IF THE SHOE OF THE SEC DOESN'T FIT: SELF-REGULATORY ORGANIZATIONS AND ABSOLUTE IMMUNITY

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ABSTRACT

The absolute legal immunity granted to self-regulatory organizations (SROs) in the securities industry has incited increasingly controversial concerns about the lack of accountability of financial regulators. Although SROs like the Financial Industry Regulatory Authority (FINRA) are deemed to "stand in the shoes" of the Securities and Exchange Commission (SEC) by carrying out delegated, quasi-governmental duties in monitoring securities markets, their alternate role as private, commercial entities raises questions as to the fairness of expansive SRO immunity. Plaintiffs have historically been denied any redress even in instances of alleged SRO fraud, misconduct, and bad faith. In 2012, the U.S. Supreme Court declined to question the Second Circuit's decision in *Standard Investment Chartered Inc. v. National Association of Securities Dealers*, which expanded SRO immunity to cover not only direct SRO functions on behalf of the government, but also actions that are "incident to" SROs' regulatory functions. This Article supports the notion that legal immunity for SROs should be subject to a fraud exception, which would hold SROs accountable for the

very same misconduct that such entities seek to police. To alleviate the common concern that limiting SRO immunity would lead to frivolous lawsuits overloading the courts, this Article will look to two requirements already in place that serve to prevent this possibility: 1) fraud cases are currently subject to heightened pleading standards and 2) the SEC must review any allegations against SROs before the court system may be invoked. In addition, by pointing out documented SEC shortfalls in SRO oversight, this Article will challenge the argument that favors expansive SRO immunity on the grounds that the SEC already adequately oversees SROs for potential abuses. By carving out a fraud exception from the expansive absolute immunity doctrine, plaintiffs would be granted the chance to seek legal recourse for those instances in which SROs have failed to stand in the shoes of the SEC.

I. INTRODUCTION

Self-regulatory organizations (SROs) have consistently been deemed to "stand in the shoes" [1] of the Securities and Exchange Commission (SEC) by carrying out delegated, regulatory functions in interpreting and monitoring the securities laws,[2] thereby historically enjoying absolute immunity from liability. Although SROs carry out quasi-governmental functions as delegates of the SEC, such entities are private organizations that engage in business-like activities such as profit making and advertising.[3] Countless plaintiffs have been denied the opportunity to seek damages from SROs even in instances of alleged fraud, misconduct, or bad faith due to SROs' shield from liability for their public regulatory functions.[4] Although absolute immunity for entities exercising

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1. D'Alessio v. N.Y. Stock Exch., Inc., 258 F.3d 93, 105 (2d Cir. 2001).

2. *Id.*; *In re* NYSE Specialists Sec. Litig. v. N.Y. Stock Exch., Inc., 503 F.3d 89, 96 (2d Cir. 2007) (quoting *D'Alessio*, 258 F.3d at 105); D.L. Capital Group, LLC v. Nasdaq Stock Mkt., Inc., 409 F.3d 93, 95 (2d Cir. 2005) (quoting *D'Alessio*, 258 F.3d at 105); *In re* Series 7 Broker Qualification Exam Scoring Litig., 510 F. Supp. 2d 35, 42 (D.D.C. 2007) (quoting *D'Alessio*, 258 F.3d at 105), *aff'd*, 548 F.3d 110 (D.C. Cir. 2008).

3. *See* Weissman v. Nat'l Ass'n of Sec. Dealers, 500 F.3d 1293 (11th Cir. 2007).

4. *See* Craig J. Springer, Weissman v. NASD: *Piercing the Veil of Absolute Immunity of an SRO Under the Securities Exchange Act of 1934*, 33 DEL. J. CORP. L. 451, 467 (2008).

governmental functions has a reasonable basis in the law, there is often a fine line between what differentiates public operations from private business activities, resulting in a unique SRO structure that one scholar described as "a peculiar mix of private sector self-regulation and delegated governmental regulation."[5]

The Financial Industry Regulatory Authority (FINRA) is one of the most significant SROs in the United States today. Born out of a merger between the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE) in 2007, FINRA enforces securities industry rules and federal securities laws, monitors the stock market, and oversees all brokerage firms and brokers in the United States.[6] In January of 2012, the U.S. Supreme Court declined to review a decision by the U.S. Court of Appeals for the Second Circuit in *Standard Investment Chartered Inc. v. National Association of Securities Dealers,* holding that SROs were absolutely immune from suit after allegations by a NASD member that NASD fraudulently made misstatements in a proxy solicitation that amended the NASD bylaws in connection with creating FINRA.[7] The Second Circuit held that the proxy solicitation to amend NASD's bylaws constituted a regulatory function, thereby denying any redress for the plaintiffs based on the doctrine of absolute immunity for SROs' quasi-governmental functions.[8] The Supreme Court passed on the opportunity to address the constitutionality of absolute immunity for SROs despite allegations that NASD officers were financially motivated to promote the bylaw amendments for reasons besides that of solely

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5. Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J.L. BUS. & FIN. 151, 151 (2008).

6. *About FINRA*, FINRA, http://www.finra.org/AboutFINRA/ (last visited Aug. 2, 2012); Order Approving Proposed Rule Changes to Amend the NASD By-Laws of NASD to Accommodate the NASD and NYSE Consolidation, Exchange Act Release No. 34-56145, File No. SR-NASD-2007-023, 1, 2-3 SEC (July 26, 2007), *available at* http://www.sec.gov/rules/sro/nasd/2007/34-56145.pdf.

7. Standard Inv. Chartered, Inc. v. Nat'l Ass'n of Sec. Dealers, 637 F.3d 112, 114-15 (2d Cir. 2011), *cert. denied,* 132 S. Ct. 1093 (2012); *see also* Greg Stohr, *FINRA's Legal Immunity Won't be Questioned by U.S. High Court*, BLOOMBERG (Jan. 17, 2012), http://www.bloomberg.com/news/2012-01-17/finra-s-legal-immunity-won-t-be-questioned-by-u-s-high-court.html; *see also* Ari Berman & Benjamin D. Tievsky, *Recent Trends in FINRA Enforcement: A Focus on FINRA's Regulatory Activities and Agenda*, BLOOMBERG LAW RES. (Mar. 26, 2012), http://www.velaw.com/uploadedFiles/VEsite/Resources/BermanTievskyRecentFINRA Enforcement.pdf.

8. *Standard Inv. Chartered, Inc.*, 637 F.3d at 116-17 (noting that SEC approval is needed for NASD to alter its bylaws and that the statutory and regulatory framework highlights "the extent to which an SRO's bylaws are intimately intertwined with the regulatory powers delegated to SROs by the SEC . . . .").

effecting the merger.[9] The bylaw amendments would change the NASD's voting structure from a "one member, one vote" system to one based on member firm size,[10] thereby creating voting disadvantages for smaller firms. Plaintiffs also questioned the truthfulness of the defendant's statement in the proxy solicitation that $35,000 was the maximum one-time incentive payment that could be made to member firms in exchange for voting to approve the bylaw amendments.[11]

Standard Investment Chartered Inc. is one of many judicial decisions that have upheld expansive absolute immunity for SROs while stretching the reach of "regulatory" functions to seemingly private, corporate activities.[12] This Article will propose that the far-reaching absolute immunity doctrine should be curtailed in instances of alleged fraud, which would allow plaintiffs some form of legal recourse for times in which SROs have stepped outside of their quasi-governmental roles to act more like private bodies. In response to concerns that the institution of such an exception would open the floodgates to an overwhelming flurry of lawsuits, this Article will argue that the existing heightened pleading requirements required for fraud claims would help to eliminate suits against SROs alleging fraud that have no merit. At the same time, however, plaintiffs would have some forum available to seek damages in instances of well-supported fraud allegations. Further, another layer of protection from frivolous lawsuits is available through the SEC's required preliminary administrative review of aggrieved plaintiffs' claims against SROs.[13] This review screens claims of SRO error or misconduct from an administrative standpoint before having a chance to reach the courts.

Part II of this Article provides an overview of the structure of self-regulatory organizations, while focusing on the dual nature of their public and private functions and on FINRA. Part III examines the current case law addressing the absolute immunity doctrine as applied to SROs and the evolution of this doctrine over recent years to encompass an ever-increasing range of arguably private duties. This Section will also address courts' analyses of a possible fraud exception to the absolute

9. Petition for Writ of Certiorari, *Standard Inv. Chartered, Inc.*, 637 F.3d 112 (2d Cir. 2011) (No. 11-381) 2011 WL 4442706, at *6.

10. *Id.*

11. *See Standard Inv. Chartered, Inc.*, 637 F.3d at 115.

12. *See, e.g.*, DL Capital Grp., LLC v. Nasdaq Stock Mkt., Inc., 409 F.3d 93, 96 (2d Cir. 2005); *In re* NYSE Specialists Sec. Litig., 503 F.3d 89, 89 (2d Cir. 2007); Sparta Surgical Corp. v. Nat'l Ass'n of Sec. Dealers, 159 F.3d 1209, 1212 (9th Cir. 1998).

13. *See The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC, www.sec.gov/about/whatwedo.html (last visited Oct. 2, 2012).

immunity doctrine and reasons for historically rejecting such a carve-out. Part IV will highlight the importance of ensuring SRO accountability in light of documented shortfalls of SEC oversight, FINRA shortcomings with respect to efficiency and transparency, and the inability of aggrieved plaintiffs to seek redress for any alleged instances of SRO fraud. This Section will consider the fraud exception as a check on instances of SRO fraud, misconduct, and bad faith.

Part V will respond to the most common arguments against the institution of a fraud exception by considering the requirement for heightened pleading standards in cases of fraud, as well as plaintiffs' obligation to exhaust administrative reviews prior to bringing a lawsuit, as methods of weeding out meritless suits to avoid disrupting the courts. This Article will highlight the ways in which SROs have "stepped out of the shoes" of the SEC over recent years, thereby weakening the proposition that such entities are subject to absolute immunity without question. By examining the fine line that exists between public and private SRO activities and the potentiality for significant overlap of these two functions, this Article will propose a fraud exception as one method of allowing plaintiffs some recourse when SROs should be held accountable.

II. SELF-REGULATORY ORGANIZATIONS

Prior to the enactment of the Securities Exchange Act of 1934 (Exchange Act),[14] securities exchanges had already enjoyed nearly 140 years of self-governance, implementing their own rules and requirements for members listing securities on such exchanges.[15] The Exchange Act retained this traditional system of self-regulation but, for the first time, required every national securities exchange to register with the SEC.[16] Pursuant to the Exchange Act, stock exchanges exercise regulatory authority over their members and may take disciplinary action against

14. Securities Exchange Act of 1934, 15 U.S.C.A § 78 (West 2006). The Exchange Act regulates all secondary public trading of securities, including the marketplace, stock exchanges, and broker-dealers. Securities traded on a national exchange must be registered with the SEC and such registration involves disclosure of the company's financial performance and business activities, which are reflected in various periodic reporting requirements mandated by the statute. *See* THOMAS LEE HAZEN, PRINCIPLES OF SECURITIES REGULATION 16-17 (2006).

