

SECURITIES LITIGATION AND ENFORCEMENT

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'A Question of Fairness'

COUNSEL FOR witnesses in securities law investigations by self-regulatory organizations (SROs) such as the NYSE and NASD can sometimes face a dilemma. When the facts are not entirely clear and it may not be in the best interest of the witness to give evidence against himself, a notice to appear for an "on the record" interview presents a troubling choice: waive the Fifth Amendment privilege against self-incrimination or be barred from the industry.

If the invitation had come from the SEC or a grand jury, the Fifth Amendment privilege would be available without jeopardy to the immediate ability to earn a living. Of course, an assertion of the privilege may pose a problem with the individual's employer and may invite an adverse inference in any subsequent civil litigation. In the SRO investigation, however, the assertion of a Fifth Amendment privilege and declination to answer will invite a disciplinary sanction.¹

This situation has generated constitutional challenges with the argument that the SROs conducting enforcement investigations are "state actors" and compelled interrogation "triggers" the privilege against self-incrimination. These challenges have been largely unsuccessful because the SROs have been able to rely on a line of cases that has refused to recognize the Fifth Amendment right in SRO disciplinary proceedings. But some courts have recognized that SROs also perform a governmental role in enforcing the federal securities laws, and in those situations, there is a good argument to be made that federal rights should be recognized.

The Fifth Amendment

The Fifth Amendment to the United States Constitution, provides in relevant part:

No person shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law. ...

Generally, the Fifth Amendment affects the conduct of state actors or private entities whose conduct is fairly attributable to the state.² Recently, in *Brentwood Academy v. Tennessee Secondary School Athletic Association*,³ the Supreme Court explained that private conduct may constitute state action where: (i) the state has exercised its "coercive power" on a private actor, or provided "significant encouragement, either overt or covert," to a private actor; (ii) the private actor "has been delegated a public function of the State"; (iii) the private actor is controlled by an "agency of the State"; or (iv) when the private actor "is entwined with governmental policies or when government is entwined in [the private actor's] management or control."

SROs, Due Process Requirements

The threshold questions for us are whether and, if so, when can an SRO be said to be performing a state function such as to be considered a "state actor"; and under what cir-



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cumstances can its actions be so "coercive" as to violate the Fifth Amendment. The Supreme Court decision in *Silver v. NYSE*⁴ set the stage for imposing the Fifth Amendment's Due Process requirements on SRO enforcement proceedings. There, the Court held that the NYSE's conduct toward a nonmember, though arguably exempt for the antitrust laws if performed as part of its role in the scheme of securities regulation, was not a justified self-regulatory act because the nonmember was "not informed of the [NYSE's] decision" to direct its members to remove direct wire communication to the nonmember and "was not afforded an opportunity to explain and refute the charges" against him. The majority's decision in *Silver* fails to make any specific reference to the Fifth Amendment or due process, but can be read as imposing the requirements of due process on the NYSE.

Leading Case

Subsequent court decisions have so recognized. The leading case on point is *Intercontinental Industries, Inc. v. AMEX*.⁵ There, Intercontinental asked the Fifth Circuit to review an order of the SEC that upheld the Amex's delisting of Intercontinental's stock without the benefit of a hearing. Although the actions of the Amex were sustained, the Court recognized its duty to evaluate Amex actions in the context of the Amex's role as a governmental actor and the necessity to adhere to fundamental standards of fair play. The Fifth Circuit stated that the "intimate involvement of the [Amex] with the [SEC] brings it within the purview of the Fifth Amendment controls over governmental due process" and identified several factors as evidence of "intimate involvement," including the fact that the Amex was required to register with the SEC, that the SEC could suspend or withdraw that registration, that the Amex's rules must be submitted to the SEC for approval and are subject to SEC revision and supplementation, that the Amex's members are themselves regulated by the SEC and that the Amex cannot delist a security without SEC approval.⁶ The "intimate involvement" described in *Intercontinental* also was recognized in two SDNY cases. In *Crimmins v. AMEX*,⁷ the court referred to the Fifth Circuit's decision in *Intercontinental* and observed:

... the day is long gone when a national stock exchange can be considered a private club when it conducts disciplinary proceedings against its members or their employees. When an exchange conducts such proceedings under the self-regulatory power conferred upon in by the [Exchange Act], it is engaged in governmental action, federal in character, and the Act imposed upon it the requirement that it comply with fundamental standards of fair play.

