

## COMMENT

### **From Sense to Nonsense and Back Again: SRO Immunity, Doctrinal Bait-and-Switch, and a Call for Coherence**

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#### INTRODUCTION

*Invigilandum est semper, multae insidiae sunt bonis.*<sup>1</sup>

In autumn of 2008, US financial markets experienced a “melt-down” of a magnitude not known in generations. The ensuing economic crisis has prompted comparisons to the Great Depression,<sup>2</sup> and brought along with it a renewed public focus on the regulatory regime that was born in the wake of the social, economic, and political carnage of that calamity.<sup>3</sup>

Amidst the widespread devastation of the 1930s, Congress sought to dramatically alter the state of securities markets in the United States. The Securities Exchange Act of 1934 and subsequent amendments,<sup>4</sup> in particular, were instrumental in achieving this goal. The Act created an elaborate system of regulation that included both the federal government and private entities known as self-regulatory organizations (SROs). It is substantially this very system, established some seventy years ago, that continues to govern the securities marketplace to this day.

In the decades since, courts have struggled to reconcile the SROs’ twin status as private entities, often operating for-profit, and as first-

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<sup>1</sup> “One must always be on one’s guard, for in good things there are many snares.” Stephen M. Sheppard, ed, 1 *The Selected Writings and Speeches of Sir Edward Coke* 431 n 12 (Liberty Fund 2003). See also *Floyd and Barker*, 77 Eng Rep 1305, 1307 (Star Chamber 1608).

<sup>2</sup> See, for example, Jon Hilsenrath, Serena Ng, and Damian Paletta, *Worst Crisis since the ‘30s, with No End Yet in Sight*, Wall St J A1 (Sept 18, 2008).

<sup>3</sup> See, for example, Ian Talley, *Obama’s Pick for Commodity Post Vows New Era of Regulation*, Wall St J A10 (Feb 4, 2009).

<sup>4</sup> Securities Exchange Act of 1934, Pub L No 73-291, 48 Stat 881, codified as amended at 15 USC § 78a et seq.

line regulators, charged with overseeing and disciplining their members in the stead of the government. One point that has proved particularly vexatious is the question of how to insulate SROs from civil liability stemming from their role as regulators. Common sense dictates that SROs ought to enjoy at least some immunity for undertaking activities normally performed by the government to preserve their incentives to act; but under what legal theory, and for which actions?

The Supreme Court provided a starting point for answering those questions in *Butz v Economou*,<sup>5</sup> a landmark 1978 decision that held that absolute immunity from civil liability—historically afforded solely to judges—ought to track function, not form. All government actors whose roles were “functionally comparable” to that of a participant in a traditional judicial proceeding (for example, judges, prosecutors, witnesses, and the like) would thus be granted immunity.<sup>6</sup> Seizing upon this “functional comparability” language, the Fifth Circuit soon thereafter extended immunity to SRO officials engaged in “quasi-judicial” disciplinary proceedings. Subsequent courts, noting that SROs engaged in regulatory activities beyond discipline, which might otherwise be undertaken by a government agency, then adopted and broadened the form of immunity offered to SROs and their employees. It was thus extended to protect not only actions deemed “quasi-judicial” but also those considered “quasi-governmental.” In the process, courts introduced notions of sovereign immunity into an area of law that had once been governed solely by the absolute immunity doctrine.

This expansive conception of SRO immunity has not escaped criticism, however, and in 2007, the Eleventh Circuit explicitly split with the Second and Ninth Circuits, interpreting quasi-governmental more narrowly than had the latter circuits. In doing so, it further exacerbated the conceptual and practical difficulties faced by courts in administering ancient doctrines grafted upon a modern regulatory regime. Conceptually, SRO immunity as it exists today seems to have exceeded the bounds of both absolute and sovereign immunity, creating questions as to its legal validity. Practically, it is difficult for courts to determine what actions fall within the ambit of the immunity’s protection.

This Comment seeks to reintroduce coherence in the realm of SRO immunity by exploring the doctrine’s roots—whence did it come, how has it evolved, and was this evolution legally sound. Part I examines the history of both SROs and the doctrines of sovereign and

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<sup>5</sup> 438 US 478 (1978).

<sup>6</sup> See *id.* at 511–12.

absolute immunity, while Part II explains the evolution of the immunity granted to SROs. Part III concludes that the modern conception of SRO immunity as shielding all quasi-governmental SRO actions is unwarranted, both legally and in principle, and suggests a contraction to its original embrace of quasi-judicial activities. Instead of protection premised on sovereign immunity, Part IV advocates for use of a separate procedural device—contractual immunity—that could serve much of the function that the broad version of SRO immunity currently occupies while dispensing with the concomitant incoherence.

### I. SROs AND THE DOCTRINES OF ABSOLUTE AND SOVEREIGN IMMUNITY

The doctrine of SRO immunity as it is applied by courts today cannot be understood without an appreciation for history, both of SROs and of the traditional doctrines of immunity on which SRO immunity rests. Part I.A briefly describes the arrival of the SRO on the legal stage in the 1930s. Part I.B traces the evolution of the doctrine of absolute immunity—the same doctrine that courts continue to rely on, in name at least, to justify SRO immunity—from its origins at English common law to its application to SROs in the 1980s. Finally, Part I.C introduces sovereign immunity, a doctrine that courts have often mentioned, and seemingly relied upon, but never explicitly adopted in the SRO context.

#### A. Regulatory Outsourcing and the Birth of the SRO

SROs serve as the first-line regulatory authority over much of the United States' securities and commodities industries. Mandated by statute,<sup>7</sup> these organizations oversee the day-to-day operations of securities and commodities exchanges, coordinating among various actors (for example, broker-dealers, floor specialists, and the like), propagating rules intended to protect investors, and disciplining members who act in contravention of those rules.<sup>8</sup>

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<sup>7</sup> Though sharing much in common, the securities and commodities industries are regulated under separate regimes, one created by the Securities Act of 1933 and Securities Exchange Act of 1934, and the other by the Commodity Exchange Act of 1936. 7 USC § 1 et seq. Despite the differences in statutory regimes, however, SROs for both industries enjoy an identical status for purposes of immunity—both are quasi-governmental entities conducting activities that might otherwise be in the purview of government agencies such as the SEC or Commodity Futures Trading Commission (CFTC).

