USEFUL LIMITS TO THE FIFTH AMENDMENT: EXAMINING THE BENEFITS THAT FLOW FROM A PRIVATE REGULATOR'S ABILITY TO DEMAND ANSWERS TO ITS QUESTIONS DURING AN INVESTIGATION

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I. INTRODUCTION

The drumbeat for financial regulatory reform is reverberating throughout Washington, D.C. Under the guidance of Secretary Henry M. Paulson, Jr., the Treasury Department issued a blueprint in March 2008 that envisions a dramatic overhaul of the regulation of financial institutions, including securities brokerage firms.[1] The

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[1] *See* DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008) [hereinafter TREASURY BLUEPRINT], *available at* http://www.treas.gov/press/releases/reports/Blueprint.pdf. The blueprint's recommendations are driven by the globalization of capital markets, the convergence of financial products including products that contain insurance, banking, securities, and futures components, and an increasing "interconnectedness of the global capital markets." *Id.* at 3-4. The Government Accountability Office's 2009 report agrees with the need for reform of our financial regulatory system and proposes a nine-part framework for evaluating regulatory reform proposals. *See* UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE

current regulatory structure of the securities industry in the United States includes multiple layers of regulation, with the Securities and Exchange Commission ("SEC") playing the primary federal role. A second layer of regulation is private, and involves stock exchanges and an association of securities brokerage firms regulating their members. Although the Treasury's blueprint contemplates sweeping changes to the federal structure, it strongly recommends preserving and strengthening this private layer, in which Self-Regulatory Organizations operate.[2]

In its long-term recommendations for an optimal regulatory structure, the blueprint recommends that Congress create a new federal business conduct regulator that focuses on the interactions between all types of financial institutions and financial services consumers. [3] The blueprint highlights that the Self-Regulatory Organization model has been effective and "should be preserved." [4] Particularly, the business conduct regulator should consider relying on Self-Regulatory Organizations for rule writing, compliance, and enforcement functions.[5]

The largest private-sector regulator of the securities industry is the Financial Industry Regulatory Authority, ("FINRA"). FINRA combined operations of the National Association of Securities Dealers ("NASD") and the regulatory arm of the New York Stock Exchange, organizations that had respectively been providing private regulation of the securities industry for seventy years and nearly two centuries. A key function that FINRA performs for brokerage firms that are members of FINRA is to monitor the securities industry for rule violations, gather evidence by

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OUTDATED U.S. FINANCIAL REGULATORY SYSTEM (2009), *available at* http://www.gao.gov/ new.items/d09216.pdf.

[2] TREASURY BLUEPRINT at 111-13. The Securities Exchange Act of 1934 ("Exchange Act") defines Self-Regulatory Organizations to include stock exchanges and registered securities associations. Exchange Act § 6, 15A, 15 U.S.C. § 78f, o-3 (2000).

[3] TREASURY BLUEPRINT at 170.

[4] *Id.* at 178.

[5] *Id.*

conducting investigations, and—when warranted—pursue disciplinary cases. These disciplinary cases can result in fines, suspensions, or expulsions from the securities industry for individuals or brokerage firms.

In whatever financial regulatory system that takes shape in the years to come, FINRA's role should be preserved. This Article explores the question of whether FINRA should continue to demand that individuals who are employed in the securities industry answer FINRA's questions during an investigation or be barred from the securities industry for life. The past practice of NASD and the New York Stock Exchange had been to require stock brokers and other employees of brokerage firms to give sworn testimony during an investigation. Failure to do so is itself a violation of FINRA rules and has consistently resulted in disciplinary proceedings and an adjudicator imposing the sanction of expelling an individual from FINRA.[6] FINRA's investigative powers stand in contrast to the restrictions placed on governmental investigations. The Fifth Amendment privilege against self-incrimination protects persons from having to answer questions by the government that would provide "a link in the chain of evidence" needed for criminal prosecution.[7] This Article concludes that FINRA should continue to act as a nongovernmental entity and enforce with

[6] FINRA consistently imposes sanctions on individuals who refuse to provide testimony in response to FINRA's formal request that they do so. The sanction is typically to bar individuals from associating with any FINRA member firm. *See* Charles C. Fawcett, Exchange Act Release No. 56,770, 91 S.E.C. Docket 2594 at 2599 (Nov. 8, 2007) [hereinafter Fawcett] (SEC upheld as appropriate FINRA's National Adjudicatory Council ("NAC"), which had imposed the sanction of a bar); Elliot M. Hershberg, Exchange Act Release No. 53,145, 87 S.E.C. Docket 436 at 439 (Jan. 19, 2006) (same for an NASD bar), *aff'd*, Hershberg v. SEC, No. 06-1086-ag, 2006 U.S. App. LEXIS 32225 (2d Cir. Dec. 28, 2006); Toni Valentino, 2004 SEC LEXIS 330, at *12-15 (Feb. 13, 2004); Dep't of Mkt. Regulation v. Sciascia, Complaint No. CMS040069, 2006 NASD Discip. LEXIS 22, at *15 (NASD NAC Aug. 7, 2006); Dep't of Enforcement v. Kapara, Complaint No. C10030110, 2005 NASD Discip. LEXIS 41, at *27-28 (NASD NAC May 25, 2005); Dep't of Enforcement v. Steinhart, Complaint No. FPI02002, 2003 NASD Discip. LEXIS 23, at *10 (NASD NAC Aug. 11, 2003).

[7] United States v. Hubbell, 530 U.S. 27, 38 (2000) (quotation omitted).

vigilance its rule that requires individuals who are employed by FINRA member firms to testify during FINRA investigations.

This Article first discusses the origins of the New York Stock Exchange and NASD. It outlines the legal structure that governs oversight of stock markets and associations of securities dealers that was first enacted in the 1930s. Part III surveys the legal authorities that have ruled on the question of whether the New York Stock Exchange, FINRA, or NASD are private actors or state actors. This part evaluates whether the consensus among federal district and circuit courts that these organizations are private actors is consistent with the Supreme Court's various tests for state actors. Part IV responds to the claims of critics that FINRA's testimony requirement or consequences for failing to testify should be abolished. It concludes that FINRA's current powers should be maintained. This Article's final section argues that FINRA's testimony requirement has provided tangible benefits, including the improvement of FINRA's ability to investigate and maintenance of the investing public's confidence in the securities industry.

II. HISTORY OF STOCK EXCHANGES AND STOCK BROKER REGULATION

The New York Stock Exchange traces its regulation over its members back to an 1817 agreement among twenty-seven brokers.[8] The New York Stock Exchange's Constitution of

[8] Stuart Banner, *The Origin of the New York Stock Exchange, 1791-1860*, 27 J. LEGAL STUD. 113, 115 (1998). The brokers created the New York Stock and Exchange Board, which shortened its name to the New York Stock Exchange in 1863. *Id.* at 114, 115; *see also* WALTER WERNER & STEVEN T. SMITH, WALL STREET 20-48 (Columbia University Press 1991) (discussing the history of stock trading in New York City).

The New York Stock Exchange's claim that the Buttonwood Agreement of 1792 established the organization that evolved into the New York Stock Exchange is disputed. *Compare* Peter Eisenstadt, *How the Buttonwood Tree Grew: The Making of a NYSE Legend*, 19 PROSPECTS: ANNUAL AM. CULTURAL STUD. 75, 91 (1994) (treating the Buttonwood Agreement as a distinct event from the formation of the New York Stock

1817 initiated self-disciplinary powers in the United States' financial markets by establishing that members could be fined for certain infractions and recorded that "any member who did not comply with Exchange rules could be expelled with a two thirds vote of the membership."[9]

Prior to the creation of the SEC in 1934, the New York Stock Exchange had long been exercising its authority to discipline its members for violations of its rules. Members who had sanctions imposed on them, however, sought to overturn them by petitioning the courts to vacate such sanctions. In 1913, the New York Court of Appeals held that a New York Stock Exchange member's ability to challenge in court his expulsion from membership was strictly limited.[10] The court ruled that if the New York Stock Exchange acted "in accordance with the constitution of the Exchange" and in good faith, its decision was final.[11] The court viewed the relationship between members and the New York Stock Exchange as essentially contractual. It reasoned that: "[t]he Exchange is a voluntary association of individuals, who have agreed to be bound, as to their several interests, rights, privileges and duties, by the provisions of a constitution and of by-laws."[12]

The Securities Exchange Act of 1934 ("Exchange Act") created the SEC, and established federal regulation over numerous financial intermediaries and participants in the

Exchange) *with* Richard Sylla, *The Origins of the New York Stock Exchange*, *in* THE ORIGINS OF VALUE: THE FINANCIAL INNOVATIONS THAT CREATED MODERN CAPITAL MARKETS 299, 308 (William N. Goetzmann & K. Geert Rouwenhorst eds., 2005) (arguing the strong linkage between these events).

[9] Susan L. Merrill, Matthew L. Moore & Allen D. Boyer, *Sharper and Brighter: Focusing on Sanctions at the New York Stock Exchange*, 3 N.Y.U. J. L. & BUS. 155, 163 n.15 (2006); New York Stock Exchange Const. arts. IV, X, XIV, XV, XVIII (1817).

[10] Cohen v. Thomas, 209 N.Y. 407, 410 (N.Y. 1913).

[11] *Id.* at 409-10.

[12] *Id.* at 410. Other court cases confirm the New York Stock Exchange's exercise of its disciplinary powers before 1934. *See* Weidenfeld v. Keppler, 84 A.D. 235, 241 (N.Y. App. Div. 1903).

securities markets, including stock exchanges.[13] The Exchange Act contained the requirement that stock exchanges register with the SEC, which the New York Stock Exchange did in 1934.[14]

A. National Association of Securities Dealers

The Exchange Act did not create any specific regulatory structure for securities that were not traded on an exchange, called the over-the-counter market.[15] The participants in this market sought to fill this void. In October 1936, the Investment Bankers Conference was incorporated under Delaware law as a membership organization whose members traded securities over the counter.[16] Although the organization was intentionally a temporary one, it invited brokers and dealers that were registered with the SEC to join and soon increased membership to 1617.[17] In June 1938, the Maloney Act amendments to the Exchange Act were enacted into law:[18] "The Maloney Act was passed primarily to provide for cooperative regulation of the over-the-counter market by placing the burden of such regulation upon representative organizations with the government exercising

[13] Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78jj). Section 6 of the Exchange Act requires stock exchanges to register with the SEC. *See* 15 U.S.C. § 78f (2000).

[14] S.E.C. Release No. 18 (Sept. 28, 1934).

[15] *See* T. Grant Callery & Anne H. Wright, *NASD Disciplinary Proceedings–Recent Developments*, 48 BUS. L.J. 791, 793 n.14 (1993).

[16] NATIONAL ASSOCIATION OF SECURITIES DEALERS MANUAL, ADMINISTRATIVE, PROFILE OF THE NASD, 159 (1997) [hereinafter NASD 1997 MANUAL]. The Investment Bankers Association of America is a trade group that created the Investment Bankers Code Committee in 1933. This committee was reorganized into the Investment Bankers Conference three years later. *See* Paul G. Mahoney, *The Political Economy of the Securities Act of 1933*, 30 J. LEGAL STUD. 1, 23-24 (2001).

[17] *Id.* The organization was temporary because Franklin D. Roosevelt's sweepingly broad enactment of industrial codes had been ruled unconstitutional by the Supreme Court in 1935. *See* A.L.A. Schechter Poultry Corp. v. United States, 295 U.S. 495 (1935).

[18] Pub. L. No. 75-719, Ch. 677, 52 Stat. 1070 (codified as amended at 15 U.S.C. § 78o-3 (2000)).

supervisory powers."[19] Such an industry group, which would draft rules to regulate brokerage firms that trade in the over-the-counter market, was termed a Self-Regulatory Organization under the operative provision of the amended Exchange Act.[20] In preparation for applying as a Self-Regulatory Organization, the Investment Bankers Conference drafted By-Laws, Rules of Fair Practice, and a Code of Procedure for Handling Trade Practice Complaints and submitted them to its members for comment.[21] The following year, 1939, the Investment Bankers Conference voted to adopt these provisions.[22] Its successor, the National Association of Securities Dealers, Inc. filed an initial registration statement with the SEC in July 1939, and was approved as a national securities association on August 7, 1939.[23]

During the early years of NASD's corporate existence, its member firms comprised a majority of the securities industry, but a substantial portion of securities firms were not members.[24] In 1983, Congress amended the Exchange Act to require nearly all brokerage firms registered with the SEC either to become a member of a national securities association or to be a member of an exchange and solely effect transactions on that exchange.[25]

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[19] Paul S. Grant, *The National Association of Securities Dealers: Its Origin and Operation*, 1942 WISC. L. REV. 597, 597 (1942).

[20] Exchange Act § 15A, 15 U.S.C. § 78o-3 (2000).

[21] NASD 1997 MANUAL, *supra* note 16, at 160.

[22] *Id.* *See* Homer V. Cherrington, *National Association of Securities Dealers, Inc.*, 27 HARV. BUS. REV. 741, 741 (1949); Grant, *supra* note 19, at 597.

[23] Grant, *supra* note 19, at 597; 5 S.E.C. 627 (1939).

[24] In 1947, for example, about sixty-six percent of broker-dealers registered with the SEC were NASD members. *See* Cherrington, *supra* note 22, at 755 (in December 1947, 4011 broker-dealers were registered with the SEC and 2648 were members of NASD).

[25] Exchange Act § 15(b)(8), 15 U.S.C. § 78o(b)(8) (2000); LOUIS LOSS & JOEL SELIGMAN, IV SECURITIES REGULATION 2824 (3d ed. 2002). The Exchange Act defines "brokers" and "dealers," both of which are required to register with the SEC. Exchange Act § 3(a)(4), 15 U.S.C. § 78c(a)(4) (2000). Although FINRA's rules refer to its members as "broker-dealers,"

Since NASD's initial adoption of rules seventy years ago, promoting high business standards for its members has been its foundation. Its central rule required that in conducting their business, NASD members "shall observe high standards of commercial honor and just and equitable principles of trade."[26]

B. Financial Industry Regulatory Authority

On July 30, 2007, NASD and NYSE Regulation, Inc. consolidated their member regulation operations into a combined organization, FINRA, now the largest U.S. private-sector provider of regulation for securities firms that do business with the public.[27] FINRA is organized as a Delaware not-for-profit corporation. FINRA regulates nearly 5000 brokerage firms in the United States and more than 650,000 brokers associated with FINRA member firms.[28] FINRA maintains a nationwide examination program to verify that FINRA member firms and their employees or contractors who are engaged in the securities business ("Registered Persons") are complying with the rules of the securities industry.[29] When FINRA detects violations of its

this article will use "brokerage firm" and "securities firm" to refer to FINRA member firms.

[26] Grant, *supra* note 19, at 602 (quoting NASD Rule 1) (requirements of this rule have remained unchanged and are currently contained in FINRA Rule 2010).

[27] *See NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority—FINRA*, July 30, 2007, http://www.finra.org/Newsroom/NewsReleases/2007/P036329; *see also* Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc., 72 Fed. Reg. 42,169 (Aug. 1, 2007).

[28] *See* FINRA Corporate Information, at http://www.finra.org/AboutFINRA/index.htm (last visited Mar. 9, 2009).

[29] This article will refer to persons who are engaged in the investment banking or securities business of FINRA member firms as "Registered Persons." FINRA's rules generally require Registered Persons to be registered as principals, representatives, or both. *See* NASD RULES 1021, 1031, FINRA MANUAL (Wolters Kluwer), at 16,135, 16,143. Although

rules or federal securities laws and completes an investigation, its Department of Enforcement takes over responsibility for the matter.[30] FINRA has consolidated the bulk of the NASD's and New York Stock Exchange's rulebooks into a single set of rules and is completing the consolidation of the remaining rules.[31] FINRA is the only organization currently registered as a national securities association and is a Self-Regulatory Organization under the Exchange Act.

FINRA provides the forum to litigate whether its rules have been violated. A FINRA disciplinary case is initiated by the Department of Enforcement or the Department of Market Regulation filing and serving a complaint on a Registered Person or a member firm.[32] A Hearing Officer,

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Registered Persons make up the majority of persons who have an obligation to provide FINRA with testimony, the requirement applies to the broader category of all persons associated with a member, a definition that includes individuals who control FINRA member firms, among others. *See* FINRA BY-LAWS Art. 1(rr), FINRA MANUAL (Wolters Kluwer), at 1304 (defining person associated with a member).

[30] In 2007, the year of FINRA's creation, NASD and FINRA filed 1177 new disciplinary actions. *See* FINRA Annual Report 2007, http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p038602.pdf.

[31] Once all the consolidated rules have been approved by the SEC, all FINRA firms will be subject to a single set of FINRA rules. Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change to Incorporate Certain NYSE Rules Relating to Member Firm Conduct, 72 Fed. Reg. 42,166, 42,167 (Aug. 1, 2007). Until that time, FINRA member firms who were previously only NASD members continue to be subject to NASD rules that have not yet been consolidated. And brokerage firms that were previously members of NASD and the New York Stock Exchange continue to be subject to both NASD and New York Stock Exchange rules until they are replaced with FINRA rules. *Id.*

The requirement to provide testimony to FINRA, which is contained in FINRA Rule 8210, applies to all persons who are registered with FINRA as well as some additional individuals. The current FINRA rules, which include NASD rules that have not yet been adopted into the consolidated FINRA rulebook, are available on FINRA's website. *See* http://finra.complinet.com/finra.

[32] Complaints are reviewed internally within FINRA and are authorized by the Office of Disciplinary Affairs, a group that operates

who is an attorney that serves full time in a judicial capacity, handles trial-level proceedings, including prehearing conferences and other preliminary matters.[33] When a case progresses to an evidentiary hearing, that proceeding is held before a three-member panel consisting of two panelists employed in the securities industry, who are current or former members of a FINRA District Committee, and the Hearing Officer, who serves as the chair of the Hearing Panel.[34] Based on the evidence presented, the Hearing Panel issues a detailed, written decision to the parties.[35] Similar to civil litigation, either party can appeal the Hearing Panel's decision to FINRA's appellate body, the National Adjudicatory Council.[36]

The National Adjudicatory Council conducts an appellate review of the case.[37] After the National Adjudicatory Council issues its written decision, if the Registered Person or member firm is aggrieved, they can appeal FINRA's final decision to the SEC.[38] The SEC's review of a FINRA disciplinary case is akin to the judicial role of a court of appeal.[39]

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independently from the Departments of Enforcement or Market Regulation. *See* FINRA RULE 9211, FINRA MANUAL (Wolters Kluwer), at 10,127.