15. James T. Koebel, *Trust and the Investment Adviser Industry: Congress' Failure to Realize FINRA's Potential to Restore Investor Confidence*, 35 SETON HALL LEGIS. J. 61, 67 (2010); HAZEN, *supra* note 14, at 328; *see also* Symposium, Roberta S. Karmel, *Do Financial Supermarkets Need Super Regulators?*, 28 BROOK. J. INT'L L. 495, 506 (2003).

16. *Id.*

members to ensure compliance with the securities laws, which may consist of denying membership or participation in the applicable exchange, limiting services offered by the exchange to members, or the imposition of sanctions on any person associated with a stock exchange member.[17] Stock exchanges such as the NYSE enforce rules relating to transactions on the exchange and the internal operations of member firms while interacting with customers.[18] Stock exchanges are also required to give the SEC notice of any disciplinary actions that they take against members of the exchange.[19] The SEC has oversight authority over the activities of stock exchanges, including the approval or amendment of exchange rules, enforcement and discipline of the exchange, and a role in structuring the market.[20]

The original Exchange Act did not extend federal regulation to non-exchange or over-the-counter (OTC) markets. The Maloney Act[21] was enacted in 1938 to require national securities associations engaged in OTC market trading to be registered with the SEC, thereby expanding the arm of the SEC's regulatory capacity over both exchanges and non-exchanges.[22] The Maloney Act obligated national securities associations to follow rules aimed at preventing fraudulent and manipulative activity in transactions on OTC markets just as exchanges were required to do for

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17. 15 U.S.C.A. §§ 78a-78b.

18. HAZEN, *supra* note 14, at 328. Such rules govern, among other items, criteria for listing securities on the exchange, delisting procedures, bids and offers on the exchange floor, activities of specialists (designated market-makers in listed securities), the form of organization of member firms and qualifications of their officers, advertising, and the managing of customers' accounts. *See id.*

19. *See* 15 U.S.C.A. § 78s.

20. *See* Koebel, *supra* note 15, at 67; Roberta Karmel, *Turning Seats Into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 HASTINGS L.J. 367, 401 (2002) (noting that the Securities Acts Amendments of 1975 further strengthened SEC oversight over stock exchanges); Austin v. Nat'l Ass'n of Sec. Dealers, 757 F.2d 676, 680 (5th Cir. 1985) ("[C]ongress granted the SEC broad supervisory responsibilities" over SROs to prevent misuse of "Congressionally-mandated power").

21. Maloney Act, Pub. L. No. 75-719, 52 Stat. 1070 (1938) (codified at 15 U.S.C.A. § 78). The Maloney Act amended the Exchange Act to include § 15A.

22. HAZEN, *supra* note 14, at 329. Exchange markets are forums in which securities are generally listed through an agreement between the issuer of the security and the exchange and transactions are limited to members, whereas OTC markets are not as focused and rule-based as exchange markets and consist of "thousands" of broker-dealers trading amongst themselves. Rohit A. Nafday, *From Sense to Nonsense and Back Again: SRO Immunity, Doctrinal Bait-and-Switch, and a Call for Coherence*, 77 U. CHI. L. REV. 847, 850 (2010) (citing Philip A. Loomis, Jr., *The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940*, 28 GEO. WASH. L. REV. 214, 215 (1959)).

listed markets.[23] The exchanges and non-exchanges that are regulated by the Exchange Act are known today as SROs,[24] with some of the most common examples being FINRA, NASDAQ, NASD, NYSE, the Chicago Stock Exchange, and the International Securities Exchange.[25]

SROs are privately funded entities that carry out quasi-governmental activities to regulate the securities markets.[26] However, as private entities, SROs also conduct acts that are non-regulatory—they are committed to promoting their business interests, increasing profits and trading volume, and administering and managing business affairs.[27] As private and proprietary organizations, SROs rent facilities, hire employees, acquire assets, and pay bonuses.[28] NASD, for example, has traditionally carried out "private, revenue-generating enterprises," including the for-profit NASDAQ stock exchange that NASD spun off in an initial public offering raising $1.5 billion in equity.[29] SROs like NASDAQ also advertise on television or in newspapers with the goal of promoting particular stocks listed on their exchange to increase individual trading volume and profits, thereby demonstrating their "money-maker" role.[30] At the same time, SROs are responsible for quasi-governmental functions. In addition to imposing disciplinary sanctions against members for non-compliance with federal securities laws, SROs are granted authority to manage trading, enforce membership rules, and

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23. Nafday, *supra* note 22, at 851 (citing Loomis, *supra* note 22, at 220); *see also* HAZEN, *supra* note 14, at 329.

24. Nafday, *supra* note 22, at 851.

25. *Self-Regulatory Organization Rulemaking*, SEC http://www.sec.gov/rules/sro.shtml (last visited Oct. 2, 2012).

26. Koebel, *supra* note 15, at 67-70; *see also* Karmel, *supra* note 20, at 400 (noting the stock exchanges' rulemaking and regulatory authority over its members).

27. Weissman v. Nat'l Ass'n of Sec. Dealers, 500 F.3d 1293 (11th Cir. 2007); *see also* Karessa Cain, *New Efforts to Strengthen Corporate Governance: Why Use SRO Listing Standards?*, 2003 COLUM. BUS. L. REV. 619, 623 (2003) (noting that the "market-aligned incentives" of SROs may cause regulatory weakness); *see also* Onnig H. Dombalagian, *Self and Self-Regulation: Resolving the SRO Identity Crisis*, 1 BROOK. J. CORP. FIN. & COM. L. 317, 334 (2006).

28. *See* Petition for Writ of Certiorari, Standard Inv. Chartered Inc. v. Nat'l Ass'n of Sec. Dealers, 637 F.3d 112 (2d Cir. 2011) (No. 11-381), 2011 WL4442706 at *4. ("In their proprietary capacity, SROs are similar to other corporations, their conduct toward their members being the *subject* of regulation, rather than constituting an *act* of delegated regulatory authority.").

29. *Id.* at *3 (noting that NASD's corporate charter indicates that one of its purposes is to transact business and manage or acquire any real and personal property necessary for the purposes of the corporation).

30. *Weissman*, 500 F.3d at 1298 (finding that particular advertisements alleged by the plaintiff "were in no sense coterminous with the regulatory activity contemplated by the Exchange Act.").

impose commissions and fees on their members.[31] SROs make available to investors the background and prior disciplinary information of their registered brokers, establish requirements for companies that list on the exchanges for trading, and impose minimum corporate governance requirements.[32] One scholar notes that if SROs were not delegated with these quasi-governmental activities, it is likely that some other government agency would be instead.[33]

The concern associated with the dual public/private nature of SROs is that such entities appear to be conveniently targeted as "quasi-governmental" organizations when it comes to immunity protections, as SROs enjoy the same safeguards against litigation as the government. However, SROs appear to be deemed private organizations for a number of other purposes, including compensation packages and the denial of constitutional due process protections. For example, SROs generally are not obligated to exercise certain constitutional controls because they are private organizations.[34] The exercise of delegated government powers to a private entity "confounds the question of whether the private body either is exercising delegated governmental power or is, indeed, a government entity."[35] Although SROs are granted absolute immunity for their quasi-governmental functions, the subjects of their investigations are not guaranteed due process protections and cannot claim their Fifth Amendment privilege against self-incrimination.[36] Members coming under SRO investigation are required to provide testimony and documents regardless of the SROs having no subpoena power, with failure to do so resulting in sanctions being imposed on the member.[37] Although SROs are entitled to absolute immunity when standing in the shoes of the SEC to carry out the regulatory duties with which the SEC has tasked them, the "SRO transforms itself into a non-governmental private entity, thereby denying the party of any relief" when targets of

31. *See* 15 U.S.C.A. §§ 78f, 78k; *see also* Nafday, *supra* note 22, at 854.

32. STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 44-45 (2005).

33. Nafday, *supra* note 22, at 854 (noting that such activities can potentially "significantly injure members, and are susceptible to abuse," giving rise to significant litigation in past years).

34. *See* Karmel, *supra* note 5, at 156.

35. *Id.* at 156 (noting that the public entity and the state action doctrines are two analyses pursuant to which FINRA may be considered either a "government agency or a private body exercising delegated governmental power.").

36. *Id.* at 177 (citing Jones v. SEC, 115 F.3d 1173, 1182-83 (4th Cir. 1997) and United States v. Solomon, 509 F.2d 863 (2d Cir. 1975)).

37. *Id.* at 177-78.

SRO investigations attempt to invoke constitutional protections.[38] In this way, SROs are benefiting from the best of both worlds—they are shielded from lawsuits as "quasi-governmental" bodies but are simultaneously not required to offer the same type of constitutional protections that are typical of government agencies.

In December of 2011, the Eleventh Circuit denied a petition for review of an SEC order sustaining FINRA's disciplinary actions against John B. Busacca, the former president of North American Clearing, Inc. (North American) for violations of NASD rules.[39] In considering Busacca's claim that FINRA denied him due process of law by concealing crucial evidence and denying his request to compel North American to produce documents "vital to his defense," the court acknowledged the existence of a circuit split as to whether FINRA is a government actor subject to the requirements of the Fifth Amendment's Due Process Clause.[40] The court did not answer this question and instead conducted its analysis by making an assumption that the Due Process Clause applies to FINRA proceedings.[41] In making this assumption, the court then proceeded with its analysis by considering whether Busacca was granted a meaningful opportunity to be heard.[42] Despite efforts to persuade the U.S. Supreme Court to rule on the issue of whether SROs are governmental actors, this question remains unsettled.[43]

The unique public/private nature of SROs is telling when examining FINRA. FINRA is a private, independent regulator that oversees approximately 4,400 brokerage firms, 162,780 branch offices, and 629,865 registered securities representatives.[44] FINRA's role as a private entity is especially visible in its compensation structure, considerable

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38. William I. Friedman, *The Fourteenth Amendment's Public/Private Distinction Among Securities Regulators in the U.S. Marketplace – Revisited*, 23 ANN. REV. BANKING & FIN. L. 727, 767 (2004); *see also In re* Series 7 Broker Qualification Exam Scoring Litig., 510 F. Supp. 2d 35, 43-44 (D.C. Cir. 2007) (posing the question of why an entity afforded absolute immunity as an extension of the sovereign immunity granted to government agencies should not be held accountable for constitutional violations in the same way as government agencies).