<sup>8</sup> See generally, Charles J. Johnson, Jr and Joseph McLaughlin, *Corporate Finance and the Securities Laws* § 6 at 6-1–6-68 (Aspen 4th ed 2009).

Securities SROs include, for example, the New York Stock Exchange (NYSE); the Financial Industry Regulatory Authority (FINRA) (formerly the National Association of Securities Dealers (NASD)); and the NASDAQ (the former NASD's over-the-counter stock market). Examples of commodities SROs include the New York Mercantile Exchange (NYMEX) and the Chicago Board of Trade (CBOT), now under common ownership.

### 1. The advent of securities and commodities SROs.

The Securities Act of 1933 ('33 Act) and the Securities Exchange Act of 1934 ('34 Act) were sweeping pieces of legislation that dramatically altered the state of securities markets in the US.<sup>9</sup> Passed in the wake of widespread reports of securities fraud and opportunism amidst the speculative craze that led to the 1929 stock market crash, the Acts were intended "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry."<sup>10</sup> The '33 Act primarily regulates the initial dissemination of securities,<sup>11</sup> while the '34 Act governs the purchase and sale of securities subsequent to initial distribution,<sup>12</sup> both on securities exchanges and over-the-counter markets.<sup>13</sup> The '34 Act sought to convert private exchanges into public institutions that enforce federal securities laws, and to that end, mandates that all exchanges register with the SEC, propagate rules that protect investors, and discipline their members.<sup>14</sup>

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<sup>9</sup> See Securities Act of 1933, Pub L No 73-22, 48 Stat 74, codified as amended at 15 USC § 77a et seq; Securities Exchange Act of 1934, Pub L No 73-291, 48 Stat 881, codified as amended at 15 USC § 78a et seq.

<sup>10</sup> *SEC v Capital Gains Research Bureau, Inc.*, 375 US 180, 186 (1963).

<sup>11</sup> See William O. Douglas and George E. Bates, *The Federal Securities Act of 1933*, 43 Yale L J 171, 171 (1933) ("All the ['33] Act pretends to do is to require the 'truth about securities' at the time of issue, and to impose a penalty for failure to tell the truth.").

<sup>12</sup> See 15 USC § 78b. See also Philip A. Loomis, Jr, *The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940*, 28 Geo Wash L Rev 214, 215-16 (1959) (distinguishing between the distribution of new issues, which are governed by the '33 Act, and trading markets, which are governed by the '34 Act).

<sup>13</sup> Exchange markets are "a development and refinement of that age old institution, the public auction," wherein securities are generally listed (that is, an agreement is entered into between the issuer of the security and the exchange), and transactions limited to members, who act primarily as "agents for customers, or sub-agents for brokers." Loomis, 28 Geo Wash L Rev at 215 (cited in note 12). Over-the-counter markets, on the other hand, lack the focus and rules of exchanges, and "consist of thousands of broker-dealers who trade among themselves and with customers in securities of all types." *Id.*

<sup>14</sup> *Id.* at 221-22.

Over-the-counter markets, on the other hand, were not adequately addressed by the '34 Act, and in the years subsequent, abuse remained rampant.<sup>15</sup> In response, Congress passed the Maloney Act<sup>16</sup> in 1938, adding § 15A to the original legislation.<sup>17</sup> This amendment created “[a] program [ ] based upon cooperative regulation, in which the task [of regulating over-the-counter markets] [was] largely performed by representative organizations of investment bankers, dealers, and brokers, with the Government exercising appropriate supervision in the public interest, and exercising supplementary powers of direct regulation.”<sup>18</sup> Direct government regulation was explicitly rejected as too heavy-handed.<sup>19</sup> National securities associations, therefore, were to effect control of—and impose order upon—over-the-counter markets much the way the exchanges did for listed markets.<sup>20</sup> Collectively, these exchanges and associations would come to be known as SROs.

Taken together, the '34 Act and the Maloney Act significantly expanded the scope of self-regulation in the securities industry, delegating to private entities what had previously always been within the province of governmental authority. SROs were afforded the power to enforce “compliance by members of the industry with both legal requirements laid down in the ['34] Act and the ethical standards going beyond those requirements.”<sup>21</sup> That is not to say, of course, that the SEC was stripped of all regulatory responsibilities in the new regime. Congress provided the SEC with extensive supervisory responsibilities over securities SROs to protect against abuses of power.<sup>22</sup> For instance, an organization must conform to stringent requirements laid out in § 15A of the '34 Act in order to become a registered securities association in the first place.<sup>23</sup> Once registered, moreover, the association still

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<sup>15</sup> See *id.* at 219–20 (noting that the original regulatory scheme for over-the-counter markets put the burden on the wrong party, namely brokers and traders rather than issuers of unlisted securities, and thus proved to be unworkable). See also *Regulation of Over-the-Counter Markets*, S Rep No 1455, 75th Cong, 3d Sess 2–3 (1938).

<sup>16</sup> Maloney Act, Pub L No 75-719, 52 Stat 1070 (1938), codified at 15 USC § 78a.

<sup>17</sup> 15 USC § 78o-3.

<sup>18</sup> S Rep No 75-1455 at 3–4 (cited in note 15).

<sup>19</sup> *Id.* at 3.

<sup>20</sup> See Loomis, 28 Geo Wash L Rev at 220 (cited in note 12).

<sup>21</sup> Securities Acts Amendments of 1975, S Rep No 75, 94th Cong, 1st Sess 22–23 (1975).

<sup>22</sup> See, for example, *Austin Municipal Securities, Inc v NASD*, 757 F2d 676, 680 (5th Cir 1985).

<sup>23</sup> In particular, the organization's rules must be designed to protect both members and the public at large. The Commission, among other things, has the statutory mandate to ensure that the organization's rules assure a fair representation of its members, 15 USC § 78o-3(b)(4), are designed to prevent fraud, 15 USC § 78o-3(b)(6), and include provisions for disciplining members who violate them, 15 USC § 78o-3(b)(7).

remains subject to SEC oversight of rules, policies, and practices.<sup>24</sup> The SEC may abrogate rules inconsistent with the '34 Act,<sup>25</sup> and retains broad sanctioning powers over those SROs it deems to be out of compliance.<sup>26</sup> Nevertheless, much of the frontline regulation remains the purview of the SROs.

