The cases in this area are, at best, fact-specific and doctrinally murky, but they traditionally required one of three circumstances: (1) the exercise of coercive power or significant encouragement by the government of the activity in question; (2) performance of a traditional governmental function by a private entity; or (3) a "symbiotic" interdependence between the government and the private entity.<sup>22</sup> One test of whether a private organization is a state actor is whether it is exercising powers traditionally and exclusively reserved to government. Therefore, a private utility company was held not to be a state actor when it cut off service without notice and a hearing.<sup>23</sup> However, running a (company) town was held to be state action,<sup>24</sup> as was holding an election for government office.<sup>25</sup> Running and regulating schools has been held not to be an essential state function,<sup>26</sup> but in an important recent case, *Brentwood Academy v. Tennessee Secondary School Athletic Association*,<sup>27</sup> the Court found a private entity regulating high school athletics was a state actor because of government "entwinement." After *Brentwood*, some courts have focused on whether "the state has so far insinuated itself into a position of interdependence with the private entity that it must be recognized as a joint participant in the challenged activity."<sup>28</sup> Another test used in the state action cases applies where the government affirmatively authorizes, encourages, or facilitates

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FINRA's CEO, FINRA's \$550 million budget is paid by the securities industry. *An Interview with FINRA CEO Mary Shapiro*, EQUITIES, Sept. 2007, at 61.

<sup>22</sup> See Nagy, *supra*, note 21; In the Matter of the Application of Justin F. Ficken, Exchange Act Release No. 54,699 (Nov. 3, 2006), at 7-9.

<sup>23</sup> *Jackson v. Metro. Edison Co.*, 419 U.S. 345, 352 (1974).

<sup>24</sup> *Marsh v. Alabama*, 326 U.S. 501 (1946).

<sup>25</sup> *Smith v. Allwright*, 321 U.S. 649, 666 (1944).

<sup>26</sup> In *Rendell-Baker v. Kohn*, 457 U.S. 830 (1982) and *Nat'l Collegiate Athletic Ass'n v. Tarkanian*, 488 U.S. 179 (1988), the Court found actions by a private school and a private entity not to be state action.

<sup>27</sup> 531 U.S. 288 (2001). In this case the Supreme Court found state action based on "entwinement" although in the past it used the phrase "entanglement" for finding state action. See EDWIN CHERMERINSKY, CONSTITUTIONAL LAW 517 (3d ed. 2006).

<sup>28</sup> *Kirtley v. Rainey*, 326 F.3d 1088, 1039 (9th Cir. 2003). See also *Mathis v. PG & E*, 75 F.3d 498, 503 (9th Cir. 1996).

private conduct that violates the Constitution. So, for example, courts cannot enforce restrictive covenants.<sup>29</sup> Generally, however, government licensing or regulating is not sufficient for a finding of state action unless the government is encouraging or facilitating unconstitutional conduct.<sup>30</sup>

As will be demonstrated below, with respect to at least some of its activities, and in particular disciplinary actions and rule-making, FINRA will be performing functions that can be considered governmental. The issue, then, is whether persons affected adversely by such actions have been accorded necessary or appropriate constitutional or other rights, for example the right to remain silent under the Fifth Amendment, or administrative law due process guarantees. This article will discuss some lines of cases in which the courts have treated the NASD or the NYSE as governmental actors, and other lines of cases in which they have been treated as private actors. Before turning to these cases, and their implications, this article will first set forth the history of FINRA, and in particular its regulatory and governance structure. This history is important because if FINRA were not the successor to private sector SROs, it might well be considered a state actor.

## **B. History and Organization of the NASD, NYSE Regulation and FINRA**

The NYSE was organized in 1792 to govern securities trading in the wake of a scandal in the government bond market in the early days of the United States.<sup>31</sup> The NASD was formed in 1936, in a restructuring of a trade group known previously as the Investment Bankers Association of America.<sup>32</sup> Shortly thereafter, the NASD was authorized as an "association" by the Exchange Act<sup>33</sup> and pursuant to that statutory authorization, the NASD incorporated in Delaware in 1939 and became registered with the SEC.<sup>34</sup>

In 1975, the Exchange Act was amended and the SEC obtained greater authority to regulate and supervise the NYSE, other exchanges and the NASD. The

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<sup>29</sup> *Shelley v. Kraemer*, 334 U.S. 1 (1948). *See also* *Lugar v. Edmonson Oil Co.*, 457 U.S. 922 (1982).

<sup>30</sup> *See* *Jackson v. Metro. Edison Co.*, 419 U.S. 345 (1974); *Moose Lodge No. 107 v. Irvis*, 407 U.S. 163 (1972).

<sup>31</sup> *See* RON CHERNOW, *ALEXANDER HAMILTON* 383-84 (2004).

<sup>32</sup> *See* Nagy, *supra* note 21, at 1023-24.

<sup>33</sup> *See* Exchange Act, § 15A, 15 U.S.C. § 78a *et seq.* (2000).

<sup>34</sup> *See* ESTATE OF LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATIONS* § 7-A-3 (3d ed. 2006); Onnig Dombalagian, *Demythologizing the Stock Exchange; Reconciling Self-Regulation and the National Market System*, 39 U. RICH. L. REV. 1069, 1076-77 (2005).

Securities Acts Amendments of 1975<sup>35</sup> gave the SEC the power to initiate as well as approve SRO rule-making, expanded the SEC's role in SRO enforcement and discipline, and allowed the SEC to play an active role in structuring the public securities markets.<sup>36</sup> For the first time, the statute set forth requirements with respect to the composition of exchange and association boards of directors, so that the Exchange Act provides that the rules of an exchange or association must "assure a fair representation of its members in the selection of its directors and administration of its affairs and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer."<sup>37</sup>

In 2002, the Exchange Act was again amended to give the SEC further authority over these SROs. The Sarbanes-Oxley Act of 2002<sup>38</sup> mandated that stock exchange rules require listed companies to have independent directors on audit, compensation and nominating committees,<sup>39</sup> but it did not affect the governance of SROs. Nevertheless, the SEC has exerted greater power over board composition of SROs in recent years, requiring a larger number of directors independent of the SRO and the securities industry.

The NASD was a private not-for-profit Delaware membership corporation organized pursuant to a statutory system authorizing SROs to act as quasi-governmental agencies for certain purpose. The NASD promoted its members' interests but also had statutory authority to sanction members who violated the NASD's rules or the federal securities laws.<sup>40</sup> From its inception, the NASD was a

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<sup>35</sup> Pub. L. No. 94-29, 89 Stat. 97 (1975).

<sup>36</sup> Exchange Act § 11A, 15 U.S.C. § 78k-1 (2000); Exchange Act § 19(c), 15 U.S.C. § 78s(c) (2000).

<sup>37</sup> Exchange Act § 6(a)(3), 15 U.S.C. § 78f(a)(3) (2000); Exchange Act § 15A(b)(4), 15 U.S.C. § 78o-3(b)(4) (2000).

<sup>38</sup> Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 11, 15, 18, 28 and 29 U.S.C.).

<sup>39</sup> See generally Roberta S. Karmel, *Realizing the Dream of William O. Douglas -The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 92-94, 108-113, 121-23 (2005).

<sup>40</sup> See *Nat'l Ass'n of Sec. Dealers, Inc. v. SEC*, 431 F.3d 803 (D.C. Cir. 2005). Its constitution specified that its purposes were:

a. To promote through cooperative effort the investment banking and securities business, to standardize its principles and practices, to promote therein high standards of commercial honor, and to encourage and promote among members observance of Federal and State securities laws;

peculiar body, designed to act as a regulator, but also functioning as a professional organization. Initially, the NASD was a nationwide voluntary organization of broker-dealers engaged in trading over-the-counter ("OTC") stocks. Its membership was nationwide, large and diverse. Its emphasis was on self-regulation and discipline by members, as distinguished from regulation by a hired staff, and in promoting voluntary compliance with ethical standards.<sup>41</sup> Principles emanating from the Exchange Act and guiding the NASD were democratic organization, business persons' judgment, and local autonomy.<sup>42</sup>

In 1971, the NASD launched the National Association of Securities Dealers Automated Quotation system ("Nasdaq"), as an electronic stock market. Initially, Nasdaq was not much more than a computer bulletin board system, and buyers and sellers continued to be connected by broker-dealers in negotiated trades. As Nasdaq added trade and volume reporting and automated trading systems, it became more of a stock market. Today, Nasdaq is completely separated from the NASD, is a public company, and is recognized by the SEC as a stock exchange.<sup>43</sup> Yet, much of

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b. To provide a medium through which its membership may be enabled to confer, consult, and cooperate with governmental and other agencies in the solution of problems affecting investors, the public, and the investment banking and securities business;

c. To adopt, administer and enforce rules of fair practice and rules to prevent fraudulent and manipulative acts and practices, and in general to promote just and equitable principles of trade for the protection of investors;

d. To promote self-discipline among members, and to investigate and adjust grievances between the public and members and between members;

e. To establish, and to register with the [SEC], as a national securities association pursuant to Section 15A of the [Exchange Act] . . . and thereby to provide a medium for effectuating the purposes of said section;

f. To transact business and to purchase, hold, own lease, mortgage, sell and convey any and all property, real and personal, necessary, convenient or useful for the purposes of the NASD." NASD, Inc., NASD Manual, Restated Certificate of Incorporation of NASD, Inc. (2006).

<sup>41</sup> SEC, REPORT OF THE SPECIAL STUDY OF THE SECURITIES MARKET, H.R. Doc. No. 88-95, pt. 4, at 679 (1963) [hereinafter Special Study].

<sup>42</sup> *Id.* at 606-07. The NASD was divided into 13 regional districts initially responsible for enforcing its Rules of Fair Practice, managed by a district committee composed of six to 18 members and a paid staff. *Id.* at 608. There was a 21-person Board of Governors, nominated for three year terms by the district committees. *Id.* at 609. The Board was the center of responsibility and authority and it functioned through a number of standing committees. The most active committee was the National Business Conduct Committee which was charged with oversight of the disciplinary process. *Id.* at 614. An executive director headed the NASD staff in Washington, D.C. . *Id.* at 624-25.

<sup>43</sup> Exchange Act Release No. 53,128, 71 Fed. Reg. 3550 (Jan. 23, 2006).

what held the NASD together was the economic self-interest of securities dealers in structuring the trading rules for the OTC market. These rules gave NASD members the ability to trade with one another at preferential prices.<sup>44</sup>

Although the efficacy of self-regulation was called into question by stock market abuses, especially in the OTC market, the 1963 SEC Special Study concluded that self-regulation should be maintained and strengthened.<sup>45</sup> Self-regulation was similarly questioned in the mid 1970s, but the Securities Act Amendments of 1975<sup>46</sup> continued the role of stock exchanges and the NASD as SROs. However, this Act strengthened the SEC's oversight role by, among other things, giving the SEC the power to initiate as well as approve SRO rule-making,<sup>47</sup> expanding the SEC's role in SRO enforcement and discipline,<sup>48</sup> and allowing the SEC to play an active role in structuring the trading markets.<sup>49</sup> Also, for the first time, the statute set forth requirements with respect to the composition of exchange and association boards of directors, providing that the rules of such organizations must "assure a fair representation of its members in that one or more directors shall be representative of issuers and investors and not be associated with a member of the [exchange or association], broker or dealer."<sup>50</sup>

The 1975 Act Amendments also created two additional broker-dealers membership organizations — the Securities Investor Protection Corporation ("SIPC") and the Municipal Securities Rulemaking Board ("MSRB.") SIPC's board members are appointed by a combination of the Secretary of the Treasury, the Federal Reserve Board and the SEC, although SIPC is a not-for-profit D.C. corporation.<sup>51</sup> The MSRB's members are appointed by the SEC.<sup>52</sup> SIPC insures cash and securities in broker-dealer customer accounts, and oversees broker-dealer

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<sup>44</sup> See Roger D. Blanc, *Intermarket Competition and Monopoly Power in the U.S. Stock Markets*, 1 BROOK. J. CORP. & COM. L. 273, 278 (2007). See also *United States v. Nat'l Ass'n of Sec. Dealers, Inc.*, 422 U.S. 694 (1975).

<sup>45</sup> Special Study, *supra* note 42, at pt. IV, p. 502.

<sup>46</sup> Pub. L. No. 94-29, 89 Stat. 97 (1975).

<sup>47</sup> Exchange Act § 19(c), 15 U.S.C. § 78s(c) (2000).

<sup>48</sup> Exchange Act § 19(c), (d), (g), 15 U.S.C. § 78s(c), (d), (g) (2000).

<sup>49</sup> Exchange Act § 11A, 15 U.S.C. § 78k-1 (2000).

<sup>50</sup> Exchange Act § 6(a)(3), 15 U.S.C. § 78f(a)(3); Exchange Act § 15A(b)(4), 15 U.S.C. § 78o-3(b)(4) (2000).

<sup>51</sup> 15 U.S.C. § 78ccc (2000). See *supra* note 12.