[33] FINRA RULES 9235(a), 9241, FINRA MANUAL (Wolters Kluwer), at 10,142-43.

[34] *See* FINRA RULE 9231(b), FINRA MANUAL (Wolters Kluwer), at 10,138 (designating Hearing Officer as chair). Respondents have the right to request an evidentiary hearing. FINRA RULE 9221(a), FINRA MANUAL (Wolters Kluwer), at 10,136. The rules also allow the appointment of Hearing Panelists who previously served on other designated NASD committees or are retired from the securities industry. FINRA RULE 9231(b)(1), FINRA MANUAL, (Wolters Kluwer), at 10,138.

[35] FINRA RULE 9268(b), FINRA MANUAL, (Wolters Kluwer), at 10,152.

[36] FINRA RULE 9311(a), FINRA MANUAL (Wolters Kluwer), at 10,158.

[37] *See* FINRA RULES 9321-49, FINRA MANUAL (Wolters Kluwer), at 10,162-70.

[38] FINRA RULE 9370, FINRA MANUAL (Wolters Kluwer), at 10,172; SEC Rules of Practice Rule 420, 17 C.F.R. § 201.420 (2008).

[39] Unlike federal courts, the SEC has the ability, sua sponte, to place a recently issued, final FINRA decision on its docket by issuing an order. *See* SEC Rules of Practice Rule 421(a), 17 C.F.R. § 201.421(a) (2008). In

Consistent with an appellate-review role, the SEC has no ongoing management or authority over FINRA's litigation of cases. The SEC does not approve a FINRA complaint, nor does it participate in the litigation of the case or monitor a case's progress.[40]

C. SEC Oversight of FINRA

The Exchange Act sets a series of standards that FINRA must meet in the areas of complying with and enforcing the securities laws, procedural fairness of disciplinary proceedings, adoption of FINRA rules, Self-Regulatory Organization governance and fees, and other requirements.[41] To ensure that FINRA complies with these standards, Congress armed the SEC with various oversight tools for FINRA and other Self-Regulatory Organizations.

Regarding compliance with the securities laws, the Exchange Act requires that FINRA comply with the Exchange Act and its related rules as well as FINRA's own rules.[42] If the SEC determines that a Self-Regulatory Organization or one of its officers or directors is not complying, it may hold a hearing and impose sanctions.[43]

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practice, the SEC has never exercised this authority over any Self-Regulatory Organization's disciplinary case.

[40] In *Larry Ira Klein*, 52 S.E.C. 1030 (1996), the SEC summarized its role as follows:

> SRO proceedings are not initiated by a government agency, nor does their initiation require our approval. We do not participate in the disciplinary proceedings before the SRO, and we do not control when the SRO begins or concludes its determination. Our sole responsibility in this context arises when an SRO imposes a final disciplinary sanction on a person who seeks review of the SRO's determination from this Commission.

Id. at 44 (footnote omitted).

[41] Exchange Act § 15A, 15 U.S.C. § 78o-3 (2000).

[42] Exchange Act § 19(g), 15 U.S.C. § 78s(g) (2000).

[43] The sanctions include: for a Self-Regulatory Organization, revoking or suspending its registration; for officers or directors, if they willfully violated the Exchange Act or Self-Regulatory Organization rules, removal

FINRA must enforce compliance by its members with the Exchange Act, including Exchange Act rules, and FINRA's rules.[44] FINRA's rules, in turn, must be "designed to prevent fraudulent and manipulative acts" and "promote just and equitable principles of trade."[45] Its rules must "in general, provide a fair procedure for the disciplining of members."[46] The SEC can seek an injunction to compel FINRA to enforce compliance by its members and associated persons with the Exchange Act, the rules thereunder, and FINRA's rules.[47]

Any FINRA proposal to change one of its rules or adopt a new rule must be submitted to the SEC and ordinarily must be approved for the rule change to become effective.[48] The SEC has the authority to abrogate a FINRA rule or order changes to FINRA's rules, after following notice-and-comment procedures.[49]

FINRA's rules must equitably allocate reasonable dues or fees.[50] Although the SEC must approve a change in FINRA's fees, the SEC's oversight lacks any power of the purse strings. FINRA receives no federal funds: It assesses dues on its members and charges a variety of fees.[51]

Given FINRA's responsibilities to verify that its member firms and Registered Persons comply with the rules of the securities industry and the SEC's oversight of FINRA, has

from office or censure. Exchange Act § 19(h)(1), (4), 15 U.S.C. § 78s(h)(1), (4) (2000).

[44] FINRA also must enforce compliance with the rules of the Municipal Securities Rulemaking Board. Exchange Act § 15A(b)(2), 15 U.S.C. § 78o-3(b)(2) (2000).

[45] Exchange Act § 15A(b)(6), 15 U.S.C. § 78o-3(b)(6) (2000).

[46] Exchange Act § 15A(b)(8), 15 U.S.C. § 78o-3(b)(8) (2000).

[47] Exchange Act § 21(e), 15 U.S.C. § 78u(e) (2000).

[48] Exchange Act § 19(b), 15 U.S.C. § 78s(b) (2000).

[49] Exchange Act § 19(c), 15 U.S.C. § 78s(c) (2000).

[50] Exchange Act § 15A(b)(5), 15 U.S.C. § 78o-3(b)(5) (2000).

[51] FINRA assesses revenue-based annual membership dues, trading fees, and fees for each Registered Person. *See* FINRA BY-LAWS Sched. A, § 1(b)-(d), FINRA MANUAL (Wolters Kluwer), at 1335-37 (trading activity fees, assessment of $1200 or more based on annual gross income, and annual assessment for each person registered with FINRA as a principal or representative), *available at* http://finra.complinet.com/finra.

FINRA become the equivalent of a government agency? Federal Courts have answered no to this question.

III. FEDERAL LAW ADDRESSING FINRA AS A STATE ACTOR AND THE SUPREME COURT'S STATE ACTOR TESTS

A central issue in court cases addressing FINRA's status as a private actor is whether a Registered Person can invoke the Fifth Amendment privilege against self-incrimination when questioned by FINRA. The Fifth Amendment to the Constitution provides, in part, that "No person . . . shall be compelled in any criminal case to be a witness against himself."[52] The Supreme Court has both enumerated the forums in which a person can invoke the privilege against self-incrimination and defined the notion of compulsion.

The privilege against self-incrimination applies during a defendant's criminal trial, but also allows a witness to refuse to provide testimony in any "other proceeding, civil or criminal, formal or informal, where the answers might incriminate him in future criminal proceedings."[53] During non-criminal proceedings, the witness seeking to invoke the Fifth Amendment must typically assert the privilege in response to specific questions; courts do not favor a "blanket" claim of a privilege not to testify.[54] The Supreme Court has held that the privilege against self-incrimination extends beyond a witness's ability to decline to answer a question

[52] U.S. CONST. amend. V. The Fifth Amendment applies to the states through the Fourteenth Amendment. *See* Malloy v. Hogan, 378 U.S. 1, 8 (1964).

[53] Minnesota v. Murphy, 465 U.S. 420, 426 (1984) (quoting Lefkowitz v. Turley, 414 U.S. 70, 77 (1973)).

[54] *See* N. River Ins. Co. v. Stefanou, 831 F.2d 484, 486-87 (4th Cir. 1987) (rejecting witness's blanket assertion of privilege because the court could not make a reasonable assessment of the risk of incrimination); United States v. Argomaniz, 925 F.2d 1349, 1355 (11th Cir. 1991) (stating that courts must review assertions of privilege on a question-by-question basis to provide the court with specific information needed to determine applicability of Fifth Amendment privilege and establish a record for review on appeal).

that constitutes evidence of a criminal offense; it also includes the right not to provide answers "which would furnish a link in the chain of evidence needed to prosecute the claimant for a federal crime."[55] The privilege further protects—as part of the link in the chain of evidence theory—testimony that "could lead to other evidence that might be" used to secure a criminal prosecution.[56]

The Fifth Amendment prohibits the use of communications that are, or have been, compelled by the government. The Supreme Court has defined "compelled" as statements not "given freely and voluntarily without any compelling influences."[57]

A Registered Person of a FINRA member firm must give sworn testimony when requested by FINRA regardless of whether that testimony will be incriminating.[58] Although many Registered Persons have challenged this testimony requirement as a violation of the Fifth Amendment, the United States Courts of Appeal have thoroughly rejected this argument.

The cornerstone federal decision that analyzes a claim of a privilege against self-incrimination in the context of a Self-Regulatory Organization's investigation is *United States v. Solomon*.[59] In *Solomon* an officer and director of a New York Stock Exchange brokerage firm was "summoned to appear before the Department of Member Firms and testify" regarding misrepresentations contained in the firm's

[55] United States v. Hubbell, 530 U.S. 27, 38 (2000) (quoting Hoffman v. United States, 341 U.S. 479, 486 (1951)).

[56] Kastigar v. United States, 406 U.S. 441, 445 (1972).

[57] Estelle v. Smith, 451 U.S. 454, 468-69 (1981) (finding a Fifth Amendment violation when a defendant's statements that were made during the course of court-ordered psychiatric examinations were used at trial).

[58] This testimony requirement is the same as requirements that were imposed by NASD and the New York Stock Exchange for more than forty years. *See* NASD RULES OF FAIR PRACTICE, Art. IV, § 4, NASD MANUAL (1966); NYSE RULE 477, NYSE CONSTITUTION AND RULES at 490 (CCH 2005) FINRA RULE 8210, FINRA MANUAL (Wolters Kluwer), at 9111-12.

[59] United States v. Solomon, 509 F.2d 863 (2d Cir. 1975).

financial statements.[60] Solomon agreed to testify after being reminded by the New York Stock Exchange interrogator that, under the New York Stock Exchange Constitution, he could be suspended from being a member of the exchange if he did not testify.[61] Under questioning, Solomon admitted that he had originated the idea of creating a false appearance of a better financial situation for his brokerage firm.[62]

Before the New York Stock Exchange filed a disciplinary case, the SEC became interested in Solomon. In response to a subpoena from the SEC, the New York Stock Exchange turned over the materials it had developed during its investigation, including a transcript of Solomon's testimony to the New York Stock Exchange.[63] Subsequently, the U.S. Attorney filed an indictment that charged Solomon with criminal violations of the recordkeeping and reporting regulations of the Exchange Act.[64] At trial, Solomon was convicted on one count of creating and maintaining false books and records.[65]

On appeal from this conviction, Solomon argued that the federal prosecutor's use of his inculpatory New York Stock Exchange testimony violated his Fifth Amendment privilege not to incriminate himself.[66] The Second Circuit rejected the argument. The court ruled that the privilege against self-incrimination applied only against state actors.[67] Solomon had argued that the New York Stock Exchange's interrogation was the equivalent of state interrogation because the SEC had numerous powers over Self-Regulatory Organizations that it could exercise.[68] The court, however,

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[60] *Id.* at 865.

[61] *Id.*

[62] *Id.*

[63] *Id.*

[64] *Id.* The recordkeeping requirements were Exchange Act Rules 17a-3 and a-5. *See* 17 C.F.R. § 240.17a-3, -5 (2008).

[65] *Solomon*, 509 F.2d at 865.

[66] *Id.* at 866.

[67] *Id.* at 867-68.

[68] *Id.* at 868.

disagreed that the New York Stock Exchange had "become in effect the arm of the government" because the process of self-regulation had not been displaced by the Exchange Act.[69] Rather, the SEC was given the power to ensure that Self-Regulatory Organizations "diligently and effectively" used their self-regulatory powers, but Self-Regulatory Organizations retain the initiative and authority to protect investors.[70] The court further held that the New York Stock Exchange's inquiry did not become the equivalent of a state-actor investigation because Solomon's misconduct violated both a New York Stock Exchange rule and federal law.[71] The court found that the New York Stock Exchange's investigation of Solomon's firm was in furtherance of its "own interests and obligations, not as an agent of the S.E.C." [72] The court concluded that Solomon's Fifth Amendment privilege was not violated because a state actor did not compel him to testify.[73]

A. The Supreme Court's State Action Jurisprudence

There is a rich body of commentary that points out the incoherence of the Supreme Court's state action jurisprudence. For decades, legal scholars have criticized the state action doctrine as a "torchless search for a way out of a damp echoing cave,"[74] a doctrine lacking "any semblance of meaning," [75] and a "bewildering series of unpredictable

[69] *Id.*

[70] *Id.* at 868-69.

[71] *Id.*

[72] *Id.*

[73] *Id.*

[74] Charles L. Black, Jr., *The Supreme Court, 1966 Term–Foreword: "State Action," Equal Protection, and California's Proposition 14*, 81 HARV. L. REV. 69, 95 (1967). Professor Black further lambastes the doctrine: "[t]he field is a conceptual disaster area" and "it is a map whose every country is marked *incognita*." *Id.*

[75] Robert J. Glennon, Jr. & John E. Nowak, *A Functional Analysis of the Fourteenth Amendment "State Action" Requirement*, 1976 SUP. CT. REV. 221, 222 (1976).

results."[76] Supreme Court Justice O'Connor made the more understated admission that "our cases . . . have not been a model of consistency."[77] Yet the state action doctrine is the pivotal test used by courts to resolve whether a person's constitutional rights apply in ostensibly private settings.

The Supreme Court's most recent state actor case, *Brentwood Academy v. Tennessee Secondary School Athletic Ass'n*, was decided in 2001.[78] In *Brentwood Academy*, the Court recognized that its state actor cases "have identified a host of facts that can bear" on state actor status, including whether (1) the state delegated a public function to a private entity; (2) the challenged activity resulted from the state's exercise of coercive power or the state provided significant encouragement to the private actor; and (3) the private actor operated as a willful participant in joint activity with the

[76] Gregory P. Magarian, *The First Amendment, the Public-Private Distinction, and Nongovernmental Suppression of Wartime Political Debate*, 73 GEO. WASH. L. REV. 101, 129 (2004).

[77] Edmonson v. Leesville Concrete Co., 500 U.S. 614, 632 (1991) (O'Connor, J., dissenting). Other scholars have, however, defended the usefulness of the state action doctrine while recognizing several contradictions among the rationale used in various Supreme Court cases. *See, e.g.*, Richard S. Kay, *The State Action Doctrine, the Public-Private Distinction, and the Independence of Constitutional Law*, 10 CONST. COMMENT. 329, 340 (1993) (maintaining that the state action doctrine cabins constitutional law as a distinct and limited body of law that should remain separate from ordinary law); Louis Michael Seidman, *Public Principle and Private Choice: The Uneasy Case for a Boundary Maintenance Theory of Constitutional Law*, 96 YALE L.J. 1006, 1007, 1026 (1987) (suggesting more broadly that the purpose of constitutional law is to maintain a "shifting, uncertain, and contested boundary" between public and private spheres that allows society to preserve its paradoxical preference for both universalist and particularist values); Robert H. Mnookin, *The Public/Private Dichotomy: Political Disagreement and Academic Repudiation*, 130 U. PA. L. REV. 1429, 1429 (1982) (observing that the public/private distinction serves to protect liberalism's conception of individual rights by limiting the power of government to abridge those rights).

[78] Brentwood Acad. v. Tenn. Secondary Sch. Athletic Ass'n, 531 U.S. 288 (2001).

state or its agents.[79] The Court also elaborated its requirements for finding state action based on pervasive entwinement.[80]

Under each of these four state-actor tests, FINRA's disciplinary function of pursuing cases against Registered Persons who have violated FINRA's rules or the federal securities laws do not qualify as state action. The state actor tests are not satisfied when a securities association, which receives no financial support from the government, imposes sanctions for violating its rules—or federal law—pursuant to its own fact-finding process, when that process is subject to the SEC's oversight powers but is not under the SEC's direct control.

B. Pervasive Entwinement

In *Brentwood Academy*, the Supreme Court held in a 5-4 decision that the Tennessee Secondary School Athletic Association ("Athletic Association") was a state actor because of the "pervasive entwinement" of Tennessee's school officials in the structure of the Athletic Association.[81] The Athletic Association was a not-for-profit corporation created to organize and regulate interscholastic sports among Tennessee's public and private schools.[82] Membership in the Athletic Association was voluntary, although there were no other comparable organizations in the state.[83] The

[79] *Id.* at 296 (quotations omitted). Previously, the Court explained that it had "articulated a number of different factors or tests in different contexts," including the public function test, state compulsion test, nexus test, and joint action test. Lugar v. Edmonson Oil, 457 U.S. 922, 939 (1982). This categorization of state-actor tests emphasizes the discreteness of these tests more than the approach of some constitutional scholars. Professor Chemerinsky, for example, observes that there are only two components to the state action doctrine: the public function exception and the entanglement exception. *See* ERWIN CHEMERINSKY, CONSTITUTIONAL LAW 472-73 (2d ed. 2005).

[80] *Brentwood Acad.*, 531 U.S. at 300-02.

[81] *Id.*

[82] *Id.* at 291.

[83] *Id.*

underlying dispute involved a finding that Brentwood Academy, a private high school, had violated a recruiting rule, which had resulted in a regulatory enforcement proceeding.[84]

The Court concluded that the Athletic Association was, despite its corporate form as a private membership corporation, an organization that acted through public school representatives, who in turn acted in their official capacity to provide an integral element of secondary public schooling.[85] The Athletic Association was therefore a state actor. The Court's finding was fact specific and found "pervasive entwinement" based on the following: (1) 84% of the members of the Athletic Association were public high schools, while the remainder were private schools; (2) public school officials and government administrators made up the voting membership of the Athletic Association's governing council and control board, which held meetings during regular school hours; (3) all Athletic Association staff were eligible to join the state retirement system; and (4) delegates of the State Board of Education affirmatively acknowledged the Athletic Association's role in regulating competition and sat as nonvoting members on the Athletic Association's governing bodies.[86] The Court emphasized that the public school officials overwhelmingly performed the functions of the Athletic Association.[87] "Only the 16% minority of private school memberships prevents this entwinement of the Association and the public school system from being total and their identities totally indistinguishable."[88]

The majority explained that the Court previously had used at least three state action tests—coercive power and encouragement, joint activity, and public function.[89] But the Court did not use those tests. Instead, it identified "entwine[ment] with governmental policies," management,

[84] *Id.* at 293.