39. Busacca v. SEC, 449 Fed.App'x 886 (11th Cir. 2011).

40. *Id.* at 6 (citing D'Alessio v. SEC, 380 F.3d 112, 120 n.12 (2d Cir. 2004) (noting that the NASD, FINRA's predecessor, "is not a state actor subject to due process requirements.") and Rooms v. S.E.C., 444 F.3d 1208, 1214 (10th Cir. 2006) (finding that due process requirements apply to the NASD)).

41. *Id.* at 6-7.

42. *Id.*; *see generally* Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. Rev. 543, 650 (2000).

43. *See supra* p. 3.

44. FINRA, http://www.finra.org (last visited Aug. 2, 2012).

financial resources, and competition with comparable organizations.[45] As of December 31, 2010, FINRA's total assets consisted of $2.2 billion, and its financial resources for 2010 consisted of approximately the following: operating revenues of $808 million, consolidated net income of $54.6 million, net investment gains of $50.1 million, and a total investment portfolio return of $252 million.[46]

According to FINRA's 2010 released tax returns, its chairman and chief executive officer, Richard G. Ketchum, earned $2.6 million in 2010, which included a $1.2 million bonus.[47] FINRA also increased its total compensation by nine percent in 2010 from the prior year to $540 million, with its top executives earning nearly $13 million "to compete with compensation on Wall Street."[48] It has been noted that FINRA executives earn "significantly more than the chairs of comparable government agencies," as SEC Chair Mary Schapiro earned $165,300 and Federal Reserve Chair Ben Bernanke earned $199,700 in 2010.[49] The significant compensation packages for FINRA executives are determined by a board of directors committee that "relied on a third-party compensation study performed by Mercer Inc. that compared FINRA executives to industry benchmarking data."[50] The nature of such "industry benchmarking data" was not disclosed, which aroused suspicion that the data may have related to private profit-making companies like investment banks, rather than governmental regulators that would be comparable to FINRA.[51]

These figures bring to light the concern that private financial regulators are receiving a paycheck that is above and beyond that of a governmental employee. FINRA offers its executive officers "million-

45. *See* Ben Protess, *Finra Executives Get Big Payday*, N.Y. TIMES (July 1, 2011), http://dealbook.nytimes.com/2011/07/01/finra-executives-get-big-payday/.

46. Kenneth B. Orenbach, *A New Twist to an On-going Debate About Securities Self-Regulation: It's Time to End FINRA's Federal Income Tax Exemption*, 31 VA. TAX REV. 135, 159 (2011).

47. Protess, *supra* note 45.

48. *Id.* ("Finra drew particular scrutiny after awarding previous chief executive, Mary L. Schapiro, $7.3 million in 2009, when she left the organization to become chairwoman of the Securities and Exchange Commission."); *see also* Aulden Burcher, *FINRA Executive Compensation Challenged by Member Firms*, REG BLOG (Aug. 15, 2011), http://www.law.upenn.edu/blogs/regblog/2011/08/finra-executive-compensation-challenged-by-member-firms.html; William P. Barrett, *FINRA Top Salaries Remain Squarely in the 1%*, FORBES, (Dec. 13, 2011), http://www.forbes.com/sites/williampbarrett/2011/12/13/finra-top-salaries-remain-squarely-in-the-1/ (noting that top FINRA executives are also offered two supplemental retirement plans and other significant fringe benefits).

49. Burcher, *supra* note 48.

50. Barrett, *supra* note 48.

51. *Id.*

dollar pay packages that are far more typical of for-profit corporations than government agencies and nonprofit corporations."[52] Although it is not unreasonable to expect that compensation for those employed in private entities may be higher than that of governmental agencies, this discrepancy offers another example of the ways in which SROs are deemed private organizations for purposes that are beneficial to them. However, when it comes to offering constitutional protections, SROs portray characteristics of non-governmental entities. In this way, "[F]INRA has become a government regulator cloaked in the garb of a private association."[53] As will be further explored in this Article, discrepancies such as these have incited debate as to whether SROs should continue to enjoy absolute immunity from suit, notwithstanding the long-held judicial belief that SROs are entitled to full protection from damages when they are carrying out delegated, regulatory duties.

III. SRO IMMUNITY THROUGH THE EYES OF THE COURTS

A. Current Legal Status of SRO Immunity

SROs are entitled to absolute immunity from suits seeking private damages in connection with the discharge of their regulatory and oversight responsibilities,[54] and are protected from liability for both their actions and omissions in this regard.[55] Absolute immunity offers protection from civil liability "unconditionally," offering immunity "regardless of any other consideration," including acts that arise from malice or corruption.[56] The U.S. Supreme Court's decision in *Butz v. Economou* initially broadened the concept of absolute immunity to focus on the specific nature of one's responsibilities rather than one's particular

52. Orenbach, *supra* note 46, at 140.

53. *Id.* at 202.

54. Standard Inv. Chartered Inc., v. Nat'l Ass'n of Sec. Dealers, 637 F.3d. 112, 115 (2d Cir. 2011), *cert. denied,* 132 S. Ct. 1093 (2012) (citing DL Capital Grp., LLC v. Nasdaq Stock Mkt., Inc., 409 F.3d 93, 96 (2d Cir. 2005); *In re* NYSE Specialists Sec. Litig. v. N.Y. Stock Exch., Inc., 503 F.3d 89, 96 (2d Cir. 2007); D'Alessio v. N.Y. Stock Exch., Inc., 258 F.3d 93, 105 (2d Cir. 2001); Barbara v. N.Y. Stock Exch., Inc., 99 F.3d 49, 59 (2d Cir. 1996); *accord* Scher v. Nat'l Ass'n of Sec. Dealers, 218 Fed.App'x 46, 47-48 (2d Cir. 2007)); *see also* In the Matter of Olick, et al., No. 99-CV-5128, 2000 WL 354191, at *4 (E.D. Pa. Apr. 4, 2000); *see also* WILLIAM M. PRIFTI, SECURITIES: PUBLIC AND PRIVATE OFFERINGS § 8:26 (2011).

55. *NYSE Specialists*, 503 F.3d at 97.

56. Nafday, *supra* note 22, at 855 ("Absolute immunity is the strongest form of immunity in the law available to individuals.").

location within the government.[57] The Court held that government and agency officials who perform adjudicatory functions within a federal agency are entitled to absolute immunity from damages arising from any of their judicial acts.[58] Courts after *Butz* have dramatically expanded this doctrine to apply absolute immunity to SROs, preventing suit for a wide range of activities that are deemed "regulatory."[59]

Standard Investment Chartered Inc. demonstrates the U.S. Supreme Court's resistance to questioning the absolute immunity doctrine as applied to SROs. As discussed earlier in this Article, the Second Circuit ruled in *Standard Investment Chartered, Inc.* that SROs are absolutely immune from suit when alleged misconduct concerns an SRO's amendment of its bylaws where such amendments are "inextricable" from the SRO's role as a regulator.[60] Plaintiffs in this case alleged that the proxy solicitation asking members to approve NASD's bylaws amendments to consummate the merger of NASD and NYSE contained material misrepresentations with respect to a one-time $35,000 payment to NASD members in exchange for their loss of significant voting control in connection with the amendments.[61] Plaintiffs alleged that NASD misrepresented that $35,000 was the maximum amount that the Internal Revenue Service permitted NASD to make to its members.[62] The Second Circuit found that the proxy solicitation's changes to the NASD voting structure in connection with the bylaws amendments constituted an exercise of NASD's regulatory function. The Second Circuit upheld the district court's analysis that the proxy solicitation was "incident to" NASD's exercise of regulatory power since it was "the only vehicle available to NASD for amending its bylaws" to effect the merger.[63] In so

57. 438 U.S. 478, 511 (1978).

58. *Id.* at 514.

59. *See NYSE Specialists*, 503 F. 3d at 97.

60. *See supra* Part I; *Standard Inv. Chartered Inc.*, 637 F.3d at 116.

61. *Standard Inv. Chartered Inc.*, 637 F.3d at 116.

62. *Id.* at 115; *see also* Larry Doyle, *Did Mary Schapiro Engage in a Fraud?* SENSE ON CENTS (Jan. 3, 2012, 10:22 AM), http://www.senseoncents.com/2012/01/did-mary-schapiro-engage-in-a-fraud/ ("If utilizing a proxy statement which includes misinformation is not an abuse of capitalism and a fraud, I do not know what is.").

63. *Standard Inv. Chartered Inc.*, 637 F.3d at 116; *see also* Dan Jamieson, *Justices Toss Suit Against FINRA; Plaintiff Argued Proxy Soliciting Member Approval for NYSE Combo was Fraudulent*, INVESTMENT NEWS (Jan. 23, 2012), http://www.investmentnews.com/article/20120122/REG/301229999; *see also* Joseph A. Giannone, *U.S. Court Upholds Dismissal of Broker Suit v. FINRA*, REUTERS NEWS, Feb. 22, 2011, http://newsandinsight.thomsonreuters.com/Legal/news/2011/02_-_february/u_s__court_upholds_dismissal_of_broker_suit_v__finra/; Misty Dalke, *Standard Investment Chartered v. FINRA: A Defeated Challenge to Absolute Immunity*, THE RACE TO THE BOTTOM (Apr. 17, 2010, 6:00 AM)

ruling, the Second Circuit expanded the SRO absolute immunity doctrine from SRO direct acts of regulatory activity to acts that are merely "incident to" SRO regulatory activity,[64] thereby including bylaws amendments with other protected acts that already included the following: disciplinary actions against members; regulatory oversight over exchange members; the interpretation of securities laws and regulations; the referral of exchange members to the SEC and other government agencies for civil enforcement or criminal prosecution; and the public announcement of regulatory decisions.[65]

Various amicus briefs were filed in support of the plaintiffs, one of which claimed that the Second Circuit drastically expanded SRO immunity far beyond the function-based immunity test typically applied to non-sovereign actors.[66] The function-based test is more limited than the blanket immunity available to sovereign federal and state governments.[67] One amicus brief focused on the need for private suit to counteract expansive SRO power that is not accountable to the executive branch and is subject to diminished oversight.[68] Other arguments focused on the extension of immunity as appropriate only to granted or delegated regulatory powers and never to alleged fraud in proxy solicitations that are instrumental in carrying out private, commercial, or business transactions.[69]

In contrast to the Second Circuit's extension of absolute immunity to SROs acting beyond the scope of specific, delegated powers, the Eleventh Circuit has adopted a more limited approach by refusing to grant SROs absolute immunity for all actions that are "merely 'consistent with' their delegated powers."[70] In *Weissman v. National Association of Securities Dealers*, Steven Weissman, an investor, sued NASD to recover losses after allegedly purchasing WorldCom, Inc. stock in reliance on NASDAQ's misrepresentations in advertisements that

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http://www.theracetothebottom.org/shareholder-rights/standard-investment-chartered-v-finra-a-defeated-challenge-t.html (describing the district court's ruling).

