No. 11-381

IN THE
Supreme Court of the United States

STANDARD INVESTMENT CHARTERED, INC.,
Petitioner,
v.
NATIONAL ASSOCIATION OF SECURITIES DEALERS, ET AL.,
Respondents.

On Petition for a Writ of Certiorari
to the U.S. Court of Appeals for the Second Circuit

BRIEF *AMICI CURIAE* OF THE CATO INSTITUTE AND THE COMPETITIVE ENTERPRISE INSTITUTE IN SUPPORT OF PETITIONER

DAVID J. BEDERMAN
Counsel of Record
Emory Law School Supreme Court Advocacy Project
1301 Clifton Road
Atlanta, GA 30321
(404) 727-6822
lawdjb@emory.edu

ILYA SHAPIRO
Cato Institute
1000 Mass. Avenue, N.W.
Washington, DC 20001
(202) 842-0200

HANS BADER
SAM KAZMAN
Comp. Enterprise Institute
1899 L St., N.W., 12th Floor
Washington, DC 20036
(202) 331-2278

QUESTION PRESENTED

Respondent National Association of Securities Dealers (NASD)—now known as the Financial Industry Regulatory Authority (FINRA)—is a private entity that engages in proprietary activities as well as certain regulatory activities of its members as a "Self-Regulatory Organization" (SRO). Petitioner, a securities dealer, is a FINRA member. Petitioner and other members lost significant voting control over FINRA through a proxy solicitation. Petitioner then brought this state-law suit alleging that FINRA had lied to the membership in the proxy statement by significantly understating the compensation they could legally receive in exchange for giving up some of their voting rights.

The Second Circuit held, in conflict with other circuits, that SROs have absolute, non-statutory immunity for any illegal acts that are "incident to" their regulatory activities. In this case, the court reasoned, the voting-rights changes were "incident to" FINRA's regulatory activities because they were part of a broader plan by FINRA to acquire assets from a competitor and to form a larger entity that would also have certain SRO responsibilities.

The Question Presented is:

Are SROs entitled to the absolute immunity given to government actors even for actions separate from the regulatory duties that shroud them in those quasi-governmental clothes for other purposes?

TABLE OF CONTENTS

Page

QUESTION PRESENTED FOR REVIEW i

TABLE OF CONTENTS ii

TABLE OF AUTHORITIES iii

INTEREST OF *AMICI CURIAE* 1

ARGUMENT 2

I. SROS MUST BE AMENABLE TO PRIVATE SUIT TO COUNTERACT THE POWER THEY HAVE BEEN DELEGATED. 3

A. Our Constitutional Framework Demands That All Entities Exercising Delegated Authority Be Held Accountable 4

B. SROs' Lack of Accountability has Created Significant Policy Failures. 9

II. ABSOLUTE IMMUNITY IS A DANGEROUS WITHDRAWAL OF ACCOUNTABILITY, AND THE SECOND CIRCUIT ERRED IN EXPANDING IT. 14

A. The Second Circuit Erred in Extending Absolute Immunity to the Conduct at Issue. 14

B. Absolute Immunity, Combined With SRO Structures, Makes Abuse of Power Almost Certain. 19

CONCLUSION 23

TABLE OF AUTHORITIES

Page(s)

Cases

A.L.A. Schecter Poultry Corp. v. United States,
295 U.S. 495 (1935) 5

Application of Beatrice J. Feins,
51 S.E.C. 918 (1993)...9

Barbara v. NYSE,
99 F.3d 49 (2d Cir. 1996) 18

Barr v. Mateo,
360 U.S. 564 (1959)...16

Burns v. Reed,
500 U.S. 478 (1991).......................................15, 19

Butz v. Economou,
438 U.S. 478 (1978).......................................16, 17

Carter v. Carter Coal Co.,
298 U.S. 238 (1936)... 5

Crowell v. Benson,
285 U.S. 22 (1932)... 5

Currin v. Wallace,
306 U.S. 1 (1939)... 5

D'Alessio v. NYSE,
258 F.3d 93 (2d Cir. 2001) 17

D.L. Capital Group v. Nasdaq Stock Market, Inc.,
409 F.3d 93 (2d Cir. 2005) 17, 22

Dr. Bonham's Case,
77 Eng. Rep. 646 (1610)....................................... 6

Edmond v. United States,
520 U.S. 651 (1997).. 2

Fed. Mar. Comm'n v. S.C. State Ports Auth.,
535 U.S. 743 (2002) 5

Forrester v. White,
484 U.S. 219 (1988) 15

Free Enterprise Fund v. Pub. Co. Acc'ting Oversight Bd.,
130 S. Ct. 3138 (2010) 1, 2, 7

Gravel v. United States,
408 U.S. 606 (1972) 16

Gregoire v. Biddle,
177 F.2d 579 (2d Cir. 1949) 14-15

Imbler v. Pachtman,
424 U.S. 409 (1976) 15-16

In re NYSE Specialists Sec. Litig.,
503 F.3d 89 (2d Cir. 2007) 17

Mireles v. Waco,
502 U.S. 9 (1991) 16

Richardson v. McKnight,
521 U.S. 399 (1997) 18

Standard Inv. Chartered v. Nat'l Ass'n of Sec. Dealers,
637 F.3d 112 (2d Cir. 2011) 17, 18

Sunshine Anthracite Coal Co. v. Adkins,
310 U.S. 381 (1940) 5

Van de Kamp v. Goldstein,
129 S. Ct. 855 (2009) 15

Weissman v. Nat'l Ass'n of Sec. Dealers,
500 F.3d 1293 (11th Cir. 2007) 17, 19

Wyatt v. Cole,
504 U.S. 158 (1992) 18

Constitutional Provisions

U.S. Const. art. I, § 1 4

U.S. Const. art. I, § 6 15

U.S. Const. art. II, § 1.. 4

U.S. Const. art. III, § 1 4

Other Authorities

About the Financial Industry Regulatory Authority, Fin. Indus. Regulatory Auth., (last visited Oct. 25, 2011), http://www.finra.org/AboutFINRA/ 20