The court went on to find that while the Fifth Amendment's due process requirements applied, those requirements did not include — at least in that case — affording the respondent in an Amex enforcement proceeding a right to be represented by counsel. And in *Villani v. NYSE*,⁸ the court accepted that it was "beyond dispute" that the Fifth Amendment's due process requirements applied to a NYSE enforcement proceeding and found that the respondents were entitled to inspect documents in the NYSE's possession. On

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reconsideration, the court reversed itself and held that due process requirements did *not* require that the respondents be permitted to inspect the NYSE's documents, a holding later affirmed by the Second Circuit in *Sloan v. NYSE*.⁹

Self-Incrimination

SROs and the Privilege Against Self-Incrimination. Thus, while it may be "beyond dispute" that the Fifth Amendment due process requirements apply to SRO enforcement proceedings, just what process is due is not entirely clear. What about the Fifth Amendment privilege against self-incrimination? The Fifth Amendment guarantees against state infringement of "the right of a person to remain silent unless he chooses to speak in the unfettered exercise of his own free will, and to suffer no penalty for such silence."¹⁰ The Supreme Court has held that, under certain circumstances, the Constitution prohibits statutes and rules that penalize persons for asserting their Fifth Amendment privilege.¹¹ That prohibition exists when two components are present: (i) there must be coercion — some palpable force or threat that makes assertion of the privilege "costly"; and (ii) the coercion must be by or fairly attributable to the State.

The Supreme Court case of *Garrity v. New Jersey*¹² is a classic example of unconstitutional "statutory coercion" by the State. *Garrity* involved New Jersey police officers convicted of fixing traffic tickets.¹³ The officers sought to have their convictions overturned on the ground that statements made to the prosecutors during the investigation were coerced, because if they refused to answer, they would have lost their jobs. The Court agreed, finding that "the option to lose their means of livelihood or to pay the penalty of self-incrimination is the antithesis of free choice to speak out or remain silent ... the statements were infected by the coercion inherent in this scheme of questioning and cannot be sustained as voluntary under our prior decisions."

In the SRO context, the leading case is *United States v. Solomon*.¹⁴ There, the defendant, Solomon, had been summoned to testify in a NYSE investigation concerning "bookkeeping inadequacies" that violated the NYSE's rules and the federal securities laws and made self-incriminating statements before the NYSE. Subsequently, those statements were presented to a grand jury and, ultimately, at Mr. Solomon's trial.¹⁵ Subsequently, Mr. Solomon sought to have his conviction overturned on the ground that the statements were extracted in

violation of his Fifth Amendment privilege against self-incrimination because he felt coerced into testifying since he was aware that if he declined to testify, he might be sanctioned. Judge Friendly, writing for the Court, concluded that in the circumstances, the NYSE was not a State actor, and that, in any event, its actions were not coercive because it was not certain that Mr. Solomon would be sanctioned by the NYSE for refusing to testify.¹⁶ The court emphasized that the NYSE's inquiry was "in pursuance of its own interests and obligations," reading *Silver* as identifying the NYSE not as the agent but the principal in the federal scheme, free to regulate its members subject to SEC oversight. The court distinguished the coercion in *Garrity*, finding it uncertain that Solomon would be sanctioned for failure to testify; and distinguished *Intercontinental, Crimmins* and *Sloan* on the somewhat superficial basis that those cases did not involve the Fifth Amendment privilege against self-incrimination.

Course of Action

We suggest that the *Solomon* rationale is outdated and open to question given the reality of SRO enforcement procedures and the expanded role of the SROs in enforcing violations of the federal securities laws. To begin with, as any defense counsel knows, the idea that the SROs might not sanction a respondent for invoking his Fifth Amendment privilege and declining to answer questions, is, to say the least, unrealistic. It seems to always happen; and in some cases, the uncontested charge of failure to cooperate becomes a substitute for not bringing a more complex case.¹⁷ The second rationale of *Solomon* is questionable when the SRO is playing its role as a statutory enforcer of the federal securities laws, whether or not the respondent's activities might also be said to violate the SRO's own rules of conduct. *Solomon* failed to adequately recognize this important distinction. There are dozens of rules governing the activities of SRO members that do not implicate the federal securities laws and the violation of which would not also subject the member to federal prosecution. Here, the SROs are clearly pursuing their own interests.¹⁸ But when they are carrying out their federally mandated roles, as part of the securities regulatory scheme, whether as agent or principal, they are pursuing the goals of securities regulation, and may fairly be regarded as State actors. Indeed, the Exchange Act mandates that, as a condition of their registration, the SROs compel compliance with the provisions of the Exchange Act and rules;¹⁹ and, appropriately sanction their members for violations.²⁰ This federal mandate existed

well before the 1975 amendments to the Exchange Act which only enhanced those obligations.²¹ Moreover, the SEC can enforce this mandate by revoking the registration of an SRO and otherwise bringing charges against an SRO and its officers and directors if it violates the Exchange Act by failing to enforce the Act and its rules through the SRO's disciplinary process.²² Thus, at least where the Exchange Act is concerned, the relationship between the SEC and the SROs is one of quintessential coercion which, as explained by the Supreme Court in *Brentwood*, is a significant factor supporting a finding of state action. Several courts have recognized the "state actor" role of the SROs in conducting disciplinary proceedings, ironically in response to the SROs' request to be so regarded.

