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Governmental Action and the National Association of Securities Dealers

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GOVERNMENTAL ACTION AND THE NATIONAL ASSOCIATION OF SECURITIES DEALERS

INTRODUCTION

In 1939, the National Association of Securities Dealers, Inc. (NASD) was established[1] as the self-regulatory organization for the over-the-counter (OTC) securities industry.[2] Since that time, the NASD has shared many of the same law enforcement responsibilities that Congress delegated to the Securities and Exchange Commission (SEC).[3] In accordance with these responsibilities the NASD often investigates and disciplines its members for improper conduct in their dealings with the investing public.[4]

The role that the NASD plays raises the question of whether in some respects it is a governmental actor for constitutional purposes. Two issues are presented: first, whether arbitrary and capricious acts by NASD officials are a violation of an individual's substantive due process rights;[5] and, second, whether the fruits of a warrantless search conducted by an NASD member and turned over to the NASD at its request are subject to the fourth amendment's exclusionary rule.[6]

Courts dealing with the issue of whether activities of the NASD should be treated as governmental have reached opposite conclusions. Recently, in *United States v. Bloom*,[7] the court held that the NASD was not a governmen-

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1. *See* Application of the National Association of Securities Dealers, Inc., 5 S.E.C. 627 (1939).

2. The OTC securities industry consists of brokers and dealers engaging in securities transactions off the stock exchanges. S. Jaffe, Broker-Dealers and Securities Markets 207 (1977). OTC trading is less centralized than trading on an exchange, which is concentrated in a central marketplace. Securities and Exchange Commission, Report of the Special Study of Securities Markets (pt. 4), H.R. Doc. No. 95, 88th Cong., 1st Sess. 603 (1963) [hereinafter cited as Special Study]. Since 1971, however, the OTC markets' somewhat diffuse and heterogeneous nature has been improved by the National Automated Quotation System (NASDAQ), which utilizes computer equipment to centralize the listing of OTC quotations. S. Jaffe, *supra*, at 212-13.

3. *See* pt. I(C) *infra*.

4. *See* notes 79-86 *infra* and accompanying text.

5. Defendants in United States v. Bloom, 450 F. Supp. 323 (E.D. Pa. 1978), argued that a criminal indictment against them should be dismissed because of alleged "government misconduct" on the part of the SEC and the NASD. *Id.* at 329. Government misconduct that violates an individual's substantive due process rights may result in a criminal indictment being dismissed or its tainted portions stricken. United States v. Fields, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,552 (2d Cir. Sept. 14, 1978) (dismissal of an indictment is justified in certain circumstances); *see, e.g.*, United States v. Jacobs, 547 F.2d 772 (2d Cir. 1976) (indictment dismissed because United States Attorney did not advise grand jury witness that he was target of an investigation, when it was a practice to do so), *cert. dismissed*, 436 U.S. 31 (1978); United States v. Rodman, 519 F.2d 1058 (1st Cir. 1975) (indictment dismissed when SEC broke its promise to recommend that defendant not be prosecuted in return for his information). Substantive due process has never been precisely defined. "Due process of law, as a historic and generative principle, precludes defining, and thereby confining, these standards of conduct more precisely than to say that convictions cannot be brought about by methods that offend 'a sense of justice.' " Rochin v. California, 342 U.S. 165, 173 (1952) (quoting Brown v. Mississippi, 297 U.S. 278, 286 (1936)); *accord*, United States v. Lovasco, 431 U.S. 783, 790 (1977).

6. *See* note 139 *infra*.

7. 450 F. Supp. 323, 330 (E.D. Pa. 1978).

tal actor and that its actions and those of its officials could not violate the fifth amendment's guarantee of due process of law[8] or the fourth amendment's protection against unreasonable search and seizure.[9] Conversely, in *Harwell v. Growth Programs, Inc.*,[10] the court found that Congress had empowered the NASD to act as a quasi-governmental agency with broad securities law enforcement responsibilities, and, therefore, held that the NASD was a governmental actor.[11]

This Note will argue that the NASD acts in a governmental manner and, therefore, is subject to the requirements of substantive due process and the fourth amendment. Part I will outline the background and history of the NASD. Part II will examine the functions of the NASD and its relationship with the SEC to determine whether the NASD satisfies the Supreme Court's tests for governmental action. Finally, Part III will analyze the applicability of the fourth amendment's exclusionary rule to certain types of private searches conducted by NASD members.

I. NASD—BACKGROUND

The Securities Exchange Act of 1934[12] places primary responsibility for regulation of the securities markets with the SEC.[13] The framers of the 1934 Act realized, however, that the federal government lacked the expertise and capabilities to oversee every aspect of the securities markets.[14] Therefore, the Act imposes self-regulatory responsibilities on the stock exchanges with respect to listed securities.[15] By 1938, Congress realized that the SEC alone could not police the OTC securities industry either.[16] Rather than enlarge the federal bureaucracy, Congress passed the Maloney Amendment of 1938,[17] which authorized the creation of national securities associations to assist the SEC in regulating brokers and dealers[18] in the OTC industry.[19] As then-

8. The fifth amendment provides in pertinent part: "No person shall be . . . deprived of life, liberty, or property, without due process of law . . . ." U.S. Const. amend. V.

9. The fourth amendment provides: "The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing the place to be searched, and the persons or things to be seized." U.S. Const. amend. IV.

10. 315 F. Supp. 1184 (W.D. Tex. 1970), *rev'd on other grounds*, 451 F.2d 240 (5th Cir. 1971), *modified per curiam*, 459 F.2d 461 (5th Cir.), *cert. denied*, 409 U.S. 876 (1972).

11. *Id.* at 1191.

12. 15 U.S.C. §§ 78a-78kk (1976).

13. *See generally* L. Loss, Securities Regulation 82-84 (1951).

14. Special Study, *supra* note 2, at 501. *See generally* Moylan, *The Place of Self-Regulation in the Securities Industry*, 6 Sec. Reg. L.J. 49 (1978).

15. S. Jaffe, *supra* note 2, at 239.

16. Special Study, *supra* note 2, at 604-05.

17. Ch. 677, 52 Stat. 1070 (current version at 15 U.S.C. § 78o-3 (1976)).

18. "Broker" is defined in the 1934 Act as "any person engaged in the business of effecting transactions in securities for the account of others . . . ." Securities Exchange Act § 3(a)(4), 15 U.S.C. § 78c(a)(4) (1976). "Dealer" is defined as "any person engaged in the business of buying and selling securities for his own account through a broker or otherwise . . . ." *Id.* § 3(a)(5), 15 U.S.C. § 78c(a)(5) (1976).

19. S. Rep. No. 1455, 75th Cong., 3d Sess. 3-5 (1938) [hereinafter cited as 1938 Senate

Chairman of the SEC, William O. Douglas, stated, the law was designed so that industry would take the lead with government "holding the shotgun behind the door."[20]

The NASD, organized in 1939, is the only association ever formed under the Maloney Amendment and is therefore the self-regulatory agency charged with primary responsibility for OTC market supervision in the same manner as the exchanges regulate the listed securities markets.[21] However, unlike the stock exchanges, which were originally private associations that only later were given self-regulatory responsibilities, the NASD is wholly a "creature of statute."[22]

The 1934 Act requires that NASD membership be open to all qualified broker-dealers.[23] As an inducement to joining, members are authorized[24] to give other members preferential treatment, as to prices, commissions, and other rates.[25] Thus, membership in the NASD is an economic necessity and the overwhelming majority of all securities firms in the United States dealing in OTC securities belong to the NASD.[26]

The 1934 Act also mandates that associations formed under the Maloney Amendment adopt rules "designed to prevent fraudulent and manipulative acts and practices [and] to promote just and equitable principles of trade."[27] With the approval of the SEC,[28] the NASD has promulgated Rules of Fair Practice which set guidelines for members' activities in the conduct of their business.[29] In order to enforce these rules, the NASD conducts member

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Report]; H.R. Rep. No. 2307, 75th Cong., 3d Sess. 4-5 (1938). "[T]he NASD was specifically established to govern conduct in the over-the-counter markets." Special Study, *supra* note 2, at 603. Section 15A(b)(6) of the 1934 Act, 15 U.S.C. § 78o-3(b)(6) (1976), permits a national securities association to register with the SEC if it has adopted rules designed to prevent stock fraud and manipulation, promote just and equitable principles of trade, and protect investors and the public interest.

20. 1938 Senate Report, *supra* note 19, at 4.