Beshears, John, et al., *How Does Simplified Disclosure Affect Individuals' Mutual Fund Choices?*, Nat'l Bureau of Econ. Research, Working Paper No. 14859 (2009) 20

Barkow, Rachel, *Insulating Agencies*: *Avoiding Capture Through Institutional Design*, 89 Tex. L. Rev. 15 (2010) 10

Brown, Rebecca L, *Accountability, Liberty, and the Constitution*, 98 Colum. L. Rev. 531 (1998).. 2

Brian, Danielle, *POGO Letter to Congress Calling for Increased Oversight of Financial Self-Regulators,* Project on Government Oversight, *available at* http://www.pogo.org/pogo-files/letters/financial-oversight/er-fra-20100223-2.html.. 12

Cleveland, Steven J., *The NYSE as State Actor?: Rational Actors, Behavioral Insights & Joint Investigations,* 55 Am. U. L. Rev. 1 (2005) 7

Coffee, John C., Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have A Better Idea?,* 95 Va. L. Rev. 707 (2009)........................11

Craig, Susanne, *Finra's Susan Merrill to Exit as Enforcement Chief*, Wall St. J., Mar. 18, 2010, at A1..21

Dombalagian, Onnig H., *Self and Self-Regulation: Resolving the SRO Identity Crisis*, 1 Brook. J. Corp. Fin. & Com. L. 317 (2007) 8

Exchange Act Release No. 51252, 70 Fed. Reg. 10,442 (Feb. 25, 2005).. 9

FINRA, *Notice of Annual Meeting of FINRA Firms and Proxy* (2010), *available at* http://www.finra.org/notices/p121716.pdf..........22

FINRA, Special Review Comm., *Report of the 2009 Special Review Committee on FINRA's Examination Program in Light of the Stanford and Madoff Schemes* (2009), *available at* http://www.finra.org /web/corporate/p120078.pdf................................11

Fisch, Jill E., *The Overstated Promise of Corporate Governance*, 77 U. Chi. L. Rev. 923 (2010) 14

Fisch, Jill E., *Top Cop or Regulatory Flop? The SEC at 75,* 95 Va. L. Rev. 785 (2009)...........12, 13

Friedman, William I., *The Fourteenth Amendment's Public/Private Distinction Among Securities Regulators in the U.S. Marketplace-Revisited*, 23 Ann. Rev. Banking L. 727 (2004)..19, 20

Gadinis, Stavros, *Is Investor Protection the Top Priority of SEC Enforcement? Evidence From Actions Against Broker Dealers*, Harv. Olin Ctr. Discussion Series (2009), *available at* http://www.ssrn.com/abstract=1333717...... 10-11

Giannone, Joseph A., *Members Urge FINRA to Increase Disclosure*, Reuters, (Aug. 13, 2010), http://www.reuters.com/article/2010/08/13/finra-proposals-idUSN1321845820100813 21

Gross, Jill I. & Barbara Black, *Perceptions of Fairness in Securities Arbitration: An Empirical Study*, U. Cin. Pub. L. Research Papers (2008), *available at* http://ssrn.com/abstract=1090969 13

Hume, Lynn & Andrew Ackerman, *SEC, FINRA Probing ARS Sales: Misrepresentations of Risk Alleged, Bond Buyer*, Apr. 11, 2008, at 1...12

Jones, Ashby, *Susan Merrill Exiting Finra for Bingham Partnership*, Wall St. J., Apr. 12, 2010, at C3..10

Karmel, Roberta S., *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 Stan. J.L. Bus. & Fin. 151 (2009) 3, 7, 8, 20

Liebmann, George L., *Delegation to Private Parties in American Constitutional Law*, 50 Ind. L.J. 650 (1975) 5, 6

Marshaw, Jerry L., *Civil Liability of Government Officers: Property Rights and Official Accountability*, 42 Law & Contemp. Probs. 8 (1978) 2

Metzger, Gillian E., *Privatization as Delegation*, 103 Colum. L. Rev. 1367 (2003) 2, 4

Nafday, Rohit A., Comment, *From Sense to Nonsense and Back Again: SRO Immunity, Doctrinal Bait-and-Switch, and a Call for Coherence*, 77 U. Chi. L. Rev. 847 (2010) 17, 18, 22

Nagy, Donna M., *Playing Peekaboo With Constitutional Law: The PCAOB and its Public/Private Status,* 80 Notre Dame L. Rev. 975 (2005) 6

Oesterle, Dale Arthur, *Securities Market Regulation: Time to Move to a Market-Based Approach*, 374 Cato Inst. Policy Analysis (2000) 8

Preston, Darrell, *FINRA Oversees Auction-Rate Arbitrations After Exit*, Bloomberg, (Apr. 29, 2009), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=agMSn6dueL3I............. 12

Scalia, Antonin, *A Note on the Benzene Case*, 4 Regulation July-Aug. 1980 5-6

Seidenfeld, Mark, *Bending the Rules: Flexible Regulation and Constraints on Agency Discretion,* 51 Admin. L. Rev. 421 (1999) 10

Shapiro, Sidney A., *Outsourcing Government Regulation*, 53 Duke L.J. 389 (2003).................. 7

Stark, Bradley R. & Ronald W. Cornew, *Compulsory Arbitration: Its Impact On The Efficiency Of Markets*, 1754 PLI/Corp 399 (2009) 13, 14