<sup>52</sup> 15 U.S.C. § 78o-4 (2000).

bankruptcies. The MSRB is a rule-making body. Both SIPC and the MSRB are funded by assessments on their members.<sup>53</sup>

The NASD was completely reorganized in 1996 in the wake of a Department of Justice and SEC investigation into anti-competitive practices by OTC market makers.<sup>54</sup> This proceeding involved a pricing convention by Nasdaq market makers by which most Nasdaq stocks were quoted in even eighths.<sup>55</sup> Other abusive market maker practices were uncovered and the NASD was criticized for its regulatory deficiencies in failing to discover these practices or discipline its members. The SEC found that the NASD was unduly influenced by Nasdaq market makers with respect to rule-making, the disciplinary process and the admission of new members.<sup>56</sup> In a settlement of these matters, the NASD agreed, among other things, to achieve greater diversity of representation on its board and its policy-making committees, to provide for the autonomy and independence of its staff with respect to disciplinary and regulatory matters, to create an enhanced audit trail and to improve its surveillance and examination of order handling and the reliability of trade reporting.<sup>57</sup>

After the 1996 reorganization, the NASD was comprised of a parent holding company and two operating subsidiaries – Nasdaq and NASD Regulation, Inc. (“NASDR”). Then, the NASD acquired the American Stock Exchange, which operated as a separate subsidiary. All four boards were constituency boards, required to have a majority of non-industry members.<sup>58</sup> Procedures for the appointment to the National Adjudicatory Council (“NAC”), also were specified in the 1996 restructuring. The NAC consists of from 12 to 14 members, and the number of non-industry members must equal or exceed the industry members.<sup>59</sup> NASDR continued to have 11 district committees, each of which had a nominating committee

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<sup>53</sup> See 78ggg (2000); Municipal Securities Rulemaking Board, <http://www.msrb.org/msrb/whatsnew/default.asp>.

<sup>54</sup> Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and Nasdaq Market, Exchange Act Release No. 37,542 (Aug. 8, 1996) [hereinafter Section 21(a) Report].

<sup>55</sup> *Id.* Subsequently, under the threat of congressional legislation, the SROs moved to decimal pricing. See PLI, THE SEC SPEAKS IN 1999, Corp. L. & Prac. Handbook B-1105, at 115-119 (1999).

<sup>56</sup> Section 21(a) Report, *supra* note 55, at 2.

<sup>57</sup> *Id.* at 3.

<sup>58</sup> By-Laws of the NASD, art. VII, § 4(a) (2006); Nasdaq By-Laws, art. IV, § 4.1 (2006); NASDR By-Laws, art. IV, §§ 4.2, 4.3 (2007), NASD MANUAL, (CCH), 1315, 1503, 1703-3 (2006).

<sup>59</sup> NASDR By-Laws, art. V, § 5.2(a).}

and served as district business conduct committees. But these district business conduct committees, which at one time were the mainstay of NASD disciplinary activity, did not maintain the power they had before 1996 because the NASD disciplinary cases began to be tried before hearing officers. Further, the NAC replaced the national business district conduct committee (which was abolished) as the appeals body for disciplinary cases.<sup>60</sup> The end result of all of these changes, essentially forced upon the NASD in its settlement of the prosecution by the SEC and Department of Justice, was that the NASDR board, and the NAC, responsible for disciplining broker-dealers had a minority of industry members and at least some of the “self” was taken out of the securities industry’s primary SRO.

Further changes resulted from the 2000 decision by the NASD membership to demutualize Nasdaq and turn it into a for-profit public company, a transaction which then occurred in several stages.<sup>61</sup> An important aspect of this transformation was that Nasdaq, which previously was registered with the SEC as a securities information processor became registered as a national stock exchange.<sup>62</sup> In order to become a public company and a national stock exchange, Nasdaq and NASDR were forced to engage in years of negotiation with the SEC to obtain the approvals needed for Nasdaq’s demutualization and recognition as an exchange. The SEC also forced a complete separation of Nasdaq from NASDR.<sup>63</sup>

In the meantime, governance changes at the NYSE also were demanded by the SEC in response to scandals. On September 17, 2003, Richard Grasso resigned as chairman and CEO of the NYSE in the midst of a storm of criticism over his compensation.<sup>64</sup> In addition, a series of major securities cases concerning questionable and illegal behavior by securities firms and stock exchange specialists,<sup>65</sup>

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<sup>60</sup> NASD Inc., NASD CODE OF PROCEDURE, Rule 9213 (2006).

<sup>61</sup> In the matter of the Application of the Nasdaq Stock Market LLC for Registration as a National Securities Exchange, Exchange Act Release No. 53,128, 71 Fed. Reg. 3550 (Jan. 23, 2006).

<sup>62</sup> *Id.*

<sup>63</sup> *See id.*

<sup>64</sup> *See* Kate Kelly & Susanne Craig, *Weakened NYSE Faces Host of Challenges*, WALL ST. J., Sept. 18, 2003, at C1.

<sup>65</sup> *See* Laurie P. Cohen & Kate Kelly, *NYSE Turmoil Poses Question: Can Wall Street Regulate Itself?*, WALL ST. J., Dec. 31, 2003, at A1. In 2005 the United States Attorney’s Office and the SEC charged fifteen specialists for violating federal securities laws through patterns of fraudulent and improper trading. *See* Press Release, U.S. Attorney’s Office, S.D.N.Y., 15 Current and Former Registered Specialists on the New York Stock Exchange Indicted on Federal Securities Fraud Charges 1 (Apr. 12, 2005), available at

raised questions not only about the NYSE's effectiveness as a regulator, but also about the long term viability of the exchange's floor trading system.<sup>66</sup> In response to these serious problems, the Interim Chairman and CEO of the NYSE, put forth a proposal to reorganize the NYSE's board of directors and alter its enforcement arm. A reconstituted board of directors, of six to twelve members, plus a chairman and CEO, was put into place.<sup>67</sup> Like the NASD's 1996 reorganization, the NYSE's changed structure was put in place under the duress of government investigations and prosecutions and reflected the SEC's ideas of appropriate SRO governance. Also, like the NASD's 1996 reorganization, this new structure took much of the "self" out of self-regulation.

Following the NYSE's reorganization, the NYSE also demutualized and became a public company through a back door merger with Archipelago Holdings, Inc. ("Arca"), an electronic trading firm.<sup>68</sup> In connection with the merger of the NYSE and Arca, NYSE Regulation, Inc. ("NYSE Regulation") was formed as a separate not-for-profit subsidiary of NYSE Group. It has a number of structural and governance features designed to ensure its independence, in addition to its separate not-for-

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<http://www.usdoj.gov/usao/nys/PressReleases/April05/SpecialistIndictmentPR.pdf>; Press Release, SEC, SEC Institutes Enforcement Action Against 20 Former New York Stock Exchange Specialists Alleging Pervasive Course of Fraudulent Trading (Apr. 12, 2005), available at <http://www.sec.gov/news/press/2005-54.htm>. In addition, the SEC charged the NYSE with failing to police the accused specialists. See Press Release, SEC Charges the New York Stock Exchange With Failing to Police Specialists (Apr. 12, 2005), available at <http://www.sec.gov/news/press/2005-53.htm>.

<sup>66</sup> See Aaron Lucchetti & Kara Scannell, *Fifteen Indicted in NYSE Case*, WALL ST. J., Apr. 13, 2005, at C1; *New Order At Big Board, Years of Turmoil Give Chief Opening for Change*, WALL ST. J., Apr. 22, 2005, at A1.

<sup>67</sup> All of the board members other than the CEO were required to be independent of management, members and listed companies. This board was then given the responsibility for appointing a board of executives of twenty-two members, responsive to the exchange's various constituencies and comprised of institutional investors, listed company CEOs, lessor members, upstairs firm CEOs, specialist firm CEOs, floor brokers and the NYSE Chair and CEO. The board of executives was scheduled to meet with the board of directors at least six times a year to discuss exchange performance, membership issues, listed-company issues and public issues relating to market structure and performance. See Order Approving Proposed Rule Change Relating to the Amendment and Restatement of the Constitution of the Exchange to Reform the Governance and Management Architecture of the Exchange, Exchange Act Release No. 48,946, 68 Fed. Reg. 74,678, 74,679 (Dec. 17, 2003) [hereinafter NYSE Constitution Reform Filing], available at <http://www.sec.gov/rules/sro/34-48946.htm>.

<sup>68</sup> See *Redrawing the battle lines*, ECONOMIST, Apr. 30, 2005, at 70.



profit form.<sup>69</sup> Subsequent to this reorganization, NYSE once again changed its identity and governance by merging with Euronext, N.V. to form NYSE Euronext, Inc. ("NYSE Euronext").<sup>70</sup>

The governance changes at both the NASD and the NYSE resulting in the separation of their market and regulatory functions and the consolidation of NASDR and the non-market regulatory functions of NYSE Regulation into FINRA need to be understood against SEC proposed rules on SRO governance<sup>71</sup> and an SEC concept release on setting forth a variety of models for self-regulation.<sup>72</sup> The SEC's proposed governance rules for stock exchanges and the NASD would have required that these SROs and any of their affiliates have boards with a majority of independent directors<sup>73</sup> and that their nominating, governance, compensation, audit and regulatory oversight standing committees be composed of independent directors. These standing committees would have been mandated, and the SEC's proposal sets forth their minimum purposes and responsibilities.<sup>74</sup>

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<sup>69</sup> Each director of NYSE Regulation, other than its CEO, must be independent and a majority of the members of NYSE Regulation's board and its compensation and nominating committees must be persons who are not directors of NYSE Group. Its programs are funded primarily through fees assessed directly on member organizations. NYSE Group, Inc., Annual Report (Form 10-K), at 41-42 (Mar. 31, 2006), available at [http://www.nyse.com/pdfs/2502T05\\_CNB.pdf](http://www.nyse.com/pdfs/2502T05_CNB.pdf).

<sup>70</sup> After the merger, the NYSE Euronext board of directors consisted of 22 directors, including an equal number of U.S. and European domiciliaries, of which 11 were NYSE directors, including the CEO and Chairman of the NYSE. See NYSE Euronext, Inc., Proxy Statement of NYSE Group, Inc. and Prospectus of NYSE Euronext, Inc. (Form S-4), at 166-67 (Nov. 27, 2006). Since the NYSE remains as a subsidiary of NYSE Euronext, the status of NYSE Regulation is unchanged.

<sup>71</sup> Fair Administration and Governance of Self-Regulatory Organizations, Exchange Act Release No. 50,699, 69 Fed. Reg. 71,126, 71,134-40, (Dec. 8, 2004) [hereinafter SRO Governance Release].

<sup>72</sup> Concept Release Concerning Self-Regulation, Exchange Act Release No. 50,700, 69 Fed. Reg. 71,256 (proposed Dec. 8, 2004) [hereinafter SRO Concept Release].

<sup>73</sup> An "independent director" would be defined as a director who has no material relationship with an exchange or affiliate of an exchange, or any member of the exchange or affiliate of a member, or any issuer listed or traded on the exchange. SRO Governance Release, *supra* note 72, at 71,214-15 (to be codified at 17 C.F.R. § 240.6a-5(b)(12)). Further, employment by an exchange or member within the past three years, or the receipt of \$60,000 by the director or an immediate family member from the exchange or a member within the past year makes a director not independent. *Id.* There is a similar definition of an "independent director" for the NASD. *Id.* at 71,219 (to be codified at 17 C.F.R. § 240.15A-3(b)(13)).

<sup>74</sup> SRO Governance Release, *supra* note 72, at 71,134-40.

Section 6(b)(3) of the Exchange Act requires that the rules of an exchange assure a fair representation of its members in the selection of its directors and the administration of its affairs. Further, an exchange must provide that one or more directors be representative of issuers and investors and not be associated with a member of the exchange, broker or dealer.<sup>75</sup> The SEC's rule proposal regarding exchange governance would have required that the nominating committee of the board administer a fair process that provides members with the opportunity to select at least 20% of the total number of directors. The SEC asserted that the board could nevertheless be composed solely of independent directors, so long as 20% of those independent directors were selected by the exchange's members. This may not be consonant with the statute, and although it justified the reorganized NYSE board described above, it transformed the NYSE into an organization without securities industry members and therefore raised an issue as to whether the NYSE would continue to be an SRO.<sup>76</sup>

Both the reorganizations and public offerings of the NYSE and NASD described above were opposed by some broker-dealers who believed their interests were not fairly represented in the demutualization and merger of the regulatory functions of NYSE Regulation and NASDR.<sup>77</sup> Essentially, some seat holders believed they were not adequately compensated for their ownership interests when the NYSE demutualized and merged with Arca, and they sued the exchange and its CEO and directors alleging conflicts of interest and breach of fiduciary duties under state law.<sup>78</sup> This case settled after the defendants lost a motion to dismiss.<sup>79</sup> In connection with the creation of FINRA, some small broker-dealers who were not NYSE members brought a lawsuit alleging that their interests had been overrun by the

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<sup>75</sup> 15 U.S.C. § 78f(b)(3) (2000). Section 15A(b)(4) of the Exchange Act contains an identical requirement applicable to the NASD. 15 U.S.C. 78o-3(b)(4) (2000).

<sup>76</sup> See Comment Letter from Edward S. Knight, Exec. Vice President and Gen. Counsel, Nasdaq, to Jonathan G. Katz, Sec'y, SEC, 11-13 (Mar. 8, 2005) (regarding the Proposed Rulemaking on SRO Governance (File No. S7-39-04), as well as the Concept Release Concerning Self-Regulation (File No. S7-40-04)) [hereinafter Nasdaq Comment Letter].