64. *Standard Inv. Chartered Inc.*, 637 F.3d at 116.

65. *Id.* (citing *In re* NYSE Specialists Sec. Litig. v. N.Y. Stock Exch., Inc., 503 F.3d 89, 96 (2d Cir. 2007); Barbara v. N.Y. Stock Exch., Inc., 99 F.3d 49, 59 (2d Cir. 1996); D'Alessio v. N.Y. Stock Exch., Inc., 258 F.3d 93, 105 (2d Cir. 2001); DL Capital Grp., LLC v. Nasdaq Stock Mkt., Inc., 409 F.3d 93, 98 (2d Cir. 2005)); Barbara Black, *Securities Law Roundup*, 1899 PRAC. L. INST. 271, 298 (2011)).

66. Brief for Standard Inv. Chartered, Inc. v. Nat'l Ass'n of Sec. Dealers, as Amici Curiae Supporting Appellants, 132 S.Ct. 1093 (2012) (No. 11-381), 2011 WL 5128951 [Hereinafter "Amici Curiae Supporting Appellants"].

67. *Id.*

68. *Id.* at 3.

69. *Id.* at 5-7.

70. Weissman v. Nat'l Ass'n of Sec. Dealers, 500 F.3d 1293, 1298 (11th Cir. 2007).

promoted the stock.[71] After WorldCom collapsed and Weissman lost almost his entire investment, he brought suit claiming that NASDAQ promoted WorldCom "without disclosing that its revenues were directly enhanced by increased trading in WorldCom stock, thereby committing fraud and/or negligent misrepresentation."[72]

Weissman claimed that he relied on a television advertisement for NASDAQ's 100 Index Trust appearing during the prime time programming of "*The West Wing*" and "*MSNBC News with Brian Williams*" that featured WorldCom stock as part of NASDAQ's 100 Index Trust.[73] Weissman argued that the fact that this stock was featured on the 100 Index Trust conveyed the message that "the world's most successful, sought-after companies, can be found on the NASDAQ stock market."[74] Weissman also relied on a two-page NASDAQ advertisement in *The Wall Street Journal* that discussed NASDAQ's belief that its listed companies must provide accurate financial reporting.[75] As one of the endorsers of the advertisement was WorldCom, Wesissman argued that such a message implicitly conveyed that WorldCom, as endorsed by NASDAQ, has "good character, accounting done in accordance with GAAP, and a viable audit committee in accordance with NASDAQ listing requirements."[76] The Eleventh Circuit found no trace of quasi-governmental functions that were served by such advertisements, which were "in no sense coterminous" with NASDAQ's delegated regulatory authority.[77]

> As a private corporation, NASDAQ places advertisements that are patently intended to increase trading volume and, as a result, company profits. Even if NASDAQ's status as a money-making entity does not foreclose absolute immunity for any number of its activities, its television and newspaper advertisements cannot be said to directly further its regulatory interest under the Securities Exchange Act. These advertisements were in the service of NASDAQ's own business, not the government's, and

71. *Id.* at 1294.
72. *Id.*
73. *Id.*
74. *Id.* at 1298-99; Andrew J. Cavo, Note, *Weissman v. National Association of Securities Dealers: A Dangerously Narrow Interpretation of Absolute Immunity for Self-Regulatory Organizations*, 94 CORNELL L. REV. 415, 427 (2009).
75. *Weissman*, 500 F.3d at 1299.
76. *Id.*; Cavo, *supra* note 74, at 428.
77. *Weissman*, 500 F.3d at 1299; *see supra* note 27 and accompanying text.

> such distinctly non-governmental conduct is unprotected by absolute immunity.[78]

The Eleventh Circuit therefore upheld the decision of the district court to deny the defendants' motion to dismiss and refused to grant SROs absolute immunity for activities that appear to be private and proprietary.[79] There is, however, ambiguity as to whether *The Wall Street Journal* advertisements constituted quasi-governmental activities, as Judge Pryor noted in his separate opinion, in which he concurred in part and dissented in part.[80]

In his dissent, Judge Pryor argued that the SEC has delegated to NASDAQ the duty to establish sound financial standards for its listed companies.[81] Because NASDAQ communicated these standards to the public via *The Wall Street Journal* advertisement, NASDAQ would be entitled to absolute immunity for such actions.[82] The dissent argued that the inquiry as to whether SRO conduct represents a function "delegated by the SEC" should be evaluated on an objective basis, focusing on how the "reasonable reader" would interpret the alleged conduct of an SRO.[83] In this case, the reasonable reader would interpret the advertisements as a communication that WorldCom was listed on NASDAQ because it met the requisite financial standards and that decisions to list or delist securities are considered delegated, regulatory duties to prevent fraudulent and manipulative acts.[84]

The Northern District of California has also addressed the issue of whether particular actions by SROs constitute public functions worthy of absolute immunity.[85] In *Opulent Fund, L.P. v. NASDAQ Stock Market,*

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78. *Weissman*, 500 F.3d at 1299.

79. *Id.*

80. *Id.* (Pryor, J., concurring in part, dissenting in part).

81. *Id.*

82. *Id.* (citing D'Alessio v. N.Y. Stock Exch., Inc., 258 F.3d 93, 105 (2d Cir. 2001) and focusing on whether the conduct performed by NASDAQ is "a function delegated by the SEC").

83. *Id.* at 1300 (the dissent noted that it considers allegations from the view of "the reasonable reader" because it makes only reasonable inferences from the facts alleged in the complaint). *Id. See also* Cavo, *supra* note 74, at 437-38 (discussing how the majority opinion views regulatory duties too narrowly); HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, GOING PUBLIC AND THE PUBLIC CORPORATION § 2:16.10 (2011) (citing *Weissman*, 500 F.3d at 1300) (noting the dissent's acknowledgement of the fact that the SEC expressly approved allowing NASDAQ to become a for-profit corporation, thereby arguing that even private activities should fall under the realm of absolute immunity).

84. *Weissman*, 500 F.3d at 1300 (citing 15 U.S.C. § 78o-3(b)(6) (2006)).

85. Opulent Fund, L.P. v. NASDAQ Stock Mkt., No. C-07-03683 RMW, 2007 WL 3010573, at *1 (N.D. Cal. Oct. 12, 2007).

private investment funds alleged negligent misrepresentation on the part of NASDAQ for miscalculating the price of the NASDAQ-100 index, thereby resulting in significant losses for the plaintiffs.[86] The court agreed with the plaintiffs' contention that the pricing of a stock index is not a regulatory function deserving of absolute immunity, as NASDAQ developed the index to encourage investors to create instruments based on the index's value and enjoys the profits from selling the market price data to induce investors to invest.[87] The court came to this conclusion by noting that NASDAQ represents only itself in such actions, as the SEC would not promote a particular fund or stock.[88] In doing so, such SRO actions are not comparable to regulatory conduct such as suspending trading, banning traders, or disciplining member actions.[89] As the above majority and dissent opinions demonstrate, there is a gray area between what differentiates private business activities from delegated quasi-governmental functions, giving rise to a difference of opinion among the courts as to the appropriate reach of SRO absolute immunity.[90]

B. The Fraud Exception

There has been consistency among the courts in rejecting a fraud exception to the absolute immunity doctrine as applied to SROs.[91] Such an exception is believed to thwart the ability of an SRO to successfully carry out its quasi-governmental functions and to result in numerous frivolous lawsuits.[92] Although allegations of bad faith, malice, and fraud may be relevant to an analysis involving qualified immunity, they do not apply to absolute immunity considerations, as qualified immunity imposes liability if a party knew or reasonably should have known that the alleged misconduct would violate the plaintiff's constitutional rights or if such person acted with malicious intent to deprive the plaintiff of its constitutional rights.[93]

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86. *Id.*

87. *Id.* at *5.

88. *Id.*

89. *Id.*

90. *See supra* notes 73-87 and accompanying text.

91. *See infra* notes 96-108 and accompanying text.

92. 79A C.J.S. *Securities Regulation* § 197 (2012); *see also In re* NYSE Specialists Sec. Litig. v. N.Y. Stock Exch., Inc., 503 F.3d 89, 101-02 (2d Cir. 2007).

93. Trama v. N.Y. Stock Exch., 76 Civ. 4898, 1978 WL 1141, at *5 (S.D.N.Y. Sept. 14, 1978) (citing Wood v. Strickland, 420 U.S. 308, 322 (1975)); Bruan, Gordon & Co. v. Hellmers, 502 F. Supp. 897, 903 (S.D.N.Y. 1980) (quoting *Wood*, 420 U.S. at 322); Zandford v. Nat'l Ass'n of Sec. Dealers, 30 F. Supp. 2d 1, 9 (1998); DL Capital Grp., LLC v. Nasdaq Stock Mkt., Inc., 409 F.3d 93, 98 (2d Cir. 2005); *see also* Cmty. House, Inc. v. City of Boise, 623 F.3d 945, 952-53 (9th Cir. 2010).

In *Mandelbaum v. N.Y. Merchantile Exchange* (NYMEX), the plaintiff, a former NYMEX member, claimed that NYMEX abused its regulatory authority by instituting baseless disciplinary claims against him to cover up NYMEX's own wrongdoing.[94] The Southern District of New York granted NYMEX's motion to dismiss, noting that allegations of fraud and nefarious acts by the defendants are irrelevant to an absolute immunity analysis.[95] "Underlying the doctrine of absolute immunity is the policy decision that—in some instances—even bad actors must be protected in their performance of certain critical functions in our society, even at the expense of innocent victims of their abuse of office."[96]

This acknowledgement is unsettling. As non-governmental actors embodying characteristics of both public and private entities, SROs should be subject to some sort of check on their power. We are left to question the extent to which absolute immunity has been stretched beyond its original intent. The origins of absolute immunity were initially only intended to protect parties "undertaking traditional judicial functions."[97] As the law stands now, SROs are subject to the same expansive immunity as the government and the judiciary despite their very different nature.[98]

Courts have refused to institute a fraud exception to the absolute immunity doctrine even when acknowledging that allegations against SROs appear "egregious," "badly motivated," "inept" or "unlawful."[99] In the case of *In re NYSE Specialists Securities Litigation*, the California Public Employees' Retirement System and Empire Programs alleged that NYSE failed to adequately monitor trading and "made misrepresentations about the integrity of its market."[100] The plaintiffs claimed that the absolute immunity doctrine was inapplicable because NYSE was not exercising its quasi-governmental duties when it "permitted and encouraged misconduct and fraud on its trading floor."[101] The plaintiffs alleged that the specialist firms executing the actual trading

94. Mandelbaum v. N.Y. Mercantile Exch., 894 F. Supp. 676, 676-80 (S.D. N.Y. 1995).

95. *Id.* at 683.