Commodities exchanges today enjoy a quasi-governmental status identical to securities SROs. The primary statute by which they are governed, the Commodity Exchange Act<sup>27</sup> (CEA), however, has different—and earlier—origins. Popular backlash in the early decades of the twentieth century against speculators<sup>28</sup> thought to be manipulating prices on grain exchanges led in 1921 to what would eventually become a commodities regulatory regime.<sup>29</sup> Futures trading of regulated commodities, however, is limited to organized exchanges;<sup>30</sup> there are no over-the-counter markets.<sup>31</sup>

<sup>24</sup> See *Austin*, 757 F2d at 680.

<sup>25</sup> 15 USC § 78s(b)(3)(C).

<sup>26</sup> See 15 USC § 78s(h) (granting the power to suspend or revoke the registration of a SRO, and expel or suspend members of a SRO).

<sup>27</sup> Commodity Exchange Act, Pub L No 75-675, 49 Stat 1491 (1936), codified at 7 USC § 1 et seq.

<sup>28</sup> Speculation, of course, is not solely a concern of the early twentieth century. Similar fears have reappeared throughout US history and were most recently stoked during the economic crisis at the end of the first decade of the twenty-first century. “Speculators” in the past two years have been blamed for, among other things, the rise (but apparently not the fall) of oil prices, David Cho, *A Few Speculators Dominate Vast Market for Oil Trading*, Wash Post A1 (Aug 21, 2008); subprime-fueled decadence and the subsequent housing crisis, Andrew Leonard, *King of the Housing Speculators*, Salon (Nov 27, 2007), online at [http://www.salon.com/tech/htww/2007/11/27/myrtle\\_beach\\_speculators](http://www.salon.com/tech/htww/2007/11/27/myrtle_beach_speculators) (visited Jan 8, 2010); and short sales of (investment) bank stocks, Kara Scannell and Jenny Strasburg, *SEC Moves to Curb Short Selling*, Wall St J A1 (July 16, 2008).

<sup>29</sup> In 1921, Congress passed the Futures Trading Act (FTA), Pub L No 67-66, 42 Stat 187, which sought to regulate the boards of trade on which futures trading was conducted. William L. Stein, *The Exchange-Trading Requirement of the Commodity Exchange Act*, 41 Vand L Rev 473, 477 (1988). Though a key provision of the FTA was declared unconstitutional the following year as an improper exercise of congressional taxing power, *Hill v Wallace*, 259 US 44, 68–70 (1922), Congress responded by passing a virtually identical statute entitled the Grain Futures Act of 1922 (GFA), Pub L No 67-331, 42 Stat 998, this time premised on the Commerce Clause. Stein, 41 Vand L Rev at 478. The Supreme Court upheld the GFA the following year, *Board of Trade of Chicago v Olsen*, 262 US 1, 32–34 (1923), and it was substantially altered and renamed the Commodities Exchange Act in 1936. Stein, 41 Vand L Rev at 478. Extensive amendments in 1974 created the CFTC, the SEC’s equivalent in futures trading markets. *Id.*

<sup>30</sup> See 7 USC § 6 (“[I]t shall be unlawful for any person to . . . enter into . . . any transaction in . . . a contract for the purchase or sale of a commodity for future delivery . . . unless . . . such transaction is conducted on . . . a board of trade which has been designated or registered by the [CFTC].”).

<sup>31</sup> Stein, 41 Vand L Rev at 482 (cited in note 29) (noting that the CFTC, courts, and commentators have all “consistently interpreted the CEA to prohibit all off-exchange futures contracts”).

Evolutionary differences notwithstanding, no substantive distinction exists between securities and commodities SROs as far as immunity is concerned.<sup>32</sup> The organizations are indistinguishable entities, and courts treat them identically.<sup>33</sup>

## 2. Disciplinary proceedings conducted by SROs.

The tension between the status of SROs as private entities and their statutory mandate to undertake activities historically within the province of government is responsible for much difficulty in the law.<sup>34</sup> Disciplinary proceedings conducted by SROs against their own members, for instance, are often at issue. The tension here is deliberate: SROs are required statutorily to discipline their members.<sup>35</sup> To resolve many of the problems inherent in private entities undertaking adjudicatory functions, the '34 Act contemplates several specific procedural safeguards modeled on those associated with traditional judicial proceedings.<sup>36</sup> SROs must "bring specific charges, notify [the] member or person of, and give him an opportunity to defend against, such charges, and keep a record."<sup>37</sup> Imposition of disciplinary sanctions, moreover, requires a statement explaining (1) the act or omission constituting the violation;<sup>38</sup> (2) the specific statutory provision, rule, or regulation;<sup>39</sup> and (3) the sanction, and reasons for its imposition.<sup>40</sup> Finally, the SEC reviews a SRO's rules for disciplinary proceedings to ensure they are fair prior to permitting registration,<sup>41</sup> and disappointed

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<sup>32</sup> Like securities SROs, commodities SROs are granted broad powers to enforce member compliance with pertinent laws and ethical standards. See 7 USC § 7(b)(6) (allowing a commodities SRO to establish and enforce disciplinary procedures). Both types of organizations, moreover, must register with their respective oversight commissions though particular registration requirements differ. Compare 7 USC § 7 with 15 USC § 78o-3. And the CFTC, like the SEC, retains broad powers of supervision. See, for example, 7 USC § 7b (allowing the CFTC to suspend or revoke designation of a registered entity for noncompliance with CFTC rules).

<sup>33</sup> See Part II.A.

<sup>34</sup> In addition to conflict over immunity from civil liability, SROs also present antitrust concerns. For a general overview of these concerns, see Marianne K. Smythe, *Government Supervised Self-Regulation in the Securities Industry and the Antitrust Laws: Suggestions for Accommodation*, 62 NCL Rev 475, 476 (1984).

<sup>35</sup> See 15 USC § 78o-3(b)(7); 7 USC § 7(b)(6).

<sup>36</sup> See *Austin*, 757 F2d at 680.

<sup>37</sup> 15 USC § 78o-3(h)(1).

<sup>38</sup> 15 USC § 78o-3(h)(1)(A).

<sup>39</sup> 15 USC § 78o-3(h)(1)(B).

<sup>40</sup> 15 USC § 78o-3(h)(1)(C).

<sup>41</sup> 15 USC § 78o-3(b)(8).

parties possess a statutory right to appeal the SRO's rulings.<sup>42</sup> The CEA provides for much the same protections.<sup>43</sup>

Considering the aforementioned tension, then, it is not remarkable that disciplinary proceedings were often the subject of early litigation dealing with SROs. Those disciplined and unhappy with the result were quick to file suit, challenging the process, the result, or both. Confronted with the prospect of each such proceeding being subsequently disputed, thereby undermining the *raison d'être* for SROs, courts resorted to absolute immunity to insulate SROs from such lawsuits.