<sup>77</sup> See *Standard Inv. Chartered, Inc. v. Nat'l Ass'n of Sec. Dealers*, Case No. 07Civ.-2014, 2008 U.S. Dist. LEXIS 4617 (S.D.N.Y. July 13, 2007); Aaron Lucchetti & Gregory Zuckerman, *The Ultimate "Mark to Market" Will Seatholders Get Fair Value Under NYSE's Proposed Deal? The Takeover Battle Takes Shape*, WALL ST. J., Apr. 27, 2005, at C1.

<sup>78</sup> See *Higgins v. N. Y. Stock Exch., Inc.*, 806 N.Y.S. 2d 339 (N.Y. Sup. Ct. 2005).

<sup>79</sup> *Id.*; *Higgins v. N. Y. Stock Exch., Inc.*, Index No. 601646/05 (N.Y. Sup. Dec. 5, 2005) (opinion accepting offer of settlement).

large NYSE member firms.<sup>80</sup> This case was dismissed on the ground that the plaintiffs had not exhausted their administrative remedies at the SEC in connection with the SEC's approval of the NASD's By-Law changes that brought FINRA into existence. While these cases are to some extent about the economics of these transactions they also highlight a governance problem. Will FINRA, which was formed at the urging of the large broker-dealer firms, and under the direction of the SEC, treat smaller firms and specialists (who were not previously NASD members) fairly?<sup>81</sup> Further, although FINRA continues to be a membership organization, it is not longer a *voluntary* SRO.

Both Nasdaq and the Securities Industry Association ("SIA"), a trade group, strongly objected to the SEC's proposal that exchange boards not include issuer or member firm representatives. Nasdaq argued that such a regulation would "either marginalize members and issuers or result in an unwieldy and excessively bureaucratic decision-making process that is ill suited to a public company."<sup>82</sup> The SIA argued that any governance reforms should be consistent with the balance between SEC oversight of SROs and regulation guided by the direct involvement of industry participants in both SRO and market functions.<sup>83</sup>

FINRA has a 23-person Board of Governors with 11 seats held by Public Governors, 9 seats held by Industry Governors, and the remaining 2 seats held by FINRA's CEO, Mary Schapiro, and the current Chief Regulatory Officer of the NYSE, Richard Ketchum, serving as the non-executive Chairman of the Board. Of the industry seats, large firms, consisting of 500 or more registered persons, and small

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<sup>80</sup> *Standard Inv. Chartered, Inc. v. Nat'l Ass'n of Sec. Dealers*, Case No. 07-CV 2014, 2007 U.S. Dist. LEXIS 32566 (S.D.N.Y. May 2, 2007).

<sup>81</sup> FINRA's proposed governance structure will accord these members three constituency seats on its Board of Governors. See SEC FINRA Approval, *supra* note 4.

<sup>82</sup> Nasdaq Comment Letter, *supra* note 77, at 12.

<sup>83</sup> Comment Letter from Marc E. Lackritz, President, SIA, to Jonathan G. Katz, Sec'y, SEC, 4 (Mar. 9, 2005) (regarding the SRO Governance and Transparency Proposal (File No. S7-39-04), as well as the SRO Concept Release (File No. S7-40-04)) [hereinafter SIA Comment Letter]. In addition to mandating a board of independent directors, the SEC proposed that exchanges and associations effectively separate their regulatory functions from their market operations and other commercial interests, use regulatory funds only to fund regulatory obligations, and establish procedures to prevent the dissemination of regulatory information to third parties. In the SEC's view, the conflicts between an exchange as a market operator and as a regulator, and as a membership organization and as a regulator, are exacerbated if an exchange demutualizes and has shareholders to whom it is responsible, and so separation of the regulatory component of an exchange or association's functions is therefore necessary. SRO Governance Release, *supra* note 72, at 71,141.

firms, consisting of 150 or fewer registered persons, are each guaranteed 3 elective seats. In addition, NYSE floor members, independent dealer/insurance affiliated firms, and investment company affiliates are each guaranteed one seat.<sup>84</sup>

The SEC's preoccupation with the conflicts between an exchange's regulatory functions and its members, market operations, listed issuers, and shareholders also prompted the issuance of a concept release on the future of SROs. Although the concept release detailed these conflicts, it is worth noting that all of these conflicts have existed for many years, except for the conflict between an exchange's regulatory functions and shareholders. Further, it can be argued that the conflicts between exchange regulatory functions and shareholders are less acute conflicts than between exchange regulatory functions and members. Nevertheless, the SEC seized upon the approvals needed by Nasdaq and the NYSE in connection with their transformation from mutualized SROs to demutualized public stock exchanges as an opportunity to restructure their boards and operations to accord with the SEC's views on how SROs for broker-dealers and market makers should function. Have the SEC's dictates regarding board composition and governance for FINRA and NYSE Regulation transformed these SROs into government agencies? Under the tripartite *Lebron* test, the answer would be in the negative since the creation of FINRA did not require a special statute and the SEC does not retain the authority to appoint a majority of FINRA's directors.<sup>85</sup> Yet FINRA could not come into existence until it was approved by the SEC. FINRA was created in large part to further the SEC's objectives regarding self-regulation, and the SEC structured its board. So FINRA comes very close to being an organization that would qualify as a government agency.

The statute creating the PCAOB specified that the SEC, after consultation with the Chairman of the Federal Reserve Board and the Secretary of the Treasury would appoint its chairman and board members.<sup>86</sup> In *Free Enterprise Fund v.*

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<sup>84</sup> See SEC FINRA Approval, *supra*, note 4; *Testimony Concerning Consolidation of NASD and Regulatory Functions of NYSE: Working Towards Improved Regulation Before the U.S. S. Comm. on Banking, Housing and Urban Affairs, 110th Cong. (2007)* (statement of Mary L. Schapiro, Chairman and CEO, NASD), available at [http://www.nasd.com/PressRoom/SpeechesTestimony/MaryL.Schapiro/NASDW\\_019169](http://www.nasd.com/PressRoom/SpeechesTestimony/MaryL.Schapiro/NASDW_019169); *NASD Members Overwhelmingly Approve Plan for New SRO for Member Regulation*, 39 SEC. REG & L. REP. (BNA), Jan. 29, 2007, at 130.

<sup>85</sup> See text at *supra* notes 20-22.

<sup>86</sup> 15 U.S.C. § 7211(e)(4)(A) (2002).

PCAOB,<sup>87</sup> the plaintiff made a number of claims that the PCAOB was unconstitutional, but the claim that has thus far received the most attention is whether, assuming the PCAOB is a government entity, the method of appointing its board violates the Appointments Clause of the Constitution.<sup>88</sup> If FINRA were held to be a government entity, these same issues would arise. In order to avoid these problems, the SEC should be careful to refrain from interfering in the appointment of persons to FINRA's board. Although the SEC has ventured beyond the securities laws in designating the characteristics of board members, thus far it has not suggested or vetoed particular individuals for these slots. Nevertheless, because the SRO rule-making process is so opaque, it is difficult to know what transpired in the negotiations between the SEC and the NASD and NYSE Regulation in the approval proceedings for FINRA.<sup>89</sup>

One argument against a finding that FINRA is a government agency is that it was advocated by the securities industry as a method for eliminating duplicative regulation, and the securities industry chooses half of its non-officer board members.<sup>90</sup> Nevertheless, the SEC has assumed so much control over FINRA's governance that its private sector liability may easily be lost.

The rapid and wrenching changes in the business and regulatory models of the NYSE and the NASD described in this section are due to technological changes in the trading of securities in an increasingly globalized capital market and such regulatory changes as the permitted combination of commercial and investment banks.<sup>91</sup> With the advent of NYSE and Nasdaq as public companies and the creation of FINRA as a single SRO for broker-dealers, it is appropriate to inquire what kind of an entity FINRA will be and whether the statutory constraints and SEC oversight of SROs are sufficient for this new SRO, even if it is not a government agency under the *Lebron* test.

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<sup>87</sup> 537 F.3d 667 (D.C. Cir. 2008).

<sup>88</sup> U.S. CONST. art. II, § 2, cl. 2. The Complaint also claimed that the creation of the PCAOB violated the Separation of Powers Clause, Art. II, §§ 1-2, and was an unconstitutional delegation. Art. I, § 1.

<sup>89</sup> See Lanny Schwartz, *Suggestions for Procedural Reform in Securities Market Regulation*, 1 BROOK. J. CORP. FIN. & COM. L. 409, 431-36 (2007).

<sup>90</sup> SIA Comment Letter, *supra* note 84, at 12.

<sup>91</sup> See generally Roberta S. Karmel, *The Once and Future New York Stock Exchange: The Regulation of Global Exchanges*, 1 BROOK. J. CORP. FIN. & COM. L. 355 (2007). The Gramm-Leach Bliley Act, Pub. L. No. 106-02, 113 Stat. 1338 (1999) repealed the Glass-Steagall barriers between commercial and investment banking.

## II. Immunity from Suit, Fifth Amendment Claims and Compulsory Arbitration

### A. Introduction

Two diametrically opposed lines of cases involve the immunity of SROs from damage actions and the ability of persons under investigation by SROs to claim their privilege against self-incrimination under the Fifth Amendment. In the former, the courts have treated SROs as if they were government entities. In the latter, the courts have refused to grant persons under investigation the right to claim the Fifth Amendment on the ground that SROs are private bodies. In cases challenging compulsory SRO arbitration, the courts have similarly sometimes viewed SROs as government actors, and sometimes viewed SROs as private actors.

In some cases, the courts have tried to distinguish between the commercial and regulatory functions of an SRO, but viewed in their totality, the holdings of these cases are impossible to reconcile. Possibly, they can be justified on policy grounds as necessary for SROs to effectively perform their regulatory functions. The courts have given deference to SRO conduct and arguments so as not to interfere with their regulatory responsibilities, in apparent disregard of the serious discrepancies in judicial precedents. Perhaps the public/private distinctions involving SROs are neither necessary nor helpful, and instead the inquiry should be whether under the circumstances, there are adequate protections for affected persons.<sup>92</sup>

An appreciation of these cases requires a brief understanding of the rule-making and disciplinary functions of SROs, and the SEC's oversight of these activities. Self-regulation always involved the promulgation of conduct rules for SRO members. Indeed, self-regulation was frequently justified as a system for imposing ethical as well as legal standards on securities industry professionals.<sup>93</sup> These ethical standards are captured in the concept of "just and equitable principles of trade," or rules of fair practice. Although these general concepts can still form the basis for disciplinary proceeding, in general, SRO standards are now contained in lengthy and detailed rule-books of NYSE Regulation and the NASD. One of the rationales for combining these entities into FINRA is that these rules are frequently contradictory

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<sup>92</sup> See Chris Sagers, *The Myth of "Privatization,"* 59 ADMIN. L. REV. 37 (2007); Paul R. Verkuil, *Privatizing Due Process,* 57 ADMIN. L. REV. 963, 979-87 (2005).

<sup>93</sup> See THE REPORT OF THE SUBCOMMITTEE ON SECURITIES OF THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, SECURITIES INDUSTRY STUDY, S. Doc. No. 13, at 149 (1<sup>st</sup> Sess. 1973).

or duplicative and the industry should be governed by a single rule-book.<sup>94</sup> These rules cover a wide variety of substantive negative and affirmative obligations of broker-dealers relating to the prevention of fraud and manipulation in securities offerings and trading; protection of broker-dealers and their customers from undue financial risk and insolvency; and fair dealing by broker-dealers with their customers.

The SEC has oversight with respect to all SRO rule-making. Section 19(b)(1) of the Exchange Act requires that all SROs file proposed rule changes with the SEC. If the SEC does not institute disapproval proceedings within 35 days of the proposed rule's publication, unless extended by the SEC to 90 days, the proposed rule becomes effective.<sup>95</sup> In reality, rule changes do not take effect this way. Generally, SROs consent to a waiver of the 35 day effectiveness period and there are long periods of negotiation between an SRO and the SEC as to whether a new rule can become effective as written.<sup>96</sup> The SEC also has the power to "abrogate, add to, and delete from" the rules of an SRO, but this power is rarely utilized.<sup>97</sup>

SROs have broad authority to investigate and prosecute violations of their own rules and also the violations of the federal securities laws.<sup>98</sup> The NASD also enforces the rules of the MSRB.<sup>99</sup> SRO sanctions can range from censure to suspension to a permanent bar of broker-dealer and associated persons licensed to engage in the securities business. Further, these sanctions overlap the ability of the SEC to discipline securities firms and personnel either in administrative proceedings or injunctive actions. Conduct that violates SRO rules and federal securities law regulations has also resulted in criminal prosecutions.<sup>100</sup>

Members of stock exchanges and the NASD have long been required to submit to arbitration of disputes among themselves. Securities arbitration between

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<sup>94</sup> See Schapiro, *supra* note 85; *NASD Members Overwhelmingly Approve Plan for New SRO for Member Regulation*, *supra* note 85.

<sup>95</sup> 15 U.S.C. § 78o-3 (2000); 15 U.S.C. § 78s(b)(1) (2000).