96. *Id.* (citing Gregoire v. Biddle, 177 F.2d 579, 581 (2d Cir. 1949) (Hand, J.); *see also* Spalding v. Vilas, 161 U.S. 483 (1896).

97. Nafday, *supra* note 22, at 872.

98. *See id.* at 855-59; *see also* Karmel, *supra* note 5, at 173.

99. *In re* NYSE Specialists Sec. Litig., 503 F.3d 89, 101 (2d Cir. 2007) (noting that the fraud exception has not been applied to situations directly implicating constitutionally protected rights in the criminal context); Dexter v. Depository Trust & Clearing Corp., 406 F. Supp. 2d 260, 264 (S.D.N.Y. 2005). *See generally* Sparta Surgical Corp. v. Nat'l Ass'n of Sec. Dealers, 159 F.3d 1209, 1209 (9th Cir. 1998).

100. In re *NYSE Specialists Sec. Litig.*, 503 F.3d at 91.

101. *Id.*

on NYSE took advantage of their position to engage in self-dealing, and that NYSE not only neglected its oversight responsibilities over their actions but also encouraged the self-dealing by allegedly falsifying reports and tipping off the specialist firms.[102] In ruling that NYSE was entitled to absolute immunity as a SRO, the court refused to carve out even a "one-time" fraud exception despite egregious allegations of fraud.[103] Such an exception was believed to "open a Pandora's box that would undermine the entire purpose behind the immunity doctrine" and hinder SROs' abilities to carry out their quasi-governmental duties for fear of disruptive and constant lawsuits.[104]

These cases demonstrate the most common arguments in support of the courts' refusal to accept a fraud exception in absolute immunity cases against SROs. In protecting a SRO's shield of absolute immunity, courts have historically considered the "balance between the evils" of denying a plaintiff any redress for SRO misconduct and subjecting governmental officials to "the constant dread of retaliation" as they carry out their regulatory duties, finding that the lesser evil is in the latter.[105] Although such a balance should be considered, the extent to which SROs are able to avoid liability appears dangerously limitless. "[N]o entity—neither regulator nor court—holds an SRO responsible for its violations of state law"—the SEC only guards against SRO violations of federal law.[106]

Given that plaintiffs are deprived of any opportunity to hold SROs accountable for wrongdoing, it is imperative to ensure that adequate safeguards against SRO abuse exist to justify their shield from liability. Although it is well-established in the law that the SEC has oversight responsibility over SROs to ensure such safeguards exist, recent findings have shown that there are shortfalls in such oversight, thereby creating concern that SROs are escaping liability without justification. In addition, the analysis as to whether SROs are subject to absolute immunity depends on whether SROs are "standing in the shoes of the SEC" by carrying out delegated, quasi-governmental duties as opposed to acting as private businesses by conducting proprietary and profit-seeking activities.[107] As the cases discussed above have revealed, such an analysis is not always as clear as one would expect in order to justify the far-reaching absolute immunity doctrine.

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102. *Id.* at 93.

103. *Id.* at 101-02.

104. *Id.*

105. Austin v. Nat'l Ass'n of Sec. Dealers, 757 F.2d 676, 687 (5th Cir. 1985) (quoting Gregoire v. Biddle, 177 F.2d 579, 581 (2d Cir. 1949)).

106. Reply Brief for Petitioner at 4, Standard Inv. Chartered, Inc. v. Nat'l Ass'n of Sec. Dealers, 637 F.3d 112 (2d Cir. 2011) (No. 11-381).

107. D'Alessio v. N.Y. Stock Exch., Inc., 258 F.3d 93, 105 (2d Cir. 2001).

IV. SRO ACCOUNTABILITY

A. Shortfalls of SEC Oversight

It is imperative that the public views SROs as trustworthy and honorable operations in the securities industry, as discontent with such operations has proven to erode investor confidence and hurt the economy.[108] The proper functioning of the stock markets depends on public confidence.[109] "[B]ecause consumer wealth drives seventy percent of the U.S. economy, a stock market like NASDAQ can easily lead the United States into recession. Thus, the relationship between the U.S. economy and its stock markets are very causal in nature."[110] The value of stocks decline when shareholder confidence is low, thereby decreasing consumer wealth as a whole when stock values are not able to improve.[111]

Public confidence in the SRO system is further threatened when considering the various deficiencies in SEC oversight over SROs. Since "the beginning of federal securities regulation," the SEC has granted stock exchanges "considerable autonomy . . . [p]laying an essentially passive role, the SEC has allowed the securities industry to govern itself in its own wisdom."[112] The SEC, "a tame watchdog,"[113] was tasked with a "residual role" when it comes to overseeing stock exchanges . . . "[g]overnment would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used."[114] The SEC is effectively on standby to intervene only in the event that an SRO commits a significant abuse. However, this type of oversight is not on par with the adequate supervisory role that justifies the absolute immunity doctrine for SROs.

In May of 2012, the United States Government Accountability Office (GAO) released a report that outlined the results of a GAO review and assessment of the SEC's oversight procedures over FINRA from

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108. Springer, *supra* note 4, at 464.

109. Nan S. Ellis et al., *The NYSE Response to Specialist Misconduct: An Example of the Failure of Self-Regulation*, 7 BERKELEY BUS. L.J. 102, 104 (2010).

110. *See* Springer, *supra* note 4, at 464 (citing Kimberly Amadeo, *Could a Stock Market Cause Recession?* ABOUT.COM, http://useconomy.about.com/od/stockmarketcomponents/f/stock_recession.htm (last visited Oct. 12, 2012)).

111. *Id.*

112. Ellis et al., *supra* note 109, at 119 (quotation omitted).

113. *Id.* at 120 (citing Toni Anne Puz, *Private Actions for Violations of Securities Exchange Rules: Liability for Nonenforcement and Noncompliance*, 88 COLUM. L. REV. 610, 612 (1988)).

114. *Id.* at 120 (citing Friedman, *supra* note 38, at 740).

August 2011 to May 2012.[115] The results of this report provide little support for the justification of absolute immunity. Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act requiring the GAO to examine the SEC's oversight over securities associations in light of recent financial scandals, the GAO instituted a review of SEC documentation, policies, and procedures for inspections of FINRA, plans for enhanced FINRA oversight, and interviewed SEC and FINRA officials.[116] The results of the GAO's findings reveal that FINRA's governance and executive compensation operations receive "limited or no" oversight and that retrospective reviews of FINRA's rules are not conducted at all.[117] Retrospective rules measure the effectiveness of FINRA rules after they have been implemented.[118] "[W]ithout a more formal process in place to examine its implemented rules, FINRA might miss opportunities to consistently evaluate the effectiveness of its rules . . . [and] whether its rules are achieving their intended purpose."[119] The SEC also lacks a mechanism by which it reviews FINRA's procedures in reviewing its own existing rules.[120] The GAO report highlighted the importance of retrospective reviews of existing rules, as recently encouraged by federal financial regulators and the President's 2011 Executive Order 13579, asking independent regulatory agencies like the SEC to develop plans to review existing significant regulations in order to alter or repeal ineffective, inefficient, or burdensome rules.[121]

The GAO report also found that the SEC Office of Compliance Inspections and Examinations (OCIE) conducts "routine inspections of FINRA's oversight related to advertising . . . less frequently than what was stated in OCIE's planned inspection timelines," as the OCIE

115. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-625, SECURITIES REGULATION: OPPORTUNITIES EXIST TO IMPROVE SEC'S OVERSIGHT OF THE FINANCIAL INDUSTRY REGULATORY AUTHORITY 3 (2012) [hereinafter GAO Report].

116. *Id.* (citing Dodd-Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C.A. §§ 5301-8232 (West 2011)).

117. *Id.* at 7; *see also* Mark Schoeff Jr. & Dan Jamieson, *FINRA Under Fire*, INVESTMENT NEWS (June 3, 2012), http://www.investmentnews.com/article/20120603/REG/306039983; *see also SEC Can Boost Oversight of FINRA – GAO Report*, REUTERS (May 31, 2012), http://www.reuters.com/article/2012/05/31/sec-finra-gao-idUSL1E8GV23320120531.

118. GAO Report, *supra* note 115, at 14 (explaining that through the SEC's "process of soliciting comments and conducting reviews of proposed" FINRA rules, the "SEC gathers information on the potential effects that [such rules] may have on the industry."; however, the SEC has no formal, "specific guidance or protocols for conducting retrospective reviews.").

119. *Id.* at 14, 15.

120. *Id.*

121. *Id.* at 15 (noting the "usefulness of retrospective reviews of rules, including the ability to inform policymakers about the design of rule and regulatory programs.").

inspected FINRA's advertising regulatory program in 1998 and 2005 as opposed to the OCIE's existing timelines calling for inspections once every four years.[122] In addition, the GAO report reveals that the SEC has conducted limited oversight of the following aspects of FINRA's operations: "conflicts of interest or recusals;" the "adequacy of FINRA's funding;" "the employment of former FINRA employees at regulated entities;" executive compensation structures; "cooperation with state securities regulators;" and the "transparency of FINRA's governance."[123] The SEC has instead traditionally focused its oversight on FINRA's regulatory departments, which are believed to most directly affect investors.[124]

The results of the GAO report are alarming in light of the fact that the courts have consistently justified absolute immunity for SROs because adequate and reliable SEC oversight is believed to exist. Courts have historically applied the analysis of whether sufficient safeguards exist in the regulatory framework to control unconstitutional conduct in determining whether absolute immunity is justified.[125] In support of its argument to uphold absolute immunity for NYSE, the Second Circuit in In re *NYSE Specialists Securities Litigation* relied on the existence of alternatives to damages suits to redress wrongful conduct.[126] "The SEC, after all, retains formidable oversight power to supervise, investigate, and discipline the NYSE for any possible wrongdoing or regulatory missteps."[127] The Fifth Circuit in *Austin v. National Association of Securities Dealers,* made similar arguments—"[t]he SEC has pervasive oversight authority in the promulgation and enforcement of NASD regulations and disciplinary procedures."[128] These cases demonstrate the extent to which the courts rely on adequate SEC oversight to ensure that there is some mechanism for holding SROs accountable for any wrongdoing. As discussed above, it no longer seems prudent to rely only on SEC oversight given weaknesses in that arena.

