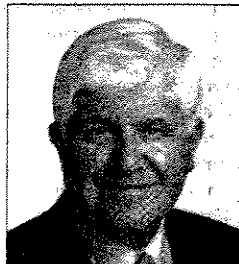


BY JOHN F.X. PELOSO AND BEN A. INDEK

## National Adjudicatory Council, Due Process and Self-Regulation

In November 2004, the National Association of Securities Dealers Inc.'s (NASD) National Adjudicatory Council (NAC) handed down an appellate decision affirming (and increasing) an administrative penalty against Frank Quattrone, former head of the Technology Group of CS First Boston (CSFB). *In re Department of Enforcement v. Quattrone*, NASD Disc. Proceeding No. CAF030008, 2004 WL 2692229 (NASDR Nov. 22, 2004).



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### The 'Quattrone' Case

Mr. Quattrone had been asked for and had given testimony to the NASD staff in connection with investigations into "spinning" and analyst conflicts of interest. After receiving a so-called Wells Notice from the NASD staff, Mr. Quattrone was put on administrative leave by CSFB after the company announced that it was conducting an investigation into the circumstances surrounding an e-mail he had sent regarding CSFB's document retention policy. A federal criminal investigation into the matter was opened on the same day.

A Wells Notice informs a member of the securities industry that charges are likely to be filed and gives him or her the opportunity to respond to regulators.

The federal criminal investigation prompted a fresh NASD request for testimony, which Mr. Quattrone first tried to delay but ultimately declined, asserting his Fifth Amendment privilege. NASD commenced a case seeking to bar him for noncooperation, leading to a decision that suspended him for one year subject to a potential bar from the industry if he continued to fail to cooperate. Subsequent to his criminal conviction relating to the email, Mr. Quattrone gave the NASD the testimony requested. Nevertheless, on appeal of the suspension, the NAC affirmed the hearing panel decision and stiffened the penalty to a lifetime bar. Press reports indicate that Mr. Quattrone intends to appeal this decision to the Securities and Exchange Commission (SEC).

This case brings sharply into focus an issue that has been around for some years and has commanded the attention of several commentators, including this column.<sup>1</sup> The issue is whether the NASD (and other self-regulatory organizations, SROs, should afford individuals Fifth Amendment due process when carrying out the federally mandated function of disciplinary activity.

Mr. Quattrone's argument to the NASD Hearing Panel and on appeal to NAC was essentially that compelling him to give testimony when he was under federal investigation, where he was free to assert his privilege, denied him due process for several reasons: first, as a factual matter, the NASD was conducting a joint investigation with the SEC and was therefore a "state actor" and as to this fact, he requested a hearing; second, forcing him to give testimony or being barred from the industry in these circumstances was a denial of due process.

The NAC decision rejected both these arguments and, in essence, held: first, that there was insufficient evidence to find that the NASD and SEC were acting jointly, and in any event, denied the request for a hearing on the matter; and second, rejected the application of the Fifth Amendment because, in its view: (a) that privilege is available only in proceedings by non-government entities when they can be regarded as performing as "state actors"; and courts generally have held that the NASD is not a state actor; and (b) "due process requirements do not apply to NASD proceedings." *Quattrone*, 2004 WL 2692229 at \*7, \*13.

This article suggests that the NAC did not give sufficient consideration and weight to other authorities that support a different point of view.

### State Action

Mr. Quattrone argued and *D.L. Cromwell Inv. Inc. v. NASD Regulation, Inc.*, 279 F.3d 155 (2d Cir. 2002) (relied on by the NAC in its decision) turned on the question whether, as a factual matter, there was a joint NASD/SEC investigation

such as to make the NASD in those circumstances a state actor. Indeed, the U.S. Court of Appeals for the Second Circuit in *Cromwell* simply concluded that the factual determination on that point by Judge Lewis A. Kaplan was "not clearly erroneous." *Id.* at 162. It is doubtful that the case can be read more broadly to support the proposition that the NASD is never a state actor when carrying out its federally mandated disciplinary process. Indeed, a non-governmental entity can be regarded as performing a governmental function in circumstances other than as focused on in the NAC decision.