<sup>96</sup> See Lanny Schwartz, *supra* note 90.

<sup>97</sup> 15 U.S.C. § 78s(c) (2000). In one of the few instances where the SEC utilized this power, the rule in question was overturned by the District of Columbia Circuit Court. *Bus. Roundtable v. SEC*, 905 F. 2d 406 (D.C. Cir. 1970).

<sup>98</sup> See Exchange Act § 15A(b)(7), 15 U.S.C. § 78o-3(b)(7) (2000).

<sup>99</sup> See *id.*; *Blount v. SEC*, 61 F.3d 938, 941 (D.C. Cir. 1995). The MSRB is an SRO for municipal securities brokers and dealers. See *supra* notes 52-53.

<sup>100</sup> See, e.g., *D.L. Cromwell Inv., Inc. v. NASD Regulation, Inc.*, 279 F.3d 155 (2d Cir. 2002).

broker-dealers and their customers has been compelled since the Supreme Court permitted contracts to this effect in 1987.<sup>101</sup> SRO arbitration facilities have a Uniform Code of Arbitration promulgated by the Securities Industry Conference on Arbitration, and changes in these rules are subject to SEC oversight as are all other SRO rules. The arbitration facilities of the NYSE and the NASD will be combined in a separate entity as part of FINRA.

### B. Immunity From Suit

The NASD, NYSE and other securities industry SROs have been found to be immune from suit when acting in their regulatory and general oversight functions. To this extent they have been treated like government entities. In some cases, the courts have treated SROs as having the same immunity from suit for conduct falling within the scope of their regulatory and oversight functions as the SEC would have because they are performing the functions of a government agency which would have sovereign immunity.<sup>102</sup> In some cases, the SROs are described as acting pursuant to “delegated” governmental authority.<sup>103</sup> In other cases, the SRO’s actions are described as “quasi-governmental.”<sup>104</sup> The courts have reasoned that if the SROs could be sued for damages in connection with exercising their regulatory responsibilities, they would be discouraged from engaging in the effective self-regulation required by statute.<sup>105</sup>

Other cases have referenced the immunity of government officials from suits as provided in *Butz v. Economou*,<sup>106</sup> in which a futures commission merchant sued the Secretary of Agriculture and other officials for their actions in bringing an administrative proceeding. Although the appeals court held that the officials had only a qualified immunity, the Supreme Court held that where officials decide to

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<sup>101</sup> *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220 (1987). See also *Rodrigues de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477 (1989).

<sup>102</sup> *Barbara v. N.Y. Stock Exch.*, 99 F.3d 49 (2d Cir. 1996). See also *Scher v. Nat’l Ass’n of Sec. Dealers, Inc.*, 218 F. App’x 46 (2d Cir. 2007).

<sup>103</sup> E.g., *Dexter v. Depository Trust & Clearing Corp.*, 406 F. Supp.2d 260 (S.D.N.Y. 2005).

<sup>104</sup> *In re NYSE Specialists Sec. Litig.*, 503 F.3d 89 (2d Cir. 2007); *DL Capital Group LLC v. Nasdaq Stock Mkt., Inc.*, No. 03 Civ. 9730 2004 U.S. Dist. LEXIS 7955 (S.D.N.Y. May 5, 2004); *D’Alessio v. New York Stock Exch., Inc.*, 125 F. Supp.2d 656 (S.D.N.Y. 2000).

<sup>105</sup> *Dexter v. Depository Trust & Clearing Corp.*, 406 F. Supp.2d 260 (S.D.N.Y. 2005); *Trama v. N.Y. Stock Exch., Inc.*, No. 78 Civ 4898, 1978 U.S. Dist. LEXIS 15543 (S.D.N.Y. Sept 14, 1978).

<sup>106</sup> 438 U.S. 478 (1978).



initiate or continue a disciplinary proceeding subject to agency adjudication they are entitled to absolute immunity from damages.<sup>107</sup> In cases involving the prosecutorial or adjudicatory functions of SROs, the courts generally have granted them absolute immunity.<sup>108</sup> In one interesting case where the SEC set aside an NASD sanction, a broker sued the NASD for malicious prosecution. The court held that, although not prosecutors, the NASD investigators were acting in a prosecutorial capacity and therefore were entitled to absolute immunity from suit.<sup>109</sup>

An important recent case, *In re NYSE Specialists Securities Litigation (California Public Employees' Retirement System v. New York Stock Exchange, Inc.)*,<sup>110</sup> was a class action against the NYSE under Section 10(b) and Rule 10b-5 of the Exchange Act for failing to provide a fair and orderly market, upon which the plaintiffs relied in trading on that exchange. This case followed an SEC investigation into NYSE specialist firm misconduct and the settlement of an enforcement action against the NYSE for failing adequately to monitor and police specialist trading activity.<sup>111</sup> Five types of specialist misconduct were alleged in the complaint and the plaintiffs alleged that the NYSE was guilty of a "complete and utter failure" to regulate the conduct of its specialist firms during the class period of 1999-2003.<sup>112</sup> The complaint also alleged that the NYSE repeatedly made public statements during the period about its oversight which created "the false impression" that the NYSE was appropriately supervising its auction market in accordance with applicable laws and regulations. Investors were therefore led to believe that the NYSE "was an honest and fair market," and they relied on these misstatements in trading NYSE listed stocks.<sup>113</sup>

The NYSE moved to dismiss the complaint on the grounds that it was entitled to absolute immunity from claims stemming from either its active or passive

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<sup>107</sup> In *Harlow v. Fitzgerald*, 457 U.S. 800 (1982) the Court distinguished between absolute immunity situations and situations which give only qualified immunity because statutory or constitutional rights have been implicated. See also *Bivens v. Six Unknown Named Agents of Fed. Bureau of Narcotics*, 403 U.S. 388 (1971).

<sup>108</sup> *Austin Mun. Sec., Inc. v. Nat'l Ass'n of Sec. Dealers*, 757 F.2d 676 (5th Cir. 1985); *Shah v. Nat'l Ass'n of Secs. Dealers*, No. 98 C 5355, 1999 U.S. Dist. LEXIS 6467 (D. Ill. 1999); *Manelbaum v. N.Y. Mercantile Exch.*, 894 F. Supp. 676, 680-82 (S.D.N.Y. 1995).

<sup>109</sup> *Zandford v. Nat'l Ass'n of Secs Dealers*, 30 F. Supp.2d 1 (D.D.C. 1998).

<sup>110</sup> 503 F.3d 89 (2d Cir. 2007).

<sup>111</sup> See Press Release, SEC Charges the New York Stock Exchange with Failing to Police Specialists (Apr. 12, 2005), available at <http://www.sec.gov/news/press/2005-53.htm>.

<sup>112</sup> 503 F.3d at 93.

<sup>113</sup> *Id.*

complicity in the specialist firms' misconduct. This motion was granted by the district court, but the Second Circuit affirmed in part and reversed in part. Referring to a series of Second Circuit precedents, the court held that the NYSE has absolute immunity where an activity relates to the proper functioning of the regulatory system it is administering. Specifically, where the "'alleged misconduct falls within the scope of the quasi-governmental powers delegated to the NYSE,' absolute immunity attaches."<sup>114</sup>

The plaintiffs argued that prior decisions protected an SRO in cases involving the affirmative assertion of regulatory power, but not where an SRO has abandoned its duty to regulate. The Second Circuit disagreed, deciding that absolute immunity should protect an SRO not only when it decides to act, but also when it decides not to act. This is because the purpose of absolute immunity is to give government officials, or those acting with delegated governmental powers, "breathing room to exercise their powers without fear that their discretionary decisions may engender endless litigation."<sup>115</sup> The issue is not whether the SRO is acting consistently with the laws it is supposed to enforce, but whether the plaintiff's allegations concern the exercise of powers within the bounds of the government functions delegated to it. Applying this analysis, the court believed it was clear that the alleged misconduct fell within the ambit of the quasi-governmental functions delegated to the NYSE by the SEC. Further, the court declined to fashion a fraud exception to such immunity.

With regard to the misrepresentation claim, however, the Second Circuit reversed and remanded. This was because the district court had dismissed the case on the theory that an action under Rule 10b-5 lies only against the issuer of a security for false statements about the security. The court thought this theory was wrong, but it expressed skepticism that the plaintiffs could successfully argue reliance. The question of whether the alleged misrepresentations related to the NYSE's commercial role, rather than its regulatory role, was not discussed. Such a distinction was, however, the basis for *Weissman v. NASD*,<sup>116</sup> a case in the Eleventh Circuit.

Steven Weissman was a purchaser of WorldCom, Inc. ("Worldcom") stock, allegedly purchased in reliance on Nasdaq's misrepresentations in advertisements

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<sup>114</sup> *Id.* at 96 (quoting from *D'Alessio v. N.Y. Stock Exch., Inc.*, 258 F.3d 93, 106 (2d Cir. 2001)).

<sup>115</sup> *Id.* at 97.

<sup>116</sup> 468 F.3d 1306 (11th Cir. 2006), *aff'd*, 500 F.3d 1293 (11th Cir. 2007).

promoting WorldCom stock. He brought a diversity suit under Florida blue sky law, alleging that Nasdaq expended \$74 million during 2000 and 2001 on advertising. This advertising campaign featured Nasdaq listed companies, including WorldCom. The Eleventh Circuit, affirming the denial of a motion to dismiss on immunity grounds, held that while Nasdaq enjoys absolute immunity for statutorily-mandated prosecutorial, regulatory or disciplinary functions, Nasdaq was not entitled to immunity with regard to its for-profit commercial activities. The only activity in the case held to be immune was posting WorldCom's financials on Nasdaq's web site. A dissenting judge expressed the view that the gist of Weissman's complaint was that Nasdaq continued to list WorldCom in order to increase its profits after it knew or should have known that WorldCom was in trouble. In addition to believing that this was essentially a regulatory decision, the dissent argued that the majority opinion was an untenable precedent.

The difficulty with the majority's decision was demonstrated by the hair-splitting which occurred in a later decision *en banc*, which involved a particular advertisement in the Wall Street Journal. After the Enron fraud came to light, in April, 2002, Nasdaq took out a two full page spread advertisement in the Wall Street Journal, discussing the need for Nasdaq listed companies to provide accurate financial reporting, supported by a knowledgeable audit committee. On the opposite page, a list of CEOs of the "good" Nasdaq listed companies included Bernard J. Ebbers, CEO of Worldcom. According to the complaint, this ad suggested that WorldCom and its CEO were endorsed by Nasdaq as "having a good character, accounting done in accordance with GAAP, and a viable audit committee in accordance with N[ASDAQ] listing requirements."<sup>117</sup> The Eleventh Circuit *en banc* decision concluded, in a very short majority opinion, that Nasdaq's advertising activity did not serve an adjudicatory, regulatory or prosecutorial function, and therefore absolute immunity was properly denied by the district court. The concurring opinion, joined by four judges, took the position that the Wall Street Journal ads were quasi-governmental conduct because they communicated to investors that Nasdaq companies had to satisfy rigorous financial disclosure standards, and the establishment of these standards was delegated to Nasdaq by the SEC.

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<sup>117</sup> *Id.* at 1312.

A California district court case was guided to some extent by *Weissman* in trying to draw a line between an SRO's governmental and commercial functions in *Opulent Fund, L.P. v. Nasdaq*.<sup>118</sup> The plaintiffs were private investment partnerships that trade in stock index options, including options derived from the value of the Nasdaq-100 index. This index is weighted by the market value of the component securities in the index, according to a computational method which the SEC has reviewed and approved. The complaint alleged that on May 9, 2006, Nasdaq negligently miscalculated and announced the opening price of the index, resulting in a significant loss on options contracts held by the plaintiff. The case was brought under California statutory and common law for negligent misrepresentation. Nasdaq argued that in calculating the opening price of the index, it was discharging duties under the Exchange Act and therefore was entitled to absolute immunity. The court disagreed, and refused to dismiss the suit, holding that the pricing of an index by Nasdaq was not a regulatory function, but part of its for-profit commercial activities.

Now that FINRA, the NYSE and Nasdaq are separate entities, it would appear that FINRA will not have too much difficulty claiming immunity for its activities which would appear to be primarily, if not entirely, adjudicatory, prosecutorial or regulatory. The NYSE and Nasdaq may have a more difficult time, however, claiming immunity now that they are for-profit public companies, even though they continue to regulate their own markets.

### C. Fifth Amendment Pleas

Curiously, in what would seem to be a related area to immunity from suit—the ability of persons under investigation by SROs for securities law violations to assert Fifth Amendment protections—the courts have not viewed the NYSE and NASD as governmental agencies and have not generally granted the targets of SRO investigations a right to claim their Fifth Amendment privilege against self-incrimination.<sup>119</sup> [FIX LINE BREAK]Because SROs do not have subpoena power, their members are required to “voluntarily” cooperate with investigators and provide testimony and documents. Failure to cooperate can result in sanctions

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<sup>118</sup> Fed. Sec. L. Rep. (CCH) ¶ 94,462 (N.D. Cal. Oct. 12, 2007).