Scholars have also noted the limited ability of administrative agencies overseeing SROs to guide SROs toward the direction of the

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122. *Id.* at 10 ("According to OCIE, the timelines were not followed due to resource constraints and competing priorities.").

123. *Id.* at 16-17.

124. GAO Report, *supra* note 115, at p. i.

125. *In re* Series 7 Broker Qualification Exam Scoring Litig., 510 F.Supp. 2d 35, 39 (D.C. Cir. 2007); Austin v. Nat'l Ass'n of Sec. Dealers, 757 F.2d 676, 688-89 (5th Cir. 1985); Butz v. Economou, 438 U.S. 478, 512-14 (1978).

126. *In re* NYSE Specialists Sec. Litig., 503 F.3d 89, 101 (2d Cir. 2007).

127. *Id.* (citing, *e.g.*, DL Capital Grp., LLC v. Nasdaq Stock Mkt., Inc., 409 F.3d 93, 95 (2d Cir. 2005)).

128. *Austin*, 757 F.2d at 690.

public interest.[129] As SROs are essential in allowing the market to operate smoothly, government agencies like the SEC may "threaten fines and require regulatory reforms," but such agencies are constrained from instituting any reform measures that would cause any market disruption.[130] The ability of the SEC to expand its regulatory oversight is also impeded by considerable budgetary constraints and the need for significant technological advancements,[131] thereby making its goal of aggressively protecting investors from fraud and market abuse increasingly difficult to reach.[132]

The belief that SEC oversight is adequate enough to justify absolute SRO immunity should be re-evaluated by courts in light of the results of the GAO report, the excessive compensation packages available to FINRA employees discussed in Part II of this Article, and the ever-increasing ambiguity as to whether SRO actions are public or private functions.

B. FINRA Failures

NASDAQ's recent blunders during the Facebook IPO resulted in public concern about the effective operations of stock exchanges.[133] During Facebook's first day of trading on May 18, 2012, NASDAQ experienced technological failures, trading delays, and unfilled stock orders that resulted in millions of dollars of losses for investors.[134] "Big-time traders and mom-and-pop investors"[135] claimed that such failures weakened their confidence in both NASDAQ and the stock market itself.[136] NASDAQ has proposed a $40 million fund to compensate firms

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129. Stavros Gadinis & Howell E. Jackson, *Markets as Regulators: A Survey*, 80 S. CAL. L. REV. 1239, 1256 (2007).

130. *Id.*

131. Pravin Rao et al., *The SEC Speaks 2011 Conference: The SEC Struggles to Manage Expanded Regulatory Mandates while Facing Budgetary Constraints from Congress*, PERKINS COIE (Feb. 8, 2011), http://www.perkinscoie.com/news/pubs_detail.aspx?op=updates&publication=2952; *see also Alleged Stanford Financial Group Fraud: Regulatory and Oversight Concerns and the Need for Reform: Hearing Before the S. Banking, Hous. & Urban Affairs Comm.* 111th Cong. (2009) (statements of Professor Onnig Dombalagian, George Denègre Professor of Law, Tulane University Law School and Ms. Rose Romero, Regional Director, Fort Worth Regional Office, U.S. Securities and Exchange Commission).

132. *See* Rao, *supra* note 131.

133. Jenny Strasburg et al., *Nasdaq CEO Lost Touch Amid Facebook Chaos*, WALL ST. J., June 11, 2012, at A1.

134. *Id.*

135. *Id.*

136. *Id.*

for monetary losses resulting from the highly anticipated yet problematic Facebook IPO.[137] Some SEC officials questioned whether NASDAQ's breakdown was linked to the transformation taking place among U.S. stock exchanges over past decades from private, member-owned organizations to "profit-focused" publicly traded companies.[138] Developments linked to such a transformation, such as increased competition from alternative electronic trading venues, the replacement of manual trading floors with electronic facilities, and the expansion of exchanges though mergers or alliances with other exchanges, have raised concern as to the continued effectiveness of stock exchanges to carry out their self-regulatory functions.[139] "For-profit exchanges are more sensitive to pressures from their constituents and more likely to abusively exercise their regulatory powers against their competitors."[140]

FINRA has also been accused of failing to uncover the most significant financial scandals that have occurred in recent years.[141] FINRA allegedly failed to adequately supervise the capital requirement compliance of Lehman, Bear Sterns and AIG; to uncover Bernard Madoff's Ponzi scheme; and to adequately respond to information allegedly received by FINRA from five sources that Stanford Financial Group was engaging in fraud.[142] Such failures resulted in so much harm for investors that FINRA's board appointed a special review committee to investigate FINRA's examination procedures, which acknowledged FINRA's shortcomings in the Stanford and Madoff frauds and recommended significant changes in its examinations.[143] At times when FINRA or other self-regulators have inspected major cases of fraud or attempted to implement change, they have tended to follow investigations started by others, such as the Attorney General's office,

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137. Brett Philbin & Aaron Lucchetti, *UBS Gets Stung by Facebook IPO*, WALL ST. J., June 9, 2012, at B1.

138. *Id.* at A10.

139. Gadinis & Jackson, *supra* note 129, at 1298.

140. *Id.*

141. *See Alliance for Economic Stability Urges Financial Crisis Inquiry Commission to Investigate FINRA*, ALLIANCE FOR ECONOMIC STABILITY (Apr. 12, 2010), http://www.eally.org/index.php?option=com_content&view=article&id=56:april-12-2010-alliance-for-economic-stability-urges-financial-crisis-inquiry-commission-to-investigate-finra&catid=36:sec-reports&Itemid=59; *Failure to Detect Fraud Sparks Call for Reform*, AUGUSTA CHRONICLE, Oct. 3, 2009, at 1; *see also* Ben Protess, *For Wall Street Watchdog, All Grunt Work, Little Glory*, N.Y. TIMES (Dec. 1, 2011), http://dealbook.nytimes.com/2011/12/01/for-wall-street-watchdog-all-grunt-work-little-glory/; Marcy Gordon, *FINRA Needs Reform after Madoff, Stanford*, ASSOCIATED PRESS (Oct. 2, 2009), http://www.katu.com/news/business/63338667.html.

142. *See supra* note 141 and accompanying text.

143. Orenbach, *supra* note 46, at 153.

the SEC, or the news media, rather than initiating their own reviews.[144] While SROs have missed detecting the scandals of major, financial players, they are believed to have targeted "the little guy, sparing the big, deep-pocketed members that wield clout at the marketplace," as most regulatory cases have been brought against individual brokers.[145]

Specialists or market makers who work with the stock exchanges to invest or fill orders for clients have also been found to engage in misconduct.[146] NYSE figures have revealed that the volume of trading for which specialists traded for their own individual accounts increased from 18% to 27% between 1996 and 2000, resulting in a rise in specialists' profits during this time.[147] *The Wall Street Journal* articles detailing an SEC investigation of specialist misconduct in 2003 reported that specialist firms on the NYSE had taken advantage of their inside knowledge of the market to interfere in transactions for their own profit and trade for their own accounts before completing orders placed by public investors.[148] Specialist firm violations of NYSE rules and self-interested trading were found to have occurred "over an extended period of time."[149] Although stock exchanges like the NYSE have rules for specialist firms to follow, enforcement of these rules was found to be inadequate.[150] The 2003 SEC Report found that "NYSE had no meaningful compliance programs for reviewing their specialists' compliance with NYSE rules," as such rules are "often vague and therefore difficult to enforce," provided little or no punishment for abuse, and posed a conflict of interest between NYSE enforcement of rules and the regulation of specialists to essentially "act against their self-interest."[151]

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144. Ernest E. Badway & Jonathan M. Busch, *Ending Securities Industry Self-Regulation As We Know It*, 57 RUTGERS L. REV. 1351, 1361 (2005) (citing Laurie P. Cohen & Kate Kelly, *A Shotgun Behind the Door*, WALL ST. J., Dec. 31, 2003, at A1).

145. Laurie P. Cohen & Kate Kelly, NYSE Turmoil Poses Question: Can Wall Street Regulate Itself? WALL ST. J., Dec. 31, 2003, at A1.

146. Ellis et al., *supra* note 109, at 115.

147. *Id.*

148. *Id.* at 116-17.

149. *Id.* at 116.

150. *Id.* at 117 (citing Dale Arthur Oesterle et al., *The New York Stock Exchange and its Out Moded Specialist System: Can the Exchange Innovate to Survive?*, 17 J. CORP. L. 223, 257 (1992) ("The effectiveness of these NYSE efforts at regulation . . . is questionable at best.")).

151. *Id.* at 117-19.

C. The Fraud Exception as a Check on SRO Abuses

The findings detailed above challenge the historical arguments relied upon by courts in support of absolute immunity. SROs do not seem as adequately overseen by the SEC as would justify a complete shield from liability. In addition, SROs are not without flaws—they have failed to detect some of the most significant financial scandals of recent years and have contributed to millions of dollars of losses for investors due to technological errors.[152] Plaintiffs have presented well-supported allegations of SRO fraud, misconduct, and bad faith to the courts to no avail.[153] The institution of a fraud exception to the immunity doctrine would serve as a check on SROs abuses.

SROs have the potential to easily traverse the line between delegated, quasi-governmental powers and private, business activities due to the fact that they actively operate in both arenas. SROs are nevertheless businesses that have an interest in establishing rules and "listing standards to attract investors," which in turn attract listed companies.[154] At the same time, they are delegates of the SEC that carry out quasi-governmental duties and serve as the "first-line regulatory authority" over U.S. securities and commodities industries.[155] The "government-like functions and operations" of SROs give rise to the question of which checks and balances and due process considerations may be necessary for SROs to have constitutional and administrative accountability and legitimacy.[156] The fraud exception offers a potential solution to the need for a check on SRO accountability, as this exception would protect SROs when carrying out their quasi-governmental duties while ensuring that plaintiffs have some recourse for those times in which SROs have acted fraudulently.

V. PLEADING FRAUD AND EXHAUSTION OF ADMINISTRATIVE REMEDIES

As examined in Part III of this Article, courts have historically rejected the carving out of a fraud exception from the SRO absolute immunity doctrine.[157]

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152. *See supra* pp. 22-24.

153. *See, e.g.*, Standard Inv. Chartered Inc. v. Nat'l Ass'n of Securities Dealers, 637 F.3d 112, 112-16 (2d Cir. 2011).

154. John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 770 (2009).

155. Nafday, *supra* note 22, at 849.

156. Karmel, *supra* note 5, at 154.

157. *See supra* Part III.B.