To begin with, decisions such as that of the U.S. Supreme Court in *Skinner v. Railway Labor Executives' Ass'n*, 489 US 602, 614-16 (1989) (holding regulation requiring railroads to conduct drug tests on its employees was sufficient to implicate Fourth Amendment protections) and *Brentwood Acad. v. Tennessee Secondary Sch. Athletic Ass'n*, 531 US 288, 296 (2001) (a nominally private entity is treated as a state actor "when it is entwined with governmental policies"), recognize that when a regulated entity is performing activity compelled by federal law, it can, for those purposes, be recognized as a "state actor." SROs such as the NASD do just that when engaging in the disciplinary process of its members and associated persons; and especially so when the activity subject to discipline also constitutes a violation of the federal securities laws or even the federal criminal statutes as in the *Quattrone* case.

This federally mandated role, which was expected under the original provisions of the Securities Exchange Act of 1934, was made clear and more explicit by the 1975 amendments to the Exchange Act. Prior to 1975, the SROs certainly were expected to discipline members as a condition of registration. But the 1975 amendments broadened the condition of membership for the NASD to include a requirement to enforce the federal securities laws and not just the rules of the Association;<sup>2</sup> and added §19(g) to the Exchange Act which expressly spelled out this federally delegated and mandated role for both the New York Stock Exchange (NYSE) and NASD.<sup>3</sup> Indeed the NASD and the Exchange can be and have been sanctioned

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by the SEC for not performing this role correctly.<sup>4</sup>

Moreover, a number of courts have recognized that when the SROs are performing this disciplinary role, they are using federally delegated power and, for those purposes, may be considered state actors.

This was recognized in *Crimmins v. AMEX*, 346 F.Supp. 1256, 1259 (S.D.N.Y. 1972) ("When an exchange conducts [disciplinary] proceedings under the self-regulatory power conferred upon it by the 1934 Act, it is engaged in governmental action"), *Trama v. NYSE*, 76 Civ. 4898, 1978 WL 1141, at \*5 (S.D.N.Y. Sept. 14, 1978) (accord), *Bruan, Gordon & Co. v. Hellmers*, 502 F.Supp. 897, 902 (S.D.N.Y. 1980) (accord) and *Flego v. Philips Appel & Walden, Inc.*, 514 F. Supp. 1178, 1181-82 (D.N.J. 1981) (accord).

Interestingly, none of these cases was discussed in *Quattrone*. See also *Austin Mun. Secs. Inc. v. NASD*, 757 F.2d 676, 690-91 (5th Cir. 1985), where the U.S. Court of Appeals for the Fifth Circuit afforded NASD disciplinary officers immunity because they "serve as surrogates for the SEC" and *Barbara v. NYSE*, 99 F.3d 49, 59 (2d Cir. 1996), where the Second Circuit granted immunity to the NYSE in carrying out its disciplinary function because of "the unique context of the self-regulation of the national securities exchanges. Under the Exchange Act, the Exchange performs a variety of regulatory functions that would, in other circumstances, be performed by a government agency."

Indeed, the distinction in *United States v. Solomon*, 509 F.2d 863, 864-65 (2d Cir. 1975), upon which the NASD and NYSE historically have relied to deny Fifth Amendment rights in disciplinary proceedings, ultimately turned on the precise point that the NYSE was enforcing "its rules." The court noted that Solomon's possible violations of federal law were not at issue simply because they might have subjected him to "consequent liability to civil and criminal enforcement proceedings by the Government." *Id.* at 869 (emphasis added). This distinction was recognized in *D'Alessio v. NYSE*, 125 F. Supp. 2d 656, 659 (S.D.N.Y. 2000) and *Martens v. Smith Barney, Inc.*, 190 F.R.D. 134, 138 (S.D.N.Y. 1999).