21. S. Jaffe, *supra* note 2, at 239.

22. Special Study, *supra* note 2, at 603.

23. Securities Exchange Act § 15A(b)(3), 15 U.S.C. § 78o-3(b)(3) (1976). A broker or dealer must be registered with the SEC and authorized to do business in any branch of the investment banking and securities industry to qualify for NASD membership. NASD By-Laws, art. I, § 1, *reprinted in* NASD Manual (CCH) ¶ 1101 (1973). A registered broker or dealer may be denied membership if it is subject to a statutory disqualification. *Id.* art. I, § 2, *reprinted in* NASD Manual (CCH) ¶ 1102 (1973). Statutory disqualifications are enumerated in § 3(a)(39) of the Securities Exchange Act, 15 U.S.C. § 78c(a)(39) (1976). National stock exchanges and the NASD have the power to determine whether a person is subject to a statutory disqualification. *Id.* § 15(b)(10), 15 U.S.C. § 78o(b)(10) (1976).

24. Securities Exchange Act § 15A(e)(1), (3), 15 U.S.C. § 78o-3(e)(1), (3) (1976).

25. NASD Rules of Fair Practice, art. III, § 25, *reprinted in* NASD Manual (CCH) ¶ 2175 (1975); *see* Special Study, *supra* note 2, at 605.

26. Comment, *Current Problems in Securities Regulation*, 62 Mich. L. Rev. 680, 681 (1964) [hereinafter cited as *Current Problems*]; *see* Special Study, *supra* note 2, at 603. Approximately 85% of all registered broker-dealers are members of the NASD. 40 SEC Ann. Rep. 47, 56 (1974).

27. Securities Exchange Act § 15A(b)(6), 15 U.S.C. § 78o-3(b)(6) (1976).

28. *Id.* § 15A(b), 15 U.S.C. § 78o-3(b) (1976). In order to register with the SEC, NASD rules must meet the specific criteria set forth in this section of the 1934 Act.

29. *See* NASD Rules of Fair Practice, art. III, §§ 1-32, *reprinted in* NASD Manual (CCH) ¶¶ 2151-82A (1976).

inspections and investigations.[30] If a violation is discovered, the NASD will file a complaint and institute disciplinary proceedings.[31] The proceedings are conducted by the NASD's regional District Business Conduct Committee (DBCC)[32] and must comply with the NASD's own procedures, which include provisions for notice and a hearing.[33] Any action taken by the DBCC is appealable as of right to the NASD Board of Governors,[34] to the SEC, which conducts a de novo review,[35] and finally to the appropriate circuit court.[36]

II. GOVERNMENTAL ACTION AND THE NASD

A. *General Principles of Governmental Action for Constitutional Purposes*

Although the Constitution prohibits governmental agencies and officials from engaging in certain activities, it "erects no shield against merely private

30. Special Study, *supra* note 2, at 602-08, 646-71; S. Jaffe, *supra* note 2, at 241-43. The NASD may inspect the books and records of any member to determine whether it is complying with the Rules of Fair Practice. Special Study, *supra* note 2, at 647-59. Another important function of the NASD is to qualify broker-dealers and the securities salesmen they employ for membership. *Id.* at 602-08, 646-71; S. Jaffe, *supra* note 2, at 241-43.

31. NASD Rules of Fair Practice, art. V, *reprinted in* NASD Manual (CCH) ¶ 2301 (1976).

32. *See generally* Special Study, *supra* note 2, at 608-41. The NASD is managed on a national scale by a Board of Governors, with membership divided into thirteen geographical districts, each of which has a DBCC. *Id.*

33. NASD Code of Procedure for Handling Trade Practice Complaints, §§ 6, 8, *reprinted in* NASD Manual (CCH) ¶¶ 3006, 3008 (1973). Although § 15A(h) of the 1934 Act, 15 U.S.C. § 78o-3(h) (1976), does not specifically state that the NASD must accord procedural due process, it requires the NASD to adopt procedures for disciplining members and their associates. These procedures must provide for specific charges, notice, an opportunity to defend, and maintenance of a record. *Id.* If the NASD sanctions a member, it must provide a statement setting forth the challenged act or omission, the specific rule or statutory provision violated, the sanction, and the reasons therefor. *Id.*

The SEC has held that the provision of the Administrative Procedure Act that prohibits a federal agency official from acting as both prosecutor and judge in administrative disciplinary proceedings, 5 U.S.C. § 554(d) (1976), does not apply to disciplinary proceedings before the NASD, on the ground that the NASD is not a federal agency. Sumner B. Cotzin, SEC Securities Exchange Act Release No. 10,850 (June 12, 1974), *reprinted in* [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,827. The Commission was careful to point out, however, that this proscription is solely statutory and that, in its opinion, such separation of functions is not constitutionally required in federal agency administrative proceedings. Thus, the Fifth Circuit has held that due process was not violated when a stock exchange, which the court labeled an administrative agency, exercised both investigative and judicial functions. Intercontinental Indus., Inc. v. American Stock Exch., 452 F.2d 935, 941-43 (5th Cir. 1971), *cert. denied*, 409 U.S. 842 (1972). This Note is concerned only with those procedures and actions that are constitutionally, as opposed to statutorily, proscribed.

34. NASD Code of Procedure for Handling Trade Practice Complaints, § 15, *reprinted in* NASD Manual (CCH) ¶ 3014 (1973).

35. Securities Exchange Act § 19(e), 15 U.S.C. § 78s(e) (1976). The SEC may "reduce, cancel, or leave undisturbed the penalty imposed." Todd & Co. v. SEC, 557 F.2d 1008, 1012 (3d Cir. 1977), *discussed at* note 65 *infra*.

36. Securities Exchange Act § 25(a), 15 U.S.C. § 78y(a) (1976). For additional descriptions of the NASD and its functions, see Special Study, *supra* note 2, at 602-82; Jaffe, *supra* note 2, at 238-69; 2 L. Loss, Securities Regulation 1365-69 (2d ed. 1961); Jennings, *Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission*, 29 Law & Contemp. Prob. 663, 675-77 (1964); White, *National Association of Securities Dealers, Inc.*, 28 Geo. Wash. L. Rev. 250 (1959); *Current Problems*, *supra* note 26.

conduct, however discriminatory or wrongful."[37] Nevertheless, private conduct that can be characterized as governmental action[38] also becomes subject to constitutional strictures.[39] The essential problem, therefore, is to distinguish between purely private conduct and governmental action. In the effort to do so, the Supreme Court has devised no one method to cover all situations.[40] The simplest test is to look for direct governmental participation in the challenged action of the private entity, such as judicial enforcement of private contractual arrangements that attempt to discriminate on the basis of race.[41] When such direct action is found, there is governmental action and no further inquiry is required. When the facts do not clearly indicate direct governmental action, the Court has employed two other approaches. These can be labelled the "public function" test, most recently discussed in *Flagg Brothers, Inc. v. Brooks*,[42] and the "symbiotic relationship" test, originally espoused in *Burton v. Wilmington Parking Authority*.[43]

The Supreme Court developed the public function test through several decisions prior to *Flagg Brothers*.[44] The test provides that governmental action is present when a private entity exercises "some power delegated to it by the [government] which is traditionally associated with sovereignty."[45] For example, a private organization's conducting political elections[46] and a corporation's performance of all necessary municipal functions[47] have been held to satisfy this test. Conversely, a private utility's supplying a city with electricity

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37. Shelley v. Kraemer, 334 U.S. 1, 13 (1948).

38. Because this Note is concerned with the fifth amendment, which applies to the federal government, the phrase "governmental action" will be used instead of the phrase "state action," which developed from the Supreme Court cases concerning due process as applied to the states through the fourteenth amendment. *See, e.g.*, Jackson v. Metropolitan Edison Co., 419 U.S. 345 (1974).

39. *See* Jackson v. Metropolitan Edison Co., 419 U.S. 345, 349-51 (1974); Moose Lodge No. 107 v. Irvis, 407 U.S. 163, 172 (1972); Burton v. Wilmington Parking Auth., 365 U.S. 715, 721-22 (1961); The Civil Rights Cases, 109 U.S. 3, 11 (1883).

40. *See, e.g.*, CBS v. Democratic Nat'l Comm., 412 U.S. 94, 115 (1973) ("[T]he line between private conduct and governmental action cannot be defined by reference to any general formula unrelated to particular exercises of governmental authority."). *See generally* Note, *State Action: Theories for Applying Constitutional Restrictions to Private Activity*, 74 Colum. L. Rev. 656, 656-59 (1974).

41. Shelley v. Kraemer, 334 U.S. 1 (1948); *accord*, Evans v. Newton, 382 U.S. 296 (1966) (city's management and control of a privately owned public park); Public Utilities Comm'n v. Pollak, 343 U.S. 451 (1952) (municipal authority specifically approved private railroad company's broadcast of radio programs on its trolleys and buses).

42. 436 U.S. 149 (1978).