### 3. Other quasi-governmental activities conducted by SROs.

Disciplinary proceedings, however, are by no means the full extent of the quasi-governmental activities in which SROs engage. Since SROs are charged with overseeing day-to-day operations of trading markets as a whole, they take part in a number of activities that cannot properly be deemed "judicial," but certainly qualify as "governmental"—if the SROs were not delegated such responsibilities, it is likely that some other governmental agency would conduct those activities instead. For instance, national exchanges promulgate rules governing membership,<sup>44</sup> impose commissions and fees,<sup>45</sup> register securities,<sup>46</sup> and manage trading among members and broker-dealers.<sup>47</sup> Similarly, registered securities associations (managing over-the-counter markets) are responsible for assessing membership,<sup>48</sup> maintaining registration and disciplinary data,<sup>49</sup> and establishing rules governing quotation of securities not registered on national exchanges.<sup>50</sup>

Though not judicial, these activities nonetheless have potential to significantly injure members, and are susceptible to abuse. It is not surprising, therefore, that these activities have given rise to a substantial amount of litigation in years past. The judicial response—extending absolute immunity here too—is the subject of this Comment. Before turning to the current state of SRO immunity, however, a historical

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<sup>42</sup> 15 USC § 78s(d)(1)–(2).

<sup>43</sup> See, for example, 7 USC § 21(b)(9) (requiring similar measures such as a statement setting forth allegations, an opportunity to be heard, and a record kept at all times).

<sup>44</sup> See 15 USC § 78f(c).

<sup>45</sup> See 15 USC § 78f(e).

<sup>46</sup> See 15 USC § 78l(b).

<sup>47</sup> See 15 USC § 78k.

<sup>48</sup> See 15 USC § 78o-3(g).

<sup>49</sup> See 15 USC § 78o-3(i).

<sup>50</sup> See 15 USC § 78o-3(b)(11).



examination of the underlying immunity doctrines courts have used is in order.

## B. Absolute Immunity

Absolute immunity is the strongest form of immunity in the law available to individuals. It frees the recipient of its protection from civil liability unconditionally. Those protected by this doctrine are immune regardless of any other consideration, including when they act out of malice or due to corruption. Naturally, such an unequivocal shield is fraught with potential for abuse, and consequently, has historically been extended only in limited circumstances and then, only to a small class of roles. The doctrine, in contrast to the concept of SROs, dates back several centuries—before the New Deal, or even the New World. Absolute immunity was originally granted only to judges for performance of their judicial function. Over the course of the twentieth century, courts extended this form of immunity to various other nonjudicial actors who performed actions comparable to those undertaken by a judge.

### 1. Historical evolution.

Judges were the first—and originally, only—recipients of absolute immunity, and then only for performance of their judicial function. As early as the seventeenth century, the matter was recognized as well settled at English common law.<sup>51</sup> Since the monarch was “*de jure* to deliver justice to all his subjects” and had delegated this authority to judges, judges answered only to the monarch, and “no other.”<sup>52</sup> By the nineteenth century, the policy rationales behind offering such protection to judges had emerged. As one English justice explained in *Fray v Blackburn*,<sup>53</sup> “It is a principle of our law that no action will lie against a Judge . . . for a judicial act, though it be alleged to have been done maliciously and corruptly.”<sup>54</sup> The justice further noted that “[t]he public are deeply interested in this rule, which, indeed exists for their benefit and was established in order to secure the independence of the Judges, and prevent their being harassed by vexatious actions.”<sup>55</sup>

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<sup>51</sup> *Floyd and Barker*, 77 Eng Rep 1305, 1307 (Star Chamber 1608) (“[I]t was resolved, that that thing, that a Judge doth as Judge of Record, ought not to be drawn in question in this Court.”).

<sup>52</sup> *Id.* at 1307.

<sup>53</sup> 122 Eng Rep 217 (QB 1863).

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

In the United States, the Supreme Court first explicitly acknowledged the principle of judicial absolute immunity in the landmark decision of *Bradley v Fisher*.<sup>56</sup> The justification for granting such protection to judges tracked that expressed by the English judges of centuries past. Since judicial proceedings often involved controversies “not merely of great pecuniary interest, but the liberty and character of the parties,”<sup>57</sup> and necessarily involved a losing party unlikely to be pleased by the result, guaranteeing judges freedom from recriminatory lawsuits was the only means of ensuring they would be able to act independently of the parties they judged.

Courts offering such impenetrable protection, moreover, were not ignorant of the potentially dire consequences of their decisions. As the eminent Judge Learned Hand observed:

It does indeed go without saying that an official who is in fact guilty of using his powers to vent his spleen upon others . . . should not escape liability for the injuries he may so cause . . . . The justification for doing so is that it is impossible to know whether the claim is well-founded until the case has been tried, and that to submit all officials, the innocent as well as the guilty, to the burden of trial and to the inevitable danger of its outcome, would dampen the ardor of all but the most resolute, or the most irresponsible, in the unflinching discharge of their duties.<sup>58</sup>

Balancing the proverbial “two evils,” courts tended to conclude that it was better to leave the occasional individual without redress for harms caused by a wayward judicial officer than to subject the whole lot to fear of retaliatory attacks.<sup>59</sup>

Fifty years after the Supreme Court’s decision in *Bradley*, absolute immunity was extended to cover government prosecutors. The Second Circuit interpreted centuries of common law precedent as standing for the proposition that federal prosecutors, “in performance of the duties imposed upon [them] by law,” are absolutely immune regardless of whether the prosecution resulted in a conviction or an acquittal.<sup>60</sup> The court’s reasoning was identical to that provided in support of absolute immunity for judges and grand jurors: such a role required independence that only absolute immunity could guarantee.<sup>61</sup>

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<sup>56</sup> 80 US 335 (1871).

<sup>57</sup> *Id.* at 348.

<sup>58</sup> *Gregoire v Biddle*, 177 F2d 579, 581 (2d Cir 1949).

<sup>59</sup> See, for example, *id.*

<sup>60</sup> *Yaselli v Goff*, 12 F2d 396, 406 (2d Cir 1926).