[85] *Id.*

[86] *Id.* at 288, 300-01.

[87] *Id.* at 300.

[88] *Id.*

[89] *Id.* at 296.

or control as its basis for finding state action.[90] The Court attempted to account for the past anomalies in its state action decisions by noting that the criteria it uses "lack rigid simplicity."[91] The Court further explained that no set of circumstances is absolutely sufficient for a finding of state action because "there may be some countervailing reason against attributing activity to the government."[92]

In dissent, Justice Thomas wrote for himself and three other justices that the Court had never previously found state action based on an entwinement test.[93] The dissent argued that none of the other state action tests mentioned by the majority supported a finding of state action, and what the dissent viewed as the proper test—the symbiotic relationship test—also yielded the answer that there was no state action.[94] The dissent concluded with the observation that the entwinement test was unclear, and it issued a warning that future development of this theory could ensnare other organizations that are composed of, or controlled by, public officials or public entities.[95]

Several legal commentators have concluded that *Brentwood Academy* represents an expansion of the state actor doctrine to cover more private actors.[96] This view of

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[90] *Id.* (citing Evans v. Newton, 382 U.S. 296, 299, 301 (1966)).

[91] *Id.* at 295.

[92] *Id.* at 295-96 (noting NCAA v. Tarkanian, 488 U.S. 179, 193, 196 (1988)). The Court further illustrated the pliability of its state actor framework by explaining that "no one fact can function as a necessary condition across the board for finding state action." *Id.* at 295.

[93] *Id.* at 305 (Thomas, J., dissenting).

[94] *Id.* at 311 (citations omitted).

[95] *Id.* at 314.

[96] *See, e.g.*, Megan M. Cooper, Note, *Dusting Off the Old Play Book: How the Supreme Court Disregarded the Blum Trilogy, Returned to Theories of the Past, and Found State Action Through Entwinement in Brentwood Academy v. Tennessee Secondary School Athletic Ass'n*, 35 CREIGHTON L. REV. 913, 990-91 (2002) (positing that *Brentwood Academy* abandoned the established state action doctrine articulated in the *Blum* trilogy, created an overly inclusive entwinement test, and opened the door for civil rights plaintiffs to rely on an "expansive state action" theory); Michael A. Culpepper, Note, *A Matter of Normative Judgment: Brentwood and the Emergence of the "Pervasive Entwinement" Test*, 35 U. RICH. L.

the Court's opinion, however, is incorrect for several reasons. *Brentwood Academy* does not establish a trend toward more findings of state action; rather, the Court's aim was to refine one aspect of the state action doctrine. First, the Court was focusing on the question of a statewide high school athletic association's status, which numerous courts had found to be a state actor. Five federal circuit courts, as well as four state courts, had ruled that a statewide athletic association was a state actor.[97] The Court's decision agreed with these courts. By siding with the result reached by a lopsided majority of courts, the Supreme Court was overruling an outlier decision; it was not launching an expansion of the state action doctrine.[98]

REV. 1163, 1165 (2002) (contending that the entwinement test is merely "camouflage" for a less-restrictive symbiotic relationship test); Lisa Mastrogiovanni, Note, *Fourteenth Amendment—Deeds of Private Organizations Constitute State Actions Under the Fourteenth Amendment Where There is Pervasive Entwinement Between the Private Organization and a Governmental Entity—Brentwood Academy v. Tennessee Secondary School Athletic Association*, 12 SETON HALL CONST. L.J. 711, 741 (2002) (concluding that *Brentwood Academy* extended constitutional rights because it could have, but did not, resolve the case in a "safer, more conservative" manner) *Cf.* 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, 770 (2004) (questioning whether *Brentwood Academy* "added fuel to the debate" about Self-Regulatory Organizations' state-actor status and asking whether the entwinement theory would result in a finding of state action).

[97] *Brentwood Acad.*, 531 U.S. at 294 n.1. The U.S. Court of Appeals for the Sixth Circuit found no state action in its decision that was on appeal to the Supreme Court. *See* Brentwood Acad. v. Tenn. Secondary Sch. Athletic Ass'n, 180 F.3d 758 (6th Cir. 1999). The Supreme Court granted certiorari to resolve the conflict among the circuits. *See* Griffin High Sch. v. Ill. High Sch. Ass'n, 822 F.2d 671, 674 (7th Cir. 1987) (finding state action); Clark v. Ariz. Interscholastic Ass'n, 695 F.2d 1126, 1128 (9th Cir. 1982) (finding state action); *In re* United States ex rel. Mo. State High Sch. Activities Ass'n, 682 F.2d 147, 151 (8th Cir. 1982) (finding state action); La. High Sch. Athletic Ass'n v. St. Augustine High Sch., 396 F.2d 224, 227-28 (5th Cir. 1968) (finding state action); Okl. High Sch. Athletic Ass'n v. Bray, 321 F.2d 269, 272-73 (10th Cir. 1963) (finding state action).

[98] *See* Gillian E. Metzger, *Privatization as Delegation*, 103 COLUM. L. REV. 1367, 1418 (2003) (observing that the Court in *Brentwood Academy* signaled its consistency with the past by citing with approval a case that

The substance of the Court's pervasive entwinement test also confirms that there was no measurable expansion of the state action doctrine. The relatively narrow dispute in *Brentwood Academy* was how to interpret what has been called the entwinement, symbiotic relationship, or close nexus test.[99] The Court's majority examined all relationships with the state in analyzing entwinement while the dissent viewed the symbiotic relationship test as requiring the private party to have a financial relationship with the state actor that is more than that of a contractor performing services for the government.[100] The dissent, citing *Burton v. Wilmington Parking Authority*, would require a showing that the state profits from the private party's challenged decision.[101] In *Burton*, the Court found state action when a privately owned restaurant that leased its space in a public parking garage building refused to serve an African-American customer.[102] Based on the restaurant's argument that its business would suffer if it did not discriminate, the Court found that the state profited from the restaurant's discriminatory conduct. That fact, in addition to the land and garage building being publicly owned, the garage building being dedicated to public uses, and the commercially leased areas in the garage being physically and financially integral to the state's plan to operate the project, supported the finding of state action.[103] Because the dissent in *Brentwood Academy* found no profit to the state from the

illustrates that "claims of pervasive entanglement will rarely succeed" (citing Rendell-Baker v. Kohn, 457 U.S. 830, 844 (1982)). For a further discussion of *Rendell-Baker*, see *infra* nn. 169-73.

[99] *See* Ronald D. Rotunda & John E. Nowak, 2 TREATISE ON CONSTITUTIONAL LAW: SUBSTANCE AND PROCEDURE 1059 (4th ed. 2007) (interpreting *Brentwood Academy* as reflecting earlier Supreme Court state-actor cases involving symbiotic relationships or multiple contacts).

[100] *Brentwood Acad.*, 531 U.S. at 298-99, 311.

[101] Burton v. Wilmington Parking Auth., 365 U.S. 715 (1961).

[102] *Id.* at 724.

[103] *Id.* at 723-24.

Athletic Association and viewed the Athletic Association as a mere contractor, it would have found no state action.[104]

The majority relied on *Evans v. Newton*, among other cases, as the basis for focusing on pervasive entwinement.[105] In *Evans*, the Court held that a previously public park that had been "swept, manicured, watered, patrolled, and maintained" by a city as a public facility for whites only did not become a private park when a court appointed private trustees who became title holders for the park.[106] The Court held that the "tradition of municipal control" over the park "had become firmly established," and the "momentum [the park had] acquired as a public facility [was] certainly not dissipated *ipso facto* by the appointment of 'private' trustees."[107] The Court concluded that "[i]f the municipality remains entwined in the management or control of the park, it remains subject to the restraints of the Fourteenth Amendment."[108]

Taking from *Evans* the lesson that substance triumphs over form, the *Brentwood Academy* majority found the recent history of the relationship between the State of Tennessee and the Athletic Association significant. Prior to 1996, the State Board of Education had a rule that designated the Athletic Association as "the organization to supervise and

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[104] *Brentwood Acad.*, 531 U.S. at 311. The dissent also relied on the Court's discussion in *Rendell-Baker* that a private school for troubled high school students that received 90% of its budget from public funds was not in a symbiotic relationship with the state because the private school's operation did not generate revenues for the state; rather, the school operators were mere contractors for the state. Rendell-Baker v. Kohn, 457 U.S. 830, 842-43 (1982).

[105] Evans v. Newton, 382 U.S. 296 (1966). The *Brentwood Academy* majority also discussed *NCAA v. Tarkanian*. NCAA v. Tarkanian, 488 U.S. 179, 193 n.13 (1988). *Tarkanian* had, in dictum, opined that a finding of no state action would "be different if the [association's] membership consisted entirely of institutions located within the same State, many of them public institutions . . . ." *Brentwood Acad.*, 531 U.S. at 298.

[106] *Evans*, 382 U.S. at 301.

[107] *Id.* at 301, 304.

[108] *Id.* at 301.

regulate the athletic activities" in Tennessee high schools.[109] After a federal district court had held in 1995 that the Athletic Association was a state actor because the State Board of Education controlled its rules, the State Board of Education deleted the designation of the Athletic Association as regulator of interscholastic athletics in public schools the following year.[110] The Court gave no credit to the deletion: "The most one can say on the evidence is that the State Board once freely acknowledged the Association's official character but now does it by winks and nods."[111] On this point, the majority was affirming the validity of *Evans* and its aversion to a formalistic evaluation of control in favor of a practical assessment.

This skirmish underscores the backward looking nature of the dispute between the majority and the dissent, and confirms that the Court was retracing old boundaries and not claiming new territory. If the dissent had prevailed and found no state action, it would have either overturned *Evans*

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[109] *Brentwood Acad.*, 531 U.S. at 292 (citing TENN. COMP. R. & REGS. 0520-1-2-.26 (1972)).

[110] *Id.* at 300 (citing Graham v. Tenn. Secondary Sch. Athletic Ass'n, No. 1:95-044, U.S. Dist. LEXIS 3211, (E.D. Tenn., Feb. 20, 1995)).

[111] *Id.* at 301. Commentators have pointed out that the majority's use of any connection between the private actor and the government for an entwinement analysis signified a conceptual comeback for a totality-of-the-circumstances approach and a shift away from examining the government's involvement in the precise decision at issue, as the Court had done in *Blum v. Yaretsky* and related cases. 457 U.S. 991 (1982). *See* Cooper, *supra* note 96, at 989; *see also Rendell-Baker*, 457 U.S. at 844 (holding that private school's decisions to terminate teachers were not compelled by the State when the school was subject to "extensive regulation" generally, but "the various regulators showed relatively little interest in the school's personnel matters"). While this observation is correct in noting the different focuses of the state compulsion versus entwinement tests, that same difference existed before *Brentwood Academy*. For example in *Burton*, the Court considered numerous connections between the parking facility in which the restaurant was located and the state, whereas in the state compulsion section of *Rendell-Baker*, the Court explained that the termination decisions were not compelled by state regulations. *Compare Burton*, 365 U.S. at 723-24, *with Rendell-Baker*, 457 U.S. at 841.

or eliminated its precedential value by constraining it to the precise facts of the case.[112] In this respect, the Court's majority maintained the state action doctrine's status quo, while the dissent would have rolled back a basis on which to find state action.

Instead of marking an advance or retreat of the state action doctrine, the Court's result merely refined the entwinement test by adding guidance that the test examines top down and bottom up connections with the government.[113] As the Court explained, the predominantly public school membership of the Athletic Association and the public school officials who performed the acts and functions of the Athletic Association proved bottom up entwinement.[114] Top down entwinement included the State of Tennessee having its Board of Education members serve as ex officio members of the Athletic Association's controlling bodies, as well as the Athletic Association's ministerial employees being eligible for membership in Tennessee's state retirement system.[115]

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[112] The dissent's reasoning on several issues would support overruling *Evans* or limiting that case to its specific facts. The dissent found that the Athletic Association was "not an entity created and controlled by the government for the purpose of fulfilling a government objective." *Brentwood Acad.*, 531 U.S. at 310. It highlighted that the State of Tennessee played no role in creating the Athletic Association. *Id.* And, it noted that although "the board of control currently is composed of public school officials," the Athletic Association's constitution does not require this. *Id.* If this reasoning were to be applied forcefully to *Evans,* the doctrinal supports for finding state action would be removed. First, the park's purpose was not to fulfill a government objective; an individual decided to devise the property in trust through his will. *Evans*, 382 U.S. at 297. Second, the state did not create the park. *Id.* Third, although the City of Macon had served as trustee for the park, a state court had appointed private trustees so that the purpose of the trust—maintenance of the park for whites only—was preserved. *Id.* at 297-98. By dismissing the importance of three of the city's connections to the park, the *Evans* decision would be reduced to a finding of state action without supporting reasons.

[113] *Brentwood Acad.*, 531 U.S. at 300.

[114] *Id.* at 299-300.

[115] *Id.* at 300.

Another gauge of *Brentwood Academy*'s limited impact is its treatment by the lower federal courts since 2001. Those courts have not applied *Brentwood Academy* as a substantive change in the state action doctrine. For example, the First Circuit has referred to *Brentwood Academy* as one of the "[l]atest Supreme Court cases to address whether apparently private actors may be considered state actors on an entwinement theory," and applied traditional factors.[116] A federal district court explained that the *Brentwood Academy* decision is "simply a straightforward application of the close nexus test." [117] Numerous other courts have treated *Brentwood Academy* as "not a departure from prior Supreme Court cases."[118]

In sum, predictions that *Brentwood Academy* signaled an expansion of the state action doctrine were vastly overblown. *Brentwood Academy* preserved the consensus in federal and state courts that state athletic associations are state actors, clarified a minor point of entwinement theory, and has been interpreted as a continuation of prior Supreme Court precedent.

Nevertheless, attorneys have written that *Brentwood Academy*'s entwinement test has changed FINRA's status

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[116] Tomaiolo v. Mallinoff, 281 F.3d 1, 9 (1st Cir. 2002).

[117] Doe v. Harrison, 254 F. Supp. 2d 338, 343 (S.D.N.Y. 2003).

[118] Keeling v. Schaefer, 181 F. Supp. 2d 1206, 1228 (D. Kan. 2001); *see, e.g.*, Village of Bensenville v. FAA, 457 F.3d 52, 62-66 (D.C. Cir. 2006) (citing pre-*Brentwood Academy* Supreme Court cases to enumerate relevant factors); Masters v. Screen Actors Guild, No. 04-2102 SVW (VBKX), 2004 U.S. Dist. LEXIS 27297, at *41-42 (C.D. Cal. Dec. 8, 2004) (citing *Brentwood Academy* and explaining that state action is determined by the three traditional tests); Fisher v. Silverstein, No. 99 Civ. 9657 (SAS), 2004 U.S. Dist. LEXIS 17278, at *16-17 (S.D.N.Y. Aug. 30, 2004) (indicating that factors to consider under the *Brentwood Academy* "entwinement" standard are the same as those considered before *Brentwood Academy*); Koerner v. Garden Dist. Ass'n, No. Civ. A. 00-2206, 2002 U.S. Dist. LEXIS 24891, at *22-24 (E.D. La. Dec. 23, 2002), *aff'd*, 78 Fed. Appx. 960 (5th Cir. 2003) (finding no "entwinement" because the plaintiff did not allege that the state exercised coercive power or provided significant encouragement); D.L. Cromwell v. NASD, 279 F.3d 155, 162 (2d Cir. 2002) (applying the traditional factors and holding that NASD was not a state actor).

such that when FINRA is enforcing the federal securities laws, it is a state actor.[119] A brief comparison of FINRA's status and membership versus the Tennessee Secondary School Athletic Association demonstrates that FINRA is not pervasively entwined with the state. In *Brentwood Academy*, the Court found "top down" entwinement in the ex officio status of the State Board of Education members on the Athletic Association's controlling bodies.[120] FINRA has no comparable top down entwinement. FINRA has no government officials on its board, and it does not have SEC Commissioners serving ex officio, or in any other capacity, as members of FINRA's board, on the National Adjudicatory Council, or any other committee. FINRA's lack of bottom up entwinement also is in stark contrast to what existed in *Brentwood Academy*. The Court noted that the Athletic Association was an association made up of 84% of public schools, and public school officials were acting within the scope of their duties when they represented their school in Athletic Association elections and other matters.[121] FINRA's membership has no public entities; its members are 100% brokerage firms, which are private business entities. When FINRA's Board of Governors takes action on behalf of FINRA, the board members are not acting as governmental officials.

In *Brentwood Academy*, the Court further found that financial support given by the public schools to the Athletic Association constituted bottom up entwinement.[122] The public schools gave up their revenues from gate receipts at

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[119] *See* Thomas K. Potter, III & Neely S. Griffith, *'Entwinement' and NASD Enforcement Proceedings: Reexamining NASD's State-Actor Status in the Post-Brentwood Era*, 39 SEC. REG. & L. REP. 1111, 1116 (2007); *see also* Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J.L. BUS. & FIN. (forthcoming 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1128329.

[120] *Brentwood Acad.*, 531 U.S. at 300.

[121] *Id.* at 298-99. The Court also gave weight to the fact that the Athletic Association's employees were able to join the state retirement system. *Id.* at 300.

[122] *Id.* at 299-300.

athletic competitions to the Athletic Association, which was the "principal part" of the Athletic Association's revenues.[123] FINRA's revenues, by contrast, involve no public sources of funds. FINRA assesses revenue-based dues and collects a variety of fees from its member firms.[124] Accordingly, *Brentwood Academy*'s entwinement test would confirm FINRA's status as a private actor because there is no top down or bottom up entwinement between FINRA and the government.[125]

C. Traditional Public Function

Courts have "found state action present in the exercise by a private entity of powers traditionally exclusively reserved to the State."[126] In *Jackson v. Metropolitan Edison Co.*, an electrical utility customer raised a due process challenge to her electrical company cutting off her service.[127] The customer argued that the electrical company had filed its general tariff with the Pennsylvania Utility Commission, which approved it.[128] The Supreme Court held that the electrical utility was not a state actor despite a state-awarded monopoly and heavy state regulation.[129]

The Supreme Court's case law demonstrates that the test of an exclusively traditional public function has been difficult to satisfy.[130] Several potential bases for being deemed a state

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[123] *Id.* at 299.