Stigler, George J., *The Theory of Economic Regulation*, 2 Bell J. Mgmt & Econ. Sci. 3 (1971) 10

Sunstein, Cass R., *Nondelegation Canons*, 67 U. Chi. L. Rev. 315 (2000)... 6

Walsh, John H., *Regulatory Supervision by the Securities and Exchange Commission: Examinations in a Disclosure-Enforcement Agency*, 51 Admin. L. Rev. 1229 (1999).............20

INTEREST OF *AMICI CURIAE*[1]

The Cato Institute believes that sound public policy requires, as the Framers understood, a limited federal government composed of properly divided branches. Cato was established in 1977 as a nonpartisan public policy research foundation dedicated to advancing the principles of individual liberty, free markets, and limited government. Cato's Center for Constitutional Studies was established in 1989 to help restore the principles of limited constitutional government that are the foundation of liberty. Toward those ends, the Cato Institute publishes books and studies, conducts conferences, publishes the annual *Cato Supreme Court Review*, and files *amicus* briefs with the courts. This case is of central concern to Cato because it implicates the core constitutional structures that secure our liberty.

The Competitive Enterprise Institute is a nonprofit public interest organization dedicated to advancing the principles of individual liberty and limited government. CEI engages in research, education, and advocacy on a broad range of regulatory and legal issues, including constitutional and administrative law, and financial regulation. CEI attorneys served as co-counsel for the petitioners in the recent separation-of-powers case, *Free Enterprise Fund v. Pub. Co. Acc'ting Oversight Bd.*, 130 S. Ct. 3138 (2010).

[1] No party's counsel authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than *amici* or their counsel made a monetary contribution to fund its preparation or submission. Both parties were given timely notice of intent to file it and have provided written consent, on file with the clerk, to the filing of all *amicus* briefs.

ARGUMENT

This petition presents an opportunity for this Court to clarify the judiciary's role in enforcing accountability of its coequal branches. Although the public has long had the power to challenge abuses of government authority through private suit, *see generally* Jerry L. Marshaw, *Civil Liability of Government Officers: Property Rights and Official Accountability*, 42 Law & Contemp. Probs. 8 (1978), the Second Circuit's decision below threatens to curtail this check on government power.

Accountability within and among branches of government is a central tenet of our constitutional structure. The principle of accountability is inextricable from such foundational theories as separation of powers, checks and balances, and federalism, and has even been labeled the "sine qua non of legitimacy in government action." Rebecca L. Brown, *Accountability, Liberty, and the Constitution*, 98 Colum. L. Rev. 531, 532 (1998).

This Court has repeatedly stressed the need for political accountability whenever government power is exercised. *See*, *e.g.*, *Free Enterprise Fund v. Pub. Co. Acc'ting Bd.*, 130 S. Ct. 3138, 3155-57 (2010); *Edmond v. United States*, 520 U.S. 651, 660 (1997). But direct accountability to the public by way of the judiciary is no less important. *See* Gillian E. Metzger, *Privatization as Delegation*, 103 Colum. L. Rev. 1367, 1401-02 (2003); *see also infra* part IA(1). Now is the time for this Court to explicitly recognize the role of the judiciary in holding quasi-governmental bodies accountable.

I. SROS MUST BE AMENABLE TO PRIVATE SUIT TO COUNTERACT THE POWER THEY HAVE BEEN DELEGATED.

Self-regulatory organizations reside within the same space in our constitutional framework that agencies and other regulatory bodies occupy. *See* Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 Stan. J.L. Bus. & Fin. 151, 196-97 (2009) (concluding that SROs should be treated as agencies despite remaining somewhat private). The SRO in question here, the Financial Industry Regulatory Authority,[2] is not accountable to the executive and, after the decision below, is no longer accountable to the public through private suit. Not only are groups like FINRA acquiring expansive power through their own private dealings, but judicial and executive decisions have vested tremendous power in these entities while simultaneously stripping away key oversight structures.

Two arguments cut in favor of reversing the decision of the Second Circuit because of its effect on SRO accountability. First, the Constitution demands checks on delegated power. Second, absolute immunity itself is a serious abdication of oversight and is not appropriate in this case.

---

[2] Throughout this brief, the National Association of Securities Dealers will be referred to by its current and more common name, the Financial Industry Regulatory Authority.

A. Our Constitutional Framework Demands That All Entities Exercising Delegated Authority Be Held Accountable.

Three characteristics of our constitutional framework require judicial oversight of SROs: (1) core principles of the non-delegation doctrine, (2) the nature of SROs as quasi-private actors, and (3) the executive branch's demonstrated lack of oversight.

1. Principles of non-delegation advise against delegating wide swaths of power without accompanying oversight or accountability.

The non-delegation doctrine cautions against expanding the scope of SRO immunity. Although the delegation of significant legislative and executive functions to agencies and SROs is a well-established practice, courts have retained a key role in overseeing agencies and policing abuses of authority. Metzger, *supra*, at 1401-02 ("A defining characteristic of the U.S. constitutional order is the authority it gives to judges to enforce constitutional constraints against other government officials at the instance of private individuals claiming injury from unconstitutional action.").[3]

Even more than in delegation to public agencies, delegation of power to private actors should be construed narrowly and reviewed with an eye toward ensuring that exercises of regulatory authority remain rooted in the enumerated powers of the Constitution. As long ago as 1936, this Court has

[3] The non-delegation doctrine emerged from the Constitution's three vesting clauses. U.S. Const. art. I, § 1 (legislative); U.S. Const. art. II, § 1 (executive); U.S. Const. art. III, § 1 (judicial).