<sup>61</sup> *Id.*

This holding was summarily affirmed in a per curiam opinion issued by the Supreme Court a year later.<sup>62</sup>

2. Quasi-judicial actors: *Butz v Economou* and “functional comparability.”

Although judges, jurors, and to an extent, prosecutors,<sup>63</sup> all had been granted absolute immunity from suits by disgruntled litigants, the Supreme Court did not extend this potent form of immunity to individuals outside the context of an Article III proceeding until the landmark 1978 decision of *Butz v Economou*. The case involved a damages suit filed against several members of the US Department of Agriculture (USDA) by an individual who had been subject to an investigation and administrative proceeding.<sup>64</sup>

The question before the Court was whether the USDA officials (including the equivalent of “judges,” “prosecutors,” and the like) ought to be protected by absolute immunity, much as their brethren in the Article III world are shielded. In analyzing the issue, the Court extracted from the past cases the logic behind the grant of absolute immunity to particular roles: “Judges have absolute immunity not because of their particular location within the Government but because of the special nature of their responsibilities.”<sup>65</sup> Hence, concluded the Court, “[i]t is the *functional comparability* of their judgments to those of the judge that has resulted in both grand jurors and prosecutors being referred to as ‘quasi-judicial’ officers, and their immunities being termed ‘quasi-judicial’ as well.”<sup>66</sup> Considering the “functional comparability” of the various roles in “quasi-judicial” administrative agency proceedings to roles in Article III courts, the Court held the doctrine ought to shield the former as much as the latter.

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<sup>62</sup> *Yaselli v Goff*, 275 US 503, 503 (1927).

<sup>63</sup> There is some indication that the Supreme Court may in the near future reconsider the scope of prosecutorial immunity. The Eighth Circuit recently refused in *McGhee v Pottawattamie County*, 547 F3d 922 (8th Cir 2008), to extend immunity to prosecutors alleged to have fabricated evidence and introduced it at trial against the defendants. *Id.* at 932–33. The Supreme Court granted certiorari in the case, 129 S Ct 2002 (2009), and heard oral arguments before the parties settled. See Tony Mauro, *High Court to Weigh Prosecutorial Immunity*, Natl L J 14 (Nov 9, 2009). The writ of certiorari was subsequently dismissed as moot. 130 S Ct 1047 (2010). See also Tony Mauro, *Supreme Court Drops Undecided Prosecutorial Immunity Case after Parties Settle*, Natl L J (Jan 5, 2010), online at <http://www.law.com/jsp/article.jsp?id=1202437396965> (visited Feb 2, 2010).

<sup>64</sup> *Butz*, 438 US at 481–82.

<sup>65</sup> *Id.* at 511–12.

<sup>66</sup> *Id.* (emphasis added).

Beyond the standard reasons for granting absolute immunity to judicial functions, an analysis of the various systemic safeguards<sup>67</sup> against abuse was central to the Court's analysis. Theoretically, at least, judges are insulated from political influence, bound by precedent, constrained by the adversarial nature of the process, and checked by the option of appeal to a higher court.<sup>68</sup> Similarly, prosecutors are restrained by both "professional obligations" and the "knowledge that their assertions will be contested by their adversaries in open court"; jurors are screened to eliminate bias; and witnesses face both "cross-examination and the penalty of perjury."<sup>69</sup>

After considering both the policy reasons for granting such protection and the various safeguards in agency proceedings, the Court reasoned that the goal of preserving the independence of administrative law judges took precedence over deterring misbehavior.<sup>70</sup> Similarly, those deciding to initiate an agency proceeding, and those attorneys serving as "prosecutors" were absolutely immune for much the same reasons as quasi-judicial roles in the traditional judicial system.<sup>71</sup>

### 3. Application of absolute immunity to SRO disciplinary proceedings.

The Supreme Court has never ruled on the issue of absolute immunity granted to individuals employed by private, nongovernmental entities such as SROs. Considering, however, that many such organizations are responsible for disciplining their members and use a process modeled on that of traditional courts and administrative agencies, it is no surprise that lower courts began to apply the logic of *Butz* to cases involving damage suits against officials of "private entities engaged in quasi-public adjudicatory and prosecutorial duties."<sup>72</sup>

Seven years after the Supreme Court's decision in *Butz*, the Fifth Circuit was confronted with a damages suit against officials of the

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<sup>67</sup> Though SROs, as private entities, are not necessarily bound by procedural due process requirements that constrain federal courts and administrative agencies, statutory rules and agency supervision often provide for similar safeguards. See Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 Stan J L, Bus & Fin 151, 184–86 (2008).

<sup>68</sup> *Butz*, 438 US at 512.

<sup>69</sup> *Id.*

<sup>70</sup> *Id.* at 514.

<sup>71</sup> See *id.* at 516–17.

<sup>72</sup> See *Barbara v NYSE*, 99 F3d 49, 58 (2d Cir 1996), citing *Corey v NYSE*, 691 F2d 1205, 1208–11 (6th Cir 1982).

NASD in *Austin Municipal Securities, Inc v NASD*.<sup>73</sup> Noting that no Supreme Court decision discussed whether absolute immunity ought to extend to private individuals, the court nonetheless decided that *Butz* justified such an extension. From that opinion, the court extracted a three-prong test for determining whether a SRO official ought to be protected by absolute immunity.<sup>74</sup> Specifically, immunity would attach if: (1) “the official’s functions share the characteristics of the judicial process”; (2) “the official’s activities are likely to result in recriminatory lawsuits by disappointed parties”; and (3) “sufficient safeguards exist in the regulatory framework to control unconstitutional conduct.”<sup>75</sup> Thus, even while expanding the scope of the absolute immunity doctrine to encompass nongovernmental actors, the Fifth Circuit in *Austin* retained the focus of the immunity on *judicial* functions conducted by *individuals*.<sup>76</sup>

### C. Sovereign Immunity

Later courts have adopted and dramatically expanded the reasoning in *Butz* and *Austin*, extending immunity both to SROs as *entities* and for actions beyond the judicial context. In crafting this broader conception of immunity, these courts have relied on the SRO’s “special status and connection”<sup>77</sup> to regulatory agencies such as the SEC, which in turn enjoy *sovereign* immunity.

Under the English common law, the government as an *entity* was immune from both civil suit and criminal prosecution under the common law precept of *rex non potest peccare*—“the King can do no wrong.”<sup>78</sup> This same rule was imported into American common law, and the federal government generally enjoys this protection unless it explicitly waives it.<sup>79</sup> Regulatory agencies (such as the SEC), moreo-

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<sup>73</sup> 757 F2d 676 (5th Cir 1985).