[124] *See* FINRA BY-LAWS Sched. A, § 1(b)-(d), FINRA MANUAL (Wolters Kluwer), at 1335-37.

[125] In ruling on an appeal of a FINRA disciplinary case, the SEC has turned away an argument that, under *Brentwood Academy*, FINRA was engaged in state action. *See* Fawcett, *supra* note 6, at 2596-97.

[126] Jackson v. Metro. Edison Co., 419 U.S. 345, 352 (1974).

[127] *Id.* at 347-48.

[128] *Id.* at 354-55.

[129] *Id.* at 351-52.

[130] *See* G. Sidney Buchanan, *A Conceptual History of the State Action Doctrine: The Search for Governmental Responsibility*, 34 HOUS. L. REV. 333, 382 (1997) (contending that under the "test of exclusivity" used in *Jackson* and subsequent cases, "the notion of public function almost

actor under the traditional public function test have been rejected by the Supreme Court.[131] A governmentally granted monopoly does not establish that a private entity becomes a state actor.[132] Nor does heavy governmental regulation of a private entity by itself make a company a state actor.[133] A private entity's creation under federal law, with federally legislated powers, does not satisfy the state actor test.[134] A private entity that is affected with the public interest also does not become a state actor.[135] And a private entity that

disappears from the judicial scene as a meaningful analytical tool for finding state action").

[131] The Court had previously created some uncertainty as to whether a traditional government function also must be exclusively a government function. In *Jackson* and three subsequent cases—*Flagg Bros. v. Brooks*, 436 U.S. 149, 157 (1978), *Rendell-Baker v. Kohn*, 457 U.S. 830, 842 (1982), and *Blum v. Yaretsky*, 457 U.S. 991, 1011 (1982)—the Court repeated the traditional and exclusive parts of the test. In 1991, however, the Supreme Court articulated the traditional government function test without including the concept of exclusivity. Edmonson v. Leesville Concrete Co., 500 U.S. 614, 621-22 (1991); *see also* Georgia v. McCollum, 505 U.S. 42, 45-46 (1992). Neither of those cases, however, involved the Court applying the public function test. In *Brentwood Academy*, the Court again referred to the exclusive and traditional requirements for the public function test. Brentwood Acad. v. Tenn. Secondary Sch. Athletic Ass'n, 531 U.S. 288, 302-03.

[132] *Jackson*, 419 U.S. at 351-52 (acknowledging that a "heavily regulated utility with at least something of a governmentally protected monopoly" is closer to being a state actor than a non-monopoly enterprise that is lightly regulated, but concluding that the nexus between the state and the regulated utility was not strong enough).

[133] *See* Am. Mfrs. Mut. Co. v. Sullivan, 526 U.S. 40, 52 (1999) (worker's compensation benefits); *Jackson*, 419 U.S. at 350.

[134] *See* S.F. Arts & Athletics, Inc. v. U.S. Olympic Comm., 483 U.S. 522, 542-45 (1987) (finding a corporation's congressionally granted federal charter not dispositive because "all corporations act under charters granted by a government, usually by a State").

[135] *Id.* at 546-47; *see Jackson*, 419 U.S. at 354 ("Doctors, optometrists, lawyers, [electrical companies, and grocery stores] selling a quart of milk are all in regulated businesses, providing arguably essential goods and services, 'affected with a public interest.' We do not believe that such a status converts their every action, absent more, into that of the State.").

has the government approve or acquiesce in its decisions does not become a state actor.[136]

In light of the Supreme Court's public function cases, FINRA's status as a private regulator is subject to little doubt under the case law. First, FINRA's core function—the regulation of its member firms and Registered Persons—is not a traditional and exclusive government function. Historically, stock markets were largely privately regulated until the enactment of the Securities Exchange Act of 1934.[137] The New York Stock Exchange's Constitution of 1817 "provided for fining members for various infractions, declared that any member who did not comply with [NYSE] rules could be expelled with a two-thirds vote of the membership," and stated that "any member convicted of making a fictitious sale would be expelled."[138] Since the 1930s, when stock exchanges registered with the SEC and NASD registered as a securities association, securities regulation of brokerage firms has been accomplished on several levels, including private Self-Regulatory Organizations and the SEC. FINRA does not satisfy either the traditional or exclusive requirement of the public function test.

Second, even when focusing more specifically on FINRA's pursuit of disciplinary cases, FINRA does not meet the rigorous test for performing a traditionally exclusive government function. Although several commentators have asserted that FINRA exercises delegated governmental authority when it brings disciplinary actions, and in particular when it brings disciplinary cases for violations of

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[136] *Blum*, 457 U.S. at 1004-05.

[137] *See* Friedman, *supra* note 96, at 728-29.

[138] Merrill et al., *supra* note 9, at 163 n.15. Both the New York Stock Exchange and NASD were formed at the initiative of private interests, namely groups of brokerage firms, "long before Congress enveloped them in a regulatory scheme." Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 1022 (2005).

the Exchange Act,[139] a private actor's use of powers provided by statute or case law is the beginning of a public function analysis, not the end of it. The public function test demands far more than a mere finding that government has "delegated" a function to a private entity. In *Flagg Bros., Inc. v. Brooks*, the Court rejected a claim by an evicted tenant that a warehouseman, among others, had deprived her of her property without due process, in violation of the Fourteenth Amendment.[140] The tenant claimed that this occurred when the city marshal arranged to store the tenant's furniture at a private warehouse, where it became subject to storage fees.[141] The Court found that the warehouseman was not a state actor when he followed a provision of New York law that allowed him to sell goods entrusted to him for storage to satisfy outstanding storage and related charges.[142] In rejecting the claim, the Court reasoned that the warehouseman's choice of selling the goods pursuant to New York law did not mean that the warehouseman's claim against the former tenant for unpaid storage fees—a private dispute—had been resolved by "an exclusive prerogative of the sovereign."[143] The parties had several choices to resolve the dispute, some private and some provided by state law.[144] Where there is such a system of

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[139] *See* Richard L. Stone & Michael A. Perino, *Not Just a Private Club: Self Regulatory Organizations as State Actors When Enforcing Federal Law*, 1995 COLUM. BUS. L. REV. 453, 492-93 (1995) (advocating that NASD and other Self-Regulatory Organizations should be treated as state actors when enforcing federal law); *see also* John F.X. Peloso & Ben A. Indek, *National Adjudicatory Council, Due Process and Self-Regulation*, 231 N.Y.L.J. 3, 6-7 (2005) (arguing that Self-Regulatory Organizations use federally delegated powers when they perform their disciplinary role and are state actors); Karmel, *supra* note 119 (manuscript at 7), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1018396 (contending that FINRA exercises delegated governmental functions when it engages in disciplinary actions and rule-making).

[140] Flagg Bros., Inc. v. Brooks, 436 U.S. 149, 153 (1978).

[141] *Id.* at 153, 157.

[142] *Id.* at 153, 157-58.

[143] *Id.* at 160.

[144] *Id.*

commercial rights and remedies, a party's use of a remedy provided by statute does not satisfy the requirement that the private party has performed an exclusive state function.[145] As the Court emphasized in turning away the state actor argument: "[w]hile many functions have been traditionally performed by governments, very few have been 'exclusively reserved to the State.'"[146]

This exclusivity requirement of the public function doctrine deflates the argument that FINRA's ability to bring a disciplinary case against a Registered Person for a violation of federal law should result in FINRA's case being treated as state action. The ability of the SEC to pursue an administrative case or a civil action against a FINRA Registered Person underscores that FINRA's disciplinary program is a nonexclusive function.[147] Moreover, the securities industry's history of self-policing demonstrates that this function was traditionally private, and since the 1930s, has been both private and public.[148] Just as the

[145] *Id.* at 161.

[146] *Id.* at 158.

[147] In addition, FINRA is not playing the role of the SEC when its Department of Enforcement litigates against a Registered Person. The remedies within a FINRA disciplinary action include fines payable to FINRA and suspensions or bars from associating with a FINRA member firm. *See* FINRA BY-LAWS Art. 13, FINRA MANUAL (Wolters Kluwer), at 1326-27. If the SEC filed a civil action, its available remedies are different, including seeking an injunction, or fines payable to the government, among other options. *See* Exchange Act § 21(d)(1), (3), 15 U.S.C. § 78u(d)(1), (3) (2000). Another important difference is that FINRA's powers to conduct an investigation do not include governmental powers such as issuing subpoenas or imposing contempt sanctions. *See* NCAA v. Tarkanian, 488 U.S. 179, 197 (1988) (concluding that the NCAA was not a state actor and noting that the "NCAA enjoyed no governmental powers to facilitate its investigations"). The real differences between a FINRA case and an SEC case cannot be glossed over.

[148] One commentator has argued that FINRA, as a private, standard-setting body, potentially violates the non-delegation doctrine because the SEC has delegated powers to FINRA, while the SEC itself is exercising delegated powers from Congress. Karmel, *supra* note 119 (manuscript at 9-10), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1128329 (acknowledging, however, that the Supreme Court has not struck down legislation on non-delegation grounds since 1935). These non-

warehouseman in *Flagg Bros.* was not deemed a state actor when he was pursuing a remedy specifically created for him by New York law, FINRA is not a state actor when it pursues disciplinary cases that the Exchange Act authorizes it to pursue. Federal law merely allows FINRA to litigate a violation of the Exchange Act within FINRA's forum; FINRA does not have the exclusive obligation to enforce the Exchange Act.

Third, the status of FINRA as the only registered securities association under the applicable provisions in the Exchange Act—the monopoly claim—does not transform FINRA into a state actor. In *U.S. Olympic Committee*, the Supreme Court found that a federally granted charter was insufficient to create a state actor, and in *Jackson* the Court

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delegation concerns are based on a misreading of the Supreme Court's ruling in *Schechter Poultry*. A.L.A. Schechter Poultry Corp. v. United States, 295 U.S. 495 (1935). In *Schechter Poultry*, the Court found that a code of fair competition sponsored by the poultry industry, which had been approved by the President under the National Industrial Recovery Act, was an unconstitutional delegation of legislative power because the President exercised "unfettered discretion to make whatever laws he thinks may be needed" to rehabilitate American industry. *Id.* at 527 & nn. 5-6, 528. When Congress provides, however, an intelligible principle to guide decision-making, Congress has complied with the Constitution. *See* Whitman v. Am. Trucking Ass'n, 531 U.S. 457, 472 (2001).

The Exchange Act's standards for a registered securities association include that the rules of the association are designed to prevent fraudulent and manipulative acts, in general, protect investors and the public interest, and provide a fair procedure for the disciplining of Registered Persons and firms, among other requirements. When compared to statutes that grant broad authority to agencies or commissions, which have passed constitutional muster, logic dictates that Congress did not improperly delegate its legislative power to FINRA. *See* Am. Power & Light Co. v. SEC, 329 U.S. 90, 104 (1946) (upholding as a proper delegation of authority to the SEC, the authority to modify the structure of holding company systems so that they do not "unfairly or inequitably distribute voting power among security holders"); *see also* Mistretta v. U.S., 488 U.S. 361, 416 (1989) (Scalia, J. dissenting) ("What legislated standard, one must wonder, can possibly be too vague to survive judicial scrutiny, when we have repeatedly upheld, in various contexts, a 'public interest' standard?"); Gary Lawson, *Delegation and Original Meaning*, 88 VA. L. REV. 327, 371 (2002) ("After 1935, the Court abandoned any serious nondelegation analysis.").

held that a government-created monopoly was insufficient to create a state actor.[149] In contrast, FINRA's level of federal authorization is far less than the entities at issue in *U.S. Olympic Committee* or *Jackson*. Unlike the U.S. Olympic Committee, FINRA has no federal charter; it is a Delaware corporation which, similar to most corporate entities, must receive a government-issued charter from a state.[150] FINRA also has not been granted a government monopoly as a registered securities association. The Exchange Act does not limit registered securities associations to a single association.[151]

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[149] S.F. Arts & Athletics, Inc. v. U.S. Olympic Comm., 483 U.S. 522 (1987); Jackson v. Metro. Edison Co., 419 U.S. 345, 350-51 (1974).

[150] In *Lebron v. Nat'l R.R. Passenger Corp.*, the Supreme Court held that Amtrak was an agency or instrumentality of the United States for purposes of analyzing constitutional claims. 513 U.S. 374, 394 (1995). While *Lebron* addresses the same ultimate issue as state action cases, the Court did not use any traditional state action test for when a private entity's actions are treated as the government's. Rather, the Court analyzed whether Amtrak, a government-created corporation, was itself part of the government. *Id.* at 378-79. The Court held that "where, as here, the Government creates a corporation by special law, for the furtherance of governmental objectives, and retains for itself permanent authority to appoint a majority of the directors of that corporation, the corporation is part of the Government for purposes of the First Amendment." *Id.* at 400.

FINRA has none of the attributes of Amtrak. FINRA is a Delaware corporation, not a government-created corporation. In an appeal concerning NASD's state actor status, the Second Circuit has ruled that NASD's "creation was not mandated by statute, nor does the government appoint its members or serve on any NASD board or committee." Desiderio v. Nat'l Ass'n of Sec. Dealers, Inc., 191 F.3d 198, 206 (2d Cir. 1999). The Second Circuit concluded that NASD was not a state actor. *Id.* FINRA's Board of Governors and committees likewise have no governmentally appointed members.

[151] Rather, Exchange Act Section 15A sets standards that an applicant must meet to be a registered securities association. *See* Exchange Act § 15A(b)(4)-(6), 15 U.S.C. § 78o-3(b)(4)-(6) (2000).

Assuming arguendo that FINRA is treated as a monopoly, courts that have analyzed this issue under the state action doctrine have concluded that NASD was not a state actor. *See* Graman v. Nat'l Ass'n of Sec. Dealers, Inc., Civ. A. 97-1556-JR, 1998 U.S. Dist. LEXIS 11624, at *8-

Although the Exchange Act imposes the requirement that nearly all brokerage firms become members of a registered securities association, this requirement falls far short of meaning that FINRA serves a traditional public function. The Second Circuit has held that the requirement imposed by NASD, that all employees of NASD members must sign a pre-dispute agreement to arbitrate all employment disputes, did not constitute state action, despite the fact that registration with a Self-Regulatory Organization was mandatory under Commission rules.[152] The court recognized that employment in the securities industry requires registration with a Self-Regulatory Organization, which in turn requires agreeing to arbitration.[153] Nonetheless, the court held that NASD did not engage in state action when it enforced the arbitration clause.[154] Just as NASD's requirement that employees agree to arbitrate employment disputes did not involve state action, neither does FINRA's requirement that associated persons respond unconditionally to requests for testimony.

Private regulation of the participants in securities markets has a long history in the United States. That history verifies that FINRA's current regulation of brokerage firms has not replaced a traditionally exclusive governmental function.

9 (D.D.C. Apr. 27, 1998) ("[T]he existence of an effective private monopoly does not create governmental action . . . .").

[152] *See Desiderio*, 191 F.3d at 201, 207.

[153] *Id.* at 201.

[154] *Id.* at 208. In 1999, the Commission approved an NASD rule change that eliminated the arbitration requirement for statutory employment discrimination claims. *Id.* at 201; *see also* Illyes v. John Nuveen & Co., 949 F. Supp. 580, 584 (N.D. Ill. 1996) (finding no state action where an employee of a brokerage firm signed a form to register with governmental regulators and NASD that contained a pre-dispute arbitration clause).

D. An Aside on the Prevalence of Governmental Regulation

Virtually any ostensibly private U.S. company is subject to state and federal regulation to some degree. Even extensively regulated entities, however, such as U.S. companies whose stock has been publicly offered, do not become state actors simply because of heavy regulation.

The SEC has detailed regulatory authority over companies that offer securities to U.S. investors. For purposes of this illustration, three of the SEC's regulatory powers are highlighted.[155] First, to sell stock or bonds to the public without violating the law, a company—an issuer—must file a registration statement for the securities offering with the SEC and wait for the SEC to declare the registration statement effective or qualify for an exemption.[156] After giving notice and an opportunity for a hearing, the SEC may suspend the effectiveness of an issuer's registration statement when the SEC finds that the registration statement contains untrue statements or material omissions. [157] Moreover, the Securities Act authorizes the SEC to investigate an issuer or underwriter relating to such a stop order.[158] Second, the SEC may seek a

[155] Issuers that have an effective registration statement must comply with several additional securities regulations during and after a public offering that are not included in this example for the sake of simplicity. These include the content and style of the prospectus, the prospectus delivery requirement, and on-going disclosure obligations. Issuers that register under the Exchange Act are also subject to proxy statement rules, audit committee requirements, and short-swing profit rules, among other requirements.

[156] Section 5 of the Securities Act of 1933 ("Securities Act") prohibits "any person" from "directly or indirectly" selling unregistered securities that are not exempt from registration requirements. 15 U.S.C. § 77e(a), (c); *see generally* HAROLD S. BLOOMENTHAL, 1 SECURITIES LAW HANDBOOK 256-57, 341-42 (2008-09 ed.).

[157] Securities Act § 8(d), 15 U.S.C. § 77h(d) (2000). The registration statement must violate section 17(a)(1) of the Securities Act, which prohibits employing "any device, scheme, or artifice to defraud." 15 U.S.C. § 77q(a)(1) (2000).

[158] Securities Act § 8(e), 15 U.S.C. § 77h(e) (2000).

preliminary or permanent injunction from a federal district court against issuers for "any acts or practices" that are a violation of the Securities Act of 1933 ("Securities Act") or the rules promulgated thereunder.[159] Third, the SEC may either seek a court order or institute an SEC administrative action that permanently bars a person from acting as an officer or director of an issuer whose securities trade on a national exchange, such as the New York Stock Exchange or NASDAQ, if the person committed fraud while selling securities.[160]

In general terms, the SEC's powers over FINRA are somewhat similar to its powers in the realm of public capital formation. The SEC's regulation of FINRA includes the ability to: (1) seek an injunction; (2) remove an officer or director; (3) revoke its registration; and (4) approve its rules. Given these rough similarities in the regulatory schemes, FINRA's status should not be radically different from the status of publicly traded companies. Yet no court has found a publicly traded private corporation to be a state actor based on the SEC's regulatory powers. Likewise, the law does not support such a result for FINRA.