43. 365 U.S. 715 (1961). Although the phrase "symbiotic relationship" was actually first used by the Supreme Court in Moose Lodge No. 107 v. Irvis, 407 U.S. 163, 175 (1972), *Burton* is recognized as having formulated the test, through use of the phrase "position of interdependence," to describe the relationship between the government and the private entity. 365 U.S. at 725. The development of the test is discussed at note 57 *infra*.

44. *See* Jackson v. Metropolitan Edison Co., 419 U.S. 345 (1974); Terry v. Adams, 345 U.S. 461 (1953); Marsh v. Alabama, 326 U.S. 501 (1946).

45. Jackson v. Metropolitan Edison Co., 419 U.S. 345, 353 (1974).

46. Terry v. Adams, 345 U.S. 461 (1953); *see* Smith v. Allwright, 321 U.S. 649 (1944); Nixon v. Condon, 286 U.S. 73 (1932).

47. Marsh v. Alabama, 326 U.S. 501 (1946).

has been held not to meet the public function test.[48] The distinguishing factor is that the public service of supplying electricity has not been a function traditionally associated with the sovereign.

The *Flagg Brothers* Court, however, adopted a more restrictive attitude toward the public function test. The case involved a proposed sale of goods by the holder of a security interest pursuant to the New York Uniform Commercial Code.[49] The Court held that the state did not delegate nor did the private entity exercise a public function within the meaning of the test.[50] The Court stressed that the elections and company town cases had in common a "feature of exclusivity," that is, the elections conducted by the political club were the only meaningful elections in the county, and the streets owned by the corporation were the only streets in town.[51] This exclusivity concept was held inapplicable in *Flagg Brothers* because the parties had other means of resolving their private dispute.[52]

Flagg Brothers appears to require a strict doctrinal analysis of whether a certain delegated activity is traditionally a sovereign function.[53] Nevertheless, the *Flagg Brothers* Court specifically left open the question of what other activities might fit the test.[54] For example, the Court declined to express an opinion with respect to the private exercise of police functions.[55] The courts have yet to apply the *Flagg Brothers* interpretation to those activities which the Supreme Court indicated might satisfy the test. Therefore, as discussed below, it is possible that law enforcement, an aspect of the police function, will be consistent with the *Flagg Brothers* interpretation of the public function test.[56]

The public function test coexists with, but is distinguishable from, the symbiotic relationship test advanced by the Court in *Burton* and developed by subsequent decisions.[57] A symbiotic relationship is present when two parties

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48. Jackson v. Metropolitan Edison Co., 419 U.S. 345, 353 (1974).

49. 436 U.S. at 151. The proposed sale was to be held under N.Y. U.C.C. § 7-210 (McKinney 1964).

50. 436 U.S. at 160-61. The *Flagg Brothers* Court relied on language in Jackson v. Metropolitan Edison Co., 419 U.S. 345 (1974), for its interpretation of the public function test. 436 U.S. at 157.

51. 436 U.S. at 159-60. The Court's mention of streets in a town is a reference to Marsh v. Alabama, 326 U.S. 501 (1946), in which a private corporation performed the exclusively sovereign function of establishing a town.

52. 436 U.S. at 160. The Court's approach has been criticized as "fraught with ambiguities" and "unduly narrow." *See The Supreme Court, 1977 Term,* 92 Harv. L. Rev. 57, 120-31 (1978). The commentator framed the issue as whether the public function exercised by the private party "is so intimately associated with [the] concept of sovereignty that [the government] ought not be permitted to authorize its exercise by a private party without the same degree of protection that would apply if the sovereign itself" exercised the function. *Id.* at 128.

53. The majority's reasoning was criticized by Justice Marshall, who charged that the question of what is a traditionally public function was decided in an "historical vacuum." 436 U.S. at 167 (Marshall, J., dissenting); *cf. id.* at 178 (Stevens, J., dissenting) (criticizing majority's limited examination of delegation of state power).

54. *Id.* at 163-64.

55. *Id.* at 163-64 n.14.

56. *See* notes 77-104 *infra* and accompanying text.

57. In *Burton,* a private lessee of a restaurant in a state-owned parking facility discriminated

rely interdependently upon each other for the effectuation of a common purpose.[58] The Supreme Court has not established concrete guidelines for determining when a symbiotic relationship exists. Thus, application of the test entails a thorough factual analysis to determine whether such a close connection exists between the government and the private entity that it is appropriate to consider the private entity's action as that of the government itself.[59]

The two tests appear to work together. When direct governmental participation is lacking and there is apparently no cooperative interaction between the government and the private entity, the doctrinal *Flagg Brothers* approach would be applied because under such circumstances the only possible manifestation of governmental action is the exercise of a traditionally public function.[60] Conversely, when there is some evidence of cooperation between the government and the private entity, not only do the courts look to see if the private entity exercises some public function,[61] they also apply the symbiotic relationship test to the government-private entity relationship.[62]

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on the basis of race by refusing to serve a black customer. 365 U.S. at 716. The Court held that this amounted to state action because the benefits mutually conferred by the private lessee and the parking authority indicated sufficient state participation in the discrimination to invoke constitutional protections. *Id.* at 724. In Moose Lodge No. 107 v. Irvis, 407 U.S. 163 (1972), the Court held that racial discrimination practiced by a state-licensed private club operated on private property did not amount to state action, because the state and the private entity did not share a symbiotic relationship. *Id.* at 175. In Jackson v. Metropolitan Edison Co., 419 U.S. 345 (1974), a privately owned and operated utility company terminated a customer's service without notice or a hearing. *Id.* at 347. The Court conceded that the acts of such a heavily regulated quasi-public entity might be state action in some cases. It held, however, that the utility acted as a private entity with respect to the specifically challenged acts because the state's regulatory powers were not directly involved. *Id.* at 351-52. The Court also noted both the absence of a symbiotic relationship, *id.* at 357, and that the utility was not performing a traditionally sovereign function. *Id.* at 353. One should not imply from the *Flagg Brothers* Court's reliance on *Jackson*, 436 U.S. at 157, that governmental regulation of a quasi-public entity is a determining factor for whether there is governmental action. *See* 419 U.S. at 358.

58. *See* Moose Lodge No. 107 v. Irvis, 407 U.S. 163, 175 (1972); Burton v. Wilmington Parking Auth., 365 U.S. at 725.

59. Jackson v. Metropolitan Edison Co., 419 U.S. 345, 351 (1974) (citing Moose Lodge No. 107 v. Irvis, 407 U.S. 163 (1972), and Burton v. Wilmington Parking Auth., 365 U.S. 715 (1961)); *see* note 57 *supra*.

60. *See, e.g.*, Kuczo v. Western Conn. Broadcasting Co., 424 F. Supp. 1325 (D. Conn. 1976), *rev'd*, 566 F.2d 384 (2d Cir. 1977). Although decided before *Flagg Brothers*, *Kuczo* is interesting because it is a harbinger of the *Flagg Brothers* test. In *Kuczo*, the federal government granted a radio station a monopoly over the local airways by ensuring that it would be the only station licensed in the city. The district court held that the station's censorship of political advertising was governmental action, because of the government's delegation of control over the local airways to the private entity. 424 F. Supp. at 1328. The Second Circuit reversed, finding no evidence of either governmental approval of the station's action or interaction between the government and the station. 566 F.2d at 388. The Second Circuit stated that the existence of a government-delegated monopoly was relevant, but found that the district court's reliance thereon was misplaced because the government specifically disapproved of such activity by enacting a statute prohibiting censorship of political advertising. *Id.* at 388 n.2. Both courts implicitly recognized that, absent evidence of cooperation between the state and the private entity, the only possible means of governmental action is the exercise of a public function. 566 F.2d at 388; 424 F. Supp. at 1328.

61. When confronted with a factual situation involving both the performance of a public

B. *The NASD Cases*

The first case to confront the issue of whether the NASD is a governmental actor was *Harwell v. Growth Programs, Inc.*[63] There, NASD members alleged that the NASD's interpretation of one of its Rules of Fair Practice without giving notice or a hearing to members was a violation of their due process rights.[64] The court found no due process violation.[65] In its analysis, the court concluded that the NASD was a governmental actor, holding that the NASD exercised governmental authority when it formulated and interpreted rules for its membership.[66] The court asserted that Congress may validly delegate governmental policy-making power to an administrative agency, and that the Maloney Amendment had placed the NASD in this

function by the private entity and evidence of governmental involvement, the courts prior to *Flagg Brothers* accorded the public function concept a broader definition than did the *Flagg Brothers* Court. *See, e.g.*, Robinson v. Price, 553 F.2d 918, 920-21 (5th Cir. 1977) (private entity performed governmental function of handling welfare-related problems with the active cooperation of the state and local governments); Ginn v. Mathews, 533 F.2d 477, 480-81 (9th Cir. 1976) (nonprofit corporation administered federal Headstart Program, subject to federal oversight); De Malherbe v. International Union of Elevator Constructors Local 8, 438 F. Supp. 1121, 1132 (N.D. Cal. 1977) (union denied an alien the opportunity to participate in an affirmative action program developed and funded by the government and administered by the union on the government's behalf).