recognized the uneasy alliance created between public and private actors when private parties receive grants of legislative authority. *See Carter v. Carter Coal Co.*, 298 U.S. 238, 311 (1936). In *Carter Coal*, this Court famously declared that delegating power to one group of citizens for rule over another was "legislative delegation in its most obnoxious form." *Id.* Despite its strong opposition to delegation, this Court quickly retreated from that categorical position in favor of a flexible standard that is familiar to agencies today. *See, e.g.*, *Sunshine Anthracite Coal Co. v. Adkins*, 310 U.S. 381 (1940); *Currin v. Wallace*, 306 U.S. 1 (1939).[4]

The move away from the categorical position laid out in *Carter Coal* occurred simultaneously with the rise of new limitations on the delegation of authority to agencies. In fact, the decline of the non-delegation doctrine occurred precisely "*because* the Court established certain safeguards surrounding the [delegation] of these powers." *Fed. Mar. Comm'n v. S.C. State Ports Auth.*, 535 U.S. 743, 773 (2002) (Breyer, J., dissenting) (citing *A.L.A. Schecter Poultry Corp. v. United States*, 295 U.S. 495 (1935) and *Crowell v. Benson*, 285 U.S. 22 (1932)) (emphasis added). Simply put, as the non-delegation doctrine weakened, safeguards against administrative abuses became proportionally more substantive.[5]

---

[4] For a review of early non-delegation doctrine cases, see George L. Liebmann, *Delegation to Private Parties in American Constitutional Law*, 50 Ind. L.J. 650, 662-67 (1975) (analyzing cases in the 1930s and early 1940s).

[5] While the categorical approach to the non-delegation doctrine has largely been superseded, its spirit continues to affect our understanding of administrative law. *See* Antonin Scalia, *A Note on the Benzene Case*, 4 Regulation, July-Aug. 1980, at 28

One of those safeguards is judicial review. A grant of quasi-legislative power to agencies, or even entirely private organizations, is made more legitimate where judicial review is also available to serve as a check on the use of that authority.[6] The judicial review requirement is not absolute, however; in many cases, such as where appropriations or taxation are involved, the "operative political checks are sufficient." George L. Liebmann, *Delegation to Private Parties in American Constitutional Law*, 50 Ind. L.J. 650, 715 (1975). In the absence of political checks, or where political checks are so weak as to be functionally meaningless, judicial review and legal liability are necessary to ensure proper oversight.

Judicial review of agency behavior is an important mechanism for ensuring legal accountability. *See* Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and its Public/Private Status*, 80 Notre Dame L. Rev. 975, 1062 (2005) (noting the importance of judicial review for accountability in the administrative state). Constitutional accountability typically stems from either of two sources: political accountability or legal accountability. Metzger, *supra*, at 1401-02.

("So even with all its Frankenstein-like warts, knobs, and (concededly) dangers, the unconstitutional delegation doctrine is worth hewing from the ice.") *Id.* ("In truth, of course, no one has ever thought the unconstitutional delegation doctrine did not *exist* as a principle in our government."); *see also* Cass R. Sunstein, *Nondelegation Canons*, 67 U. Chi. L. Rev. 315 (2000) (noting that the principles of the delegation doctrine are still widely applied, albeit in several different forms).

[6] Notably, one of the first instances of judicial review, *Dr. Bonham's Case*, 77 Eng. Rep. 646 (1610), entails review of a private board that was delegated licensing authority. *See* Liebmann, *supra*, at 700.

Here, political accountability is *de minimis* due to the layers of authority separating FINRA from executive branch officers. *See Free Enterprise Fund* 130 S. Ct. *at* 3154 ("Without the ability to oversee the [agency], or to attribute the [agency's] failings to those whom he *can* oversee, the President is no longer the judge of the [agency's] conduct."). Unfortunately, legal accountability—judicial review—has also eroded, leaving FINRA and similarly situated SROs almost entirely unaccountable.

2. SROs continue to operate as private organizations and face the same pressures as other private actors.

The second reason SROs require judicial oversight is because of their largely private status. SROs, and especially those in the financial sector, typically maintain the ethos of a private actor. *See* Steven J. Cleveland, *The NYSE as State Actor?: Rational Actors, Behavioral Insights & Joint Investigations,* 55 Am. U. L. Rev. 1 (2005) (concluding that SROs are generally not governmental actors based on their incentive structure and decisionmaking processes); Sidney A. Shapiro, *Outsourcing Government Regulation*, 53 Duke L.J. 389 (2003) (applying tools of economic analysis to explain decisionmaking of private regulators).

The history of both the New York Stock Exchange and the NASD suggests that both component parts of FINRA have evolved as largely private organizations. *See* Karmel, *supra*, at 159-70 (describing the history of both organizations from 1792 through the formation of FINRA). The NYSE

formed in 1792 in reaction to a scandal in the government bond market and the NASD, FINRA's predecessor, formed in 1936 as the reorganization of a trade group. *Id.*; *see also* Dale Arthur Oesterle, *Securities Market Regulation: Time to Move to a Market-Based Approach*, 374 Cato Inst. Policy Analysis, at 3 (2000), *available at* http://www.cato.or g/pubs/pas/pa374.pdf. Even today, despite their role as front-line regulators, many are "looking for ways to shed their self-regulatory responsibilities and join the ranks of their erstwhile members as for-profit competitors." Onnig H. Dombalagian, *Self and Self-Regulation: Resolving the SRO Identity Crisis*, 1 Brook. J. Corp. Fin. & Com. L. 317, 317 (2007); *see also id.* at 331-35 (explaining how the self-interest of SROs and their officials is pushing those organizations into an increasingly for-profit model). The pressure on many SROs to dabble in both public and private activities is certainly understandable, but courts and the public should not be blind to these forces. *See* Oesterle, *supra*, at 5 ("The SRO regime does not comport with common sense about basic human incentives in economic markets."). More importantly, however, courts and the public should not conflate SROs' private and public activities as the Second Circuit did here.