Southern District

Two SDNY decisions, both authored by Judge Motley, have so held. In *Trama v. NYSE*,²³ the court accepted the NYSE's argument that "as a body which is engaged in prosecutorial functions as required by federal law, the Exchange is immune from damage suits." In holding that the NYSE enjoyed qualified immunity, the court said, "the Exchange, by virtue of 15 U.S.C. 78f(b)(6), may be considered an agent or arm of the [SEC] with respect to the discipline of persons such as plaintiff." Two years later in *Bruan, Gordon & Co. v. Hellmers*,²⁴ Judge Motley held that the NASD also enjoyed qualified immunity in its conduct of disciplinary proceedings "as an agent or arm of the SEC." Other courts have acknowledged the governmental role of the SROs in their enforcement activity. For example, in *Austin Municipal Securities v. NASD*,²⁵ plaintiffs charged the NASD and certain of its officials with various due process violations arising out of a disciplinary proceeding. The Fifth Circuit held that NASD enforcement staffers performed a traditional prosecutorial function, and that the NASD's District Business Conduct Committee performed both traditional prosecutorial as well as judicial functions. Noting that "[t]he NASD exercises quasi-governmental authority pursuant to a statutory scheme enacted by the national sovereign," the court concluded that, in prosecuting and adjudicating disciplinary violations, the NASD and its officials enjoyed absolute immunity from suit. Subsequently, the Fifth Circuit's analysis was heavily relied in *Mandelbaum v. NYMEX*,²⁶ a SDNY decision that found that the NYMEX and certain of its officials also enjoyed absolute immunity when prosecuting and adjudicating disciplinary violations. Then, in *Barbara v. NYSE*,²⁷ the Second Circuit squarely held that the NYSE

enjoyed absolute immunity from a suit for damages arising out of allegedly unlawful conduct of an NYSE disciplinary hearing on the ground that, pursuant to the federal securities laws, the NYSE "performs a variety of regulatory functions that would, in other circumstances, be performed by the [SEC]." The court characterized the NYSE activity in disciplinary proceedings as "federally mandated conduct" and a "governmental function." Accordingly, the *Barbara* court held that the NYSE employees enjoyed the same immunity that the SEC employees would have enjoyed if the proceeding had been an SEC proceeding. In so doing, the court seems to have relied on the fact, articulated in *Brentwood*, that insofar as the NYSE was enforcing the federal securities laws, there had been a "delegation of a public function."

The tension between the Second Circuit's holdings in *Solomon* and *Barbara* has not gone unnoticed. In *D'Alessio v. NYSE*,²⁸ Judge Rakoff held that the NYSE, when carrying out its disciplinary function, enjoyed the same immunity as the SEC in carrying out its role, saying that the issue was controlled by the Second Circuit opinion in *Barbara*. At the same time, the court acknowledged that "some of the broader dicta in *Solomon* are not easily reconciled with some of the statements in *Barbara*" rationalizing that "what *Solomon* sought to emphasize was the distinction between the [NYSE's] quasi-governmental duties and its private functions."

Case Law Pattern

What emerges from all of this is a fairly clear pattern. When the SROs are engaged in their disciplinary function as enforcers of the federal securities laws, they are to be regarded as "state actors" and may enjoy the same immunity privilege afforded their governmental counterparts. That is the reasoning of the Second Circuit in *Barbara*, the Fifth Circuit in *Austin* and the various district court cases cited above. However, the SROs arguably may not always be governmental actors when they are simply pursuing their own interests under circumstances which do not implicate the federal securities laws or expose members to federal prosecution.

This is a distinction that has been recognized in several post *Barbara* decisions. For example, in *Datek Securities Corp. v. NASD*,²⁹ Judge Motley, who had no trouble finding the NYSE and NASD respectively to be state actors in *Trama* and *Braun, Gordon* where they were carrying out their disciplinary function, declined to broaden that status to protect them against claims of bias. Also in *American Benefits Group Inc. v. NASD*,³⁰ Judge Koeltl, citing *Barbara* and *Austin* and recognizing that the NASD is a state actor for immunity purposes in carrying out its disciplinary functions, declined to entertain constitutional

claims against the NASD acting in a rule-making capacity. Soon after, in *Desiderio v. NASD*,³¹ a case challenging the arbitration rules of the NASD, the Second Circuit declined to regard the NASD as a state actor in imposing a mandatory arbitration provision but nonetheless recognized that in other circumstances private entities "may be held to constitutional standards if their actions are 'fairly attributable' to the state." The result in *Desiderio* is not inconsistent with *Barbara* because the arbitration function in *Desiderio* was not mandated by federal law. To be sure, some district courts have superficially used *Solomon* to decline to afford Fifth Amendment rights. That was the case in *United States v. Shvarts*,³² where Judge Glasser in the Eastern District of New York followed *Solomon* without any real analysis; and in *D. L. Cromwell Investments v. NASD*,³³ where Judge Kaplan in the Southern District somewhat myopically applied the *Solomon* distinction about the SRO pursuing its own interests, to a specific set of facts. We suggest these cases are neither controlling nor persuasive.