Finally, the point is made clear by contrasting decisions that declined to recognize that the NASD was a federal actor while performing functions other than disciplinary proceedings. See, e.g., *Desiderio v. NASD*, 191 F.3d 198 (2d Cir. 1999) (arbitration); *Am. Benefits Group v. NASD*, 99 Civ. 4733, 1999 WL 605246 (S.D.N.Y. Aug. 10, 1999) (rulemaking); and *Datek Sec. Corp. v. NASD*, 875 F. Supp. 230 (S.D.N.Y. 1995) (defending bias claim).

## Due Process

This is all part of the larger theme that when the SROs engage in the disciplinary process, they have the power to affect a valuable right and therefore, must afford the subject of their disciplinary proceeding due process. This was recognized by the U.S. Supreme Court in *Silver v. NYSE*, 373 U.S. 341 (1963) and made clear in *Intercontinental Indus. v. AMEX*, 452 F.2d 935, 941 (5th Cir. 1971), and in *Crimmins*, 346 F. Supp. at 1259, *Villani v. NYSE*, 348 F. Supp. 1185, 1188 n.1 (S.D.N.Y. 1972) and *Flego*, 514 F. Supp. at 1182.

Thus, we question the correctness of the NAC *Quattrone* decision that states: "constitutional and criminal law due process requirements do not apply to NASD proceedings." *Quattrone*, 2004 WL 2692229 at \*13 (citing *Datek* and *Cromwell*). As noted earlier, *Datek*, 875 F. Supp. 230, involved claims of bias under circumstances that would suggest it was not performing the role of a federal actor; and *Cromwell*, 279 F.3d at 162, simply affirmed a factual finding as "not clearly erroneous."

Neither case can be read as supporting the broad statement that NASD proceedings need not afford due process. In fact, a reading of the legislative history of the 1975 amendments reflects the contrary. See Securities Acts Amendments of 1975: Hearing Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, S. Rep. No. 94-75, 94th Cong., 1st Sess. 1 (1975) at 25 ("Recognizing that the self-regulatory organizations utilize governmental-type powers in carrying out their responsibilities under the Exchange Act highlights the fact that these organizations must be required to conform their activities to fundamental standards of due process.")

Further, the *Quattrone* decision misapprehends the application of the right against self-incrimination through due process. Specifically, in deciding that the NASD was not a state actor for Fifth Amendment purposes, the NAC followed cases involving purely private actors without considering the unique nature of SROs in the securities law legislative scheme (as noted in *Barbara*) and narrowly focused on NASD's request for information rather than the investigation that prompted the request.

The NASD's blanket assertion that it is merely a "private corporation" when it is disciplining its members is contradicted by the obligations imposed and authority granted by the Exchange Act, especially after the enhanced responsibilities spelled out in the 1975 amendments. Indeed, more than 40 years ago when the 1963 Spe-

cial Study of the Securities Markets focused on the interplay between the roles of the SEC and the SROs, the SEC recognized that when an SRO conducts delegated activity, it is "acting as an official arm or delegate of governmental power." See Securities and Exchange Commission, Report of Special Study of the Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., Part 4, Chapter XII at 697 (1963).

Courts also have recognized that because SROs are "private organizations exercising exclusive regulatory authority pursuant to federal law, [SROs] straddle the border between the private and public realms." *Martens*, 190 F.R.D. at 138. Yet, in its decision, the NAC follows *Jackson v. Metropolitan Edison*, 419 U.S. 345 (1974), and *Blum v. Yaretsky*, 457 U.S. 991 (1982), without considering whether these cases involved actors and activities similar to SROs and their federally mandated disciplinary function.