62. *See* Jackson v. Metropolitan Edison Co., 419 U.S. 345 (1974); Anastasia v. Cosmopolitan Nat'l Bank, 527 F.2d 150 (7th Cir. 1975) (hotelkeeper took property for nonpayment of rent pursuant to a state statute), *cert. denied,* 424 U.S. 928 (1976); Coleman v. Wagner College, 429 F.2d 1120 (2d Cir. 1970) (private college expelled students for violation of rules promulgated by the college at the behest of the state and required to be filed with the state); cases cited note 61 *supra.*

63. 315 F. Supp. 1184 (W.D. Tex. 1970), *rev'd on other grounds,* 451 F.2d 240 (5th Cir. 1971), *modified per curiam,* 459 F.2d 461 (5th Cir.), *cert. denied,* 409 U.S. 876 (1972). In *Harwell,* investors instituted a class action for breach of contract against various broker-dealers and the NASD. The NASD and SEC decided that the particular investment program involved was harmful to public investors and, "after extensive consultation with and the express approval of" the SEC, the NASD issued an interpretation barring NASD member securities dealers from participating in the program. The defendant broker-dealers complied, thus repudiating their existing contracts with the plaintiff investors. *Id.* at 1186-87. Plaintiffs argued that the NASD's action was an interference with their contract, a violation of the antitrust laws, and a violation of due process of law. The court entered summary judgment against plaintiffs on all claims. *Id.* at 1192. The Fifth Circuit reversed on the grounds that the district court had not fully considered certain factual issues and that parties are not always free from liability on contracts that government regulation renders impossible to perform. 451 F.2d at 244-47.

The issue of the NASD's governmental status has arisen in two nonconstitutional contexts. *See* Todd & Co., SEC Freedom of Information Act Release No. 41 (Jan. 20, 1976), *reprinted in* 8 S.E.C. Docket 1085 (1976) (the NASD is not a federal agency for purposes of the Freedom of Information Act); Sumner B. Cotzin, SEC Securities Exchange Act Release No. 10,850 (June 12, 1974), *reprinted in* [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,827, *discussed at* note 33 *supra.*

64. 315 F. Supp. at 1189.

65. *Id.* at 1189-91. In Todd & Co. v. SEC, 557 F.2d 1008 (3d Cir. 1977), the court reviewed an NASD disciplinary sanction upheld by the SEC and found that the NASD rules were not unconstitutionally vague. Although its decision assumes that the NASD is not a governmental actor, the court did not discuss this issue.

66. 315 F. Supp. at 1192.

role.[67] Therefore, the court reasoned, the NASD is in effect a congressionally created regulatory agency.[68]

The argument that the NASD is a governmental actor for constitutional purposes was also raised in *United States v. Bloom*.[69] The *Bloom* court rejected *Harwell*[70] and held that the NASD was a private professional association whose actions could not be constitutionally proscribed.[71] The *Bloom* court based its holding upon two findings. First, the court found that there was no implied private cause of action for violation of NASD rules. The court reasoned that private causes of action are implied only for violation of federal regulations; therefore, if no cause of action has been implied for violation of NASD rules, those rules cannot be federal regulations.[72] Second, the court stated that stock exchanges, the NASD's counterpart in the listed securities markets, had been held not to be governmental actors. By analogy, the court reasoned that the same holding should apply to the NASD.[73] Finally, the *Bloom* court expressed a concern that a holding that the NASD is a governmental actor would create an unwanted expansion of its regulatory powers.[74]

The inconsistency of these two cases points out the unsettled nature of the law. In addition, neither *Bloom* nor *Harwell* applied the Supreme Court's tests for governmental action to the activities of the NASD. Moreover, the *Harwell* court based its holding on a delegation of governmental authority.[75] In light of *Flagg Brothers'* restrictive application of the public function test, this method, as applied to the NASD, may no longer be appropriate. Therefore, an application of the Supreme Court's tests for governmental action to the NASD is necessary. This is especially true in light of the possibility that the NASD can investigate and discipline members without regard to constitutional strictures.

C. *The Public Function and Symbiotic Relationship Tests as Applied to the NASD*

The public function test should be discussed first because a determination that the NASD meets *Flagg Brothers'* strict interpretation of a traditionally sovereign function obviates the task of "sifting facts and weighing circumstances"[76] required by the symbiotic relationship test. If the public function test is not met but there is some evidence of government-private entity interaction and the NASD's performing some public function, governmental

67. *Id.*

68. *Id.* at 1188.

69. 450 F. Supp. 323 (E.D. Pa. 1978), *discussed at* pt. III *infra*.

70. *Id.* at 330 n.3.

71. *Id.* at 329-30.

72. *Id.* at 329; *see* notes 90-102 *infra* and accompanying text.

73. *Id.* at 329-30; *see* notes 125-38 *infra* and accompanying text.

74. *Id.* at 330. Without elaborating, Judge Newcomer maintained that "it would be difficult to draw the line" on the extent of the powers self-regulatory bodies would gain if they were deemed to be governmental. In his opinion, the NASD's purposes would be thwarted by such a holding. *Id.*; *see* note 138 *infra* and accompanying text.

75. 315 F. Supp. at 1188-91.

76. Burton v. Wilmington Parking Auth., 365 U.S. 715, 722 (1961).

action may still be found through use of the symbiotic relationship test. This approach is particularly useful in examining the cooperative relationship between the SEC and the NASD.

1. The Public Function Test—The NASD's Role in Enforcement of the Federal Securities Laws

As stated above, the *Flagg Brothers* Court noted that police protection may be traditionally a sovereign function within the Court's strict interpretation of the public function test.[77] One aspect of police protection is law enforcement. If it can be established that the NASD enforces the federal securities laws, one may argue that such activity will satisfy the public function test as it is further defined by the courts in the future.

The Maloney Amendment's primary purpose was to provide for the establishment of an organization devoted to developing and enforcing ethical standards among broker-dealers in the OTC industry.[78] Through the promulgation and enforcement of rules governing members' conduct, the NASD has significantly achieved this purpose. In addition, however, the NASD has taken a more active role in the enforcement of federal securities law, a distinctly legal function.

The extent of the NASD's role in enforcing the securities laws is demonstrated by the power it wields in the OTC market. In accordance with the duty imposed upon it by the 1934 Act, the NASD enforces compliance with the provisions of the 1934 Act and all rules and regulations promulgated thereunder.[79] The Securities Acts Amendments of 1975 (1975 Act)[80] extended this duty to include enforcing compliance not only by members, but also their associates and employees.[81] A violation of SEC rules and regulations, the 1934 Act, or any other statute under SEC jurisdiction may constitute a violation of the NASD rule[82] which requires members to maintain high standards of professional conduct.[83] If the member firm or associate of such

77. *See* notes 54-55 *supra* and accompanying text.

78. Special Study, *supra* note 2, at 609.

79. Securities Exchange Act § 15A(b)(2), 15 U.S.C. § 78o-3(b)(2) (1976).

80. Pub. L. No. 94-29, § 1, 89 Stat. 97 (amending 15 U.S.C. §§ 77-80 (1970)). The 1975 Act made significant changes in the securities industry regulatory structure. The Act ended fixed commission rates for the public and intrabroker transactions, Securities Exchange Act § 6(e)(1), 15 U.S.C. § 78f(e)(1) (1976), directed the SEC to develop a national market system, *id.* § 11A(a), 15 U.S.C. § 78k-1(a) (1976), and generally strengthened the SEC's oversight authority. *See* S. Rep. No. 75, 94th Cong., 1st Sess. 22-23 (1975), *reprinted in* [1975] U.S. Code Cong. & Ad. News 179, 200-01 [hereinafter cited as 1975 Senate Report].

81. Securities Exchange Act § 15A(b)(2), 15 U.S.C § 78o-3(b)(2) (1976).

82. NASD Rules of Fair Practice, art. III, § 1, *reprinted in* NASD Manual (CCH) ¶ 2151 (1973) ("A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.").