<sup>74</sup> *Id* at 688–89.

<sup>75</sup> *Id* at 688.

<sup>76</sup> The court in *Austin* did discuss briefly the immunity that may be afforded to the entity. See *id* at 692. In this case, however, the court concluded that the allegation that the NASD was “complicit” in the immune officials’ alleged mischief was not sufficient to withstand summary judgment. Moreover, it restricted such immunity only to instances where the “sole basis” for charges against the parent organization was a result of an allegation that hinged on representative capacity of its employees, who received absolute immunity by virtue of their quasi-judicial function. *Id*.

<sup>77</sup> *Barbara*, 99 F3d at 59.

<sup>78</sup> See William Blackstone, 3 *Commentaries on the Laws of England* 254–55 (Chicago 1979).

<sup>79</sup> See *United States v Lee*, 106 US 196, 204 (1882); Gregory C. Sisk, *Litigation with the Federal Government* § 2.02(b)(2) at 80 (ALI 4th ed 2006). See also David A. Webster, *Beyond Federal Sovereign Immunity: 5 U.S.C. § 702 Spells Relief*, 49 Ohio St L J 725, 726–32 (1988).

ver, are routinely protected by sovereign immunity in performing their delegated, discretionary duties.<sup>80</sup>

Though for over a century sovereign immunity had often been assumed to cloak the federal government, the Supreme Court did not explicitly rule on this subject until 1882 in *United States v Lee*.<sup>81</sup> The holding in that case, moreover, was narrow: even while acknowledging the doctrine as well established,<sup>82</sup> the slim majority expressed reservations about its continued use in the United States because, unlike England, the former had no monarch.<sup>83</sup> Additionally, the Court was unwilling to extend this protection to officers of the government, as opposed to the government itself.<sup>84</sup> Indeed, at the time, the Court might have been preparing for the doctrine's eventual eradication.<sup>85</sup>

Some seventy years later, however, the Court changed its mind. In *Larson v Domestic & Foreign Commerce Corp*,<sup>86</sup> the Court held that the distinction between the federal government and an officer acting on its behalf was untenable.<sup>87</sup> Instead, courts should determine whether a suit against the officer "is, in substance, a suit against the Government over which the court, in the absence of consent, has no jurisdiction."<sup>88</sup> But there were two exceptions to this protection according to the Court. First, an officer acting beyond her delegated authority under the statute was not to be protected. Second, even if she were acting pursuant to statutory authority, she would not be immune if her conduct breached constitutional boundaries.<sup>89</sup>

The holding in *Larson* was reinforced in *Malone v Bowdoin*.<sup>90</sup> In that case, the Court concluded that *Larson* had resolved the discrepancy between conflicting precedents on sovereign immunity,<sup>91</sup> and

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<sup>80</sup> See *Tort Claims against the United States*, HR Rep No 2245, 77th Cong, 2d Sess 10 (1942) ("[Section 402 of the Federal Tort Claims Act] is also designed to preclude application of the bill to a claim against a regulatory agency, such as the . . . Securities and Exchange Commission, based upon an alleged abuse of discretionary authority by an officer or employee, whether or not negligence is alleged to have been involved."). See also 28 USC § 2680(a).

<sup>81</sup> 106 US 196 (1882).

<sup>82</sup> *Id* at 204.

<sup>83</sup> *Id* at 220 ("No man in this country is so high that he is above the law.").

<sup>84</sup> *Id* at 220–21.

<sup>85</sup> See Sisk, *Litigation with the Federal Government* § 2.02(b)(2) at 83 (cited in note 79) (suggesting that the *Lee* majority was "doubtful about the legitimacy of sovereign immunity as a threshold matter" and may have sought to open the door widely to suits against government officers).

<sup>86</sup> 337 US 682 (1949).

<sup>87</sup> See *id* at 689.

<sup>88</sup> *Id* at 688.

<sup>89</sup> *Id* at 689–90.

<sup>90</sup> 369 US 643 (1962).

<sup>91</sup> For a thorough discussion of the conflicting precedents, see *Larson*, 337 US at 701–04.

further cabined the holding in *Lee* as a specific constitutional exception to the general rule.<sup>92</sup> This decision marked the death knell for the anti-sovereign immunity movement.

Like absolute immunity, notions of federal sovereign immunity were extended beyond their narrow historical confines during the twentieth century, in particular under the common law principles of contract specification and agency. Historically, both private and government contractors could use the contract specification defense to avoid liability. This defense provided that those contractors hired to manufacture or perform under very specific orders would be shielded from liability for any defect in the product, with the liability instead attaching to the employer who ordered a specific product design.<sup>93</sup>

In a series of cases emerging from the New Deal's public works projects, courts began to use agency theory to broaden the embrace of the federal government's "cloak of immunity" to also protect from tort liability those contractors who strictly followed government specifications.<sup>94</sup> The Supreme Court first discussed an early version of this protection—what came to be known as the "government contractor defense"—in the 1940 case, *Yearsley v W.A. Ross Construction Co.*<sup>95</sup> There it observed that there could be "no liability on the part of the contractor for executing" Congress's will, and further, that in such instances, liability would only exist if the agent "exceeded his authority or it was not validly conferred."<sup>96</sup> Together, these concepts formed the nascent extension of sovereign immunity to nongovernmental entities.

In the years since, courts have both expanded and refined the government contractor defense in particular contexts. The modern notion of the defense evolved from two lower court cases decided in the 1980s, both of which dealt with products liability in the national defense context.<sup>97</sup> The Supreme Court in 1988 crystallized the devel-

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<sup>92</sup> *Malone*, 369 US at 646–48.

<sup>93</sup> Charles E. Cantu and Randy W. Young, *The Government Contractor Defense: Breaking the Boyle Barrier*, 62 Albany L Rev 403, 408–09 (1998).

<sup>94</sup> *Id* at 405–06.

<sup>95</sup> 309 US 18 (1940).

<sup>96</sup> *Id* at 20–21.