<sup>119</sup> See, e.g., *Jones v. SEC*, 115 F.3d 1173, 1182-83 (4th Cir. 1997); *United States v. Solomon*, 509 F.2d 863 (2d Cir. 1975). But see *In Re Quattrone*, Exchange Act Rel. No. 53,547, 2006 SEC LEXIS 703 (Mar. 24, 2006).

ranging from censure to a bar from the securities business. Historically, the NYSE imposed a bar for non-cooperating witnesses until they were willing to cooperate,<sup>120</sup> while the NASD imposed a permanent bar against witnesses who refused to testify.<sup>121</sup> In one case the SEC justified the necessity for the NASD's testimonial compulsion as necessary for its regulatory responsibilities, but reversed a permanent bar, suggesting that the NASD review the appropriateness of this sanction.<sup>122</sup> Similarly, in *PAZ Securities, Inc. v. SEC*,<sup>123</sup> the D.C. Circuit remanded a case where the NASD had permanently barred an associated person for failing to respond to requests for information, where the SEC had affirmed the bar without addressing potentially mitigating factors. The court viewed such a bar as the industry equivalent of capital punishment, and the court held that the SEC was required to explain why such a severe sanction was remedial rather than punitive.<sup>124</sup>

The reasoning of the cases described above, giving SROs immunity from suit, is that this immunity is necessary for SROs to exercise their regulatory functions effectively. Similarly, cases denying persons under investigation by SROs the right to plead their privilege against self-incrimination under the Fifth Amendment are justified on the grounds that since SROs do not have subpoena power, they could not effectively operate as regulators if they could not bar persons from continuing to be associated with member firms for their failure to cooperate when they refuse to testify or produce documents in an investigation.<sup>125</sup> Nevertheless, in a number of cases, persons investigated by SROs and subsequently charged in criminal actions for the same conduct have argued that the sanction of being barred from the securities business for non-cooperation is essentially a deprivation of their Fifth Amendment constitutional right because the Supreme Court has held that a witness cannot be deprived of his employment for declining to provide testimony that could be used against the witness in a criminal prosecution.<sup>126</sup>

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<sup>120</sup> NYSE Rule 477; In the matter of Brian D. Stoker, NYSE Hearing Panel Dec. 05-103 (Dec. 19, 2005) and cases cited therein.

<sup>121</sup> NASD Rule 8310; In the matter of Robert J. Langley, Exchange Act Release No. 50917, 2004 SEC LEXIS 3048 (Dec. 22, 2004).

<sup>122</sup> 2004 SEC LEXIS 3048.

<sup>123</sup> 494 F.3d 1059 (D.C. Cir. 2007).

<sup>124</sup> *Id.* at 1062-63.

<sup>125</sup> See, e.g., *Dep't of Enforcement v. Steinhart*, 2003 NASD Discip. LEXIS 23 (NASD Discip. 2003); *In re Fierro*, Exchange Act Release No. 39,544, 53 SEC Docket 434 (Jan. 13, 1998).

<sup>126</sup> See, e.g., *Lefkowitz v. Cunningham*, 431 U.S. 801 (1977); *Lefkowitz v. Turley*, 414 U.S. 70 (1973); *Garrity v. New Jersey*, 385 U.S. 493 (1967).

The key case relied upon when a denial of Fifth Amendment rights is claimed is *United States v. Solomon*,<sup>127</sup> in which testimony by an officer of a NYSE member firm was used to indict him. The defendant in the criminal case argued that the NYSE had become an arm of the government, so the Fifth Amendment privilege excluding involuntary confessions from evidence should apply. The Second Circuit held that the actions of the NYSE were those of a private body and not the government and therefore the Fifth Amendment privilege was unavailable. The court stated: "This is but one of many instances where the government relied on self-policing by private organizations to effectuate the purposes underlying federal regulating statutes."<sup>128</sup> Similarly, in *Jones v. SEC*,<sup>129</sup> the Fourth Circuit rejected a claim based on the Fifth Amendment's Double Jeopardy Clause on the ground that the NASD is not a government agency. These precedents have been followed in district court cases.<sup>130</sup> In a case where a party argued that the NASD is a quasi-governmental agency, the court held to the contrary, stating: "NASD is not a government agency: it is a private, not-for-profit corporation chartered in Delaware. It received no funding from any government, federal or state."<sup>131</sup>

In recent years, the claims that the constitutional rights of persons under SRO investigation have been compromised have become more vociferous because of the simultaneous actions and cooperation of SROs, the SEC and the Department of Justice in the prosecution of securities industry professionals. The SEC has begun to acknowledge that under some circumstances, an SRO may be acting as an agent for the government in conducting an investigation. In *Frank P. Quattrone*,<sup>132</sup> a person under investigation acknowledged that he failed to respond to an NASD request for information, contending that he had a Fifth Amendment right not to respond because his requested testimony related to a joint investigation by the SEC, the NASD and the NYSE into spinning and research analyst conflicts of interest at 12 broker-dealer firms. He claimed the NASD investigation was therefore "state

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<sup>127</sup> 509 F.2d 863 (2d Cir. 1975).

<sup>128</sup> *Id.* at 869.

<sup>129</sup> 115 F.3d 1173, 1182-83 (4th Cir. 1997).

<sup>130</sup> See, e.g., *D.L. Cromwell Invs., Inc. v. NASD Regulation, Inc.*, 132 F. Supp. 2d 248 (S.D.N.Y. 2001); *Datek Sec. Corp. v. Nat'l Ass'n of Sec. Dealers, Inc.*, 875 F. Supp. 230, 234 (S.D.N.Y. 1995); *SEC v. Musella*, 1983 U.S. Dist. LEXIS 17999 (S.D.N.Y. 1983).

<sup>131</sup> *Graman v. Nat'l Ass'n of Sec. Dealers*, No. 97-1556-JR, 1998 U.S. Dist. LEXIS 11624, at \*5-6 (D.D.C. 1998).

<sup>132</sup> Exchange Act Release No. 53,547, 2006 SEC LEXIS 703 (Mar. 24, 2006).

action." At a proceeding before a Hearing Panel, Frank P. Quattrone ("Quattrone") refused to testify in view of a related pending criminal indictment against him. The NAC increased the hearing panel's sanction to a bar in all capacities because it "found that Quattrone's misconduct in refusing to testify was egregious."<sup>133</sup> The SEC reversed and remanded, holding that Quattrone had the right to present evidence that the NASD's role in the joint investigation rendered its request for information and testimony state action.<sup>134</sup>

Justin F. Ficken ("Ficken") was a former associated person of an NASD member firm who refused to provide testimony in an investigation into improper market timing and late trading in mutual fund shares. A Hearing Panel barred Ficken from associating with any NASD member in any capacity, and the NAC affirmed this sanction, finding that Ficken's "unsubstantiated, generalized assertion" that NASD staff had forwarded documents to the SEC and the Department of Justice did not support a finding of state action.<sup>135</sup> The SEC reversed and remanded, giving Ficken the opportunity to conduct discovery to prove his allegations of joint action between the NASD and the SEC, but noted that "cooperation between the Commission and NASD will rarely render NASD a state actor, and the mere fact of such cooperation is generally insufficient, standing alone, to demonstrate state action."<sup>136</sup> A similar opportunity to prove state action in an NYSE proceeding where a specialist was barred for asserting the Fifth Amendment in an investigation was afforded in *Warren E. Turk*.<sup>137</sup>

A better procedural approach to granting the Fifth Amendment privilege is provided by the PCAOB. The PCAOB has the power of investigation similar to SROs, and can suspend or bar a public accounting firm or associated person who refuses to testify.<sup>138</sup> In addition, if a witness refuses to cooperate, the PCAOB may request that the SEC issue a subpoena. Further, the PCAOB is required to coordinate its investigations of potential securities law violations with the SEC.<sup>139</sup> Perhaps for these reasons, the PCAOB explicitly permits witnesses to claim a Fifth Amendment

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<sup>133</sup> *Id.* at \*8.

<sup>134</sup> *Id.* at \*11.

<sup>135</sup> *In re Ficken*, Exchange Act Release No. 54699, 2006 SEC LEXIS 2547, at \*11 (Nov. 3, 2006).

<sup>136</sup> *Id.* at 11.

<sup>137</sup> Exchange Act Release No. 55,942 (June 22, 2007).

<sup>138</sup> Sarbanes-Oxley Act § 105, 15 U.S.C. § 7215 (2002).

<sup>139</sup> *Id.*

privilege, but it has reserved the right to draw an adverse inference from the assertion of such a claim.<sup>140</sup> With the recent recognition by the SEC that many SRO investigations are joint investigations with the SEC and the Department of Justice, and the D.C. Circuit's caution that a permanent bar is a severe sanction which must be justified, it seems appropriate for the SROs similarly to provide for Fifth Amendment pleas by persons under SRO investigation. If this unduly hampers SRO investigations, two solutions are possible: first, a temporary suspension until the witness decides to testify; or second, subpoena assistance from the SEC. The imposition of a permanent bar by SROs for failure to testify would appear to be ill advised in view of legal developments with regard to this area.

#### D. Arbitration Facilities

Compulsory arbitration between member firms and member firms and their employees has generally been viewed as a matter of private contract, a condition of being a member of an SRO. Similarly, contractual arbitration provisions between member firms and their customers have been upheld. Nevertheless, SRO arbitration has proven controversial for a variety of reasons, most of which are not directly relevant to this article.<sup>141</sup> With the formation of FINRA, the arbitration facilities of the NASD and the NYSE were combined into a single subsidiary.<sup>142</sup>

In *Desiderio v. NASD*,<sup>143</sup> the plaintiff argued that her Fifth and Seventh Amendment rights were violated by the NASD when she was required to agree to an arbitration provision in her offer of employment as a securities broker. The court held that the SEC had not compelled the NASD to require arbitration and that there was no state action. According to the court, the NASD "is a private corporation that

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<sup>140</sup> See PCAOB Rule 5106; PCAOB Rulemaking, Proposed Rules Relating to Investigations and Adjudications, Exchange Act Release No. 49,454, 2004 SEC LEXIS 644 (Mar. 19, 2004); PCAOB Rulemaking Order Approving Rules Relating to Investigations and Adjudications, Exchange Act Release No. 49,704, 2004 SEC LEXIS 1018 (May 14, 2004).

<sup>141</sup> See Marilyn Blumberg Cane & Marc J. Greenspon, *Securities Arbitration: Bankrupt, Bothered & Bewildered*, 7 STAN. J. L. BUS. & FIN. 131 (2002); Jennifer J. Johnson, *Wall Street Meets The Wild West: Bringing Law and Order to Securities Arbitration*, 84 N. C. L. REV. 123 (2005); David S. Ruder, *Elements of a Fair and Efficient Securities Arbitration System*, 40 ARIZ. L. REV. 1101 (1998); Marc I. Steinberg, *Securities Arbitration: Better for Investors Than the Courts?*, 62 BROOK. L. REV. 1503 (1996).

<sup>142</sup> See Press Release, NASD, NASD and NYSE Group Announce Plan to Consolidate Regulation of Securities Firms, (Nov. 28, 2006), available at [http://www.nasd.com/PressRoom/NewsReleases/2006newsreleases/NASDW\\_017963](http://www.nasd.com/PressRoom/NewsReleases/2006newsreleases/NASDW_017963).

<sup>143</sup> 191 F.3d 198 (2d Cir. 1999).



receives no federal or state funding. Its creation was not mandated by statute, nor does the government appoint its members or serve on any NASD board or committee. Moreover, the fact that a business entity is subject to 'extensive and detailed' state regulation does not convert that organization's actions into those of the state."<sup>144</sup>

A rather different result was obtained in cases involving California Ethics Standards for Neutral Arbitrators in Contractual Arbitration ("California Standards"), which in certain respects were in conflict with NASD and NYSE rules relating to arbitrations. In *Mayo v. Dean Witter Reynolds, Inc.*<sup>145</sup> a federal district court held that the California Standards were preempted by both the Exchange Act and the Federal Arbitration Act. The court found conflicts between the SROs and California Standards with regard to arbitrator disclosures, control of the case by the SRO Director of Arbitration as opposed to the parties under court supervision, and the applicability of the California Standards in SRO dispute resolution cases. Further, the court found that SROs are an integral part of the federal regulatory scheme administered by the SEC and that an important function of the SROs was the conduct of arbitrations. If SROs were forced to comply with the California Standards they would become subject to a patchwork of state regulation at odds with their national function. In *Credit Suisse First Boston Corp. v. Grunwald*,<sup>146</sup> a federal circuit court subsequently held that SEC approval of SRO rules preempted the California Standards.

In *Jevne v. The Superior Court of Los Angeles County*,<sup>147</sup> a California appellate court also held that the California Standards were preempted by the Exchange Act, but on narrower grounds. The court thought that there was no actual conflict between the arbitrator disclosure provisions of the California Standards and SRO procedural rules, but that the added disclosure provisions were nevertheless an obstacle to the SRO procedures because the California standards would increase the costs and complexity of and inject uncertainty into the arbitration process and

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<sup>144</sup> *Id.* at 206, citing *Jackson v. Metro. Edison Co.*, 419 U.S. 345, 350 (1974).