Unlike SROs, neither the electric company in *Jackson* nor the doctors or nursing homes in *Blum* were mandated by law to take the actions complained of by the plaintiff. Instead, these private entities merely made decisions that were "permissible under state law." *Jackson*, 419 U.S. at 358. As the Supreme Court stated, had federal law affirmatively commanded these actions, "we would have a different question before us." *Blum*, 457 U.S. at 1005.

Thus, in its application of the holdings in *Jackson* and *Blum*, the NAC failed to consider the substantial intertwining between NASD disciplinary proceedings and its place in the federal regulatory scheme (*Brentwood*) and the fact that disciplinary proceedings are mandated by federal law (*Skinner*).

Rather, the NAC relied on an expansive interpretation of a narrowly applied rule of affirmance in *Cromwell*, discussed above, and held that Mr. Quattrone lacked a right against self-incrimination because the NASD request for testimony was made "under NASD authority and for NASD's own regulatory purposes."

By doing this, the NAC focused on the administrative activity without examining the underlying authority and policy for that activity. Understandably, it cited in support of its conclusions *Gilmore v. Salt Lake Cmty. Action Program*, 710 F.2d 632 (10th Cir. 1983), and *Perkins v. Londonderry Basketball Club*, 196 F.3d 13 (1st Cir. 1999), without noting that in each of those cases there was no governmental linkage to the policies that led up to the administrative activity.

That is not so with SROs in the securities industry. For example, in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware*, 414 U.S. 117, 134-36 (1973), the U.S. Supreme Court recognized that NYSE arbitration rules could be preempted by state law because they were not mandated by federal law in contrast to its disciplinary rules. In *Desiderio*, 191 F.3d at 207, the Second Circuit followed *Merrill Lynch* in deciding the NASD could not be considered a state actor when it requires arbitration. Moving in the other direction with the same rationale, in *Austin*, 757 F.2d at 692, the Fifth Circuit held the NASD was immune from liability for its actions during a disciplinary proceeding because it is "required by statute to enforce the securities laws."

These cases make clear that in analyzing the nexus between the government and the specific action, the courts look not only at the decision that allegedly harmed the plaintiff, but whether the state created a policy that led to that decision. In following its overly expansive interpretation of *Cromwell*, the NAC did not take into account federal mandates requiring the NASD to conduct an investigation that inevitably led to its decision to request testimony from Mr. Quatrone. In essence, the NAC promoted form over substance at the expense of the Fifth Amendment rights of those regulated by the NASD.

## Conclusion

This issue continues to be very important to the SROs. Their real argument and motivation is that since they do not have subpoena power over those in the industry, they cannot perform their responsibilities without such individuals' cooperation. That may be; but we question whether that practicality is a sufficient basis to deny constitutional due process in a proceeding to bar individuals from the securities industry.

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1. John F.X. Peloso & Ben A. Indek, "A Question of Fairness," 225 N.Y.L.J. 3 (2001); see also William I. Friedman, "The Fourteenth Amendment's Public/Private Distinction Among Securities Regulators in the U.S. Marketplace-Revisited," 23 Ann. Rev. Banking & Fin. 727 (2004); John J. Falvey, Jr. & Stephanie H. Gibson, "The NASD's Invitation to Testify: An Offer You Can't Refuse," 16 No. 19 Andrews Del. Corp. Litig. Rep. 12 (2002).

2. Securities Exchange Act of 1934, 15 U.S.C. §78o-3(b) (1975).

3. 15 U.S.C. §78s-g(1) (1975); see also Stone and Perino, "Not Just a Private Club: Self-Regulatory Organizations as State Actors When Enforcing Federal Law," 1995 Colum. Bus. L. Rev. 453 for an interesting analysis of the legislative history and impact of these amendments.

4. *In re National Association of Securities Dealers, Inc.*, Exchange Act Release No. 37538, 1996 WL 447193 (Aug. 8, 1996) and *In re New York Stock Exchange, Inc.*, Exchange Act Release No. 41574, 1999 WL 430863 (June 29, 1999).