> It behooves the court not to carve out a fraud exception to the absolute immunity of an SRO. It is, after all, hard to imagine the plaintiff (or plaintiff's counsel) who would—when otherwise wronged by an SRO but unable to seek money damages—fail to concoct some claim of fraud in order to try and circumvent the absolute immunity doctrine. Thus, rejecting a fraud exception is a "matter not simply of logic but of intense practicality since [otherwise] the [SRO's] exercise of its quasi-governmental functions would be unduly hampered by disruptive and recriminatory lawsuits.[158]

The courts are concerned that a fraud exception to absolute immunity would cause plaintiffs to conjure up claims of fraud through artful pleading, which, if successful, would overload the courts.[159] However, it is likely that the heightened pleading requirements that are necessary for a successful fraud claim would weed out meritless suits, thereby protecting the judicial system. In addition, the requirement that plaintiffs wishing to challenge SRO actions must first exhaust administrative remedies before invoking the courts offers further protection from a flurry of superfluous lawsuits.

A. Heightened Pleading Requirements for Fraud Claims

Under Federal Rule of Civil Procedure 9(b) (Rule 9(b)), all pleadings of fraud or mistake must be stated "with particularity,"[160] which differs from the general pleading requirements for ordinary civil actions requiring only "a short and plain statement of the claim showing that the pleader is entitled to relief."[161] In addition, the Private Securities Litigation Reform Act (PSLRA) requires that complaints alleging misrepresentations specify each statement alleged to have been misleading, the reasons why the statement is misleading, and, with

158. Gurfein v. Ameritrade, Inc., 411 F. Supp. 2d 416, 423-24 (S.D.N.Y. 2006) (citing D'Alessio v. N.Y. Stock Exch., Inc., 125 F. Supp. 2d 656, 658 (S.D.N.Y. 2000)); *see also* DL Capital Grp., LLC v. Nasdaq Stock Mkt., 409 F.3d 93, 99 (2d Cir. 2005).

159. *Gurfein*, 411 F. Supp. 2d at 423-24.

160. FED. R. CIV. P. 9(b). ("Malice, intent, knowledge, and other condition of a person's mind may be averred generally."). Kundrat v. Chi. Bd. Options Exch., No. 01 C 9456, 2001 WL 31017808, at *4 (N.D. Ill. Sept. 6, 2002).

161. FED. R. CIV. P. 8(a)(2).

particularity, all facts on which the belief relating to the allegation is formed.[162]

In private actions in which plaintiffs are seeking money damages based on proof that the defendant acted with a particular state of mind, the complaint "must state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind"[163]—"knowingly and with the intent to defraud" regarding each act or omission.[164] Complaints containing inferences of scienter will only survive if a reasonable person deems such inference "cogent" and "at least as compelling as any opposing inference one could draw from the facts alleged."[165] "The complaint should set out the 'who, what, when, where and how' of the events at issue."[166] In determining Federal Rule of Civil Procedure 12(b)(6) motions to dismiss (12(b)(6) motions), courts examine the plaintiff's complaint in its entirety, including "documents incorporated into the complaint by reference and matters of which a court may take judicial notice."[167] Courts will disregard "catch-all" or "blanket" assertions that do not comply with the particularity requirements of Rule 9(b) and the PSLRA.[168]

Plaintiffs are also limited as to what materials they may use to formulate their fraud claim. The PSLRA's discovery stay prevents the plaintiff from being able to obtain discovery to construct the allegations of their complaint until the motion to dismiss is resolved.[169] Therefore, plaintiffs' lawyers rely on items like SEC filings, press releases, and witness interviews to construct their fraud claims.[170] For a successful fraud pleading under the PSLRA, plaintiffs must identify specific

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162. 15 U.S.C.A. § 78u-4(b)(1) (West 2011); *see also* John M. Wunderlich, *Bankruptcy's Protection for Non-Debtors from Securities Fraud Litigation*, 16 FORDHAM J. CORP. & FIN. L. 375, 408-09 (2011).

163. 15 U.S.C.A. § 78u-4(b)(2).

164. Prager v. Knight Trading Grp., 250 F. Supp. 2d 412, 417 (D.N.J. 2001).

165. Mill Bridge V., Inc. v. Benton, No. 08–2806, 2009 WL 4639641, at *22 (E.D. Pa. Dec. 3, 2009) (citing Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 324 (2007)).

166. *Mill Bridge*, 2009 WL 4639641, at *7 (citing *In re* Alphapharma Inc. Sec. Litig., 372 F.3d 137, 148 (3d Cir. 2004)).

167. ABA Subcommittee on Annual Review, Committee on Federal Regulation of Securities, *Significant 2007 Caselaw Developments* 63 ABA Section of Business Law 969 (2008); *Tellabs*, 551 U.S. at 322.

168. Cal. Pub. Emp. Ret. Sys. v. Chubb Corp., 394 F.3d 126, 145 (3d Cir. 2004).

169. A.C. Pritchard & Hillary A. Sale, *What Counts as Fraud? An Empirical Study of Motions to Dismiss Under the Private Securities Litigation Reform Act*, 2 J. EMPIRICAL LEGAL STUD. 125, 128 (2005) (citing 15 U.S.C. § 78u-4(b)(3)); Charles W. Murdock, *Sarbanes-Oxley Five Years Later: Hero or Villain*, 39 LOY. U. CHI. L.J. 525, 542-43 (2008).

170. Pritchard & Sale, *supra* note 170, at 128.

documents on which their allegations in a complaint are based.[171] Claims brought under Section 10(b) and Rule 10b-5 of the Exchange Act also require the strict pleading requirements of Rule 9(b) and PSLRA, as such claims "sound in fraud."[172] To state a claim under Section 10(b) and Rule 10b-5, a plaintiff must allege a material misrepresentation or omission, scienter, a connection with the purchase or sale of a security, reliance, economic loss and causation.[173] Liability under Rule 10b-5 for misrepresentations about a security is not limited to the issuer of such security but may be brought against other parties, including "underwriters, brokers, bankers and non-issuer sellers."[174]

The purpose of Rule 9(b) and the PSLRA is to discourage meritless securities fraud suits and to reduce the cost of defending class actions.[175] The heightened pleading requirements in securities fraud actions contributed to a 39.1% dismissal rate at the pleadings stage between 2006 and 2007.[176] The results of a 2004 study reveal that the Ninth Circuit granted dismissals 63% of the time.[177] Plaintiffs are also subject to sanctions for filing "overly prolix pleadings," thereby further discouraging the filing of meritless lawsuits.[178] Private securities fraud actions, if not checked by stringent pleading requirements, could create significant costs on companies and individuals.[179]

It seems clear that plaintiffs face increased difficulty in bringing forth complaints that will survive the pleadings stage due to these heightened pleading requirements. Such requirements offer one method of eliminating meritless suits against SROs, allowing only those that

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171. *Mill Bridge*, 2009 WL 4639641, at *15.

172. *Id.* at *6; 15 U.S.C.A. § 77j(b) (West 2011); 15 U.S.C.A. § 78u-4(b)(1) (West 2011); 17 C.F.R. § 240.10b-5 (2011); *see* FED. R. CIV. P. 9(b).

173. *Mill Bridge*, 2009 WL 4639641, at *6 (citing Dura Pharm. Inc. v. Broudo, 544 U.S. 336, 341-42 (2005)); 15 U.S.C.A. § 77j(b). 17 C.F.R. § 240.10b-5.

174. *In re* NYSE Specialists Sec. Litig., 503 F.3d 89, 102-03 (2d Cir. 2007); 17 C.F.R. § 240.10b-5.

175. Brian S. Sommer, *The PSLRA Decade of Decadence: Improving Balance in the Private Securities Litigation Arena with a Screening Panel Approach*, 44 WASHBURN L.J. 413, 423 (2004-2005); Pritchard & Sale, *supra* note 170, at 127; *see* FED. R. CIV. P. 9(b); 15 U.S.C.A. § 78u-4(b)(1).

176. Elizabeth Chamblee Burch, *Securities Class Actions as Pragmatic Ex Post* Regulation, 43 Ga. L. Rev. 63, 79 (2008).

177. Sommer, *supra* note 176, at 430.

178. Shaun Mulreed, Private Securities *Litigation Reform Failure: How Scienter Has Prevented the Private Securities Litigation Reform Act of 1995 from Achieving its Goals*, 42 SAN DIEGO L. REV. 779, 802 (2005).

179. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 313 (2007) ("As a check against abusive litigation by private parties, Congress enacted the Private Securities Litigation Reform Act of 1995."); 15 U.S.C.A. § 78u-4(b)(1); *see also* THOMAS LEE HAZEN, CIVIL LIABILITIES TO PRIVATE PARTIES UNDER THE 1934 ACT 377 (2012).

adequately state and support specific instances of fraud. In one case, a buyer of auction rate securities brought an action against Merrill Lynch, as the underwriter of the securities, claiming unlawful acts and misrepresentations in the buyer's purchase of the securities.[180] Plaintiffs alleged scienter by stating that Merrill Lynch's motive in committing alleged fraud was to expand its potential customer base, the size and volume of the products that it underwrote, and the underwriting fees that it generated to collect millions of dollars.[181] In considering these allegations, the court ruled that the defendant's motive to merely increase or maintain profit is insufficient under the PSLRA requirements.[182] "Allegations of a generalized motive that could be imputed to any for-profit endeavor are not concrete enough to infer scienter."[183] Therefore, plaintiffs attempting to sue SROs will not be able to rely solely on the argument that SROs were acting out of private, proprietary interests.

B. Preliminary Administrative Review of SRO Actions

Plaintiffs are not able to simply run to the judicial system each time they believe that they have been wronged in some manner by SROs.[184] When it comes to member firms wishing to challenge SRO disciplinary actions or sanctions against such members for noncompliance with the securities laws, plaintiffs must first exhaust their administrative remedies before judicial review becomes available.[185] FINRA's disciplinary process to regulate broker-dealers involves various steps: first, review by FINRA's Hearing Panel; second, an appeal (if requested) to FINRA's National Adjudicatory Council (NAC); third, review by the FINRA Board of the NAC decision, if desired; fourth, an application by an aggrieved FINRA member or associated person subject to disciplinary proceedings for review by the SEC; and, finally, appeal of an adverse SEC determination by an aggrieved FINRA member or associated person

180. *In re* Merrill Lynch Auction Rate Sec. Litig., 851 F. Supp. 2d 512, 519 (S.D.N.Y. 2012).

181. *Id.* at 528.

182. *Id.*

183. *Id.* (citing Defer LP v. Raymond James Fin., Inc., 654 F. Supp. 2d 204, 217 (S.D.N.Y. 2012)).

184. *See, e.g.*, PennMont Sec. v. SEC, 414 F. App'x 465, 466 (3d Cir. 2011).