<sup>145</sup> *Mayo v. Dean Witter Reynolds, Inc.*, 258 F. Supp. 2d 1097, amended by 260 F. Supp. 2d 979 (N.D. Cal. 2003); accord *Wilmot v. McNabb*, 269 F. Supp.2d 1203 (N.D. Cal. 2003). The court in *Mayo* also held that the California Standards were preempted by the Federal Arbitration Act because they interfered with the contractual provisions between a broker-dealer and its customer to arbitrate according to SRO procedural rules.

<sup>146</sup> 400 F.3d 119 (9th Cir. 2005).

<sup>147</sup> *Jevne v. Superior Court*, 111 P.3d 954 (Cal. 2006).

therefore frustrate the Exchange Act's purpose of protecting investors and the public. In view of the SEC's intense oversight in the area of SRO arbitrations, the court was reluctant to second guess the federal agency on this matter. With respect to the procedures for arbitrator disqualification, the court did find a direct conflict between the California Standards and SRO procedural rules, and therefore found preemption on this ground as well. In these cases SRO rules were essentially treated as SEC rules, and the SROs were therefore essentially regarded as state actors.

The creation of FINRA generated some adverse comments on the combination of NYSE and NASD arbitration, to the effect that investor rights would be reduced by cutting the number of available arbitration venues in half.<sup>148</sup> The SEC found that the combination of SRO arbitration facilities was consistent with the Exchange Act and would take advantage of economies of scale.<sup>149</sup> As the SEC noted, the criticisms of compelled arbitration go beyond the issues of FINRA's creation. Yet, if FINRA is for some purposes exercising delegated governmental functions, is this compelled broker-dealer-customer arbitration forum an alternative federal court? If so, how should it be governed and operated and how should arbitrators be selected?

#### IV. Due Process Rights of Persons Subject to FINRA

If FINRA were held to be a government entity, persons subject to its regulation would have a variety of constitutional and statutory rights applicable to those who deal with federal administrative agencies. In addition to basic constitutional protections, the Administrative Procedure Act,<sup>150</sup> the Freedom of Information Act<sup>151</sup> and the Government in the Sunshine Act<sup>152</sup> could become

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<sup>148</sup> SEC FINRA Approval, *supra* note 4, at 36.

<sup>149</sup> *Id.* at 86, 89.

<sup>150</sup> 5 U.S.C. § 551(1) (1994) (applying to "each authority of the Government of the United States, whether or not it is within or subject to review by another agency . . .," The SEC is covered by this definition. *Commercial Capital Corp. v. SEC*, 360 F.2d 856, 858 (7th Cir. 1966).

<sup>151</sup> 5 U.S.C. § 552(f)(1) (2002) (covering "any independent regulatory agency"). In *Independent Investor Protective League v. NYSE*, 367 F. Supp. 1376, 1377 (S.D.N.Y. 1973), the court held that the NYSE was not an "agency" under the Freedom of Information Act because it was not an authority of the Government of the United States but rather a not-for-profit corporation of the State of New York. Since then, there has been litigation as to whether advisory committees or consultants of federal agencies are subject to this statute. *See, e.g., Wash. Research Project, Inc. v. Dep't of Health, Ed. & Welfare*, 504 F.2d 238, 245 (D.C. Cir. 1974), *cert. den.* 421 U.S. 963 (1974) *Wash. Legal Found. v. Am. Bar Ass'n Standing Comm. on Fed. Judiciary*, 648 F. Supp. 1353, 1354 (D.C. 1986).

<sup>152</sup> 5 U.S.C. § 552(b) (1995).

applicable to the deliberations, rule-making procedures and disciplinary activities of FINRA and possibly other SROs. A wide variety of other statutes and regulations could apply to the funding, budgeting, contracting activities and other operations of the SROs. The SROs would be turned into government bureaucracies and would not be able to recruit personnel, pay salaries and operate in the manner in which they have long conducted themselves. These problems will become apparent at the PCAOB if that body is declared a government entity. Currently, even though the PCAOB affords the auditing firms and accountants subject to its jurisdiction certain rights, it denies that it is subject to the constraints applicable to government agencies.<sup>153</sup>

At one time, SROs denied their members certain rights commonly viewed as fundamental in connection with their investigations and disciplinary proceedings. For example, persons under investigation were not entitled to bring counsel to investigative hearings.<sup>154</sup> By reason of the 1975 amendments to the Exchange Act, the SEC's oversight of the NYSE, the NASD and other SROs was made consistent and assured that all members of SROs would be treated fairly in connection with investigations and disciplinary proceedings. In addition, since 1975, all SRO rules have been required to be approved by the SEC, and in that process they become subject to the notice and comment process.

Under the Exchange Act, the rules of an exchange must "assure a fair representation of its members in the selection of its directors and administration of its affairs."<sup>155</sup> In addition, the rules of the exchange must "provide for the equitable allocation of reasonable dues, fees and other charges among its members and issuers and other persons using its facilities."<sup>156</sup> With respect to discipline, SROs must provide a "fair procedure" which includes bringing specific charges, notifying a

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<sup>153</sup> See Comment Letter from Deloitte & Touche, LLP to SEC, File No. PCAOB-2003-07 (Apr. 15, 2004), PCAOB Proposed Rules on Investigations and Adjudications, Apr. 15, 2004, at 53.

<sup>154</sup> See *Villani v. N.Y. Stock Exch.*, 348 F. Supp. 1185, 1191 (S.D.N.Y. 1972), *aff'd sub nom. Sloan v. N.Y. Stock Exch.*, 489 F.2d 1, 2 (2d Cir. 1973).

<sup>155</sup> Exchange Act § 6(b)(3) (codified as 15 U.S.C. § 78f(b)(3) (2000)). Before it became an exchange, a similar provision applied to the NASD. Exchange Act § 15A(b)(4) (codified as 15 U.S.C. § 78o-3(b)(4) (2000)).

<sup>156</sup> Exchange Act § 6(b)(4) (codified as 15 U.S.C. § 78f(b)(4) (2000)). Before it became an exchange, a similar provision applied to the NASD. Exchange Act § 15A(b)(5) (codified as 15 U.S.C. § 78o-3(b)(5) (2000)).

person subject to discipline and giving him an opportunity to defend against such charges and keeping a record. Further, in order to impose a sanction, there needs to be a statement setting forth the act or practice in which the member engaged or omitted, the provisions of the regulation(s) violated and the sanction and reason for its imposition.<sup>157</sup> A person who has been sanctioned by an exchange or association has a right to appeal from a decision by the trier of fact to the SRO board or other committee, which in the case of the NASD has been the NAC.<sup>158</sup> A further appeal to the SEC also is provided.<sup>159</sup> In most respects, all of these due process rights are similar to the rights granted to persons subject to SEC disciplinary proceedings.<sup>160</sup> As pointed out by the Senate Committee on Banking, Housing and Urban Affairs when the 1975 Act Amendments were drafted, since the SROs “exercise government power . . . by imposing a disciplinary sanction, broadly defined, on a member or person affiliated with a member . . . [they] must be required to conform their activities to fundamental standards of due process.”<sup>161</sup>

All SRO new rules and rule changes must be filed with the SEC and approved by the SEC before they can become effective.<sup>162</sup> In addition, the SEC can abrogate, add to or delete from existing SRO rules.<sup>163</sup> In the course of this rule-making approval process, any new SRO rules or amendments are put out for comment, and the comments are considered by the SEC in its determination as to whether to approve the SRO’s filing. The Senate Committee Report on the 1975 Act Amendments to the Exchange Act criticized the fact that SROs did not have to explain or justify their rule proposals and expressed the view that the SEC should require a “concise general statement of the basis and purpose” of proposed rule

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<sup>157</sup> Exchange Act § 6(d)(1) (codified as 15 U.S.C. §§ 78f(b)(7), 78o-3(h)(1) (2000)).

<sup>158</sup> See National Adjudicatory Council, FINRA Regulatory Enforcement (NAC), available at <http://www.finra.org/Industry/Enforcement/Adjudication/NAC/index.htm>.

<sup>159</sup> Exchange Act § 19(d)(2), 15 U.S.C. § 78s(d)(2) (2000).

<sup>160</sup> See SEC Rules of Practice, 17 C.F.R. §§ 201-1106. Prior to 1975, these procedural rights were afforded to persons subject to NASD discipline, but not stock exchange discipline. See SUBCOMM. ON SECURITIES OF S. COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, SECURITIES INDUSTRY STUDY, S. Doc. No. 13, at 150-51 (1st Sess. 1973).

<sup>161</sup> S. COMM. ON BANKING, HOUSING & URBAN AFFAIRS, SECURITIES ACT AMENDMENTS OF 1975, REP. NO. 94-75, at 24-25 (1975). The Committee also noted that SROs can adversely affect the interests of particular persons by denying membership to an applicant or requiring members to case doing business in specified ways. *Id.*

<sup>162</sup> Exchange Act § 19(b), 15 U.S.C. § 78s(b) (2000).

<sup>163</sup> Exchange Act § 19(c), 15 U.S.C. § 78s(c) (2000).

changes in order to hold SROs “to the same standards of policy justification that the Administrative Procedure Act imposes on the SEC.”<sup>164</sup>

While the SROs would deny that they are governmental entities subject to the Administrative Procedure Act, all of the procedures set forth above essentially guarantee that the procedures of the Act relating to disciplinary proceedings and rule-making are followed. The degree of SEC oversight of these processes is extensive, perhaps at times overly rigid and bureaucratic. To subject disciplinary proceedings and rule-making to greater scrutiny by declaring that SROs are subject to the constitutional and administrative law protections applicable to government agencies would probably ossify the work of the SROs, and would not necessarily be useful.<sup>165</sup> At the same time, to the extent that SROs do not afford persons subject to their discipline ample due process protections in their disciplinary and rule-making processes, the legitimacy of SRO action is undermined and an SRO could be subject to adverse court review.<sup>166</sup>

## V. SRO Rule-Making to Displace Anti-Trust Regulation and State Laws

### A. General

One of the interesting aspects of SRO rule-making is that an NASD or NYSE rule can create a conflict with state laws or federal anti-trust laws. If the SRO rule is then viewed as federal securities regulation, it can displace state law or anti-trust law. There have been only a few cases where preemption of state law has occurred because of an SRO rule, but FINRA rule-making could create more such conflicts in the future. Although there have been more cases of conflict between SRO rules and the anti-trust laws, a recent Supreme Court case<sup>167</sup> giving the SEC considerable leeway in displacing the anti-trust laws will probably lead to fewer such cases in the future.

Of particular importance with regard both to state law and to anti-trust law conflicts with SRO rules is the NASD Corporate Financing Rule.<sup>168</sup> Like all NASD rules, this rule applies to NASD members but affects the structure of initial public offerings (“IPOs”) because it regulates underwriters’ compensation. This is a merit

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<sup>164</sup> S. REP. NO. 94-75, at 29.

<sup>165</sup> Cf. Metzger, *supra* note 17, at 1408-09, 1456.

<sup>166</sup> See *Silver v. NYSE*, 373 U.S. 341 *passim* (1963).

<sup>167</sup> *Credit Suisse Sec. (USA) LLC v. Billing*, 127 S. Ct. 2383, 2396 (2007).

<sup>168</sup> NASD Rule 2710, SEC Release No. 34-30587 (Apr. 15, 1992).

regulation analogous to state blue sky merit regulation, which enabled state commissioners to determine whether underwritings were “fair, just and equitable.”<sup>169</sup> Administration of such statutes included a review of a corporation’s capitalization and the sale of cheap stock to underwriters and insiders. Similarly, a wide variety of arrangements between underwriters and issuers are included in the analysis of underwriters compensation, and the NASD has the power to disapprove of “unfair” compensation.

### B. SRO Preemption of State Law<sup>170</sup>

Federal preemption of state law may occur under the Supremacy Clause of the Constitution, and Congress has frequently preempted state law in the area of financial regulation. Preemption may be express or implied. Preemption is express when there is an explicit statutory command that state law be displaced.<sup>171</sup> Preemption is implied and state law is therefore displaced, “if federal law so thoroughly occupies a legislative field as to make reasonable the inference that Congress left no room for the states to supplement it.”<sup>172</sup> This type of implied preemption is often referred to as field preemption. State law may be displaced under an implied conflict analysis if either it is impossible to comply with both a state and a federal law, or if the state law “stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.”<sup>173</sup>

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<sup>169</sup> See generally Mark A. Sargent, *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785 (1986).

<sup>170</sup> A more comprehensive treatment of this topic by the author is contained in Roberta S. Karmel, *Reconciling Federal and State Interests in Securities Regulation in the United States and Europe*, 28 BROOK. J. INT’L L. 495, 497-524 (2003).

<sup>171</sup> See *Morales v. Trans World Airlines*, 504 U.S. 374, 383 (1992). A clear example of express preemption in financial regulation is in the Employee Retirement Income Security Act of 1974 (“ERISA”) which states that the provisions of that act “shall supersede any and all state laws insofar as they may now or hereafter relate to any employee benefit plan.” 29 U.S.C. § 1144(a).