The SEC's authority to regulate the process of issuers offering and selling securities to the public is detailed and comprehensive. There is, however, little doubt that an issuer does not become a state actor when it seeks to raise capital, files a registration statement, and becomes subject to SEC regulation. A public company's need to submit a proposal to a governmental agency for approval and the concomitant requirement to comply with an interlocking series of regulations describes a common and widespread situation for many companies that operate within the modern

[159] Securities Act § 20(b), 15 U.S.C. § 77t(b) (2000).

[160] Securities Act § 20(e), 15 U.S.C. § 77t(e) (2000). For a discussion of the SEC's efforts to have federal courts impose a bar from acting as a public-company officer or director and its authority under the Sarbanes Oxley Act, see Jayne W. Barnard, *SEC Debarment of Officers and Directors After Sarbanes-Oxley*, 59 BUS. LAW. 391 (Feb. 2004).

administrative structure of the United States. [161] Consequently, the SEC's oversight authority for FINRA, even though it involves detailed and sweeping authority, does not present a unique situation that categorically isolates FINRA from scores of other heavily regulated entities.

E. State Compulsion Test

In *Blum v. Yaretsky*, the Court articulated the state compulsion test as requiring "that a state normally can be held responsible for a private decision only when it has exercised coercive power or has provided such significant encouragement, either overt or covert, that the choice must in law be deemed to be that of the State." [162] In *Blum*, Medicaid patients who had been transferred to a lower-level care facility sued nursing homes and others claiming a violation of the Due Process Clause of the Fourteenth Amendment.[163] In holding that the nursing homes were not state actors, the Court found pivotal the fact that private physicians, not the government, made the decisions about whether a patient's care was medically necessary at an intensive-services facility or at a less-skilled facility, even though "the State responded to [the transfer] decisions by adjusting the patient's Medicaid benefits," and even though the State required the physician to complete a State-created assessment form. [164] *Blum* established that the state

[161] Justice O'Connor emphasized a related point when she wrote that "[g]iven the pervasive role of Government in our society, a test of state action predicated upon public and private 'interdependence' sweeps much too broadly and would subject to constitutional challenge the most pedestrian of everyday activities . . . ." Lebron v. Nat'l R.R. Passenger Corp., 513 U.S. 374, 411 (1995) (O'Connor J., dissenting).

[162] *Blum*, 457 U.S. at 1004 (1982); *see also* Flagg Bros. Inc. v. Brooks, 436 U.S. 149. 164 (1978) ("Our cases state 'that a State is responsible for the . . . act of a private party when the State, by its law, has compelled the act.'") (quoting Adickes v. S.H. Kress & Co., 398 U.S. 144, 170 (1970)).

[163] *Id.* at 995-96.

[164] *Id.* at 1005, 1019 ("We cannot say that the State, by requiring completion of a form, is responsible for the physician's decision.").

compulsion test focuses on the decision maker, not on the amount of regulation or legal authority between the government and the recipient of government benefits.[165] If private decision makers act on their own initiative, the decision qualifies as private action.[166]

In *Blum*, the Court also rejected the argument that because health care providers were potentially subject to fines from a state for violating Medicaid program regulations, the decisions made by physicians regarding medically necessary care were state actions.[167] "[T]hose regulations themselves do not dictate the decision to discharge or transfer in a particular case. Consequently, penalties imposed for violating the regulations add nothing to respondents' claim of state action."[168]

In a second state action decision, *Rendell-Baker v. Kohn*, issued on the same day as *Blum*, the Court ruled on several additional state compulsion arguments.[169] *Rendell-Baker* involved a private school for special needds students whose teachers and a counselor challenged the school's decision to terminate their employment, claiming that they were terminated for exercising their First Amendment right to free speech.[170] The Court noted that although the school needed to comply with "detailed regulations," including record keeping and student-teacher ratios to be eligible for the state to pay tuition for students, the employment termination decisions were not compelled by any state

[165] The Court rejected the claim that nursing homes are state actors because of extensive regulation by reiterating its holding in *Jackson* that "[the] mere fact that a business is subject to state regulation does not by itself convert its action into that of the State." *Blum*, 457 U.S. at 1004 (quoting Jackson v. Metro. Edison Co., 419 U.S. 345, 350 (1974)).

[166] *See Jackson*, 419 U.S. at 357 ("Respondent's exercise of the choice allowed by state law where the initiative comes from it and not from the State, does not make its action in doing so 'state action' for purposes of the Fourteenth Amendment." (footnote omitted)).

[167] *Blum*, 457 U.S. at 1009-10.

[168] *Id.* at 1010.

[169] 457 U.S. 830, 830 (1982).

[170] *Id.* at 834-35.

regulation.[171] The Court therefore found the school to be a private actor.[172] *Rendell-Baker* highlighted that a private institution's reliance on the state, even for ninety percent of its budget, does not establish state compulsion. The "relationship between the school and its teachers and counselors is not changed because the State pays the tuition of the students."[173]

Applying the state compulsion test to FINRA's enforcement activities leads to the conclusion that FINRA is not a state actor when its Department of Enforcement litigates allegations of rule violations against Registered Persons. As illustrated by *Blum* and *Rendell-Baker*, the key question is whether FINRA's decision to ask a Registered Person to give testimony involved governmental use of coercive power or significant encouragement. FINRA's investigations do not qualify under this test. FINRA's investigations are not pre-cleared by the SEC. The SEC has no statutory authority, and therefore, no coercive power to order FINRA to litigate any specific case. The initiative for typical cases is entirely FINRA's. FINRA investigates, files a complaint, and litigates the case, all without any government approval or pressure to do so.[174] Because the decisions are made by FINRA, FINRA is not a state actor under the government compulsion test.[175]

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[171] *Id.* at 833, 841.

[172] *Id.* at 843.

[173] *Id.* at 841.

[174] The fact that FINRA's rules that govern the conduct of its member firms have previously been approved by the SEC, as is required by § 19(b) of the Exchange Act, does not establish state action. *See* Jackson v. Metro. Edison Co., 419 U.S. 345, 354 (rejecting the proposition that a utility's cutting off of service was "state action because the state 'has specifically authorized and approved' the termination practice" when the utility filed a general tariff that was not disapproved by the Public Utility Commission); *see also* Desiderio v. Nat'l Ass'n of Sec. Dealers, Inc., 191 F.3d 198, 207 (2d Cir. 1999) (the SEC's approval of an NASD rule that required an arbitration clause in member firm's employment forms was not enough for NASD to be deemed a state actor).

[175] *See* Blum v. Yaretsky, 457 U.S. 991, 1006, 1007 n.16 (1982).

The SEC's oversight powers also do not equate to control over FINRA pursuant to the state action doctrine. The SEC's statutory authority over FINRA is broad and includes: the ability to approve proposed FINRA rules, judicial review of FINRA's disciplinary cases, authority to seek to suspend or revoke FINRA's registration, the ability to impose limitations on FINRA's activities, and to remove FINRA officers and directors of FINRA.[176] But these powers are all some form of a penalty that the SEC could impose on FINRA for FINRA's violation of the Exchange Act. As such, the SEC's oversight powers are akin to the potential penalties in *Blum*, which could have been imposed on nursing homes for violating Medicaid program regulations.[177] Just as a detailed regulatory structure surrounding nursing homes did not mean that a physician's decision about a patient's level of care qualified as state compulsion, so too the SEC's regulatory authority over FINRA does not mean that FINRA's decision to investigate misconduct and request a Registered Person's testimony qualifies as state compulsion.[178]

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[176] Exchange Act § 19(b), (d), (e), (h), 15 U.S.C. § 78s(b), (d), (e), (h) (2000) (addressing respectively, rule approval, disciplinary review, and the suspension of officers and directors).

[177] *Blum*, 457 U.S. at 1009-10.

[178] One of the few examples of the Supreme Court finding state compulsion involved an employee drug-testing program. Skinner v. Ry. Labor Executives' Ass'n, 489 U.S. 602 (1989). There, the Court held that a statutory scheme, which removes all legal barriers to drug-testing railroad employees, grants the government the right to receive drug-test results, and forbids railroads from bargaining away their drug-testing authority, converts private railroads into state actors when administering drug tests. *Id.* at 615. "These are clear indices of the Government's encouragement, endorsement, and participation, and suffice to implicate" constitutional protections. *Id.* at 615-16.

The SEC's oversight powers contrast starkly with the magnitude of the state compulsion found by the Supreme Court in *Skinner*. Unlike the government's near complete control over drug testing in that case, the Exchange Act gives the SEC no mechanism to express a strong preference for FINRA to pursue or abandon any disciplinary case or the authority to forbid FINRA from pursuing a case or group of cases.

Moreover, the SEC's oversight authority is an essential component of Congress's plan to create a unique system of private front-line regulation with government oversight, instead of either the securities industry purely policing itself or the government directly regulating the industry.[179] To base a state actor finding for FINRA on the extensive authority given to the SEC to maintain the dual system of Self-Regulatory Organization responsibilities together with government regulation would grossly conflate the concepts of oversight and control. It would also destroy Congress's multi-leveled regime of self regulation backed by government oversight.[180]

In sum, the SEC's oversight authority does not qualify as coercive power or significant encouragement under the state compulsion test. Because FINRA makes an individual decision to request testimony in its disciplinary cases, those decisions embody private actions.

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[179] In *Silver v. New York Stock Exchange*, the Supreme Court explained that the scheme enacted by the Exchange Act relied on industry self-regulation and SEC supervision over stock exchanges:

> The pattern of governmental entry, however, was by no means one of total displacement of the exchanges' traditional process of self-regulation. The intention was rather, as Justice Douglas said, while Chairman of the S.E.C., one of "letting the exchanges take the leadership with Government playing a residual role. Government 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."

373 U.S. 341, 352 (1963) (quoting WILLIAM O. DOUGLAS, DEMOCRACY AND FINANCE 82 (Allen ed., 1940)). *Cf.* Otto v. SEC, 253 F.3d 960, 964 (7th Cir. 2001) (observing that the SEC relies on Self-Regulatory Organizations to enforce the securities laws and Self-Regulatory Organization rules because the SEC lacks the resources to do so itself).

[180] A governmental regulator's concern about a problem does not transform a private actor's efforts to address that problem into state action. *See* Mathis v. Pac. Gas & Elec. Co., 75 F.3d 498, 503 (9th Cir. 1996) (nuclear power plant operator's actions in seeking to eliminate off-site drug sales, which addressed concerns expressed by the Nuclear Regulatory Commission, did not trigger state actor status).

F. Joint Action Test

The Supreme Court's test for state action under a joint action theory asks whether a private party willfully participates "in joint action with the State or its agents."[181] In *Dennis v. Sparks*, the Court found the allegation that a private party had bribed a judge to obtain an injunction as part of a corrupt conspiracy to be sufficient to allege state action.[182] The conspiracy was between the judge who entered the injunction, the party that applied for the injunction, and two other interested parties.[183] The case is a precise example of both parties being necessary for the joint action, and the action at issue resulting directly from the corrupt conspiracy.

In *United States v. Price*, the Supreme Court found joint action between private persons and police officers when the police released three detained individuals from arrest, later intercepted them on a highway and transported them to a place where the police, together with others, assaulted, shot, and killed them.[184] In addition to finding that private persons become the equivalent of state actors when they are "a willful participant in joint activity with the State or its agents,"[185] the Court found that "[s]tate officers participated in every phase of the alleged venture: the release from jail, the interception, assault and murder. It was a joint activity, from start to finish."[186] Although *Dennis* and *Price* establish that start-to-finish joint activities meet the joint action test, they do not address whether joint activities that are less

[181] Dennis v. Sparks, 449 U.S. 24, 27 (1980).

[182] *Id.* at 26. Although the plaintiffs were suing for a deprivation of constitutional rights that occurred "under color of" state law, the Court has held that the test for "under color of" law pursuant to 42 U.S.C. § 1983 is the same as the state actor test under the Fourteenth Amendment. *See* Lugar v. Edmondson Oil Co., 457 U.S. 922, 935 (1982); *accord* Rendell-Baker v. Kohn, 457 U.S. 830, 838 (1982).

[183] *Dennis*, 449 U.S. at 25.

[184] United States v. Price, 383 U.S. 787, 790, 794 (1966) (the three murdered men were civil rights workers James Earl Chaney, Andrew Goodman, and Michael Henry Schwerner).

[185] *Id.* at 794.

[186] *Id.* at 795.

than start-to-finish, or activities with intervening private action, result in a finding of no joint action.[187]

Federal courts of appeal have developed two approaches to finding state action based on joint action.[188] Some courts have hued closely to *Dennis* and required evidence of a conspiracy between private and public actors with the purpose of a constitutional violation.[189] Other courts have focused on the degree of cooperation between private and state officials.[190] Both of these tests illustrate that

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[187] In *NCAA v. Tarkanian*, the Court criticized the dissent's conclusion that state action was present because the dissent disregarded the requirement in *Dennis* that the corrupt conspiracy began with an agreement that the parties would have the judge perform a judicial act and continued until that act had been taken. 488 U.S. 179, 198 n.17 (1988). By implication, the Court found that numerous points of contact between a state actor and a private actor—without any ongoing agreement—do not support a joint action finding. *See id.* Rather, an agreement to deprive persons of their constitutional rights must be the basis.

[188] *See generally* Gallaher v. Neil Young Freedom Concert, 49 F.3d 1442, 1454 (10th Cir. 1995).

[189] *See* Cunningham v. Southlake Ctr. for Mental Health, Inc., 924 F.2d 106, 107 (7th Cir. 1991) ("A requirement of the joint action charge . . . is that both public and private actors share a common, unconstitutional goal."); Malak v. Associated Physicians, Inc., 784 F.2d 277, 281-84 (7th Cir. 1986) (reversing grant of summary judgment to members of hospital management committee in light of testimony that state official participated in allegedly unconstitutional employment decision); Wagenmann v. Adams, 829 F.2d 196, 209-11 (1st Cir. 1987) (affirming finding that private citizen was a state actor because of evidence that he exerted influence over police investigation).

[190] *See* Collins v. Womancare, 878 F.2d 1145, 1154 (9th Cir. 1989); Hoai v. Vo, 935 F.2d 308, 313 (D.C. Cir. 1991) (finding that state action requires at a minimum some "overt and significant state participation" in the deprivation of constitutional rights); Jackson v. Pantazes, 810 F.2d 426, 429 (4th Cir. 1987).

The fact that a state and private actor share a goal, however, does not necessarily mean that a related adverse action qualifies as a joint action. For example, the Ninth Circuit found no state action under a joint action theory when an employer terminated a contractor whom it suspected of selling marijuana after the employer had cooperated with the police in a drug-selling undercover operation. *See* Mathis v. Pac. Gas & Elec. Co., 75 F.3d 498, 503. The court found dispositive that the private

allegations of joint action are particularly fact-intensive. So much so that a finding that a private party did not engage in joint action on one occasion could have little bearing on whether the private party engaged in joint action on a separate occasion.[191]

Applying the joint action test to FINRA disciplinary cases confirms that the results of the test are fact-specific. Beginning with the scenario that a Registered Person is simultaneously under investigation by FINRA and a governmental actor, but the subject matter of the investigations is different, these facts do not support a joint action finding. When FINRA and governmental authorities investigate the same activities, but in separate investigations, FINRA is not engaged in joint action. In *D.L. Cromwell Investments, Inc. v. NASD Regulation, Inc.*, NASD had required Registered Persons to give testimony as part of an investigation into stock trading when the FBI and a U.S. Attorney were investigating the same stock trading activity.[192] NASD's Department of Enforcement knew about

employer's termination decision was not a joint decision with the police. *Id.* at 504. The court rejected the argument that without the employer's participation in the police's undercover operation—without a joint "course of conduct"—he would not have been terminated. *Id.* The court concluded that there was no state action because the employer did not rely "on the direct or indirect support of state officials in making and carrying out its decision" to terminate the employee. *Id.*

[191] For example, joint action claims occur frequently when the police arrest shoplifting suspects. The results, however, are highly dependent on the circumstances. *Compare* Murray v. Wal-Mart, Inc., 874 F.2d 555, 559 (8th Cir. 1989) (finding state action when store security guard requested that police arrest an alleged shoplifter and prosecuting attorney pursued the case without conducting an independent investigation), *with* Cruz v. Donnelly, 727 F.2d 79, 80-81 (3d Cir. 1984) (finding police search of an alleged shoplifter, after a request by the shopkeeper, was not joint action because the police made the decision to search the suspect); *see also* Lee v. Estes Park, 820 F.2d 1112, 1114-15 (10th Cir. 1987) (finding no state action by a landowner when he made a "citizen's arrest" and brought a trespasser to the police station because, although the police filed charges, landowner and police were not working together).

[192] D.L. Cromwell Invs., Inc. v. NASD Regulation, Inc., 279 F.3d 155, 157-58 (2d Cir. 2002).

the U.S. Attorney's investigation, "shared details about the progress of their respective investigations," and shared information learned from a witness.[193] The Second Circuit held that NASD was not a state actor, even when NASD and governmental investigators pursued "similar evidentiary trails because their independent investigations were proceeding in the same direction."[194]

In summary, the legal test to find FINRA to be engaged in joint action with the government is fact-intensive and requires either an agreement between FINRA and the SEC to conduct an investigation with the purpose of violating a Registered Person's constitutional rights, or an overt and high degree of cooperation between FINRA and the SEC during an investigation.

G. Federal Courts' and the SEC's Rulings on State Actor Arguments

In light of the Supreme Court's refinements to the state actor doctrine since the Second Circuit's 1975 ruling in *Solomon* that the privilege against self-incrimination does not apply in Self-Regulatory Organization proceedings, does that decision remain sound today? The unqualified answer is yes. The uniform result reached by lower federal courts and the SEC has been that FINRA, NASD, and the New York Stock Exchange are private actors.[195]

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[193] *Id.* at 158.