3. Executive oversight has been largely non-existent.

Finally, the lack of executive oversight militates for judicial review of FINRA's behavior. As oversight from the highest levels of the executive branch is nearly impossible due to the layered hierarchy of the executive branch, only other agencies and the courts are available to provide meaningful oversight of

FINRA. Although formal oversight procedures may exist, executive agencies cannot be relied upon to police these powerful organizations.

In the present case, for example, the SEC declined to rule on the fraud claim brought by petitioners, noting that a decision on the merits of the state law claim was for the courts. *See* Petition for Certiorari at 14-15. Furthermore, deferment of key questions of law is far from unusual: the SEC routinely defers to courts for the substance of state law claims. *See, e.g.*, *Application of Beatrice J. Feins*, 51 S.E.C. 918, 922 n.14 (1993) ("We do not reach Ms. Feins' claim [for] . . . violations of the federal Age Discrimination Act of 1975 . . . and New York State's Human Rights Law [because] [a]dministration and interpretation of these statutes are outside our jurisdiction, and redress, if any, under these statutes must be pursued in other forums."); Petition for Certiorari at 8 (citing Exchange Act Release No. 51252, 70 Fed. Reg. 10,442, 10,444 (Feb. 25, 2005)). The SEC's functional abandonment of its oversight authority should give courts pause when determining whether to also relinquish their oversight powers.

B. SROs' Lack of Accountability Has Created Significant Policy Failures.

Checks and balances created by the separation of powers are designed to prevent abuses of power. FINRA's extra-constitutional operation has fostered significant policy failures including agency capture, lax regulation, and biased arbitration.

1. Lack of accountability has led to agency capture.

Although FINRA is a quasi-private organization, the principle of "agency capture" still plagues its operations. *See generally* Rachel Barkow, *Insulating Agencies*: *Avoiding Capture Through Institutional Design*, 89 Tex. L. Rev. 15 (2010); George J. Stigler, *The Theory of Economic Regulation*, 2 Bell J. Mgmt & Econ. Sci. 3 (1971). Courts should not extend absolute immunity to SROs any time they act "incident to" their regulatory authority, because those organizations are already exempt from traditional tools for monitoring agencies.[7]

FINRA exhibits one of the telltale signs of capture: a persistent revolving door among its senior leadership. *See, e.g.*, Barkow, *supra*, at 23. Many FINRA executives arrive from large financial firms and return as company executives or counsel when they depart. *See, e.g.*, Ashby Jones, *Susan Merrill Exiting Finra for Bingham Partnership*, Wall St. J., Apr. 12, 2010, at C3. This routine practice is symptomatic of favoritism toward large companies, as executives strive to retain or earn favor with past and future employers. Recent research on the SEC suggests, even with its increased levels of accountability, the revolving door principle influences disciplinary proceedings in favor of large institutions. Stavros Gadinis, *Is Investor Protection the Top Priority of SEC Enforcement? Evidence From*

---

[7] FINRA is exempt from many of the most common mechanisms of preventing capture. *See* Mark Seidenfeld, *Bending the Rules: Flexible Regulation and Constraints on Agency Discretion,* 51 Admin. L. Rev. 421, 429 (1999); *see also* Barkow, *supra*, at 26-41 (identifying "traditional lodestars of independence").

Actions Against Broker Dealers, Harv. Olin Ctr. Discussion Series (2009), *available at* http://www.ssrn.com/abstract=1333717.

2. Lack of accountability has resulted in relaxed regulation.

The proliferation of substantial financial industry scandals over the past decade is evidence that FINRA is, at best, a hands-off regulator and, at worst, a corrupt and self-serving company. *See* John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have A Better Idea?,* 95 Va. L. Rev. 707, 760 (2009).

The cases of Bernard Madoff and Stanford Financial provide evidence of this lax enforcement; in-house reports addressed FINRA's responsibilities in each. *See* FINRA, Special Review Comm., *Report of the 2009 Special Review Committee on FINRA's Examination Program in Light of the Stanford and Madoff Schemes*, *available at* http://www.finra.org/web/corporate/p120078.pdf. While FINRA conveniently concluded that the Madoff Ponzi scheme fell outside its jurisdiction, it made recommendations to expand and clearly define its jurisdiction to prevent such incidents in the future. *Id.* at 64, 71-75. Further evaluation of the Stanford CD scheme, however, revealed that FINRA missed key points of factual analysis and communication that would have unearthed fraud earlier and prevented substantial losses. *Id.* at 3.

Another gross failure of regulation is apparent from the auction-rate securities breakdown of 2008. Several major banks misrepresented auction-rate securities to customers as liquid assets without

disclosing the risks involved. Jill E. Fisch, *Top Cop or Regulatory Flop? The SEC at 75,* 95 Va. L. Rev. 785, 801-02 (2009). When the market demand dropped significantly, many investors were unable to sell their ARSs. FINRA has been criticized for failing to prevent or at least soften this collapse. Danielle Brian, *POGO Letter to Congress Calling for Increased Oversight of Financial Self-Regulators,* Project on Government Oversight, *available at* http://www.pogo.org/pogo-files/letters/financial-oversight/er-fra-20100223-2.html; *see also* Fisch, *Top Cop*, *supra*, at 801.