<sup>172</sup> *Cipollone v. Liggett Group, Inc.*, 505 U.S. 504, 516 (1992) (quoting *Fidelity Fed. Sav. & Loan Ass’n v. de la Cuesta*, 458 U.S. 141, 153 (1982)). See also *Shaw v. Delta Air Lines*, 463 U.S. 85, 96-99 (1983) (finding that state laws having a connection with or reference to employee benefit plans are preempted by ERISA, with which Congress intended to preempt an entire field); *Rice v. Santa Fe Elevator*, 331 U.S. 218, 230 (1947); *Patenaude v. Equitable Life Ins.*, 290 F.3d 1020, 1023 (9th Cir. 2002) (“[A] statute may so completely preempt state law that it occupies the entire field, barring assertion of any state law claims and permitting removal to federal court.”).

<sup>173</sup> *Jones v. Rath Packing Co.*, 430 U.S. 519, 526 (1977) (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)).

An example of conflict preemption in securities law is *Edgar v. MITE Corp.*, where an Illinois takeover statute was found to conflict with the Exchange Act.<sup>174</sup> In all cases involving preemption, the courts look to the intent of Congress.<sup>175</sup>

When the federal securities laws were initially passed, Congress did not explicitly preempt state law. To the contrary, Congress inserted “savings clauses” in both the Securities Act of 1933 (“Securities Act”)<sup>176</sup> and the Exchange Act.<sup>177</sup> In view of these savings clauses, the

Supreme Court found that state blue sky laws regulating the substantive merits of securities offerings remained valid after the Securities Act and the Exchange Act were passed,<sup>178</sup> but the securities industry chafed at having to comply with federal and state regulation, and advocated preemption of state blue sky laws concerning offerings and the regulation of brokers and dealers. Initially, complaints concerning duplication and inconsistency of unnecessary regulatory burdens were answered by a 1980 statute<sup>179</sup> adding (former) Section 19(c)(1) to the Securities Act authorizing the SEC to cooperate with state government representatives in securities matters to achieve effective, uniform securities regulations with a minimum interference with the business of capital formation.<sup>180</sup> Although the SEC then worked with the North American Securities Administrators Association (“NASAA”) and the NASD to develop a state law uniform limited offering exemption and a uniform

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<sup>174</sup> 457 U.S. 624 (1982).

<sup>175</sup> *Gade v. Nat'l Solid Wastes Mgmt Ass'n*, 505 U.S. 88, 96 (1992).

<sup>176</sup> Former Section 18 of the Securities Act provided: “Nothing in this Subchapter shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person.” Securities Act of 1933, ch. 38, § 18, 48 Stat. 74, 85 (current version at 15 U.S.C. § 77r).

<sup>177</sup> Former Section 28(a) of the Exchange Act was similar to former Section 18 of the Securities Act. It provided: “Nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder.” 15 U.S.C. § 78bb(a) (1982).

<sup>178</sup> See *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 557 (1917); *Caldwell v. Sioux Falls Stock Yards Co.*, 242 U.S. 559, 567-68 (1917); *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568, 572 (1917).

<sup>179</sup> Omnibus Small Business Capital Formation Act of 1980, § 505, Pub. L. No. 96-477, 94 Stat. 2275, 2292-93 (adding Section 19(c) of the Securities Act).

<sup>180</sup> 15 U.S.C. § 77s(c)(1), (2) (now 77s(d)) (2002). The statute mandated an annual conference of SEC and state regulators for the purpose of developing uniform securities forms and procedures and a small issues exemption from registration. Further, the act provided that “[n]othing in this Act shall be construed as authorizing preemption of State law.” *Id.* § 77s(d) (3)-(4).

system of registration for securities salesmen,<sup>181</sup> there was considerable securities industry dissatisfaction with the slow and essentially voluntary progress of the SEC and NASAA in achieving uniform regulations pursuant to Section 19(c).<sup>182</sup>

Much more sweeping deregulation of the state blue sky laws through preemption was accomplished in the late 1990s, first by the National Securities Markets Improvements Act of 1996 ("NSMIA")<sup>183</sup> and then by the Securities Litigation Uniform Standards Act of 1998 ("SLUSA").<sup>184</sup> NSMIA preempted state securities law in two areas of relevance to this article. First, it preempted blue sky securities registration, merit review and prospectus disclosure requirements for stock exchange and Nasdaq listed securities. It also preempted blue sky law in most private placements.<sup>185</sup> Prior to NSMIA blue sky laws all contained a requirement for registration of securities, but most state laws had an exemption from their registration requirements for issuers listed on a national securities exchange.<sup>186</sup> The NASD had lobbied for Nasdaq listed securities to be similarly exempt, but NASAA wished greater control over the criteria for a blue chip exemption.<sup>187</sup> NSMIA essentially mandated a blue chip exemption for all nationally traded securities. This preemption did not completely eliminate merit standards because of the NASD regulation of underwriting terms and conditions with respect to offerings underwritten by broker-dealers.<sup>188</sup> This SRO regulation is a uniform national standard, whereas state blue sky regulations were quite varied.

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<sup>181</sup> See Securities Uniformity: Annual Conference on Uniformity of Securities Law, Securities Act Release No. 33-7050, 56 SEC Docket 764 (1994), available at 1994 WL 95225.

<sup>182</sup> See State Regulators Adopt Model Commodity Code, 17 Sec. Reg. & L. Rep. (BNA) 619, 622 (Apr. 12, 1985); Hugh H. Makens et al., *Blue Sky Practice Part I: Doing it Right: Avoiding Liability Arising from State Private Offerings under ULOE and Limited Offering Exemptions*, in AMERICAN LAW INSTITUTE-AMERICAN BAR ASSOCIATION, REGULATION D OFFERINGS AND PRIVATE PLACEMENTS 271, 280 (2001); David F.E. Banks, *Hawaii Response to Regulation D*, 23 HAWAII B. J. 1, 3 (1991); Mark A. Sargent & Hugh H. Makens, *ULOE: New Hope, New Challenge*, 45 BUS. LAW. 1319, 1319-20 (1990).

<sup>183</sup> Pub. L. No. 104-290, 110 Stat. 3416 (codified in scattered sections of 15 U.S.C.)

<sup>184</sup> Securities Litigation Uniform Standards Act of 1998, Pub. L. No.105-353, 112, Stat. 3227 (1998).

<sup>185</sup> 15 U.S.C. §77r (1996). See, e.g., *Pinnacle Comm'ns Int'l Inc. v. Am. Family Mortgage Corp.*, 417 F. Supp. 2d 1073 (Minn. 2006).

<sup>186</sup> See Mark A. Sargent, *State Disclosure Regulation and the Allocation of Regulatory Responsibilities*, 46 MD. L. REV.1027, 1032 (1987).

<sup>187</sup> See NASAA *Agrees to Propose Amendments to '56 Uniform Acts at Spring Meeting*, 18 SEC. REG. & L. REP. (BNA), Mar. 21, 1986, at 399.

<sup>188</sup> NASD Rule 2710, SEC Release No. 34-30587 (Apr. 15, 1992).



Second, NSMIA preempted state regulation of broker-dealers with respect to capital, custody, margin, financial responsibility, records, bonding and reporting requirements to the extent inconsistent with federal law.<sup>189</sup> In addition, NSMIA provided as follows:

No law, rule, regulation, or order, or other administrative action of any State or political subdivision thereof shall establish capital, custody, margin, financial responsibility, making and keeping records, bonding, or financial or operational reporting requirements for brokers, dealers, municipal securities dealers, government securities brokers, or government securities dealers that differ from, or are in addition to, the requirements in those areas established under this chapter.<sup>190</sup>

The preemption of state regulation of SEC regulated broker-dealers and investment advisers and their associated persons was not complete. The States retained authority to investigate and bring enforcement actions for fraud, deceit, or other unlawful conduct by a broker-dealer or investment adviser or their associated persons.

The congressional justification for the preemption provisions of NSMIA was that the system of dual federal and state securities regulation had resulted in duplicative and unnecessary regulation. Further, this dual system was redundant, costly and ineffective.<sup>191</sup> Therefore regulatory responsibility was allocated based on the nature of the securities offering.<sup>192</sup> Inherently national offerings were made subject only to federal regulation, and the regulation of broker-dealer members of the NASD and NYSE was also preempted.<sup>193</sup>

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<sup>189</sup> National Securities Markets Improvements Act of 1996, Pub. L. No. 104-290, § 103(a), 110 Stat. 3420 (1996) (codified as amended at 15 U.S.C. §78o(h)(1) (2006)). Although the SEC regulates all of these areas, further regulation is imposed and enforced by SROs. The SEC was also given exclusive regulatory authority over investment advisers to SEC registered investment companies and advisers with \$25 million or more in assets under management.

<sup>190</sup> *Id.*

<sup>191</sup> H.R. CONF. REP. 104-864, at 39 (1996), reprinted in 1996 U.S.C.C.A.N. 3920.

<sup>192</sup> *Id.* at 40.

<sup>193</sup> *Id.* at 39. See Manning Gilbert Warren III, *Federalism and Investor Protection: Constitutional Restraints on Preemption of State Remedies for Securities Fraud*, 60 L. & CONTEMP. PROBS. 169, 170 (1997).

SLUSA was even more deregulatory and its way of effecting preemption was more radical. SLUSA provides that no class action based on state law alleging fraud in connection with the purchase or sale of a "covered security" (essentially an exchange listed security) may be maintained in state or federal court and any such action shall be removable to a federal district court and dismissed.<sup>194</sup> Although the Congress that passed SLUSA was generally committed to federalism, it found that promoting efficient national securities markets was more convincing and compelling than reinforcing state rights.<sup>195</sup> State securities fraud cases not instituted as class actions were not preempted.<sup>196</sup>

Until the preemption of state blue sky law by NSMIA and SLUSA, it was generally accepted that there was neither field nor conflict preemption of state securities anti-fraud laws because SEC disclosure laws and regulations and state disclosure or fiduciary laws complimented one another. Where a state court action is instituted as a broad statutory or common law antifraud claim, it is difficult to find preemption unless the SEC has acted by adopting detailed regulations. In *Zuri-Invest AG v. NatWest Finance, Inc.*, a federal district court held that a state fraud action was not preempted by the federal securities laws, including NSMIA.<sup>197</sup> Rather, the primary purpose of NSMIA was to preempt state blue sky laws regulating the registration and underwriting of securities. It did not preclude states from regulating fraudulent conduct or extinguish state claims based on fraud.<sup>198</sup> Similar issues have arisen under SLUSA.<sup>199</sup> On the other hand, if the SEC reviews a practice that could be construed as fraudulent, but determines either it should be permitted to continue or it should merely be disclosed to investors, can state law which would outlaw such a

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<sup>194</sup> Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, §101, 112 Stat. 3227 (1998) (codified as amended at 15 U.S.C. §§ 77p(b)-(c) (2000)).

<sup>195</sup> See S. REP. NO. 105-182, at 4 (1998).

<sup>196</sup> See Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 287 (1998).

<sup>197</sup> 177 F. Supp. 2d 189, 197 (S.D.N.Y. 2001); *accord*, *IDS Bond Fund, Inc. v. Gleacher NatWest Corp.*, No. CIV. 99-116 (MJDJGL), 2002 WL 373455, at \*7 (D. Minn. March 6, 2002); *Gabriel Capital, L.P. v. NatWest Finance, Inc.*, 122 F.Supp.2d 407, 431-34 (S.D.N.Y. 2000); *Gabriel Capital, L.P. v. NatWest Finance, Inc.*, 94 F.Supp.2d 491, 512 (S.D.N.Y. 2000). *But see* *Myers v. Merrill Lynch*, 1999 WL 696082, at \*8-10 (N.D. Cal. Aug. 23, 1999), *aff'd* 249 F.3d 1087 (9th Cir. 2001).

<sup>198</sup> See also H.R. REP. NO. 104-622, as reprinted in 1996 U.S.C.C.A.N. 3877, 3899 ("Committee's intention not to alter . . . State statutory or common law with respect to fraud or deceit").

<sup>199</sup> See *Green v. Ameritrade, Inc.*, 279 F.3d 590, 597 (8th Cir. 2002) (holding that state contract claims are not preempted by SLUSA).

practice, or impose liability for its continuation, be allowed to coexist with federal law? This issue was raised in state law cases challenging payment for order flow and most of the courts which addressed the issue found implied or field preemption.

Payment for order flow is the remuneration in the form of monetary or other benefits given to retail securities broker-dealers for routing customers' orders for execution to particular wholesale dealers, market makers or exchanges.<sup>200</sup> The growth and pervasiveness of payment for order flow practices in the 1980s and 1990s aroused extensive debate over its merits and harms. In response, the SEC conducted a comprehensive study of order flow payments. The SEC concluded that the practice produces certain economic benefits to customers.<sup>201</sup> The SEC also recognized opposing concerns as to the possible conflict of interest and breach of duty of best order execution.<sup>202</sup>

In an attempt to address the issue with particularity, the SEC amended Rule 10b-10, which governs confirmation disclosure to broker-dealer customers, in 1994.<sup>203</sup> Amended Rule 10b-10 requires a broker-dealer to disclose in each transaction confirmation slip whether payment for order flow was received, and that the source and nature of the payment would be available at the customer's request.<sup>204</sup> In addition, the SEC adopted a new rule, 11Ac1-3, which required annual disclosure to customers of a broker's or dealer's policies regarding receipt of payments for order flow, the market makers to which customer orders are routed, and the aggregate amount of payments received for order flow in the previous year.<sup>205</sup>

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<sup>200</sup> Exchange Act Release No. 34-34902, 59 Fed. Reg. 55006, 55008 (Nov. 2, 1994).