83. *See, e.g.*, Management Financial, Inc., SEC Securities Exchange Act Release No. 12,098 (Feb. 11, 1976), *reprinted in* 8 S.E.C. Docket 1248 (1976) (NASD disciplinary sanction for violation of the SEC's net capital rule, 17 C.F.R. 240.15c3-1 (1978), and §§ 10 and 17 of the Investment Company Act, 15 U.S.C. §§ 80a-10, -17 (1976)); Joseph Blumenthal, 41 S.E.C. 133 (1962) (NASD disciplinary action against a registered broker-dealer for violation of the Federal Reserve Board's Regulation T, 12 C.F.R. 220 (1978), and the SEC's net capital rule, 17 C.F.R. 240.15c3-1 (1978)).

firm is found to have violated this rule, the person or firm may be suspended or expelled from the NASD.[84] Such a suspension or expulsion must be noted both on applications for employment as a broker and for registration of firms with the SEC.[85] In addition, expulsion from the NASD is considered a statutory disqualification under section 6(c)(2) of the 1934 Act,[86] thereby excluding a person or firm from membership in a stock exchange. Therefore, the NASD, on its own initiative, can banish from the securities industry a violator of federal law. This power is indicative of the evolution of the NASD's role in the OTC securities market. Rather than merely attempting to upgrade ethical standards, the NASD is an essential element in Congress' law enforcement scheme for the securities industry.

The legislative history of the 1975 Act contains authority to support the proposition that the NASD's federal law enforcement responsibility is a delegated public function. The Senate report stated that "[t]he self-regulatory organizations must exercise governmental-type powers if they are to carry out their responsibilities under the [1934] Act. When a member violates the Act or a self-regulatory organization's rules, the organization must be in a position to impose appropriate penalties or to revoke relevant privileges."[87] The House report added: "[I]ndustry organizations [must] exercise *delegated governmental power* in order to enforce at their own initiative compliance by members of the industry with both the legal requirements laid down in the Securities Exchange Act and ethical standards which go beyond those requirements."[88] The SEC's conclusions on the NASD's function further supports this proposition: "[I]n important respects, the self-regulatory body is an official arm or delegate of governmental power."[89] In effect, both Congress and the SEC believed that the NASD must exercise some delegated governmental power in order to perform its statutory responsibility of assisting in the enforcement of the federal securities laws and upgrading the industry's ethical standards.

The controversy surrounding implied private causes of action for an NASD member's violation of the Association's rules is further evidence that the NASD may be performing a delegated public function. Federal courts have implied private causes of action for violation of several federal regulations not containing express remedies when it would be appropriate under the criteria established by the Supreme Court.[90] Therefore, not all federal regulations will support an implied private cause of action.

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84. NASD Rules of Fair Practice, art. V, § 1, *reprinted in* NASD Manual (CCH) ¶ 2301 (1976).

85. S. Jaffe, *supra* note 2, at 242.

86. 15 U.S.C. § 78f(c)(2) (1976).

87. 1975 Senate Report, *supra* note 80, at 24, *reprinted in* [1975] U.S. Code Cong. & Ad. News at 203.

88. H.R. Rep. No. 123, 94th Cong., 1st Sess. 48 (1975) (emphasis added).

89. Special Study, *supra* note 2, at 723.

90. An implied private cause of action exists for violation of the antifraud provisions of § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1976), and rule 10b-5, 17 C.F.R. § 240.10b-5 (1978), provided plaintiff investor can show "scienter" on the part of the defendant. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212 (1976). Implied liability also exists for violation of the proxy solicitation requirements of § 14 of the 1934 Act, 15 U.S.C. § 78n(a) (1976). J.I. Case Co. v. Borak, 377 U.S. 426 (1964). In Cort v. Ash, 422 U.S. 66 (1975), the Supreme Court set forth the criteria for determining whether a private cause of action will be implied: (1) whether the plaintiff

Two courts have implied a private cause of action[91] for violation of one of the rules contained in the NASD's Rules of Fair Practice.[92] Recognition of an implied private right of action for violations of these rules demonstrates that NASD rules and SEC regulations serve the same purpose.[93] On the other hand, several courts have refused to recognize an implied cause of action for violation of NASD rules.[94] These latter courts, however, have not relied upon a finding that the NASD is not a governmental actor. Rather, they have determined that, under the established criteria, it would be inappropriate to imply a cause of action for certain rules.[95] Because the courts uniformly

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is a member "of the class for whose *especial* benefit the statute was enacted"; (2) whether there is legislative intent to create or deny such a remedy; (3) whether implying a remedy would be consistent with statutory purposes; and (4) whether the cause of action is traditionally brought under state law. *Id.* at 78.

91. Avern Trust v. Clarke, 415 F.2d 1238, 1242 (7th Cir. 1969), *cert. denied*, 397 U.S. 963 (1970); Geyer v. Paine, Webber, Jackson & Curtis, Inc., 389 F. Supp. 678, 683 (D. Wyo. 1975).

92. NASD Rules of Fair Practice, art. III, § 2, *reprinted in* NASD Manual (CCH) ¶ 2152 (1976). This section, commonly referred to as the "suitability rule," requires the broker to ascertain whether the investment advice he gives is suitable to the investor's financial condition and needs. This requirement goes beyond the 1934 Act's abolition of caveat emptor and its substitution of rules of full disclosure. *See* S. Jaffe, *supra* note 2, at 250. Three courts have found implied liability for violation of the New York Stock Exchange's similar rule, Rule 405, commonly referred to as the "know your customer rule." Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135, 142 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969); Rolf v. Blyth, Eastman Dillon & Co., 424 F. Supp. 1021, 1041-43 (S.D.N.Y. 1977), *modified*, 570 F.2d 38 (2d Cir. 1978); Starkman v. Seroussi, 337 F. Supp. 518, 520-21 (S.D.N.Y. 1974).

93. *See* United States v. Bloom, 450 F. Supp. at 329 (NASD rules that serve as a basis for an implied private cause of action would be federal regulations in the same sense as SEC regulations). One commentator has noted that NASD rules encompass the same fiduciary duties between broker and investor as are provided for in the 1934 Act. Note, *Implied Liability for Violation of Stock Exchange and NASD Rules—After* Rolf *and* Faturik, 9 Loy. Chi. L.J. 685, 689 (1978) [hereinafter cited as *Implied Liability*]. Another commentator has noted that certain NASD rules are substitutes for SEC rules and regulations. Lowenfels, *Private Enforcement in the Over-the-Counter Securities Markets: Implied Liabilities Based on NASD Rules*, 51 Cornell L.Q. 633, 643, 654 (1966) [hereinafter cited as *Private Enforcement*]. At least one court has recognized that the self-regulatory system produces rules that amount to substitutes for SEC regulation. Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 182 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966).

94. Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 183 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966); Lange v. H. Hentz & Co., 418 F. Supp. 1376, 1383 (N.D. Tex. 1976); Plunkett v. Dominick & Dominick, Inc., 414 F. Supp. 885, 890 (D. Conn. 1976). *See generally Private Enforcement, supra* note 93; Lowenfels, *Implied Liabilities Based Upon Stock Exchange Rules*, 66 Colum. L. Rev. 12 (1966); *Implied Liability, supra* note 93. Several other courts have declined to discuss the implied cause of action issue because of the availability of another basis for liability. *See* Clark v. John Lamula Investors, Inc., 583 F.2d 594, 599 (2d Cir. 1978); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 41 (2d Cir. 1978).

95. *See, e.g.*, Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 182-83 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966); Lange v. H. Hentz & Co., 418 F. Supp. 1376, 1381-83 (N.D. Tex. 1976); Plunkett v. Dominick & Dominick, Inc., 414 F. Supp. 885, 889-90 (D. Conn. 1976). The courts prior to the decision in Cort v. Ash, 422 U.S. 66 (1975), developed tests for implied liability specifically for violation of NASD and stock exchange rules. The Second Circuit's approach, devised by Judge Friendly in *Colonial*, looks to the degree of specificity of the given rule upon which the private claim is based, and whether it plays an integral part in the total scheme of

employ these criteria in their analyses, there is an implicit recognition that, although not all NASD rules support an implied cause of action, they may serve the same purposes that federal regulations serve.[96]

The *Bloom* court briefly discussed this issue,[97] citing *Lange v. H. Hentz & Co.*,[98] in which the court did not imply a cause of action for violation of an NASD rule. The *Bloom* court reasoned that NASD rules cannot be federal regulations in the same sense as SEC regulations, because they cannot support an implied cause of action. The court interpreted language in *Lange* that the NASD is a private association[99] to be the basis upon which the *Lange* court decided the issue.[100] The language to which *Bloom* referred, however, precedes the *Lange* court's extensive analysis of the criteria necessary to imply a cause of action.[101] Thus, contrary to the *Bloom* court's interpretation, *Lange's* holding is not based upon a finding that the NASD is a private association, but specifically upon a finding that the NASD rules in issue do not meet the implied cause of action criteria established by the Supreme Court and the federal courts.[102] In addition, the *Bloom* court did not discuss any of the other decisions that have dealt with private causes of action for violation of NASD rules.