FINRA turned a blind eye to the questionable advertising practices of these banks, despite its knowledge of the potential pitfalls of ARSs. Fisch, *Top Cop*, *supra*, at 801-02. During the years immediately preceding the collapse, FINRA acquired a substantial amount of ARSs. Darrell Preston, *FINRA Oversees Auction-Rate Arbitrations After Exit*, Bloomberg, (Apr. 29, 2009), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=agMSn6dueL3I. By July of 2006, FINRA held over $860 million in ARS investments. *Id.* FINRA referred to its ARSs explicitly as non-cash assets on its annual reports for the duration of holding, exhibiting its understanding of the non-liquid nature of ARSs. *Id.* FINRA divested itself of all ARS investments in 2007 without any warning to consumers. Brian, *supra*. Furthermore, when the ARS market froze, FINRA lagged behind the Attorney General of New York in investigating and recovering the lost investments. Fisch, *Top Cop*, *supra*, at 801-02 (citing Lynn Hume & Andrew Ackerman, *SEC, FINRA Probing ARS Sales: Misrepresentations of Risk Alleged, Bond Buyer*, Apr. 11, 2008, at 1). Whether these lapses were derivative

of negligence or corruption is not a matter for resolution here. It is apparent, however, that FINRA failed in its goal of protecting investors.

3. Lack of accountability has led to biased arbitration.

FINRA arbitration stands as the sole means for resolving broker-customer disputes within the FINRA community. These disputes often include matters of misrepresentation and fraud, matters historically reviewable in criminal or civil court. Despite heavy criticism, the process remains less than transparent. Fisch, *Top Cop*, *supra*, at 802-03.

FINRA's mandatory arbitration has shown itself biased in favor of the industry as well as inefficient for individual disputes and market stability. Jill I. Gross & Barbara Black, *Perceptions of Fairness in Securities Arbitration: An Empirical Study*, U. Cin. Pub. L. Research Papers (2008), *available at* http://ssrn.com/abstract=1090969; *see also* Bradley R. Stark & Ronald W. Cornew, *Compulsory Arbitration: Its Impact On The Efficiency Of Markets*, 1754 PLI/Corp 399, 406-07 (2009). A recent study in fairness of the arbitration process shows that a majority of small members recently involved in FINRA arbitration feel that the process is biased to the large industry groups. Gross, *supra.*

Biased mandatory arbitration can have a crippling effect on the overall efficiency of the market. The present arbitration structure favors leniency in adjudication for sizable members of FINRA, thereby creating a vacuum where fraud and meltdown flourish. Stark, *supra*, at 407. The opportunity for small players to bring complaints in

civil litigation would serve as a litmus test for the health of the market and a check to prevent future meltdown. *Id.* Indeed, scholars have suggested that the general absence of private litigation was a contributing factor in the 2008 market crash. *See, e.g.*, Jill E. Fisch, *The Overstated Promise of Corporate Governance*, 77 U. Chi. L. Rev. 923, 937-38, 957 (2010). Decreasing arbitrary barriers to litigation would make fraud and insider trading more costly, thus deterring corruption from the outset.

II. ABSOLUTE IMMUNITY IS A DANGEROUS WITHDRAWAL OF ACCOUNTABILITY, AND THE SECOND CIRCUIT ERRED IN EXPANDING IT.

The Second Circuit expanded the circumstances under which absolute immunity applies to include actions merely "incident to" a SRO's regulatory function. This expansion is unjustifiable in light of the historic justification for extensions of absolute immunity: namely, that without absolute immunity an organization would be unable to serve a vital social purpose.

A. The Second Circuit Erred in Extending Absolute Immunity to the Conduct at Issue.

Individuals occupying a handful of public offices wield such sensitive power that courts must balance the evils associated with impunity against the harms that spring from administrative paralysis. *See Gregoire v. Biddle,* 177 F.2d 579, 581 (2d Cir. 1949), *cert. denied*, 339 U.S. 949 (1950) (Whether to grant

absolute immunity requires a "balance" of "evils" between encouraging impunity and "dampen[ing] the ardor of all but the most resolute, or the most irresponsible, in the unflinching discharge of their duties."); *Imbler v. Pachtman*, 424 U.S. 409, 427-28 (1976) (Absolute immunity should be granted to prosecutors only because to withhold it would "prevent the vigorous and fearless performance of a prosecutor's duty that is essential to the proper functioning of the criminal justice system."). But an invitation to impunity is always an evil. Absolute immunity therefore should never extend "further than its purposes require." *Forrester v. White*, 484 U.S. 219, 224 (1988). Yet the Second Circuit's ruling here extends immunity far beyond what the circumstances require.

1. Grants of absolute immunity apply only to narrow circumstances that follow functional considerations.

This Court has recognized that grants of absolute immunity are to be construed according to the functional considerations that give rise to them. *See Van de Kamp v. Goldstein*, 129 S. Ct. 855, 861 (2009); *Burns v. Reed*, 500 U.S. 478, 486 (1991) (collecting cases). Even in cases where functional considerations dictate that the range of action covered by the immunity be broad, the circumstances of the immunity's applicability are narrow. Absolute immunity from civil suit applies to members of Congress through the Speech and Debate clause of the Constitution, *see* U.S. Const. art. I, § 6, cl. 1, to judges and prosecutors because the exercise of their offices demands it, *see Imbler*, 424 U.S. at 422-23, and to administrative agencies because they are

functionally similar to judges and prosecutors when acting in their adjudicative capacity, *see Butz v. Economou*, 438 U.S. 478, 511-12 (1978).