<sup>201</sup> These were: lower unit costs; increased retail brokerage firm revenues; lowered commissions; more expeditious executions; enhanced customer services; increased competition from automated execution systems and related practices; increased competition between wholesale dealers and exchanges and vertically integrated firms; and reduced execution costs in all markets, including the exchanges. Payment for Order Flow, Exchange Act Release No. 34-33026, at 24-26, 58 Fed. Reg. 52934, 52939-40 (Oct. 13, 1993).

<sup>202</sup> 59 Fed. Reg. 55006, 55008.

<sup>203</sup> See 59 Fed. Reg. 55006. The amended Rule 10b-10, which became effective in October 1995, defined order flow payments as "all forms or arrangements compensating for directing order flow." *Id.* at 55008.

<sup>204</sup> *Id.* at 55010. The SEC rejected as too burdensome and unworkable proposals that order flow payments be passed through to the customers, *id.* at 55010-11, n.42, as well as its own initial proposal that brokers disclose the amount of payments for order flow. *Id.* at 55010, n.39.

<sup>205</sup> 17 C.F.R. § 240.11Ac1-3 (1995) (repealed 2005).

Subsequently, payment for order flow was tested in a number of state courts in cases claiming breach of fiduciary duty. The highest courts of New York,<sup>206</sup> Minnesota,<sup>207</sup> Illinois,<sup>208</sup> and Pennsylvania,<sup>209</sup> as well as two other states' intermediate appellate courts,<sup>210</sup> found that the 1975 amendments to the Exchange Act and SEC disclosure regulations implicitly preempted state common law regarding any breach of fiduciary duty involved in payment for order flow practices. The prevailing view of the state courts that considered cases alleging that payment for order flow was a breach of fiduciary duty was that federal law and regulations implicitly preempted state law. Except for the Supreme Court of Pennsylvania, which found field preemption, all other courts found implicit conflict preemption, in that permitting state common law cases to go forward would be an obstacle to the national market system provisions of the Exchange Act. The interesting question for this article is this: what if Rules 10b-10 and 11Ac1-3 had been NASD, rather than SEC rules? Now that FINRA has a single rule book applicable to all SEC registered broker-dealers, delegation by the SEC to FINRA to establish this type of controversial, complicated rule-making, where broad industry input is important for future compliance, seems likely. Would courts similarly find implied conflict preemption by reason of an SRO rule?

A few cases involving the California Standards relating to arbitrator qualifications would suggest an affirmative answer to this question. Because these standards went beyond the NASD's arbitrator qualification standards, the NASD adopted a rule requiring parties to an arbitration to waive the California Standards. In a series of cases, the California Superior Court<sup>211</sup> and the Ninth Circuit<sup>212</sup> held that the NASD rules regarding arbitrator qualifications pre-empted the California Standards, which had been promulgated by the California Judicial Council. The reason for such preemption was that the NASD and NYSE had "operated their own

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<sup>206</sup> Guice v. Charles Schwab & Co., 674 N.E.2d 282, 290 (N.Y. 1996).

<sup>207</sup> Dahl v. Charles Schwab & Co., 545 N.W.2d 918, 925 (Minn. 1996).

<sup>208</sup> Orman v. Charles Schwab & Co., 688 N.E.2d 620, 626 (Ill. 1997).

<sup>209</sup> Shulick v. PaineWebber & Co., 722 A.2d 148, 151 (Pa. 1998).

<sup>210</sup> Eirman v. Olde Disc. Corp., 697 So.2d 865, 866 (Fla. Dist. Ct. App. 1997); Mickey v. Charles Schwab, 79 Cal. Rptr. 2d 213, 219 (Ca. App. 1998). *But see* Thomas v. Charles Schwab, Civ.A. No. 95-0307, 1995 WL 626522, at \*2 (W.D. La. July 12, 1995) (finding neither express preemption nor implied congressional preemptive intent).

<sup>211</sup> See Jevne v. Superior Court, 111 P.3d 954 (Cal. 2005).

<sup>212</sup> Credit Suisse First Boston Corp. v. Grunwald, 400 F.3d 1119, 1136 (9th Cir. 2005); NASD Dispute Resolution, Inc. v. Judicial Council, 488 F.3d 1065, 1068 (9th Cir. 2005).

securities arbitration services for decades under federal auspices” and their standards and procedures were “not entirely consistent with the California standards.”<sup>213</sup> Since the SEC had approved these SRO standards, preemption had occurred by delegated authority.<sup>214</sup>

### C. Conflict With Antitrust Laws

Where regulatory statutes are silent with regard to antitrust, courts are required to determine whether, and in what respects there has been an implicit repeal of the antitrust laws.<sup>215</sup> Implied repealers of the antitrust laws “are strongly disfavored, and have only been found in cases of plain repugnancy between the antitrust and regulatory provisions.”<sup>216</sup> Conflicts between the antitrust laws and the securities laws involving SRO regulation have been common, because the initial foundation for SRO regulation was fixed minimum commissions for NYSE members and preferential price dealing for NASD members. In *Silver v. New York Stock Exchange*,<sup>217</sup> a nonmember broker sued the NYSE under the Sherman Act after the NYSE ordered the discontinuance of his wire connections with the offices of NYSE members without notice, explanation or a hearing. In this case, a test for reconciling antitrust laws with securities regulation was set forth as follows: “Repeal [of the antitrust laws] is to be regarded as implied only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary.”<sup>218</sup> The Court held that no policy of the Exchange Act was served by this conduct and therefore the NYSE had acted in violation of the Sherman Act.

Over a decade later the Supreme Court broadened the area in which the antitrust laws may be impliedly repealed by the securities laws. In *Gordon v. New York Stock Exchange, Inc.*,<sup>219</sup> the Court held that the antitrust laws did not apply to the system of fixed commission rates then utilized by the stock exchanges because the SEC had the authority to do away with fixed commissions if it found them

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<sup>213</sup> *Id.* at 1067.

<sup>214</sup> *Credit Suisse First Boston*, 400 F.3d at 1128. In another case, involving compulsory NYSE arbitration between a registered representative and a member firms and associated persons, the Second Circuit held that such compulsory arbitration was within the purposes of the Exchange Act, as amended in 1975. *Drayer v. Krasner*, 572 F.2d 348, 355 (2d Cir. 1978).

<sup>215</sup> *Credit Suisse Sec. (USA), LLC v. Billing*, 127 S. Ct. 2383, 2385 (2007).

<sup>216</sup> *United States v. Phila. Nat'l Bank*, 374 U.S. 321, 351 (1963).

<sup>217</sup> 373 U.S. 341 (1963).

<sup>218</sup> *Id.* at 357.

<sup>219</sup> 422 U.S. 659, 685 (1975).

inconsistent with the regulatory structure. Direct and active supervision by the SEC over rate-fixing by securities exchanges negated the possibility of antitrust liability for fixed commissions. In a second case of the same year, the Court found that the SEC had not exercised the same degree of supervision with regard to the secondary trading of mutual funds, but read the applicable legislative history as granting the SEC the informed administrative judgment to do so.<sup>220</sup>

The 1975 amendments to the Exchange Act, passed in the same year as these cases, made clear that the SEC's role in passing on exchange or other SRO rules must include an evaluation of the anti-competitive aspect of such rules. Within one year after the effective date of the statute, the SEC was required to determine whether the rules of any national securities exchange or registered securities association complied with the Exchange Act. Thereafter, proposed rule changes of exchanges and associations were subjected to prior rule-making procedures by the SEC and could not take effect without an SEC finding that such rule was consistent with the Exchange Act. These provisions required the SEC to take competition into consideration in reviewing all existing and any new exchange or association rules.<sup>221</sup>

A more recent antitrust case addressed questionable joint action by underwriters. *Credit Suisse Securities (USA) v. Billing*<sup>222</sup> was a class action against a number of investment banks, acting as underwriters, alleging various illegal practices: (1) laddering, or buying shares of an IPO at escalating prices; (2) paying unusually high commissions on other securities; and (3) tying or purchasing less desirable securities. The Second Circuit essentially held that since these practices were alleged to be illegal under both the securities laws and the antitrust laws, the antitrust case could proceed.<sup>223</sup> The Supreme Court framed the issue differently as whether there was a plain repugnancy between the antitrust claims and the federal securities laws, and concluded that there was. Referring to *Gordon* and *NASD*, Court set forth a number of factors showing sufficient incompatibility to warrant an implication of antitrust repeal: (1) regulatory authority under the securities laws to supervise the activities in question; (2) evidence that the SEC has exercised such authority; and (3) a risk of conflicting guidance under both the antitrust and

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<sup>220</sup> *United States v. Nat'l Ass'n of Secs. Dealers, Inc.* 422 U.S. 694, 728 (1975).

<sup>221</sup> See Exchange Act § 6(b)(8), 15 U.S.C. § 78f(b)(8); Exchange Act § 11A(1)(C)(ii), 15 U.S.C. 78k-1(a)(1)(C)(ii); Exchange Act § 15A(b)(9), 15 U.S.C. § 78o-3(b)(9).

<sup>222</sup> 127 S. Ct. 2383 (2007).

<sup>223</sup> 426 F.3d 130 (2005), *rev'd*, 127 S.Ct. 2383 (2007).

securities laws.<sup>224</sup> In the Court's view, since the activities under attack were in an area important to the functioning of the capital markets, only an expert body like the SEC could properly determine whether the activities were legal or illegal, since all underwriting syndicates involve joint action. Therefore the courts should be precluded from judging these activities under the antitrust laws.

In the antitrust cases discussed above, the rules which permitted the conduct under attack were all SRO, not SEC, rules, although the SEC had authority to approve, disapprove or amend these rules. It was therefore SROs, not the SEC, that were making the determination in the first instance to condone conduct that could be a violation of the antitrust laws. Yet, none of the cases focused on the fact that an SRO rule was displacing the antitrust laws. Rather, the focus was on the SEC's authority and the SEC's oversight of the conduct in question.<sup>225</sup>

## VI. Conclusion

Although FINRA may not be a government entity, in all or virtually all of its activities, it can be viewed as exercising powers delegated to it by the SEC. This is a delegation from an agency which itself is exercising delegated powers, and therefore is not directly accountable to the public. Accountability by FINRA to its members has been undermined by the governance reforms imposed by the SEC. In the final analysis, FINRA is accountable only to the SEC. Yet initially, the regulatory powers of the NYSE were not governmental but rather a matter of private contract between the NYSE and its members. Similarly, the origins of the NASD were in a trade association. At what point did these powers become transmogrified into governmental powers? This was a gradual development, probably finally accomplished without much consideration by the 1975 Act Amendments to the Exchange Act.

Although FINRA undoubtedly will deny that it is an agency subject to the Constitutional and legislative constraints applicable to the SEC, in many areas it will nevertheless "voluntarily" adopt equivalent procedures. Two important questions are raised by this construct: First, should further compliance be compelled; and second, what is the real difference between FINRA and a government agency? One difference is its corporate governance. FINRA's directors are not appointed by the SEC and a substantial number, although not a majority, come from the securities

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<sup>224</sup> 127 S. Ct. 2383, 2394.

<sup>225</sup> *Id.* at 2392.

industry. Another difference is its funding, which comes from membership fees. But as the SEC exercises ever increasing oversight of FINRA are these differences sufficient to keep FINRA a private sector body?

As organizations, SROs have several advantages over government agencies. They can be more flexible in their hiring, pay higher salaries and develop cadres of experts as their employees. They are financed by assessments on the securities industry, rather than out of general tax revenues. They are not bound by the many accountability mechanisms imposed upon government organizations, which may make these organizations operate in a more open and democratic fashion, but also can turn them into slow moving bureaucracies. Because SROs involve the securities industry in their decision making, they are able to fashion regulations which often are more realistic than government regulations, and effect voluntary compliance with these regulations. Yet, the very freedom of action that SROs have may sometimes give them the ability to ignore the constitutional and other rights of persons subject to their rule-making or disciplinary actions. When SROs are exercising governmental powers, they should be subject to constitutional constraints in their dealings with securities industry personnel and the public. They should similarly be bound by the fundamental due process protections contained in the Administrative Procedure Act and similar statutes.

Nevertheless, to subject SROs to all of the constraints to which the SEC is subject with regard to their operations would reduce their utility in the scheme of securities regulation. If FINRA is going to be regulated like the SEC, it may as well become part of the SEC. If the SEC becomes too controlling of FINRA's governance and operations, FINRA will no longer be an SRO. While, criticism of SROs as being insufficiently responsive to the public interest has been leveled over the years by Congress, there is a danger that FINRA will be insufficiently responsive to the needs and concerns of the securities industry, and will become merely an arm of the SEC. Should this occur, the duplicative nature of SEC and SRO regulation of broker-dealers will make such regulation inefficient and ineffective. FINRA should be given the opportunity to operate as an independent, non-political expert body engaged in the regulation of broker-dealers, without undue interference from the SEC or Congress, but it will have to prove that it can be sensitive and responsive both to the securities industry and the public interest.