Because the parameters of the public function test remain somewhat amorphous, what constitutes a traditionally public function cannot easily be ascertained. Enforcement of securities law is certainly an important governmental function, and may be a traditionally public function within the *Flagg Brothers* Court's interpretation of the test.[103] Of course, if traditional is interpreted to mean what was considered a public function at the time of the inception of the Republic, securities regulation would not satisfy the test. Nevertheless, it is apparent that Congress gave the NASD the equivalent of governmental power to enforce federal law because it recognized that the purposes of the 1934 Act could not otherwise be effectuated.[104] In addition, some courts, by their recognition that certain NASD regulations serve the same purpose as federal regulations, have appreciated this need. Therefore, it

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securities regulation. 358 F.2d at 182. A slight variation was proposed by the Seventh Circuit, which determines whether the rule was designed for the direct protection of investors. Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135, 142 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969). The *Plunkett* court relied upon *Colonial*, 414 F. Supp. at 889-90, and the *Lange* court applied the criteria established by *Cort*, *Colonial*, and *Buttrey*. 418 F. Supp. at 1381-83. For a discussion of the *Cort* test, see note 90 *supra*.

96. *See Private Enforcement*, *supra* note 93, at 643, 654.

97. 450 F. Supp. at 329.

98. 418 F. Supp. 1376 (N.D. Tex. 1976). For a critical analysis of *Lange*, see Note, *Securities Regulation*—Lange v. H. Hentz & Co.—*The Implication of a Private Remedy for Violations of the NASD Rules of Fair Practice*, 3 J. Corp. L. 386 (1978) [hereinafter cited as *Implication*].

99. 418 F. Supp. at 1379.

100. 450 F. Supp. at 329.

101. 418 F. Supp. at 1381-83.

102. *Id.* at 1383. One commentator has suggested that to imply a private remedy for members' violations of the NASD rules would limit the necessity for greater regulation by the SEC, thereby avoiding the creation of an even larger bureaucracy. *Implication*, *supra* note 98, at 395-96. Indeed, containing the size of the federal bureaucracy was a motivating factor for the establishment of the NASD. *See* note 17 *supra* and accompanying text.

103. *See* notes 44-55 *supra* and accompanying text.

104. *See* notes 87-88 *supra* and accompanying text.

is arguable that the NASD, to some extent, performs a traditionally public function when it does the work that the SEC would otherwise have to do in the OTC securities industry.

2. Applicability of the Symbiotic Relationship Doctrine—Governmental Involvement

The preceding section indicates that the NASD does perform certain governmental functions. When there is evidence of governmental involvement in the challenged action of an entity that exercises some governmental function, the courts have applied the symbiotic relationship test for governmental action.[105] Thus, it is appropriate to examine the pervasiveness of governmental involvement in NASD activities to determine whether a symbiotic relationship exists between it and the federal government—specifically the SEC.

The legislative history of the 1975 Act demonstrates that Congress intended a close relationship between the SEC and the NASD. According to the Senate committee which drafted the bill: "Industry regulation and government regulation are not alternatives, but complementary components of the self-regulatory process. [The 1934 Act established] a unique pattern of regulation combining both industry and government responsibility . . . . The Committee concurs in the need to emphasize the mutual regulatory responsibilities of the industry and the SEC."[106] In the same vein, the SEC concluded its major study of securities self-regulation by asserting that "[t]he relationship between the Commission and the self-regulatory organizations has at times been referred to as a 'partnership' or 'cooperative regulation.' Under either expression the roles of the Commission and the self-regulatory agencies are essentially complementary . . . ."[107]

That relationship was strengthened by the 1975 Act, which increased the SEC's involvement in NASD rulemaking actions,[108] made explicit the SEC's ability to sanction the NASD for failing to enforce its own rules,[109] and expanded the SEC's authority to compel the NASD to enforce compliance by its members with the securities laws and the Association's rules.[110] Thus, it appears that Justice Douglas' observation needs updating—the SEC has emerged from behind the door with guns blazing.[111]

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105. *See* cases cited notes 61-62 *supra*.

106. 1975 Senate Report, *supra* note 80, at 22-23, *reprinted in* [1975] U.S. Code Cong. & Ad. News at 201. The committee added: "[T]he industry and the government [do not] fulfill the same function in the regulatory framework or . . . enjoy the same order of authority . . . . The self-regulatory organizations exercise authority subject to SEC oversight. They have no authority to regulate independently of the SEC's control." *Id.*

107. Special Study, *supra* note 2, at 723.

108. *See* Securities Exchange Act § 19(b), (c), 15 U.S.C. § 78s(b),-(c) (1976), *discussed at* notes 113-14 *infra* and accompanying text.

109. *Id.* § 19(h), 15 U.S.C. § 78s(h) (1976), *discussed at* note 115 *infra* and accompanying text.

110. Section 19(g)(2) makes it an affirmative duty of the NASD to comply with and enforce compliance by members with the 1934 Act and the Association's own rules. 15 U.S.C. § 78s(g)(2) (1976). Section 21(e)(2) allows the SEC to apply to a federal district court for an order compelling the NASD to enforce compliance by its members or associated persons. 15 U.S.C. § 78u(e)(2) (1976).

111. *See* note 20 *supra* and accompanying text.

In order to satisfy the symbiotic relationship test, the Supreme Court requires not only the existence of a cooperative relationship between the government and the private entity, but also a showing that the government has "insinuated itself into a position of interdependence with the [private entity such that it is] a joint participant in the enterprise."[112] It is submitted that such joint participation does exist between the NASD and the SEC. For example, although the NASD can promulgate its own rules, the SEC must approve each rule.[113] In addition, the Commission may "abrogate, add to, and delete from" the NASD's rules.[114] If the SEC takes such action, the amended rule becomes an NASD rather than an SEC rule. Moreover, a failure by the NASD to enforce its own rules may result in an SEC sanction.[115] Therefore, the NASD is compelled by the SEC to enforce not only the rules it has promulgated but also those created by the SEC. Finally, any disciplinary action taken by the NASD is appealable as of right by the person aggrieved and is reviewable by the SEC on its own motion.[116]

One court has held that when a state requires a private entity to promulgate rules and have them approved by state authorities, governmental action may be present. In *Coleman v. Wagner College*,[117] New York State required private universities to adopt disciplinary codes for the control of campus demonstrations and to file those codes with the state.[118] The court suggested that the following factors were indications of governmental action: first, whether state officials had authority to reject regulations of which they did not approve; second, whether those officials participated in formulating the regulations' content; and third, whether university officials held a reasonable belief that the state intended them to adopt a particular stance toward student demonstrators.[119] The first two *Coleman* factors indicate governmental action is present with the NASD. First, all NASD rules submitted by the NASD must be approved by the SEC.[120] Second, the SEC may amend or abrogate NASD rules and write rules that the NASD must adopt as its own.[121] As for *Coleman's* third factor, each situation would have to be analyzed to determine the extent of the NASD officials' "reasonable beliefs." It is reasonable to assume that because the NASD is subject to SEC control, it would likely accede to SEC demands when the two organizations conflict on policy determination.

The *Coleman* decision is significant for another reason. In his concurring opinion, Judge Friendly observed that because the state benefitted from the colleges' action, it would have to accept responsibility for preventing over-

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112. Jackson v. Metropolitan Edison Co., 419 U.S. 345, 357-58 (1974).

113. Securities and Exchange Act § 19(b), 15 U.S.C. § 78s(b) (1976). Prior to the 1975 Act, no such approval was required.

114. Securities and Exchange Act § 19(c), 15 U.S.C. § 78s(c) (1976).

115. Section 19(h) permits the SEC to suspend or revoke the NASD's registration, censure the NASD, or impose limitations upon its operations. 15 U.S.C. § 78s(h)(1) (1976).

116. *Id.* § 19(d)(2), 15 U.S.C. § 78s(d)(2) (1976). The SEC may affirm, modify, set aside, or remand the disciplinary action. *Id.* § 19(e)(1), 15 U.S.C. § 78s(e)(1) (1976).

117. 429 F.2d 1120 (2d Cir. 1970).

118. *Id.* at 1125.

119. *Id.*

120. *See* note 113 *supra* and accompanying text.