For all, absolute immunity applies only when they are acting under circumstances that necessitate their protection. *See Gravel v. United States*, 408 U.S. 606, 626 (1972) (Absolute immunity applies only to actions by members of Congress that are "part and parcel of the legislative process."); *see also Mireles v. Waco*, 502 U.S. 9, 11 (1991) (". . . [A] judge is not immune from liability for nonjudicial actions, *i.e.*, actions not taken in the judge's judicial capacity."); *Imbler*, 424 U.S. at 430 (Prosecutors only possess absolute immunity for actions "intimately associated with the judicial phase of the . . . process."); *cf. id.* (If administrative agencies receive immunity for the same reasons as judges and prosecutors, those agencies should only receive immunity in like circumstances.).

Administrative agencies are granted absolute immunity because their capacity as quasi-judicial officers makes them functionally comparable to judges and prosecutors and therefore likely to suffer the same pressures. *See Butz*, 438 U.S. at 511-12. Consequently, an administrative agency's immunity as a quasi-judicial officer is coterminous with that of judges and prosecutors. Actions not "intimately associated with the judicial phase of the . . . process," *Imbler*, 424 U.S. at 430, should not fall under the immunity's protection.[8]

---

[8] Instead of applying sovereign immunity principles relating to FINRA's role as an executive-branch entity, *see Barr v. Mateo*, 360 U.S. 564, 573 (1959), the Second Circuit awarded FINRA an absolute immunity stemming from its regulatory—and thus

2. Absolute immunity should not be granted for actions solely incident to an SRO's regulatory power.

When courts have found that SROs require absolute immunity, they have done so in the belief that SROs' function as a regulatory enforcer requires that it be given immunities of the same sort given to fully-governmental regulatory organizations under the Exchange Act. *See*, *e.g.*, *D'Alessio v. NYSE*, 258 F.3d 93, 105 (2d Cir. 2001) ("The NYSE, as a SRO, stands in the shoes of the SEC in interpreting the securities laws for its members and in monitoring compliance with those laws. It follows that the NYSE should be entitled to the same immunity enjoyed by the SEC when it is performing functions delegated to it under the SEC's broad oversight authority."); *see also In re NYSE Specialists Sec. Litig.*, 503 F.3d 89, 96 (2d Cir. 2007); *D.L. Capital Group v. Nasdaq Stock Market, Inc.*, 409 F.3d 93, 95 (2d Cir. 2005); *see generally* Rohit A. Nafday, *Comment, From Sense to Nonsense and Back Again: SRO Immunity, Doctrinal Bait-and-Switch, and a Call for Coherence*, 77 U. Chi. L. Rev. 847, 858-59. (2010). But administrative agencies have absolute immunity to shield them from paralyzing retaliation by targeted parties. *See Butz*, 438 U.S. at 511-12. By this logic, an SRO's immunity should extend no further than the limit necessary to shield it from retaliation for the exercise of its delegated regulatory functions. *See Weissman v. Nat'l Ass'n of Sec. Dealers*, 500 F.3d 1293, 1297 (11th Cir. 2007).

---

adjudicatory—power. *See Standard Inv. Chartered v. Nat'l Assn. of Sec. Dealers*, 637 F.3d 112, 116 (2d Cir. 2011). As such, the animating principles which govern extensions of immunity to judges and prosecutors should rule here, too.

Nevertheless, the Second Circuit has, over the last 15 years, shifted the immunity granted to SROs from that which administrative agencies have because they act like judges and prosecutors to sovereign immunity granted to administrative agencies as part of the government. *See*, *e.g.*, *Barbara v. NYSE,* 99 F.3d 49, 59 (2d Cir. 1996); Nafday, *supra*, at 847. (The Second Circuit's approach creates an immunity chimera with the privileges of both absolute and sovereign immunities but the justifications of neither. *Id.* at 862-68.

Moreover, private actors' immunity is more narrow than it would be for government officials exercising the same authority. *See Richardson v. McKnight*, 521 U.S. 399, 412 (1997) (noting that "*Wyatt* [*v. Cole*, 504 U.S. 158 (1992)] makes clear that private actors are not *automatically* immune (i.e., § 1983 immunity does not automatically follow § 1983 liability)." Whatever immunity remains for private actors is exceptionally narrow.

But here again, in this case, the Second Circuit has greatly widened the ambit of shielded action. According to the Second Circuit, an SRO may act with impunity in all actions only "incident to" regulation. *See Standard Inv. Chartered, Inc. v. Nat'l Assn. of Sec. Dealers*, 637 F.3d 112, 116 (2d Cir. 2011). This would be the equivalent of shielding a judge who ran down a pedestrian on his way to the courthouse simply because his travel there eventually will lead to his exercising judicial power. Such a finding would plainly contradict the purpose behind the absolute immunity judges enjoy. Surely a self-regulatory organization, run for-profit by a private board, does not have a broader immunity when it commits fraud in circumstances only

tangentially related to its regulatory power than would a judge who acts in his non-judicial capacity as a private person. The standard must be higher.[9]

In fact, the standard is higher, but only in the Eleventh Circuit. Likening SROs to municipal corporations, that court found in *Weissman* that SROs only enjoy absolute immunity from claims involving conduct that "constitutes a delegated quasi-governmental prosecutorial, regulatory, or disciplinary function." 500 F.3d at 1297. Actions whose "objective nature and function" are not prosecutorial, regulatory, or disciplinary are not covered by the immunity. *Id.* This understanding is much more compatible with the Court's precedent on when immunity should apply.