Conclusion

The fact of the matter is that the NYSE, NASD and other SROs *do* have an important governmental function in the statutory mandate to enforce not only their own rules, but the federal securities laws. To be sure, many of their rules do not implicate federal law, and there may be no reason in these situations to regard them as state actors for federal privilege purposes because members are not exposed to criminal prosecution for their violation. But when carrying out the federal mandate, they are "state actors" and the weight of judicial authority has so recognized in affording them the same privileges as their SEC counterparts. It is simply illogical, illegal and unfair for the SROs to decline to afford respondents in their disciplinary proceedings the same constitutional protections they claim for themselves.

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(1) See NASD Rules 8221(b), 8310(a); NYSE Disciplinary Rules 476, 477.

(2) See *Lugar v. Edmundson Oil Co.*, 457 U.S. 922, 937 (1982); *Desiderio v. National Association of Securities Dealers, Inc.*, 191 F.3d 198, 206 (2d Cir. 1999).

(3) 121 S. Ct. 924 (2001).

(4) 373 U.S. 341 (1963).

(5) 452 F.2d 935 (5th Cir. 1971).

(6) *Id.* at 941 n.9.

(7) 346 F. Supp. 1256 (SDNY 1972).

(8) 348 F. Supp. 1185 (SDNY 1972).

(9) 489 F.2d 1 (2d Cir. 1973).

(10) *Malloy v. Hogan*, 378 U.S. 1, 8 (1964).

(11) See, e.g., *Stochower v. Board of Education of the City of New York*, 350 U.S. 551 (1956); *Spevak v. Klein*, 385 U.S. 511 (1957).

(12) 385 U.S. 493 (1967).

(13) *Id.* at 494.

(14) 509 F.2d 863 (2d Cir. 1975).

(15) *Id.* at 866.

(16) *Id.* at 867, 869.

(17) See, e.g. *Matter of Joseph Jett*, 1994 WL 676718 (NYSE August 4, 1994) (imposing bar on registered representative who failed to testify in an NYSE investigation).

(18) We recognize that an argument can be made that because the 1975 amendments to the Exchange Act resulted in the SEC's unprecedented involvement in SRO rulemaking, even SRO rules (including, especially, the very rules that the SROs invoke to discipline associated persons when they assert their Fifth Amendment rights and refuse to answer questions) may be considered to be fairly attributable to the state.

(19) 15 U.S.C. §§78(f)(b)(1), 78o-3(b)(2).

(20) 15 U.S.C. §§78(f)(b)(6), 78o-3(b)(7).

(21) See H. R. Rep. No. 73-1383, 73d Cong., 2d Sess. (1934); H.R. Rep. No. 75-2307, 75th Cong., 1st Sess. (1938).

(22) See 15 U.S.C. §§78s(h), 78u(e). See also *In the Matter of New York Stock Exchange, Inc.*, Admin. Proc. File No. 3-9925, Exchange Act Rel. No. 34-41574, 1999 WL 430863 (SEC June 29, 1999) (proceeding under Exchange Act §19(h) against NYSE for failure to enforce Exchange Act provisions and rules and NYSE rules); *In the Matter of National Association of Securities Dealers, Inc.*, Admin. Proc. File No. 3-9056, Exchange Act Rel. No. 34-37538, 1996 WL 447193 (S.E.C. Aug. 8, 1996) (proceeding under Exchange Act §19(h) against NASD for failure to enforce Exchange Act provisions and rules and NASD rules); *San Francisco Mining Exch. v. S.E.C.*, 378 F.2d 162, 164-66 (9th Cir. 1967) (upholding SEC's withdrawal of exchange registration for, inter alia, failing to enforce Exchange Act provisions).

(23) 1978 WL 1141 (SDNY Sept. 14, 1978).

(24) 502 F. Supp. 897 (SDNY 1980).

(25) 757 F.2d 676 (5th Cir. 1985).

(26) 894 F. Supp. 676 (SDNY 1995).

(27) 99 F.3d 49 (2d Cir. 1999).

(28) 125 F. Supp.2d 656 (SDNY 2000).

(29) 875 F. Supp. 230 (SDNY 1995).

(30) 1999 WL 605246 (SDNY August 10, 1999).

(31) 191 F.3d 198 (2d Cir. 1999).

(32) 90 F. Supp.2d 219 (EDNY 2000).

(33) 132 F. Supp.2d 248 (SDNY 2001).