121. *See* note 114 *supra* and accompanying text.

zealous conduct on the part of those colleges.[122] Judge Friendly stated that government cannot undermine constitutional restraints by using a private entity to pursue governmental policies, and that under such circumstances governmental action can be found.[123] Applying Judge Friendly's reasoning to the NASD, one may argue that the SEC should not be permitted to undermine the constitutional restraints that apply to its actions by using the NASD to carry out its objectives.[124]

An additional argument for finding that NASD action is governmental action is the NASD's similarity to the other major self-regulatory organizations, the national stock exchanges. Several courts have held that the stock exchanges are governmental actors and that, therefore, exchange disciplinary proceedings and exchange actions that involve the impairment of substantial rights are subject to the strictures of constitutional due process.[125] The following instances of "intimate" government involvement between the exchanges and the SEC, each of which is equally applicable to the NASD, have influenced these courts: first, stock exchanges must register with the SEC; second, their rules are subject to amendment or change by the SEC; third, their members are closely regulated by the SEC; fourth, each may be suspended or its registration withdrawn by the SEC;[126] and fifth, their power to conduct disciplinary proceedings is conferred upon them by the SEC.[127]

Despite the numerous similarities between the NASD and the exchanges,[128]

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122. 429 F.2d at 1126 (Friendly, J., concurring).

123. *Id.* (Friendly, J., concurring).

124. Judge Friendly also noted the importance of the disciplinary codes' symbolic effect, which he asserted was the rationale of Burton v. Wilmington Parking Auth., 365 U.S. 715 (1961). 429 F.2d at 1127 (Friendly, J., concurring). He stated that, even if the government does not direct a private entity's particular act, if it has placed the private entity in a position such that it is reasonable for the person affected to believe that the government authorized the act, governmental action may be found. *Id.* (Friendly, J., concurring). Application of that consideration to the NASD would require courts faced with the issue of whether NASD action is governmental to determine if it reasonably appeared that the SEC authorized a particular NASD act. For example, in the event the NASD and the SEC jointly pursue an investigation of an NASD member, it might well appear that the NASD's acts are in fact the SEC's acts. Indeed, the defendants' allegations of government misconduct in *Bloom* were directed at both the NASD and the SEC. 450 F. Supp. at 328-32. Hornblower's supervisor testified that, in his belief, the SEC and the NASD actively cooperated in a joint investigation. *Id.* at 331. Although the *Bloom* court dismissed this testimony as not credible, such assertions, if true, might support a constitutional challenge of NASD action under Judge Friendly's reasoning.

125. *See* Intercontinental Indus., Inc. v. American Stock Exch., 452 F.2d 935, 940-43 (5th Cir. 1971) (delisting proceeding), *cert. denied,* 409 U.S. 842 (1972); Villani v. New York Stock Exch., Inc., 348 F. Supp. 1185, 1188 n.1 (S.D.N.Y. 1972) (disciplinary proceeding), *aff'd sub nom.* Sloan v. New York Stock Exch., Inc., 489 F.2d 1 (2d Cir. 1973); Crimmins v. American Stock Exch., Inc., 346 F. Supp. 1256, 1259 (S.D.N.Y. 1972) (disciplinary proceeding). Relying upon *Burton,* the *Intercontinental* court found that the Exchange's intimate involvement with the SEC brought it "within the purview of the Fifth Amendment controls over governmental due process." 452 F.2d at 941 (footnote omitted).

126. Intercontinental Indus., Inc. v. American Stock Exch., 452 F.2d 935, 941 n.9 (5th Cir. 1971), *cert. denied,* 409 U.S. 842 (1972).

127. Villani v. New York Stock Exch., Inc., 348 F. Supp. 1185, 1188 n.1 (S.D.N.Y. 1972), *aff'd sub nom.* Sloan v. New York Stock Exch., Inc., 489 F.2d 1 (2d Cir. 1973).

128. *See* Special Study, *supra* note 2, at 504-06, 602-03; notes 15-21 *supra* and accompanying

the *Bloom* court refused to hold that NASD actions are governmental.[129] It relied on *United States v. Solomon,*[130] interpreting it as holding that the exchanges are not governmental and, therefore, cannot be held responsible for violations of constitutional rights.[131]

In *Solomon,* an officer of a New York Stock Exchange (NYSE) member firm had testified before the NYSE regarding financial irregularities discovered in his firm's accounts. Solomon incriminated himself at the hearing, and a transcript was forwarded to the SEC pursuant to a subpoena. Subsequently, he was indicted and convicted of violating certain recordkeeping and reporting regulations promulgated by the SEC.[132] On appeal, the defendant claimed that the NYSE had violated his fifth amendment right against self-incrimination. The court held that the privilege against self-incrimination is not available to those who testify at a stock exchange investigatory proceeding.[133]

The *Solomon* court based its holding on three considerations. First, when the NYSE compelled members to testify at its proceedings, it did not act on behalf of the SEC.[134] Second, if the privilege against self-incrimination was made available to persons testifying before exchanges, it would lead to its application to self-policing organizations in other industries, thereby depriving those organizations of their one effective investigative device, removal from the organization for refusal to answer questions.[135] Finally, acceptance of defendant's argument would enable the NYSE, and other similar organizations, to grant immunity from future use of compelled testimony "without any weighing of the need for the evidence against the undesirability of conferring an immunity . . . and without the supervision of the Attorney General."[136]

In relying on *Solomon,* the *Bloom* court ignored the fact that the *Solomon* court expressly limited its decision to the fifth amendment's privilege against self-incrimination: "We need not here decide whether stock exchanges may be

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text. Congress enacted the 1975 Act to, among other things, preserve and improve self-regulation by strengthening the "total regulatory fabric." 1975 Senate Report, *supra* note 80, at 23. The 1975 Act treats the exchanges and the NASD equally in several respects: (1) eligibility for registration by the organization with the SEC; (2) procedures covering rule promulgation, conduct of disciplinary proceedings, and eligibility for membership; (3) direct SEC sanctions of members or persons associated with members; and (4) SEC-enforced compliance with an organization's rules or regulations or with 1934 Act provisions if the self-regulatory organization fails to enforce such provisions. *Id.* at 22-36.

129. 450 F. Supp. at 330.

130. 509 F.2d 863 (2d Cir. 1975).

131. 450 F. Supp. at 328.

132. 509 F.2d at 865.

133. *Id.* at 867. The court also considered the issue of whether the defendant's testimony was in fact compelled by the NYSE. The court held that the witness' statements were voluntary because the penalty the NYSE would prescribe if he refused to appear and testify was uncertain. *Id.* at 872; *cf.* Garrity v. New Jersey, 385 U.S. 493 (1967) (police officers questioned during investigation into corruption were told that if they refused to answer, they would be fired).

134. 509 F.2d at 869.

135. *Id.* at 869-70.

136. *Id.* at 870. The court noted the public policy consideration that certain constitutional provisions, such as the privilege against self-incrimination, "are incapable of violation by anyone except government in the narrowest sense." *Id.* at 867.

subject to some due process requirements for certain types of action . . . . We deal here with special factors concerning the privilege against self-incrimination . . . ."[137] From this statement and the court's three considerations, it is apparent that *Solomon* held that the privilege against self-incrimination involves special factors that militate against making it available in a proceeding of a self-regulatory body. The *Bloom* court incorrectly interpreted *Solomon* to mean that constitutional guarantees never apply to stock exchange proceedings.

Finally, the *Bloom* court also interpreted *Solomon* as evidencing a concern that, if self-regulatory bodies were held governmental for constitutional purposes, it would expand their regulatory powers.[138] The court apparently misunderstood the effect of characterizing the NASD as a governmental actor. Indeed, the effect of holding NASD action to be governmental action is to constrict rather than to expand its governmental authority. As a governmental actor, the NASD will be prevented from exercising its powers in ways inimical to basic constitutional provisions.

In conclusion, the realities of the self-regulatory scheme established by Congress for the OTC securities industry suggest that the NASD's investigative and disciplinary activities meet the constitutional tests for governmental action. Although the SEC has overall responsibility for enforcing the securities laws, the NASD plays an essential role in the regulatory scheme. The NASD's law enforcement duties demonstrate that its function is to police the OTC industry, an activity that may satisfy the public function test. In addition, because of its interaction with the SEC, NASD activities meet the symbiotic relationship test. The legislative history and the SEC's own observations support the conclusion that the government has insinuated itself into a position of interdependence with the NASD. Finally, because the NASD's operations and responsibilities are so substantially similar to the exchanges', they should be treated the same way for constitutional purposes.

III. Application of the Fourth Amendment to a Search Conducted by an NASD Member

In *Bloom,* the court also faced the issue of whether the fourth amendment's exclusionary rule[139] should apply to a private search conducted by an NASD

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137. *Id.* at 871.

138. 450 F. Supp. at 330. Here again, the *Bloom* court's interpretation is questionable because *Solomon* was limited to the problem of endowing such organizations with the power to grant use immunity. 509 F.2d at 870.