[194] *Id.* at 162-63. Although the court in *D.L. Cromwell* was responding to an argument that NASD was a state actor based on a state compulsion theory, the court's analysis bears directly on whether NASD's investigation was independent, as opposed to joint. *Id.* at 163.

[195] Every court that considered whether NASD was a state actor concluded that it was not. *See, e.g., id.* at 161-62 (holding that NASD is a private actor and noting that "even heavily-regulated private entities generally are held not to be state actors."); Desiderio v. Nat'l Ass'n of Sec. Dealers, Inc., 191 F.3d 198, 206 (2d Cir. 1999) ("The NASD is a private actor, not a state actor."); First Jersey Sec., Inc. v. Bergen, 605 F.2d 690, 698 (3d Cir. 1979); Marchiano v. Nat'l Ass'n of Sec. Dealers, Inc., 134 F. Supp. 2d 90, 95 (D.D.C. 2001) ("The court is aware of no case . . . in which NASD Defendants were found to be state actors either because of their regulatory responsibilities or because of any alleged collusion with

An appeal to the SEC is the most frequent forum for litigating the question of whether a Registered Person has a Fifth Amendment right against self-incrimination in a FINRA investigation. In a typical dispute, FINRA's enforcement department files a complaint alleging that a Registered Person violated FINRA's rule that requires a Registered Person to provide information when requested.[196] The SEC reviews such cases after FINRA's trial-level proceeding and an appeal to FINRA's National Adjudicatory Council.

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criminal prosecutors."); Bahr v. Nat'l Ass'n. of Sec. Dealers Inc., 763 F. Supp. 584, 589 (S.D. Fla. 1991) ("In the present litigation, the alleged violation of the Plaintiff's Fifth and Fourteenth Amendment rights are not fairly attributable to any action of a state or federal government. Rather, the conduct which is complained of is solely that of a private corporation insofar as it arose as the result of agreements that the Plaintiff entered into with the NASD."); United States v. Bloom, 450 F. Supp. 323, 330 (E.D. Pa. 1978) ("The Court must conclude that the NASD is not part of the government and its actions cannot be imputed to it nor its agents to bind it. To hold otherwise would be to eliminate a bulwark of our economic regulatory scheme, for there would be no need for a NASD if it were in effect a lower level of the SEC.").

Before 1975, however, the courts had reached different results on related state actor questions. Professor Cleveland, for example, has observed that several cases in the early 1970s found that Self-Regulatory Organizations were state actors, but after the Second Circuit's *Solomon* decision in 1975, courts have upheld the private nature of Self-Regulatory Organization actions. *See* Steven J. Cleveland, *The NYSE as State Actor?: Rational Actors, Behavioral Insights & Joint Investigations*, 55 AM. U.L. REV. 1, 20-21 (2005). "No recent decision has been identified that attributes the actions of a securities exchange or association to the government." *Id.* at 21-22.

[196] FINRA Rule 8210(a)(1) authorizes FINRA to require persons associated with a member "to testify at a location to be specified by FINRA staff . . . with respect to any matter involved in the investigation, complaint, examination, or proceeding," and Rule 8210(c) imposes on associated persons and member firms an unqualified obligation to provide testimony when requested by FINRA under Rule 8210. FINRA RULE 8210, FINRA MANUAL (Wolters Kluwer), at 9111-12. Other Self-Regulatory Organizations have similar rules. *See* NYSE RULE 477(a), NYSE MANUAL (Wolters Kluwer), at 8671; AMERICAN STOCK EXCHANGE, CONSTITUTION AND RULES, Article V, § 4(k) (2007); CHICAGO BOARD OPTIONS EXCHANGE, CBOE MANUAL, RULE 17.2(b) (2007).

For three decades, the SEC has held that the Fifth Amendment right against self-incrimination does not apply to disciplinary actions taken by FINRA, NASD or the New York Stock Exchange. In 1979, the SEC ruled that a person registered with NASD who refused to respond to NASD's written questions about his involvement in selling unregistered securities did not have a Fifth Amendment privilege against self-incrimination.[197] The SEC found that NASD's questions were not state actions covered by the Fifth Amendment because "NASD is not a federal agency, does not have a federal charter, and does not receive federal funding."[198] In a series of decisions since 1979, the SEC consistently has ruled that Registered Persons do not have a Fifth Amendment privilege against self-incrimination in Self-Regulatory Organization disciplinary actions.[199]

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[197] Lawrence H. Abercrombie, 47 S.E.C. 176, 177 (1979).

[198] *Id.* The SEC also has held that neither the New York Stock Exchange nor NASD is a governmental actor or an agency of the government when evaluating if other constitutional protections apply. *E.g.,* Scott Epstein, Exchange Act Release No. 59,328, 2009 SEC LEXIS 217 (Jan. 30, 2009) (rejecting claim of constitutional due process rights); E. Magnus Oppenheim & Co., Exchange Act Release No. 51,479, 85 SEC Docket 298 at 300 (Apr. 6, 2005) (rejecting due process and free speech claims as inapplicable in an NASD proceeding); Ivan M. Kobey, 51 S.E.C. 204, 207 n.4 (1992) ("We note that no self-regulatory organization, including the NYSE, is an agency of the United States government.").

[199] *See* Vladislav Zubkis, 53 S.E.C. 794, 797 n.2 (1998) ("It is well established . . . that the self-incrimination privilege does not apply to questioning in proceedings by self-regulatory organizations, since such entities are not part of the government."); Dan Adlai Druz, 52 S.E.C. 416, 428-29 (1995) ("We have often stated that the Fifth Amendment privilege against self-incrimination does not apply to disciplinary actions taken by self-regulatory organizations such as the Exchange."), *aff'd* 103 F.3d 112 (3d Cir. 1996); Edward C. Farni II, 51 S.E.C. 1118, 1119 (1994); Daniel Turov, 51 S.E.C. 235, 238 (1992); Frank W. Leonesio, 48 S.E.C. 544, 549 (1986) ("Leonesio contends that the NASD's rule impinges on his Fifth Amendment privilege against self-incrimination. However, we have repeatedly rejected similar arguments."); Daniel C. Adams, 47 S.E.C. 919, 921 (1983); Richard Neuberger, 47 S.E.C. 698, 700 (1982) (holding that privilege against self-incrimination does not apply to New York Stock Exchange's request for testimony).

The SEC has, however, overturned an NASD decision barring Silicon Valley investment-banker Frank Quattrone for failing to provide testimony, but the SEC's reversal was based on procedural grounds rather than on a finding of a Fifth Amendment violation.[200] NASD's Department of Enforcement had requested, pursuant to NASD rules, that Quattrone provide testimony. But Quattrone declined, citing his Fifth Amendment privilege.[201] The topic of NASD's request for testimony was in dispute between the parties, and this disagreement played a crucial part in the SEC's ruling that NASD had inappropriately decided, on a motion for summary judgment, that Quattrone violated its rule requiring testimony.[202]

In Quattrone's view, NASD made its request that he testify as part of a joint investigation that included NASD, the SEC, and the New York Stock Exchange. NASD had been participating in large, joint investigations of initial public offering ("IPO") spinning and research analyst conflicts of interest at several Wall Street brokerage firms.[203]

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[200] Frank P. Quattrone, Exchange Act Release No. 53,547, 87 S.E.C. Docket 1847 (Mar. 24, 2006) [hereinafter Quattrone SEC Decision].

[201] *Id.* at 1849, 1849 n.11.

[202] *Id.* at 1851. Under FINRA's rules, either party can make a pre-hearing motion for summary disposition. FINRA RULE 9264(a), FINRA MANUAL (Wolters Kluwer), at 10,149. For simplicity, this section will refer to the Department of Enforcement's motion for summary disposition as a motion for summary judgment. The legal standard for prevailing on a motion for summary disposition in FINRA's disciplinary system is the same as the federal court standard for summary judgment. *See* Dep't of Enforcement v. U.S. Rica Fin. Inc., Compl. No. C01000003, 2003 NASD Discip. LEXIS 24, at *12 (NAC Sept. 9, 2003) (adopting the Supreme Court trilogy of Celotex Corp. v. Catrett, 477 U.S. 317 (1986), Matsushita Elec. Indus. v. Zenith Radio Corp., 475 U.S. 574 (1986), and Anderson v. Liberty Lobby, Inc., 477 U.S. 242 (1986), for guidance on motions for summary disposition).

[203] IPO spinning occurs when a brokerage firm allocates shares in IPOs to the personal brokerage accounts of corporate or venture-capital executives. When the share price of the IPO shoots up, the brokerage firm allows the executives to sell, or "spin," the shares for a quick profit. The brokerage firm aims to attract future underwriting business from the executives in recognition for the spinning. *See* Dep't of Enforcement v.

Quattrone previously had given testimony to NASD in the fall of 2002 concerning both IPO spinning and research analyst conflicts. Four months later, Quattrone received an additional NASD request that he provide testimony, but his attorney informed NASD that Quattrone would assert his Fifth Amendment privilege not to testify because federal and state prosecutors were conducting criminal investigations of him.[204] Quattrone argued several reasons why NASD was a state actor, including that NASD's request for testimony was part of a joint investigation with the government regarding IPO spinning and research analyst conflicts.[205]

NASD Enforcement's view was that its request for testimony was part of a separate and unrelated investigation of whether Quattrone had encouraged Credit Suisse First Boston employees to destroy documents.[206] In December 2000, Quattrone endorsed another employee's email that had urged brokers to "clean up those files" by following Credit Suisse First Boston's document retention and disposal

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Quattrone, Compl. No. CAF030008, 2004 NASD Discip. LEXIS 17 at *7-8 (NASD NAC Nov. 22, 2004) [hereinafter Quattrone NAC Decision].

The research analyst's conflicts investigation focused on whether investment bankers were pressuring research analysts in their firms to issue favorable recommendations regarding investment banking clients, thereby compromising the independence and objectivity of the research analysts. *Id.* at *8.

[204] *Id.* at *14. Quattrone was indicted in federal district court for the Southern District of New York and he stood trial on obstruction of government investigations charges in 2003. That trial ended with a hung jury. *Id.* at *16-17. The federal prosecutors tried the case a second time and, in May 2004, the jury found Quattrone guilty of obstruction. *Id.* at *17. He was sentenced to eighteen months in prison. *Id.* On appeal, the Court of Appeals for the Second Circuit overturned Quattrone's conviction based on faulty jury instructions and ordered a new trial. United States v. Quattrone, 441 F.3d 153, 177-78, 193 (2d Cir. 2006). Quattrone settled with prosecutors and avoided a possible third trial by entering into a one-year deferred prosecution agreement that did not include an admission of wrongdoing. Andrew Ross Sorkin, *Star Banker, With Future, Emerges Free*, N.Y. TIMES, Aug. 23, 2006, at C1.

[205] *See* Quattrone NAC Decision, *supra* note 203, at *23-37.

[206] *See* Quattrone SEC Decision, *supra* note 200, at 1851 n.27.

policy.[207] Immediately before NASD requested Quattrone's testimony in 2003, Credit Suisse First Boston had announced in a press release that it was placing Quattrone on administrative leave based on new information about whether Quattrone "was aware of pending investigations" when he endorsed the "clean-up-those-files" message by emailing employees that "I strongly advise you to follow these procedures."[208]

On appeal, the SEC overturned NASD's decision and ruled that NASD had granted summary judgment in error.[209] The SEC's decision first acknowledged that the investigations of IPO spinning and research analyst conflicts involved the SEC, NASD, and the New York Stock Exchange working together.[210] The SEC noted that two days after NASD's letter requesting Quattrone's testimony, an SEC staff member sent a letter to Quattrone's counsel that emphasized the joint nature of the IPO spinning and research analyst investigations and specified that any settlement would need to involve all three regulators.[211] The SEC found significant that NASD's request for testimony was written by the same NASD investigator who earlier had written a request for Quattrone's testimony in the research analyst investigation and that the request included the file number for the research analyst investigation.[212]

The SEC concluded, taking all these factors together, that NASD was wrong to rule that "Quattrone failed to earn the

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[207] Andrew Ross Sorkin, *Corporate Conduct: The Overview; Wall St. Banker Is Found Guilty of Obstruction,* N.Y. TIMES, May 4, 2004, at A1.

[208] *See* Quattrone SEC Decision, *supra* note 200, at 1848 & n.7; Andrew Ross Sorkin, *Corporate Conduct: The Overview; Wall St. Banker Is Found Guilty of Obstruction,* N.Y. TIMES, May 4, 2004, at A1.

[209] *See* Quattrone SEC Decision, *supra* note 200, at 1852.

[210] *Id.* at 1847-48. Although the joint nature of these investigations was not in dispute, the SEC cited the congressional testimony of its Director of the Division of Enforcement that all three organizations worked together on the investigations and made a joint request from the SEC, NASD, and the New York Stock Exchange to Credit Suisse First Boston for documents. *Id.* at 1847-48 n.6.

[211] *Id.* at 1848.

[212] *Id.*

right to present evidence regarding whether NASD's role in the Joint Investigation rendered the [request for testimony] state action."[213] But the SEC did not reach the merits of the argument that NASD's request for testimony constituted state action because it limited its holding to the procedural issue of whether summary judgment was granted in error.[214] In doing so, the SEC's decision explained that the burden of proof is high for proving joint action between NASD and the SEC and that showing cooperation or collaboration is insufficient.[215] In explaining that it was not deciding Quattrone's argument that NASD disciplinary proceedings always constitute state action, the SEC acknowledged that its own decisions, in addition to federal court opinions, had "consistently" held that NASD disciplinary proceedings were not state action.[216] And the SEC strictly limited the future application of its decision by noting that its consideration of the facts separately would not "necessarily have raised a genuine issue of material fact."[217]

The SEC reached an opposite result from the *Quattrone* outcome in a decision with similar issues, *Michael Sassano*,

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[213] *Id.* at 1851.

[214] *Id.* at 1851-52. The SEC opinion does not explain why its response to an improperly granted motion for summary judgment was to dismiss NASD's case against Quattrone. Federal appellate courts ordinarily remand cases to lower courts for trials when summary judgment was granted in error, especially when the non-moving party established that there were genuine issues of material fact that were in dispute. *See, e.g.*, Cement & Concrete Workers Dist. Council v. Lollo, 35 F.3d 29, 34 (2d Cir. 1994) (reversing summary judgment because material facts were in dispute and remanding case for further proceedings); Billish v. Chicago, 962 F.2d 1269, 1301 (7th Cir. 1992) (remanding a portion of case when the district court used an incorrect legal standard in granting summary judgment); 11 *Moore's Federal Practice-Civil* § 56.41[3][a] (Matthew Bender 3d ed. 2007) ("If the disputed fact presents a genuine issue of material fact, then summary judgment is precluded and the case is appropriately referred to trial."). The SEC opinion cited no legal authority to support dismissal, as opposed to remand, of the case.

[215] *See* Quattrone SEC Decision, *supra* note 200, at 1851-52 n.28.

[216] *Id.* at 1850 n.20.

[217] *Id.* at 1851.

which was issued in 2008.[218] Sassano was simultaneously under investigation for alleged market timing of mutual funds by the New York Stock Exchange and the SEC.[219] When the New York Stock Exchange's Division of Enforcement requested Sassano's on-the-record testimony, he failed to appear.[220] The Division of Enforcement repeated its demand that Sassano give testimony five months later, but he refused again.[221] The Division of Enforcement then filed a disciplinary action against Sassano. Sassano responded by arguing that because the New York Stock Exchange was engaged in state action, he had a Fifth Amendment privilege not to testify.[222] The New York Stock Exchange Hearing Officer allowed Sassano to conduct discovery on three specific claims that the New York Stock Exchange and the SEC were acting jointly in investigating Sassano.[223] After this discovery, both the New York Stock Exchange Hearing Panel and, on appeal, the New York Stock Exchange Board of Directors found that Sassano had failed to respond. They further found that because the Division of Enforcement was not engaged in a joint investigation with the government, it was not a state actor.[224]

On appeal, the SEC found that the New York Stock Exchange was not engaged in state action and upheld the ruling that Sassano violated the New York Stock Exchange's rule by failing to testify.[225] The SEC reiterated that, to meet the high burden of proving state action, Sassano "must demonstrate a specific nexus between the government and

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[218] Michael Sassano, Exchange Act Release No. 58,632, 2008 WL 4346410 (Sept. 24, 2008).

[219] Market timing involves frequent purchases and sales of mutual fund shares to exploit pricing discrepancies in different markets. *Id.* at *2. Sassano's firm was also under investigation by the New York Attorney General and the SEC. *Id.*

[220] *Id.*

[221] *Id.* at *4.

[222] *Id.*

[223] *Id.*

[224] *Id.* at *4-5.

[225] *Id.* at *11-12. The SEC also affirmed the sanction of a bar. *Id.* at *12-13.

the [New York Stock Exchange] requests for testimony triggering Sassano's invocation of the Fifth Amendment."[226]

The SEC held that the existence of both the New York Stock Exchange and SEC investigations into the same potential misconduct does not prove a "causal connection" demonstrating that the investigations were interdependent or inextricably intertwined.[227] Likewise, the fact that the two investigations were taking place at the same time did not prove that the "parallel investigations" involved any joint action.[228] In addition, the SEC found that a meeting between Sassano's counsel, SEC Enforcement attorneys, and New York Stock Exchange Enforcement attorneys, which occurred jointly at the suggestion of Sassano's counsel, did not demonstrate joint action between the New York Stock Exchange and SEC.[229] The SEC found that Sassano had been allowed discovery on this issue, but that the evidence showed that no information about the New York Stock Exchange's investigation of Sassano flowed to the SEC.[230] The SEC concluded that sharing information, including on-the-record testimony between an SRO and the SEC fails to establish state action.[231] The SEC distinguished *Quattrone* because Sassano was afforded discovery on the state action issue whereas Quattrone had not been.[232] The SEC explained that the evidence in *Quattrone* that raised the prospect of joint SRO-SEC action was "considerably stronger" than the evidence in *Sassano*.[233]

The *Quattrone* decision spawned three related decisions. In *Justin F. Ficken*, a case in which a formerly Registered Person refused to provide testimony in response to an NASD request, the SEC remanded NASD's summary judgment

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[226] *Id.* at *6.

[227] *Id.*

[228] *Id.* at *7.