<sup>97</sup> In the first, *In re Agent Orange Product Liability Litigation*, 534 F Supp 1046 (EDNY 1982), the district court for the Eastern District of New York fashioned a three-prong test to determine whether a government contractor ought to be shielded from liability. Under this test, immunity attached when: (1) the government wrote the specifications for the product; (2) the product conformed to the government specifications in all material respects; and (3) the government knew as much or more about the hazards of the product as the contractor. *Id* at 1055. This test was then refined by the Ninth Circuit in *McKay v Rockwell International*, 704 F2d 444 (9th Cir 1983). There, the court relaxed the first and third prongs of the *Agent Orange* test, hold-

opments in those cases in *Boyle v United Technology Corp.*<sup>98</sup> concluding that military contractors sued in tort should be shielded from liability when (1) the United States “approved reasonably precise specifications”; (2) the product “conformed to those specifications”; and (3) the contractor “warned the United States about dangers in the use of the equipment that were known to the supplier but not to the United States.”<sup>99</sup> That test is now used to extend the government contractor defense, at least in the national defense context. There is some indication that *Yearsley* might today survive independently of *Boyle*,<sup>100</sup> but this is by no means certain. Regardless, as the discussion above intimates, the extension of sovereign immunity to private entities is both limited in scope and in reach.

Far from the battlefield and in a context vastly removed from military equipment, courts have also invoked sovereign immunity to defend greater protection for SROs. But Congress has never indicated that SROs ought to enjoy sovereign immunity, nor, for that matter, has the Supreme Court. More problematically, the courts that have extended sovereign immunity to SROs have consistently confused the doctrines of absolute and sovereign immunity. Part II examines this confusion.

## II. FROM QUASI-JUDICIAL TO QUASI-GOVERNMENTAL: THE SHIFT FROM ABSOLUTE TO SOVEREIGN IMMUNITY

In the quarter century since the Fifth Circuit’s decision in *Austin*, courts have moved from applying the doctrine of absolute immunity to individual SRO employees that exercise judicial functions, to applying what seems like the doctrine of sovereign immunity to both SROs and their employees for virtually all activities deemed “regulatory” or “governmental.” This conceptual shift, however, has not been accompanied by an attendant doctrinal adjustment to acknowledge the distinct forms of immunity. Instead, courts have continued to employ the *Austin* framework, albeit with an altered first prong, which was originally premised on—and technically applicable only to—absolute immunity. The first prong now covers quasi-governmental activities, essentially granting SROs sovereign immunity for performing government

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ing that the government need only have established or approved reasonably precise design specifications and that the contractor need only have warned the government about the dangers involving the product that were known to the manufacturer but not the government. *Id.* at 451. The Ninth Circuit’s formulation also included a requirement that the federal government be immune from suit under the Federal Tort Claims Act. *Id.* at 448.

<sup>98</sup> 487 US 500 (1988).

<sup>99</sup> *Id.* at 512.

<sup>100</sup> See *Ackerson v Bean Dredging LLC*, 589 F3d 196, 205 (5th Cir 2009).



functions. Through these subtle, piecemeal modifications, SRO immunity has morphed into an amalgamation of independent doctrines, recognizable as both but identifiable as neither. This mutation is problematic both as a matter of law and of principle, as argued in Part III.

First, however, an explanation of the doctrinal metamorphosis is in order. Part II.A discusses chronologically the Second and Ninth Circuit case law that catalyzed the conceptual shift from absolute to sovereign immunity. Part II.B describes the Eleventh Circuit's response to this shift. Finally, Part II.C describes the recent developments in the Second Circuit.

#### A. Advent of the Shift in the Second and Ninth Circuits

SRO immunity, as discussed above,<sup>101</sup> grew out of the Supreme Court's decision in *Butz*, which held that the doctrine of absolute immunity ought to be extended on the basis of function, not form. The Fifth Circuit subsequently relied on *Butz* to apply this form of immunity to officials employed by SROs. From the mid-1990s to the early 2000s, a number of circuits adopted the Fifth Circuit's approach. The initial adoptions were hardly revolutionary—seemingly, they were only a straightforward application of *Austin*. But in a series of cases decided in the Second and Ninth Circuits, the immunity began to morph. As with many other evolutions at common law, each change was subtle, but collectively, no less substantial than had they occurred in one fell swoop.

##### 1. The Second Circuit hints at sovereign immunity.

In 1995, after having twice held that SRO employees are entitled to a minimum of qualified immunity in conduct associated with disciplinary proceedings,<sup>102</sup> the district court for the Southern District of New York adopted the *Austin* holding in *Mandelbaum v NYMEX*.<sup>103</sup> Agreeing with the Fifth Circuit that the defendants were shielded from civil suit by virtue of satisfying the *Butz* tripartite formula, the district court dismissed the complaint on the basis of absolute immunity.<sup>104</sup>

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<sup>101</sup> See Part I.B.2.

<sup>102</sup> See *Bruan, Gordon & Co v Hellmers*, 502 F Supp 897, 902–03 (SDNY 1980) (providing immunity to members of SROs that initiate disciplinary proceedings unless they knew or reasonably should have known that their actions violated the constitutional rights of the plaintiff); *Trama v NYSE*, 1978 WL 1141, \*5–6 (SDNY).

<sup>103</sup> *Mandelbaum v NYMEX*, 894 F Supp 676 (SDNY 1995).

<sup>104</sup> *Id* at 680–81.

The next year marked the Second Circuit's first foray into the realm of SRO immunity. In *Barbara v NYSE*,<sup>105</sup> the plaintiff alleged, among other things, that the New York Stock Exchange<sup>106</sup> both reached the wrong result in a disciplinary proceeding it conducted against him,<sup>107</sup> and violated his constitutional rights while doing so.<sup>108</sup> The district court granted the NYSE's motion to dismiss on the basis that the plaintiff failed to exhaust administrative remedies specified under the '34 Act.<sup>109</sup>

Despite concluding that the district court erred in dismissing the complaint,<sup>110</sup> the Second Circuit nevertheless affirmed the district court's judgment on absolute immunity grounds for two separate reasons. First, since the regulatory scheme created by Congress resulted in SROs undertaking many of the regulatory functions that would otherwise be performed by a government agency entitled to *sovereign* immunity from all suits for money damages, shielding the SROs' conduct in disciplinary proceedings with *absolute* immunity would be logical.<sup>111</sup> Second, since allowing suits against SROs "would clearly stand as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress," specifically to "encourage the forceful self-regulation of the securities industry," extending absolute immunity in these sorts of situations was strongly supported by the same public policy concerns pertaining to judges at common law.<sup>112</sup>

Thus, even while purporting to adopt *Austin*, the Second Circuit in *Barbara* subtly altered the doctrine. The Fifth Circuit based its holding in *Austin* on the "functional comparability" of SRO officials engaged in disciplinary hearings to traditional judges engaging in judicial proceedings; the Second Circuit's opinion, by contrast, included reasoning that relied not only on the "functional comparability" of an individual's conduct, but also on the unrelated notion of *sovereign immunity*, which the SEC enjoys as a government entity. This language

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<sup>105</sup> 99 F3d 49 (2d Cir 1996).