B. Absolute Immunity, Combined With SRO Structures, Makes Abuse of Power Almost Certain.

SROs are no longer the private, opt-in clubs that once regulated the markets before the Great Depression. *See* William I. Friedman, *The Fourteenth Amendment's Public/Private Distinction Among Securities Regulators in the U.S. Marketplace-Revisited*, 23 Ann. Rev. Banking L. 727, 730 (2004). SROs' power has grown beyond merely regulating market participants and, in some cases, has gone so

[9] The Second Circuit's logic is identical to that which was rejected by this Court in *Burns*, 500 U.S. at 495. There, the United States argued in an *amicus* brief that a prosecutor was shielded from suit because his actions were "in some way related to the ultimate decision whether to prosecute," and thus to the judicial process. *Id.* The Court rejected this reasoning, holding that a prosecutor's actions are absolutely immune only if they are "closely associated with the judicial process." *Id.*

far as to circumvent the due process of criminal proceedings—this despite congressional action in the 1970s to curb SROs' power and increase oversight. *Id.*; *see also* Karmel, *supra*, at 152.

SROs such as FINRA have also used their financial largess to influence the regulations that govern them and their members. *Id.* at 160. Modern SROs donate huge sums of money to interest groups and educational funds with an eye towards influencing the policy that governs them. For example, FINRA has donated over $63 million to "education and protection initiatives through a combination of grants and targeted projects." *About the Financial Industry Regulatory Authority*, FINRA, (last visited Oct. 24, 2011), http://www.finra.org/AboutFINRA/. FINRA also takes advantage of the broad interpretation of its immunity powers by claiming that a wide variety of behavior falls within its regulatory authority. For example, it claims that education is the "best form of investor protection," *id.*, in order to bring donations to education funds under its regulatory umbrella. *See* John Beshears, et al., *How Does Simplified Disclosure Affect Individuals' Mutual Fund Choices?*, Nat'l Bureau of Econ. Research, Working Paper No. 14859 (2009).

As a private organization, FINRA's transparency is, in essence, voluntary. FINRA is not subject to the Freedom of Information Act and publishes records in keeping with the practice of private companies. *See* John H. Walsh, *Regulatory Supervision by the Securities and Exchange Commission: Examinations in a Disclosure-Enforcement Agency*, 51 Admin. L. Rev. 1229, 1241-43 (1999) (noting that financial regulators are typically exempt from disclosure requirements that apply to most agencies). FINRA

has certainly not volunteered much of the information members and investors have requested. Joseph A. Giannone, *Members Urge FINRA to Increase Disclosure*, Reuters, (Aug. 13, 2010), http://www.reuters.com/article/2010/08/13/finra-proposals-idUSN1321845820100813. The decision below makes it increasingly difficult to obtain any documents from SROs like FINRA.

As a result of FINRA's lack of transparency, many of its investments cannot be scrutinized. Any conflicts of interest between FINRA and the groups it oversees are invisible to all but FINRA itself because of its special status as a quasi-governmental entity. *See* Walsh, *supra*. These interests remain undisclosed to the public despite FINRA's growing position as a regulator and its infamous revolving door.

FINRA's off-the-record, non-regulatory activities are disconcerting, but equally alarming is the group of individuals within FINRA who are given the responsibility of making non-regulatory decisions. FINRA executives are hand-picked by the brokerage industry to regulate and have historically short regulating careers before returning to the very market they were hired to enforce standards upon. *E.g.*, Susanne Craig, *Finra's Susan Merrill to Exit as Enforcement Chief*, Wall St. J., Mar. 18, 2010, at A1 ("The executive hired by Wall Street to enforce its rules is stepping down after nearly three years in which the organization's disciplinary actions and fines against the brokerage industry have declined."). SROs' very structures thus create incentives for abuses of immunity—abuses that extend beyond the actions of individual executives.

Indeed, SROs regulating the brokerage market have claimed absolute immunity for allegations as egregious as outright fraud. *See D.L. Capital Group*, 409 F.3d at 96. Immunity is granted to other "regulating" bodies such as judges and prosecutors to allow them to better fulfill their duties as a matter of public policy. *See supra* part IIA(1). But those government entities are not immune from scrutiny in that they are bound by checks such as more stringent transparency standards that SROs' status as private corporations allow them to avoid. Fin. Indus. Regulatory Auth., *Notice of Annual Meeting of FINRA Firms and Proxy* (2010), *available at* http://www.finra.org/notices/p121716.pdf. FINRA reasons that transparency would "hinder the ability of the FINRA board to engage in a candid discourse." *Id.* However, transparency has not been found to be a hindrance to the government agencies that operate under public scrutiny. Rather, the combination of absolute immunity and an unwillingness to disclose create an inappropriate shield from public accountability.

In short, immunity is inappropriate for SROs, which are already alleviated of their responsibility to the public. Nafday, *supra*, at 885. The lack of transparency and blatant non-regulatory interests of SROs as they currently exist is unprecedented when compared with other regulatory bodies that enjoy immunity. *Id.* Granting immunity to SROs without requiring transparency allows FINRA to abuse that very immunity by denying the right to legitimate litigation at its executives' discretion.

CONCLUSION

The Constitution requires that the judicial branch, through private suit, review the actions of independent agencies. In this case, judicial review is especially important because the agencies in question have great incentive to act in their own interests as private corporations. Their quasi-private status also allows them to benefit from lax transparency standards.

The independent agencies are also largely shielded from executive control; the SEC has failed to properly exercise its role in checking SRO power. All these structural problems make clear that judicial review is the essential remaining check. Because the Second Circuit erred in refusing to check FINRA's power, the petition should be granted.

Respectfully submitted,

DAVID J. BEDERMAN
Counsel of Record
Emory Law School Supreme Court Advocacy Project
1301 Clifton Road
Atlanta, GA 30321
(404) 727-6822
lawdjb@emory.edu

ILYA SHAPIRO
Cato Institute
1000 Mass. Avenue, N.W.
Washington, D.C. 20001
(202) 842-0200

HANS BADER
SAM KAZMAN
Comp. Enterprise Institute
1899 L St., N.W., 12th Floor
Washington, D.C. 20036
(202) 331-2278

October 26, 2011