[229] *Id.* at *8-9.

[230] *Id.* at *9.

[231] *Id.*

[232] *Id.* at *8.

[233] *Id.* at *8 n.41.

decision for additional factual discovery.[234] The SEC held again that the party asserting that NASD was a joint actor must meet a high burden of proof.[235] In *Quattrone* and the three related decisions, the SEC's focus was on the procedural question of whether the proponent of the state action claim had been granted sufficient discovery on that issue. In *Sassano*, by contrast, the New York Stock Exchange satisfied the procedural requirement and the SEC rejected Sassano's joint action claim on the merits.

The upshot of the SEC's recent state-action decisions is that when a Registered Person makes a solid argument that FINRA was engaged in joint action with the SEC, it is unlikely that such a case will be decided on summary judgment in the future. Even accounting for the *Quattrone* line of remanded decisions, however, the SEC's decisions since 1979 have uniformly and consistently held that Self-Regulatory Organization's disciplinary actions do not involve state action.

IV. THE HISTORICAL BASES FOR THE FIFTH AMENDMENT PRIVILEGE DO NOT SUPPORT EXTENDING THIS PRIVILEGE TO FINRA ACTIONS

In spite of the uniform consensus among the courts and in the SEC's appellate opinions that FINRA is a private actor, a host of commentators have contended that courts should treat Self-Regulatory Organizations as state actors.[236] Few of

[234] Justin F. Ficken, Exchange Act Release No. 54,699, 89 S.E.C. Docket 650 at 655 (Nov. 3, 2006).

[235] *Id.* The SEC reached similar results in two later appeals from New York Stock Exchange disciplinary cases. *See* Gregg Heinze, Exchange Act Release No. 56,100, 91 S.E.C. Docket 243 at 247-48 (July 19, 2007) (remanding New York Stock Exchange summary judgment decision, in which the applicant was barred for failure to testify, for the adjudicator to assess the credibility of assertions that New York Stock Exchange investigators had coordinated their requests for testimony with SEC staff); *see also* Warren E. Turk, Exchange Act Release No. 55,942, 90 S.E.C. Docket 2541, 2545 (June 22, 2007).

[236] Ernest E. Badway & Jonathan M. Busch, *Ending Securities Industry Self-Regulation As We Know It*, 57 RUTGERS L. REV. 1351, 1374-75 (2005) (proposing that the SEC exclusively handle enforcement of Self-

these commentators, however, have analyzed the overall benefits of FINRA's industry policing and the benefits of FINRA's testimony requirement in particular. Critics of FINRA's testimony requirement, for example, have not argued that providing a Fifth Amendment privilege would result in better protection of the investing public or the integrity of securities markets. Instead, their position is that FINRA should be treated as a state actor and state actors must recognize constitutional rights. For example, Stone and Perino argue that courts have incorrectly applied the law in concluding that Self-Regulatory Organizations are not state actors when they are enforcing violations of the federal securities laws.[237] Although they further contend that Self-Regulatory Organizations should be subject to constitutional restrictions because consistent rules would apply between the SEC and FINRA enforcement proceedings, they do not

Regulatory Organization rules and noting that witnesses would be entitled to "the full panoply of constitutional rights, including the Fifth Amendment right against self-incrimination"); Karmel, *supra* note 119, (manuscript at 44), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1128329 (calling for Self-Regulatory Organizations to provide for Fifth Amendment claims during investigations); Leo F. Orenstein, *The NASD and the Constitutional Right to Remain Silent*, S&P'S THE REV. OF SEC. & COMMODITIES REG. (Oct. 17, 2001) (contending that NASD is a state actor based on engaging in public functions and being subject to the government's coercive power); Stone & Perino, *supra* note 139 (arguing that Self-Regulatory Organizations should be considered state actors when enforcing federal law); Peloso & Indek, *supra* note 139 (arguing that NASD should be treated as a state actor for Fifth Amendment purposes as well as Fourteenth Amendment due process when bringing disciplinary cases); John F.X. Peloso & Ben A. Indek, *A Question of Fairness*, N.Y.L.J., June 21, 2001, at 3 (arguing that when Self-Regulatory Organizations bring disciplinary cases for misconduct that could be a violation of federal securities law, Self-Regulatory Organizations are state actors). The earliest criticism that called for more individual rights in Self-Regulatory Organization disciplinary proceedings was authored by Lewis Lowenfels. *See* Lewis D. Lowenfels, *Lack of Fair Procedure in the Administrative Process: Disciplinary Proceedings at the Stock Exchanges and the NASD*, 64 CORNELL L. REV. 387 (1979). *But see* Norman S. Poser, *Reply to Lowenfels*, 64 CORNELL L. REV. 402 (1979).

[237] Stone & Perino, *supra* note 139, at 486-92.

argue that applying constitutional restrictions would benefit FINRA or the investing public.[238]

These articles indirectly raise a different, normative question: whether FINRA should itself reverse its policy of requiring testimony—even though this reversal is not required by law. Looking to the future, the Treasury Department's blueprint for modernized financial regulation and other reform proposals raise the question of whether Self-Regulatory Organizations should retain their current private status and continue to investigate financial intermediaries in a restructured regulatory environment.[239]

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[238] *Id.* at 461. Lowenfels argues in favor of Registered Persons being granted the privilege against self-incrimination as a matter of fairness. Lowenfels, *supra* note 236, at 379. Badway and Busch advocate terminating altogether Self-Regulatory Organizations' ability to conduct investigations or pursue enforcement matters and relying exclusively on the SEC to perform these functions. Badway & Busch, *supra* note 236, at 1369-70. Although Badway and Busch assert that SEC enforcement would be superior, they simultaneously maintain that exclusive SEC enforcement would result in those under investigation being given *more* protection against investigators, "including the Fifth Amendment right against self-incrimination." *Id.* at 1374-75. While Fifth Amendment protections are valuable to attorneys defending FINRA actions, they do not in any sense lead to more robust protection for securities markets. Professor Karmel observes that conducting Self-Regulatory Organization disciplinary proceedings and rule-making under constitutional standards and administrative law requirements "would not necessarily be useful." Karmel, *supra* note 119, (manuscript at 51), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1128329. Peloso and Indek acknowledge that Self-Regulatory Organizations request testimony from Registered Persons in order to perform their investigatory and enforcement responsibilities, but nevertheless argue that Self-Regulatory Organizations should be subject to constitutional due process requirements. Peloso & Indek, *supra* note 139, at 9.

[239] *See* TREASURY BLUEPRINT, *supra* note 1, at 178-79 (2008), *available at* http://www.treas.gov/press/releases/reports/Blueprint.pdf. Former Federal Reserve Board Chairman Paul Volcker headed a Group of Thirty working group that issued a November 2008 report that compares and analyzes the financial regulatory approaches of seventeen countries. THE STRUCTURE OF FINANCIAL SUPERVISION: APPROACHES AND CHALLENGES IN A GLOBAL MARKETPLACE (2008), *available at* http:///www.group30.org/pubs/pub_1428.htm. The debate over financial regulatory reform promises to be hard fought. *See, e.g.*, Congressional Oversight Panel, *Special Report on*

Evaluated as a question of policy, the starting point is to examine whether the historical rationales supporting the privilege against self-incrimination are persuasive in the context of FINRA's goals and the best interests of the investing public. They are not. The concepts that individuals should suffer no consequences for refusing to answer questions and are protected from the power of the government by a privilege against self-incrimination are anchored in an individual's rights and privileges against the government. When the government is removed from the equation, a thoughtful balancing of rights should take account of an individual's obligations to a private organization and the resulting benefits.

A. FINRA's Testimony Requirement Does Not Force an Unfair Choice

The Supreme Court has explained that in criminal cases the Fifth Amendment privilege against self-incrimination protects defendants from being forced to choose between incriminating themselves, lying, or facing punishment for contempt of court for refusing to answer questions.[240] Critics of FINRA's investigations maintain that Registered Persons should not be forced to make the unfair choice between answering potentially incriminating questions or being stripped of employment in the securities industry.[241] This

Regulatory Reform, (Jan. 2009), *available* at http://cop.senate.gov/blog/entries/blog_012909_reformreport.cfm. Three members of the congressionally appointed panel called for reducing systemic risk by imposing "heightened regulatory requirements for systemically significant institutions to reduce the risk of financial crises." *Id.* at 22-23. Two other members of the panel disagreed, noting that the panel's recommendations, "such as those dealing with systemic risk and leverage, include highly proscriptive proposals that would be difficult, if not impossible to implement outside the walls of academia." *Id.* at 86.

[240] *See* Murphy v. Waterfront Comm'n, 378 U.S. 52, 55 (1964) (deploring the "cruel trilemma of self-accusation, perjury or contempt").

[241] *See* Lowenfels, *supra* note 236, at 378; *see also* Peloso & Indek, *supra* note 236, (arguing that a Self-Regulatory Organization's need to have cooperation in its investigation should not outweigh constitutional protections); *see also* Karmel, *supra* note 119, (manuscript at 44), *available*

critique therefore recasts a criminal law justification for the Fifth Amendment privilege in the private realm of securities industry self-policing. The fairness required in a suit brought by the government, however, differs from that required between private parties.[242] Registered Persons who join FINRA member firms choose to join a profession that polices itself in order to maintain high business standards and that demands full cooperation by Registered Persons during investigations. When a Registered Person who has criminal exposure is called on to abide by that commitment, the difficulty in doing so is no reason for FINRA to grant that Registered Person a privilege not to answer questions.

In the private realm, society does not recognize a person's right to refuse to answer investigative questions. Judge

at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1128329 (relying on SEC and court decisions to conclude that Self-Regulatory Organizations would be "ill advised" to impose a bar for a failure to testify).

[242] Even for public sector employees, refusing to answer their employer's questions about their job performance can result in termination by the government in many circumstances. Several courts have held that the Fifth Amendment does not prevent a public employer from disciplining an employee who refuses to answer job-related questions, as long as the employee is not also required to waive the privilege against self-incrimination or immunity. *See* Spielbauer v. County of Santa Clara, 2009 Cal. LEXIS 1010 *24 (Feb. 9, 2009). Three federal circuits require the government to tell public employees that they have immunity, but after giving this notice the government can constitutionally punish them for refusing to make self-incriminating statements. *See* Weston v. U.S. Dep't of Hous. & Urban Dev., 724 F.2d 943, 948 (Fed. Cir. 1983); Confederation of Police v. Conlisk, 489 F.2d 891, 895, 895 n.4 (7th Cir. 1973); Uniformed Sanitation Men Ass'n v. Comm'r of Sanitation, 426 F.2d 619, 621, 627 (2d Cir. 1970). Other federal circuits have no such notice requirement. Aguilera v. Baca, 510 F.3d 1161, 1172 n.6 (9th Cir. 2007) (holding that a public employer need not "expressly inform an employee that his statements regarding actions within the course and scope of his employment cannot be used against him in a criminal proceeding"); Hill v. Johnson, 160 F.3d 469, 471 (8th Cir. 1998); Wiley v. Mayor & City Council of Balt., 48 F.3d 773, 777 (4th Cir. 1995). These cases illustrate that public employees who refuse to answer job-related questions based on the privilege against self-incrimination can be terminated despite the sense that this consequence is unfair.

Friendly explained that private parties completely reject any privilege against self-incrimination:

> No parent would teach [a privilege against self-incrimination] doctrine to his children; the lesson parents preach is that while a misdeed, even a serious one, will generally be forgiven, a failure to make a clean breast of it will not be. Every hour of the day people are being asked to explain their conduct to parents, employers and teachers. Those who are questioned consider themselves to be morally bound to respond, and the questioners believe it proper to take action if they do not.[243]

Therefore, FINRA's testimony requirement reflects the norm in private party relationships in which an organization can expect responses to its questions.

The obligation to provide testimony upon request by FINRA is not a unique burden for a Registered Person. Registered Persons, like most private employees, have no Fifth Amendment privilege if their supervisor is conducting an internal investigation into an apparent theft of a customer's funds. A Registered Person who refuses to discuss what he or she knows will often be terminated. In this sense, Registered Persons have an obligation to provide information in response to their employer. Moreover, Registered Persons work in an environment in which a brokerage firm's securities transactions are routinely documented as part of compliance with various trade reporting, audit trail, and books and records rules.[244] If Registered Persons decide to deceive customers or the

[243] Henry J. Friendly, *The Fifth Amendment Tomorrow: The Case for Constitutional Change*, 37 U. CIN. L. REV. 671, 680 (1968).

[244] *See* FINRA RULES 7410-60 (reporting of order information for Nasdaq-listed equity securities or over-the-counter equity securities); FINRA RULES 6550, 6622, FINRA MANUAL (Wolters Kluwer), at 8140-48, 7166-72 (transaction reporting for non-exchange-listed securities); NASD RULE 3110, FINRA MANUAL (Wolters Kluwer), at 17,360-64 (maintenance of books and records). Securities transactions executed on a stock exchange have similar requirements. *See, e.g.*, NYSE RULE 128A, B (reporting sales of securities to the tape and reporting of corrections); NYSE RULE 132B, C (order tracking information collection and reporting).

markets about transactions, they often must confront the reality that they either accurately record transaction-related information, and therefore risk detection of the violation, or they lie when providing data to their brokerage firm or FINRA. In light of this obligation to record transactions accurately, FINRA's requirement that Registered Persons provide testimony imposes a similar albeit broader obligation. Consequently, FINRA Registered Persons have no uniquely cruel choice forced upon them by the testimony requirement when they may face severe consequences for refusing to answer their employer's questions and they must accurately report securities transactions.

Advocates of a Fifth Amendment privilege in FINRA proceedings could posit that innocent Registered Persons would be unfairly barred by FINRA when they refuse to answer questions. This scenario of the wrongly accused person would be as follows: A rogue prosecutor has targeted a Registered Person for a criminal prosecution that involves the Registered Person's securities business. Around the same time, FINRA begins to investigate a related aspect of the Registered Person's securities business. The Registered Person consults an attorney who weighs the risks of answering FINRA's questions and advises the client to refuse to answer. Afterwards, the overhang of criminal prosecution persists for a lengthy time, during which FINRA files a disciplinary case and eventually imposes a sanction after the Registered Person, on the advice of counsel, refuses to testify. Eventually, the criminal charges are dropped or the defendant prevails at trial. Despite this vindication, however, FINRA has already imposed its sanction of a bar.

Although this hypothetical scenario engenders considerable sympathy, a Self-Regulatory Organization should not set its policy on cooperation with its investigations based on the possibility of criminal prosecutors pursuing innocent people. Although innocent

people have doubtless been prosecuted, there are safeguards against rogue prosecutors.[245]

FINRA's policy that requires testimony should be evaluated by considering all its benefits and drawbacks, not by focusing solely on a hypothetically wrongly accused Registered Person. On balance, a FINRA policy of imposing consequences on Registered Persons who do not provide testimony during an investigation more effectively protects the investing public and the securities markets than does a policy of granting a privilege against self-incrimination. When a Registered Person refuses to answer questions during a FINRA investigation, FINRA has no ability to determine if a criminal case against that person is meritorious. As a rough rule, a Registered Person who is the target of a criminal investigation or prosecution is exactly the type of person that FINRA should be investigating thoroughly. This is not to say that FINRA should be investigating a Registered Person merely because it learns that a criminal investigation is underway. Indeed, FINRA has no such enforcement policy. If, however, FINRA is investigating a Registered Person for its own reasons, the fact that the same person is the target of a criminal probe for the same conduct indicates that completing FINRA's investigation is more important, not less important.

B. Unfair To Lessen The Burden On The Accuser

Several jurists have considered the purpose of the Fifth Amendment privilege against self-incrimination to be that

[245] The ABA model rules of professional conduct impose special responsibilities on prosecutors, including a prohibition on prosecuting "a charge that the prosecutor knows is not supported by probable cause." MODEL RULES OF PROF'L CONDUCT R. 3.8(a) (2007). The comment to this rule emphasizes that prosecutors are held to a higher standard than other types of attorneys. "A prosecutor has the responsibility of a minister of justice and not simply that of an advocate." *Id.* at 3.8 cmt. 1. Although the ABA's model rule does not guarantee that innocent people will not be prosecuted, it does establish a policy against unsupported prosecutions and creates a disincentive to such misconduct occurring.

the government must "shoulder the entire load"[246] when seeking to obtain a criminal conviction. Justice Frankfurter wrote for the majority of the Supreme Court in 1958 when he summarized that:

> The sole, although deeply valuable, purpose of the Fifth Amendment privilege against self-incrimination is the security of the individual against the exertion of the power of the Federal Government to compel incriminating testimony with a view to enabling that same Government to convict a man out of his own mouth.[247]

This fixing of the burden on the government rationale is entirely consistent with the Bill of Rights' focus on protecting the individual from the power of the government.[248] In attempting to uproot the privilege against self-incrimination and transplant it to FINRA disciplinary proceedings, however, the privilege's rationale is missing. A citizen's relationship to the government is fundamentally different

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[246] Tehan v. United States, 382 U.S. 406, 415 (1966) (holding that the Supreme Court's earlier ruling in *Griffin v. California*, 380 U.S. 609 (1965), that adverse comment on a defendant's failure to testify in a state criminal trial violates the privilege against self-incrimination will not be applied retroactively).

[247] Knapp v. Schweitzer, 357 U.S. 371, 380 (1958), *overruled by* Murphy v. Waterfront Comm'n, 378 U.S. 52 (1964).