185. *Id.* at 466; *see also* MFS Sec. Corp. v. SEC, 380 F.3d 611, 621 (2d Cir. 2004); Shimoda-Atlantic Inc. v. Fin. Indus. Regulatory Auth., No. 07–CV–5222, 2008 WL 2003160, at *4 (W.D. Ark. May 8, 2008); Meyers v. Nat'l Ass'n of Sec. Dealers, No. 95–CV–75077, 1996 WL 1742619, at *2 (E.D. Mich. Mar. 29, 1996); Bruan, Gordon & Co. v. Hellmers, 502 F. Supp. 897, 897 (S.D.N.Y. 1980).

to a federal court of appeals.[186] During the fourth level of review, the SEC may dismiss or modify the disciplinary proceedings of the SRO against an aggrieved member if it finds that the SRO disciplinary action is not necessary or appropriate to further the purposes of the Exchange Act.[187] Given the various layers of review, this process may take several years to complete.[188] Congress viewed this extensive process as beneficial, as the "expertise and intimate familiarity" that SROs and the SEC possess with respect to "complex securities operations" would be ideal in resolving regulatory issues in the securities industry.[189]

The rule of exhaustion of prescribed administrative remedies prior to entitlement to judicial relief for a supposed or threatened injury is a long-settled doctrine,[190] as such procedures prevent the "premature interruption" of the administrative process.[191] The exhaustion of administrative remedies doctrine also allows administrative agencies the chance to correct any errors that SROs may have made, thereby avoiding the need to invoke the court system altogether.[192] There are recognized exceptions to the doctrine when courts may decide to hear cases despite a lack of initial exhaustion of administrative remedies, including when the administrative procedure is inadequate to prevent irreparable injury or when an unambiguous statutory or constitutional violation exists.[193]

In *Standard Investment Chartered Inc. v. National Association of Securities Dealers*, the district court addressed the doctrine of exhaustion of administrative remedies before the case was appealed to the Second Circuit.[194] The defendants argued that the district court lacked jurisdiction to consider the plaintiffs' claims because they had failed to first exhaust their administrative remedies.[195] Plaintiffs argued that the

186. Charles Schwab & Co., Inc. v. Fin. Indus. Regulatory Auth., No. C–12–518 EDL, 2012 WL 1859030, at *2 (N.D. Cal. May 11, 2012).

187. *See* 15 U.S.C.A. § 78s (West 2011).

188. *Charles Schwab & Co., Inc.*, 2012 WL 1859030, at *2 (citing Paz Sec. Inc. v. SEC, 494 F.3d 1059 (D.C. Cir. 2007)).

189. *Charles Schwab & Co., Inc.*, 2012 WL 1859030, at *5; *see also* Hayden v. N.Y. Stock Exch., 4 F. Supp. 2d 335, 339-40 (S.D.N.Y. 1998).

190. Alton v. Nat'l Ass'n of Sec. Dealers, Inc., No. C–94–0618 MHP, 1994 WL 443460, at *2 (N.D. Cal. July 26, 1994).

191. First Jersey Sec., Inc. v. Bergen, 605 F.2d 690, 695 (3d Cir. 1979); PennMont Sec. v. Frucher, 586 F.3d 242, 245 (3d Cir. 2009).

192. Swirsky v. Nat'l Ass'n of Sec. Dealers, 124 F.3d 59, 62 (1st Cir. 1997) (citing Ezratty v. Puerto Rico, 648 F.2d 770, 774 (1st Cir. 1981)).

193. *First Jersey Sec., Inc.*, 605 F.2d at 696; Marchiano v. Nat'l Ass'n of Sec. Dealers, 134 F. Supp. 2d 90, 94 (D.C.C. 2001).

194. Standard Inv. Chartered, Inc. v. Nat'l Ass'n of Sec. Dealers, No. 07 Civ.2014(SWK), 2007 WL 1296712, at *2 (S.D.N.Y. May 2, 2007), *aff'd* 637 F.3d 112 (2d Cir. 2011). *See supra* notes 60-69 and accompanying text (discussing appeal).

195. *Standard Inv. Chartered, Inc.*, 2007 WL 1296712, at *2.

exhaustion doctrine was inapplicable based on the argument that it was limited to securities law enforcement issues.[196] The district court acknowledged that plaintiffs must exhaust administrative remedies before seeking judicial review not only when challenging disciplinary proceedings of SROs, but also with respect to challenges to procedures that are part of SRO's rulemaking authority.[197] "[T]he SEC has power to oversee the procedures incident to rulemaking, which is comparable, if not equal, to its power to review the procedures incident to an SRO's disciplinary proceedings."[198]

In so deciding, the district court focused on the power of the SEC to amend the rules of an SRO as the SEC deems necessary to ensure compliance with the federal securities laws.[199] The court reasoned that the bylaws and articles of incorporation of an SRO also constitute "rules," thereby allowing the SEC to impose any bylaw amendments or disapprove a proposed bylaw amendment without the vote of the SRO's members if such an action were deemed necessary to the fulfillment of the goals of the securities laws.[200] These actions would be justified because SROs and their members, by registering as such, "necessarily forfeit" certain powers that such entities had prior to their registration.[201] Based on this premise, the district court found that the plaintiffs' claims that NASD made fraudulent misrepresentations in its proxy solicitation in connection with its bylaw amendments must be dismissed in favor of the existing SEC review proceeding.[202]

The institution of a fraud exception may be viewed as a first step in allowing some mechanism for redress in instances of wrongdoing. As the law currently stands, SROs are fully shielded from liability for fraudulent activities as long as such actions were carried out as part of their delegated, regulatory duties.[203] This structure poses a risk for unchecked abuse. The fraud exception is one way of allowing only truly worthy allegations of fraud to stand. The heightened pleading requirements for fraud and the exhaustion doctrine serve as mitigating factors to the concerns most commonly held by fraud exception opponents that such an

196. *Id.* at *3; *see also* Christopher W. Cole, *Financial Industry Regulatory Authority (FINRA): Is the Consolidation of NASD and the Regulatory Arm of NYSE a Bull or a Bear for U.S. Capital Markets?*, 76 UMKC L. REV. 251, 262 (2007).

197. *Standard Inv. Chartered, Inc.*, 2007 WL 1296712, at *6.

198. *Id.*

199. *Id.*

200. *Id.*

201. *Id.*

202. *Id.*

203. Gurfein v. Ameritrade, Inc., 411 F. Supp. 2d 416, 423-24 (S.D.N.Y. 2006)

exception would "unduly hamper" the judicial system.[204] The arguments against the creation of a fraud exception have been centered around the preoccupation that the courts would be overburdened by an excess of frivolous lawsuits by plaintiffs "concocting"[205] a fraud claim just to find a way to sue an SRO. As the above section has revealed, it is often very difficult for plaintiffs to meet the stringent pleading requirements in a fraud claim, especially considering the limits associated with the PSLRA's stay on discovery and burdensome scienter pleading requirement.[206] The inability of numerous plaintiffs to meet such strict requirements has resulted in many of such cases being dismissed.[207] In addition, plaintiffs' access to the federal court system is blocked by the initial administrative layers of review of a plaintiff's challenge to an SRO disciplinary proceeding or rulemaking procedures.[208] Such hurdles create an uphill battle for plaintiffs wishing to seek redress in the federal courts. This doctrine would serve as an additional layer of protection in ensuring that only those complaints deserving of a federal court hearing will be granted.

VI. CONCLUSION

SROs are unique organizations that embody characteristics of both profit-seeking corporations and public government agencies.[209] Because of SROs' familiarity with the complexities of the securities markets, such entities have been delegated with the power to regulate their members to ensure the efficient operations of the stock market.[210] SROs institute regulations for compliance with the federal securities laws, imposing disciplinary actions on members that fail to meet these standards.[211] The lines are often blurred between the public and private functions of SROs, as some courts have granted SROs absolute immunity for all actions that are "incident to" carrying out regulatory duties, while others have denied it for actions like advertising that are considered to further private, business interests.[212] Despite some difference of opinion as to when

204. *See id; see also* Part V.A.

205. *See supra* Part.V.A.

206. *See* Mill Bridge V., Inc. v. Benton, No. 08–2806, 2009 WL 4639641, at *22 (E.D. Pa. Dec. 3, 2009); 15 U.S.C.A. § 78u-4(b)(1) (West 2011).

207. *See supra* pp. 27-28.

208. *See supra* Part V.B.

209. *See* Weissman v. Nat'l Ass'n of Sec. Dealers, 500 F.3d 1293, 1302 (11th Cir. 2007).

210. *See supra* p. 29-30.

211. *See supra* Part II.

212. *See supra* Part III.A.

absolute immunity is warranted, courts have refused to carve out a fraud exception to the absolute immunity doctrine.[213]

The fraud exception has been rejected for fear of overloading the courts with suits involving "concoctions" of fraud and for the reason that the SEC is already exercising adequate oversight authority over SROs.[214] Recent findings and events have revealed that the SEC is lacking in many areas of SRO oversight, which creates concern as to whether SROs are being held accountable for actions in which they have acted fraudulently.[215] In addition, regulators have become concerned that the transformation of SROs over past decades from member-owned organizations to "profit-focused" publicly traded companies has been to blame for recent technological shortcomings and failures of stock exchanges,[216] which has had the effect of weakening investor confidence in the markets. Such facts pose the question of whether SROs are still quite as controlled and in check as the courts believe them to be. The availability of a fraud exception to the expansive absolute immunity doctrine would offer plaintiffs the opportunity to hold SROs accountable for acts of fraud and abuse. It is unlikely that such an exception would have the result of creating a flood of meritless suits, as such claims would be subject not only to heightened pleading standards but also to preliminary administrative review by government agencies.[217] These requirements would help to weed out unsupported and undocumented instances of fraud.

The fact that SROs are quasi-governmental actors should not fully shield such organizations from liability without inquiry as to the underlying nature of a plaintiff's claim. A fraud exception to SRO immunity would help to ensure that SROs are held accountable during those times that they may act out of self-interest or engage in fraud in furtherance of their business motives. As this Article has revealed, SROs, although tasked with delegated regulatory powers, have various opportunities to step out of the SEC's regulatory shoes and into those of a private, profit-seeking corporation. It is during such times that those aggrieved by fraudulent SRO actions should have some recourse to justice.

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213. *See, e.g.*, Standard Inv. Chartered Inc. v. Nat'l Ass'n of Securities Dealers, 637 F.3d 112, 112-16 (2d Cir. 2011).

214. *See supra* Part III.B.

215. *See supra* Part IV.A.

216. *See supra* Part IV.B.

217. *See supra* Part V.