139. Although the fourth amendment itself does not speak of a remedy in the event of a violation, the Supreme Court has held that evidence seized during a search that violates the amendment is inadmissable in state and federal criminal prosecutions. Mapp v. Ohio, 367 U.S. 643 (1961) (state prosecution); Weeks v. United States, 232 U.S. 383 (1914) (federal prosecution). The exclusionary rule has not escaped criticism. *See, e.g.,* People v. Defore, 242 N.Y. 13, 21, 150 N.E. 585, 587 (Cardozo, J.) ("The criminal is to go free because the constable has blundered."), *cert. denied,* 270 U.S. 657 (1926). Nevertheless, because of its value as a deterrent to "future unlawful police conduct," the exclusionary rule has remained intact. Stone v. Powell, 428 U.S. 465, 484 (1976). For an analysis of the development of and the controversy surrounding the exclusionary rule, as well as its validity in the future, see Comment, *Reason and the Fourth Amendment—The Burger Court and the Exclusionary Rule,* 46 Fordham L. Rev. 139 (1977).

member firm. In general, the exclusionary rule applies to searches conducted by government officials.[140] Nevertheless, a private search comes within the scope of the fourth amendment if it is conducted for a public purpose or is governmentally motivated.[141] No court other than *Bloom* has faced this issue in a securities self-regulatory context. Several courts, however, have attempted to determine whether the circumstances of a particular private search converted it into a government search.[142]

In *Bloom,* an NASD member broker-dealer, Hornblower and Weeks, Hemphill-Noyes, Inc., terminated two of its securities salesmen without allowing them to clear out their desks.[143] After they had left the office, a Hornblower supervisor searched their desks and confiscated certain personal papers and records. Shortly thereafter, Hornblower notified the NASD of the terminations and the NASD began its own investigation of the firings, requesting that Hornblower turn over relevant information. Hornblower forwarded copies of papers taken from the salesmen's desks to the NASD. These materials were eventually passed on to the SEC and used in the criminal prosecution of the defendants.[144] At trial, the *Bloom* defendants moved to suppress the evidence obtained from their desks on the ground that Hornblower's search violated their fourth amendment rights against unreasonable search and seizure. The court denied their motion, holding that the firm's actions were purely private and without governmental influence.[145]

The defendants in *Bloom* based their fourth amendment argument on a contention that the search of their desks was governmentally motivated. After examining the facts for evidence of governmental motivation, the court concluded that Hornblower conducted the search to protect itself from the

140. Burdeau v. McDowell, 256 U.S. 465 (1921); *see* United States v. Janis, 428 U.S. 433, 455 n.31 (1976); United States v. Jackson, 578 F.2d 1162, 1163 (5th Cir. 1978).

141. *See, e.g.,* Corngold v. United States, 367 F.2d 1 (9th Cir. 1966). In *Corngold,* customs agents suspected contraband in certain packages and asked an airline employee if he wished to open the packages. The airline employee opened the packages with the agents' assistance. The court held that the private search was subject to the exclusionary rule because it was "conducted solely in aid of the enforcement of a federal statute." *Id.* at 5; *accord,* Knoll Associates, Inc. v. FTC, 397 F.2d 530, 535 (7th Cir. 1968) (private party stole defendant's documents on behalf of the government for use in a pending proceeding); United States v. Stein, 322 F. Supp. 346, 348 (N.D. Ill. 1971) (government encouraged private party to seize defendant's records and turn them over to prosecutors).

142. *See, e.g.,* United States v. Freeland, 562 F.2d 383, 385 (6th Cir.), *cert. denied,* 434 U.S. 957 (1977); United States v. Newton, 510 F.2d 1149, 1153 (7th Cir. 1975); United States v. Mekjian, 505 F.2d 1320, 1328 (5th Cir. 1975). Because each case presents a new factual context, the courts have emphasized different factors in reaching their conclusions. *See* United States v. Jackson, 578 F.2d 1162, 1163 (5th Cir. 1978) (exclusionary rule did not apply because the government did not have prior knowledge of the search); United States v. McDaniel, 574 F.2d 1224, 1226 (5th Cir. 1978) (privately motivated search is not subject to the exclusionary rule); United States v. Fannon, 556 F.2d 961, 963 (9th Cir. 1977) (private search authorized by a federal statute is subject to the exclusionary rule); Corngold v. United States, 367 F.2d 1, 4 (9th Cir. 1966) (a search conducted solely to assist enforcement of federal law is subject to the exclusionary rule).

143. The terminations followed customer complaints that the two might be involved in illegal stock manipulation. 450 F. Supp. at 326.

144. *Id.*

145. *Id.* at 327-28.

administrative penalties and civil liabilities it could face if it were found guilty of lax supervision of its employees.[146] Although the court conceded that the searches aided law enforcement, it reasoned that Hornblower acted to protect itself because no statute or regulation specifically required it to search the desks.[147]

One may criticize the *Bloom* court's analysis on several grounds. The court decided the fourth amendment question before it discussed the issue of whether the NASD was a governmental actor.[148] Thus, the court reached its decision to admit the evidence without considering whether an organization that is at least arguably governmental exercised any form of influence over Hornblower which could have motivated the search.[149] Subsequently, the court held that the NASD's actions were not governmental. As discussed above, because NASD investigative and disciplinary activities satisfy the Supreme Court's tests for governmental action,[150] the *Bloom* court should have concluded that the NASD is a governmental actor.

A finding of governmental status would have an effect on the applicability of the fourth amendment because it would allow a court to consider certain additional factors that the *Bloom* court did not discuss. For instance, NASD member firms must promptly notify the NASD of the termination of any employees who are registered representatives,[151] which the Hornblower employees were. At that point, in accordance with its statutorily mandated and SEC-enforced responsibility as a self-regulatory organization, the NASD would generally conduct its own investigation.[152] This is especially true in cases such as *Bloom,* which involve allegations of fraud and stock manipulation. In *Bloom,* the NASD did conduct such an investigation, and asked Hornblower to forward to the NASD "any relevant information" in its possession. Hornblower knew that if it did not comply with this request it would violate the Rules of Fair Practice,[153] thereby exposing itself to suspension or expulsion from the NASD, and possible loss of the right to participate in the securities industry.[154] Because the NASD's role in securities law enforcement is governmental, it appears that Hornblower's search was at least in part governmentally motivated.

The *Bloom* court further concluded that Hornblower conducted the search to protect itself from possible civil and administrative liabilities.[155] One may question the court's reasoning because, if in fact the firm was responsible for the employees' wrongdoing, its searching of the desks after the wrongdoing had occurred could not have protected the firm from any future liabilities. Therefore, because the search could not have aided Hornblower's private interest of avoiding future liability, its primary effect was to aid law enforce-

146. *Id.* at 326-28.

147. *Id.* at 327-28.

148. *See id.* at 326-28.

149. *Id.* at 327 n.1.

150. *See* pt. II *supra.*

151. NASD Bylaws, art. XV, § 5, *reprinted in* NASD Manual (CCH) ¶ 1625 (1978).

152. *See* notes 109-15 *supra* and accompanying text.

153. *See, e.g.,* Boren & Co., 40 S.E.C. 217 (1960) (SEC review of NASD disciplinary proceeding which found a violation of art. I, § 3 of the Rules of Fair Practice).

154. *See* notes 82-86 *supra* and accompanying text.

155. 450 F. Supp. at 327-28.

ment by uncovering evidence eventually used in a criminal prosecution. As such, the purpose of the search would appear to be public rather than private.

The holding in *Bloom* creates a potential for abuse by the NASD of the investigatory powers given to it by Congress. For example, under *Bloom* an NASD official can request one of its member firms to assist an NASD investigation by searching the desks of its employees. The same request by an SEC official would violate the employees' fourth amendment rights. Moreover, the exigent circumstances that might justify a warrantless search are not present in a case such as *Bloom*.[156] Assuming probable cause, there is ample time for the member firm to inform the proper authorities and obtain a warrant so that it may lawfully conduct its search.

CONCLUSION

The NASD performs a delegated public function by enforcing compliance with both its own rules and the federal securities laws. The SEC's pervasive oversight and active intervention in NASD operations demonstrates that a symbiotic relationship exists between it and the NASD. In short, the NASD plays an integral role in the regulatory mechanism of the OTC securities market. As such, the NASD carries heavy constitutional responsibilities. As the facts of *Bloom* demonstrate, fundamental constitutional guarantees may be undermined as long as the NASD is permitted to act in a governmental manner beyond the boundaries of constitutional limitations. Thus, the NASD should be subject to the fifth amendment's prohibition against arbitrary and capricious governmental acts. Moreover, the fourth amendment's exclusionary rule should be made applicable to an NASD member firm's search and seizure of employee's personal property when the evidence suggests that the search was motivated by NASD procedures and carried out for the public purpose of assisting law enforcement.

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156. For a discussion of the circumstances that might validate a warrantless search, see Coolidge v. New Hampshire, 403 U.S. 443, 474-76 (1971).