[248] Several scholars, however, contend that all the typical rationales cited in support of the privilege (including several rationales not discussed here) fail to satisfactorily explain the current scope of the privilege and why the proffered rationales are limited or invalid in other parts of our legal system. *See, e.g.*, AKHIL REED AMAR, THE CONSTITUTION AND CRIMINAL PROCEDURE 65-70 (Yale University Press 1998) (discussing zone of mental privacy, historic rationale that defendants were not allowed to testify on their own behalf, the concept that government should not be allowed to use defendants as the means to their own destruction, police brutality, and reliability); William J. Stuntz, *Self-Incrimination and Excuse*, 88 COLUM. L. REV. 1227, 1228 (1988) ("It is probably fair to say that most people familiar with the doctrine surrounding the privilege against self-incrimination believe that it cannot be squared with any rational theory."); *but see* ALAN M. DERSHOWITZ, IS THERE A RIGHT TO REMAIN SILENT? 144-50 (Oxford Univ. Press 2008) (critique of Professor Amar's proposal).

from a Registered Person's relationship with FINRA, a private, professional association. The stakes for the citizen are much higher in a criminal case, and the power of the government is unmatched in comparison to FINRA. In conducting a criminal investigation the police can, among other actions, receive permission to tap a person's phone conversations, subpoena their associates to provide testimony, and search their car, home and person. FINRA has no equivalent powers. Government prosecutors can pursue criminal charges and ask a court to impose criminal penalties when they prevail. Again, FINRA has no comparable punishment it can impose. FINRA's decision not to shoulder the burden of a privilege against self-incrimination reflects the proportionate difference between FINRA's most severe sanction and the gravity of criminal law penalties.

Private organizations do not place on themselves the heavy burden of demonstrating wrongdoing by members of their organization without asking those members to explain their actions. For FINRA to adopt such a policy would be to unnecessarily impose on itself a more difficult standard for proving misconduct.

C. Compelled Extraction of Testimony Is Cruel

An additional argument, that forcing a Registered Person to answer questions is unfair, focuses on the method of extracting information. The argument is that compelling people to provide incriminating information about themselves is a particularly cruel method and therefore should not be tolerated.[249] The cruelty rationale, however,

[249] Even within the criminal context, scholars have argued that a cruelty rationale for the privilege against self-incrimination is underinclusive in protecting people. The judicial system compels witnesses in numerous situations, on pain of contempt or perjury, to testify and "creates as difficult a choice as does compelled self-incrimination." David Dolinko, *Is There a Rationale for the Privilege Against Self-Incrimination?*, 33 UCLA L. REV. 1063, 1094 (1986). For example, fear of physical harm does not excuse testimony. *See* Piemonte v. United States, 367 U.S. 556, 559 n.2 (1961) (stating in dicta that

has virtually no merit in a private setting. FINRA's sanction of a bar cannot naturally be described as "cruel." When FINRA imposes the sanction of a bar from being associated with a FINRA member firm, this event has considerable economic impact, but no direct impact on a person's liberty. Courts that hold witnesses in criminal contempt, however, deprive those persons of their freedom and subject them to the many restrictions on their liberty that define prison life.

In addition, FINRA can not force a Registered Person to testify. A request from FINRA to provide testimony typically is contained in a letter that arrives on the desk where a Registered Person conducts his or her securities business. The Registered Person can reflect upon their options, consult with trusted advisors, and make their decision. For a Registered Person who has committed a serious crime, the best course of action may indeed be to refuse to provide FINRA with testimony. Even though a Registered Person's refusal will start a process that will probably result in a bar, the rational choice may well be to avoid providing damaging evidence of criminal culpability. Rational choices that involve serious consequences, however, are appropriate to expect from persons who are registered in the securities industry. There is nothing cruel about Registered Persons rationally deciding that they will not provide FINRA with testimony.

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petitioner's expressed fear for his life and lives of his family should he testify to the grand jury was no defense to contempt citation); Dupuy v. United States, 518 F.2d 1295, 1295 (9th Cir. 1975) ("fear of physical harm does not excuse a witness from testifying"); LaTona v. United States, 449 F.2d 121, 122 n.2 (8th Cir. 1971) (contempt citation affirmed when immunized witness refused to testify to grand jury investigating gambling; cooperative witness in previous investigation had been killed); *but see* EDWIN N. GRISWOLD, THE FIFTH AMENDMENT TODAY: THREE SPEECHES 7 (Harvard University Press 1955) ("[W]e do not make even the most hardened criminal sign his own death warrant, or dig his grave, or pull the lever that springs the trap on which he stands.").

V. FINRA'S TESTIMONY REQUIREMENT FOSTERS PUBLIC CONFIDENCE IN THE SECURITIES INDUSTRY AND DEMONSTRATES ITS COMMITMENT TO INVESTOR PROTECTION

As a professional organization that seeks to uphold high standards of conduct for the securities industry, FINRA should continue to bar individuals for refusing to provide testimony during an investigation. First, FINRA can conduct more effective investigations by requiring associated persons to answer questions. Second, FINRA furthers its goal of investor protection by establishing a high standard of conduct that requires cooperation in investigations. Third, FINRA's requirement that Registered Persons cooperate has the salutary effect of raising the incentive for all well-intentioned Registered Persons to avoid even the suspicion of criminal activities.

A. Effective Investigations

FINRA's requirement that Registered Persons provide testimony produces the benefit of more effective investigations. FINRA's investigators can sort out cases involving potentially serious misconduct from cases involving no misconduct by requiring a Registered Person to give sworn testimony. The FINRA questioner can directly establish what facts are not in dispute, probe the Registered Person's state of mind, and reach a well-informed recommendation about whether to pursue a disciplinary case. Were FINRA to relinquish its unqualified ability to ask Registered Persons questions, disciplinary investigations would require more time and resources. FINRA's testimony requirement is an essential investigative tool, and a Registered Person's "[f]ailure to provide information fully and promptly undermines the NASD's ability to carry out its regulatory mandate."[250]

[250] Michael David Borth, 51 S.E.C. 178, 180 (1992); *see also* Morton Bruce Erenstein, Exchange Act Release No. 56,768, 91 SEC Docket 2579 at 2585 (Nov. 8, 2007), *aff'd*, Erenstein v. SEC, No. 07-15736 (11th Cir.

If FINRA's testimony requirement were stripped away, its investigations would become stunningly more difficult. FINRA lacks any powers to compel the production of evidence equivalent to government powers. FINRA has no authority to: (1) issue subpoenas and seek judicial intervention for failure to comply; (2) seek a court order to compel the attendance of a witness; or (3) seek civil or criminal contempt sanctions for failure to testify. This means that witnesses that are not Registered Persons, including customers and most issuers of securities, will provide FINRA with information during an investigation only when they agree to do so voluntarily. These limits to FINRA's jurisdiction make the cooperation of Registered Persons all the more vital.[251] Although FINRA has other investigative tools, including requesting documents from brokerage firms and Registered Persons, when cases are based on customer complaints about a Registered Person's misconduct, the inability to pose questions to the Registered Person seriously hobbles the progress of an investigation.[252]

FINRA's testimony requirement also benefits its investigations by advancing the search for the truth. In situations where the privilege against self-incrimination applies, it hinders a court's ability to search for the truth.[253]

Sept. 16, 2008) (finding it "critically important to the self-regulatory system that members and their associated persons cooperate with [FINRA] investigations"); Toni Valentino, Exchange Act Release No. 49,255, 82 SEC Docket 602, at 605 (Feb. 13, 2004) (stating that "compliance with [NASD's] rules requiring cooperation in investigations is essential to enable NASD to carry out its self-regulatory functions") (citation omitted).

[251] *See* PAZ Sec., Inc., Exchange Act Release No. 57,656, 93 SEC Docket 47, at 49 (Apr. 11, 2008) [hereinafter PAZ] ("[FINRA's] lack of subpoena power thus renders compliance with Rule 8210 essential to enable [FINRA] to execute its self-regulatory functions."); *appeal docketed*, No. 08-1188 (D.C. Cir. May 13, 2008).

[252] *Cf.* Barry C. Wilson, 52 S.E.C. 1070, 1075 (1996) ("Delay and neglect on the part of members and their associated persons undermine the ability of the NASD to conduct investigations and thereby protect the public interest.").

[253] One critic has observed that "the [p]rivilege eliminates an invaluable source of information and thereby seriously impedes the search

In FINRA investigations, a privilege against self-incrimination would similarly hinder the investigator's ability to uncover the truth. Although the testimony requirement will normally disadvantage a Registered Person who must answer questions about the episode after violation of a FINRA rule, the testimony requirement has the benefit of assisting those who are wrongly under suspicion and investigation. The innocent suspect could finger the true rule violator. And FINRA's investigators could require testimony and information from that person, as long as he or she was a Registered Person.[254] By expecting testimony from those closest to misconduct, the testimony requirement advances the effectiveness of FINRA's investigations.

In addition to hindering the search for the truth, eliminating the testimony requirement would create indeterminate delays in FINRA's disciplinary system. If a Registered Person could potentially delay or avoid giving testimony because of possible criminal liability such cases would be subject to numerous litigation delays.[255] If

for truth." Vincent Martin Bonventre, *An Alternative to the Constitutional Privilege Against Self-Incrimination*, 49 BROOK. L. REV. 31, 44 (1982); *see* Friendly, *supra* note 243, at 679-80 (highlighting that the privilege against self-incrimination impedes the "ascertainment of the truth" while benefiting only those who have broken the criminal law "or believe they may be charged as such").

[254] *See* Friendly, *supra* note 243, at 680-81.

[255] If FINRA were to alter its rules, one scenario would be to allow a Registered Person to move to stay a disciplinary case based on a privilege against self-incrimination. In civil litigation, parties that make a motion to stay based on Fifth Amendment grounds, however, do not automatically win them. *See* SEC v. Dresser Indus., 628 F.2d 1368, 1375 (D.C. Cir. 1980). Rather, federal courts evaluate requests to stay a civil action on a case-by-case basis and use a multi-factored balancing test. *See* Keating v. Office of Thrift Supervision, 45 F.3d 322, 325 (9th Cir. 1995) (five-factor test); Milton Pollack, Parallel Civil and Criminal Proceedings, 129 F.R.D. 201, 203-05 (1989); *see also* Volmar Distrib. v. N.Y. Post Co., 152 F.R.D. 36, 39 (S.D.N.Y. 1993) (noting that the "strongest case for granting a stay is where a party under criminal indictment is required to defend a civil proceeding involving the same matter"), *dismissed*, 899 F. Supp. 1187 (S.D.N.Y. 1995). Successful motions to stay in civil litigation result in indeterminate delays because the parties ordinarily wait until any criminal trial is complete.

FINRA's investigators were required to wait until a criminal case was resolved, FINRA would incur monitoring costs while tracking these matters and would further need to preserve evidence and re-evaluate if the evidence retains its potency as the case gets older. FINRA's granting of a privilege against self-incrimination would therefore trigger a cascading effect and FINRA would need to continue to commit investigative and litigation resources as criminal proceedings unfold. Assuming that FINRA operates on the same budget that it has historically, the operational impact of rescinding the testimony requirement would be additional litigation and monitoring costs for Fifth Amendment cases and a resultant crowding out of investigative resources for other cases. FINRA's current investigations, by contrast, avoid increased costs and slower investigations. FINRA's testimony requirement therefore allows for more effective investigations of potential misconduct by Registered Persons.

B. Furthering FINRA's Commitment to Investor Protection

Two essential tasks for a lasting organization are to craft an effective mission statement and to define its criteria for membership. FINRA has accomplished both of these undertakings. FINRA's mission is to provide investor protection and further market integrity.[256] FINRA applies its membership criteria during its membership application process. New brokerage firms and non-members that seek to become FINRA members must both meet a comprehensive series of requirements[257] and agree to abide by FINRA's rules and By-Laws.[258] Similarly, any person who applies to become a Registered Person of a FINRA member firm agrees to

[256] FINRA, http://www.finra.org/AboutFINRA/index.htm (last visited Mar. 9, 2009).

[257] NASD RULE 1014(a), FINRA MANUAL (Wolters Kluwer), at 16,123-26.

[258] *See* FINRA BY-LAWS, Art. IV, Sec. 1(a), FINRA MANUAL (Wolters Kluwer), at 1307.

comply with FINRA's rules and By-Laws.[259] Among other obligations, FINRA's rules require firms and their Registered Persons to observe high standards of commercial honor and just and equitable principles of trade and to cooperate fully with FINRA investigations.

Moreover, FINRA's disciplinary policy as well as its past practices demonstrates the seriousness of a Registered Person's refusal to provide testimony. FINRA's Sanctions Guidelines emphasize that, absent mitigating factors, the standard sanction for such a refusal is a bar.[260] Because very few mitigating factors exist in these cases, a majority of FINRA actions involving refusals to testify result in bars.[261] Consequently, FINRA's adherence to the testimony requirement has solidified this requirement into a central tenant of a Registered Person's responsibilities.[262]

If FINRA were to reverse its testimony requirement and institute a policy of allowing Registered Persons to claim a Fifth Amendment privilege that overrides this requirement, FINRA's values would be fundamentally disrupted.[263] A unique power of a private organization is its ability to establish standards that are different from ordinary membership in society. FINRA's unique standards include a

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[259] FINRA BY-LAWS, Art. V, Sec. 2(a)(1), FINRA MANUAL (Wolters Kluwer), at 1310.

[260] FINRA SANCTION GUIDELINES § 5 (2007), *available at* http://www.finra.org/Industry/enforcement/SanctionGuidelines/SG/P011484.

[261] Refusals to provide testimony in response to FINRA's formal request will typically result in a bar, preventing indiviudals from associating with any FINRA member firm. *See supra* note 6.

[262] It is well-settled, for example, that Registered Persons must fully and promptly cooperate with FINRA. *See* Mark Allen Elliott, 51 S.E.C. 1148, 1150-51, (1994). Also, Registered Persons cannot second guess FINRA information requests or impose conditions on responding. *See* Joseph Patrick Hannan, 53 S.E.C. 854, 859 (1998) ("[A]n NASD member may not 'second guess' or 'impose conditions on' the NASD's request for information."); Michael David Borth, 51 S.E.C. 178, 181 (1992) ("The Rules do not permit second guessing the NASD's requests" or permit a respondent "to shift his responsibility to others.").

[263] *Cf.* PAZ, *supra* note 251, at 53 (concluding that Registered Person's failure to provide FINRA with requested information "threatens investors and markets").

Registered Person's pledge to uphold high standards of commercial honor and an obligation to cooperate fully in investigations.[264] Because these obligations are universal, all FINRA member firms can claim membership in an organization that requires full cooperation from its Registered Persons during investigations. As an organization, FINRA can leverage the responsibility to cooperate in its investigations to instill public confidence in its ability to protect investors.

Without the testimony requirement, however, FINRA's message to both its Registered Persons and the investing public would be significantly changed. FINRA's values of cooperation and self-policing would be severely undermined by the example of a criminally indicted stock broker who continues to be employed in the securities industry but flatly refuses to answer FINRA's questions. FINRA's words might remain "investor protection," but in reality its investigations would pointedly alter that statement to: "Investor protection, but subject to delays that are out of our control." FINRA

[264] If FINRA had its testimony requirement reversed by a court or other outside authority, FINRA would involuntarily lose the ability to exclude from its membership a Registered Person that it would prefer to expel. This result would strike a blow at the heart of FINRA's control over who constitutes its members and would implicate FINRA's rights as an association. The Supreme Court has held that associations have a First Amendment right to freedom of association that can be violated by forced acceptance of unwanted members.

> There can be no clearer example of an intrusion into the internal structure or affairs of an association than a regulation that forces a group to accept members it does not desire. Such a regulation may impair the ability of the original members to express only those views that brought them together. A freedom of association therefore plainly supposes a freedom not to associate.

Roberts v. U. S. Jaycees, 468 U.S. 609, 623 (1984) (holding that a state's interest in eliminating gender discrimination outweighed an association's right to exclude women from full voting membership when the association showed no restriction on the effectiveness of its expressive activities).

should not undercut its mission of investor protection by changing its policy.[265]

FINRA's collective effectiveness would be diminished as well. FINRA would surrender the power of condemnation by one's peers. If FINRA were to adopt a policy of granting a privilege against self-incrimination, part of its distinctive status would be lost. Group members may no longer identify strongly with the group when it has abandoned one of its higher standards. The responsibility of Registered Persons to cooperate embodies the enlightened self-interest of the group, which imposed the requirement knowing that its burden might fall on any group member. Reversing this requirement would make the mistake of elevating the importance of individuals who face criminal investigations over the benefits that inure to all FINRA member firms from the testimony requirement. These benefits remain compelling today and should not be cast aside.

C. Raise the Standards for Everyone

FINRA's policy of requiring Registered Persons to provide testimony puts real teeth into its investigations. Particularly by making the standard sanction for failing to testify a bar, the message is clear that refusal to give answers has meaningful consequences. In addition, there are collateral benefits from this policy. The policy creates a positive spillover effect of careful avoidance of criminal activities related to the securities business.

From the perspective of all the members of FINRA, widespread understanding of the testimony requirement is beneficial. In an industry where maintaining public confidence can drive business success, the purpose of strong

[265] In light of the Supreme Court's expansion of the right to due process and other constitutional rights, Professor Saltzburg has argued that the privilege against self-incrimination "is now invoked in circumstances which create the impression that it is no longer a great protection of civilized people, but a safe harbor for those who break society's rules." Stephen A. Saltzburg, *The Required Records Doctrine: Its Lessons for the Privilege Against Self-Incrimination*, 53 U. CHI. L. REV. 6, 8 (1986).

disincentives to refusing to provide testimony is to alter behavior to avoid wrongdoing. The realization that Registered Persons in the securities industry must provide information should have a salutary effect on misconduct that is being contemplated at a brokerage firm. Some practices will never be allowed because the participants realize that they cannot justify their actions when considered with the benefit of hindsight. The scrutiny would not justify the risk. In this indirect way, FINRA's robust ability to investigate potential misconduct should result in across-the-board better conduct by Registered Persons of FINRA member firms.

VI. CONCLUSION

FINRA reaps several benefits from its requirement that its members agree to provide sworn testimony when asked. The testimony requirement allows FINRA to conduct effective and focused investigations. The testimony requirement also fortifies FINRA's ability to effectively root out wrongdoing and therefore protect investors. Moreover, the testimony requirement, together with serious consequences for refusing to testify, establishes a strong disincentive for Registered Persons to engage in misconduct. FINRA should not weaken its ability to complete timely investigations by adopting a policy of allowing its Registered Persons to refuse to testify because such testimony may tend to incriminate them. To adopt such a rule would unjustifiably impair the group's desire to uphold high ethical standards and would undermine public confidence in FINRA's private regulation. The benefits of the testimony requirement to FINRA vastly outweigh either the individual benefit of a privilege not to testify or any collective benefit to FINRA. FINRA should continue the practices of the New York Stock Exchange and NASD, which have long required cooperation with their investigations as an element of high standards of commercial honor.