<sup>106</sup> Though the suit, like in *Austin*, was against both individual employees of the SRO and the SRO itself, the latter was only implicated through theories of vicarious liability. *Barbara*, 99 F3d at 52.

<sup>107</sup> *Id.*

<sup>108</sup> *Id.* at 53.

<sup>109</sup> *Id.*

<sup>110</sup> Specifically, the Second Circuit held that the district court erred in dismissing the complaint for failure to exhaust administrative remedies since the plaintiff sought damages, not the reversal of the NYSE's adverse determination. *Barbara*, 99 F3d at 57.

<sup>111</sup> See *id.* at 59. Note, however, that the court in *Barbara* explicitly denied that SROs receive the SEC's sovereign immunity. *Id.*

<sup>112</sup> *Id.*

would be the departure point for later decisions in which SRO immunity was altered.

## 2. The Ninth Circuit extends sovereign immunity to SROs.

Only two years after *Barbara*, the Ninth Circuit seized upon the Second Circuit's language to grant SROs immunity outside of the disciplinary context. In *Sparta Surgical Corp v NASDAQ Stock Market, Inc.*,<sup>113</sup> the Ninth Circuit had occasion to decide the issue of SRO immunity with respect to an exchange's decision to temporarily de-list and suspend trading in a particular stock on the day of its initial public offering.<sup>114</sup> Contending that the unexplained de-listing and suspension, though temporary, nevertheless rendered the offering unmarketable, the plaintiff sued for damages, asserting various state common law claims.<sup>115</sup> Since the SRO was acting as a market facilitator, rather than in an adjudicatory role, the plaintiff argued that absolute immunity did not apply. The court, however, disagreed. Since suspension of trading was "quintessentially regulatory," required to "preserve and strengthen the quality of and public confidence in its market," and therefore, something the SEC would do unless the exchange did, the court reasoned that no liability should follow from its actions.<sup>116</sup>

The Ninth Circuit's decision in *Sparta Surgical* was significant for a number of reasons. First, it marked a departure from foundations of the *Butz* and *Austin* immunity analysis—functional comparability to traditional judicial proceedings—and envisioned a different scope of protection, one premised on the doctrine of sovereign immunity. To this point, courts had only granted SROs immunity in context of disciplinary proceedings. But in drawing comparison to *regulatory* rather than *judicial* activities, the Ninth Circuit shifted the conceptual basis of SRO immunity from absolute to sovereign immunity, which protects a wider swath of government activity. Second, and directly following from this shift, was the underlying question that the Ninth Circuit failed to answer meaningfully—what SRO activities would *not* be granted immunity? The proclamation that a SRO would be immune only when "acting under the aegis of the [’34] Act's delegated authority" and not when "conducting private business"<sup>117</sup> would not provide much guidance to future courts in answering this critical question;

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<sup>113</sup> 159 F3d 1209 (9th Cir 1998).

<sup>114</sup> *Id.* at 1210–11.

<sup>115</sup> *Id.* at 1211.

<sup>116</sup> *Id.* at 1214, citing 59 Fed Reg 29834, 29843 (1994).

<sup>117</sup> *Sparta Surgical*, 159 F3d at 1214.

much of what SROs do could conceivably be—and indeed, was by later courts—characterized as regulatory.

### 3. The Second Circuit extends sovereign immunity to SROs.

With the quasi-judicial limitation abandoned by the Ninth Circuit's decision in *Sparta Surgical*, the stage was set for rapid expansion of the doctrine. Three years later, in *D'Alessio v NYSE*,<sup>118</sup> the Second Circuit explicitly adopted the broader conception of SRO immunity.<sup>119</sup> The plaintiff in that case accused the SRO of misinterpreting federal securities rules and encouraging members to take actions that later turned out to be illegal.<sup>120</sup> The NYSE, according to the plaintiff, "concoct[ed] a phony interpretation" of "statutory and regulatory prohibitions governing unlawful trading," encouraged floor brokers such as the plaintiff to rely on and engage in such unlawful practices, and then, "in an effort to keep its activities secret and curry favor with law enforcement authorities," provided the authorities with false and misleading information about the plaintiff's activities.<sup>121</sup>

The Second Circuit concluded that despite the SRO's alleged misinterpretation of federal securities laws, and its subsequent tortious conduct, it still ought to be absolutely immune from civil liability. Though the holding in *Barbara* was limited to disciplinary proceedings, the court reasoned that "*Barbara* stood for the broader proposition that a SRO . . . may be entitled to immunity from suit for conduct falling within the scope of the SRO's regulatory and general oversight function."<sup>122</sup> Finding, moreover, that all of the NYSE's allegedly tortious acts were "consistent with the *quasi-governmental* powers delegated to it pursuant to the ['34] Act,"<sup>123</sup> the Second Circuit held the NYSE to be immune from civil suit as a matter of law.<sup>124</sup>

The limits of SRO immunity once again were pushed outward. The Ninth Circuit in *Sparta Surgical* morphed SRO immunity from a protection premised on absolute immunity to one dependent on sovereign immunity. In altering the first prong of the absolute immunity test to mean "consistency" with "quasi-governmental power," the

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<sup>118</sup> 258 F3d 93 (2d Cir 2001).

<sup>119</sup> Id at 106 (allowing SRO immunity when the adjudicatory determination at issue fell within the SRO's "quasi-governmental powers").

<sup>120</sup> Id at 97–98.

<sup>121</sup> Id (quotation marks omitted).

<sup>122</sup> *D'Alessio*, 258 F3d at 105.

<sup>123</sup> Id at 106 (emphasis added).

<sup>124</sup> See id.

Second Circuit did the same—it conflated the doctrine of *absolute* immunity, premised on the protection historically afforded to judges, with *sovereign* immunity. The question that appeared to underpin the analysis was whether the SEC, if it were to engage in such conduct, would have been granted sovereign immunity.

4. The Second Circuit morphs SRO immunity further.

The Second Circuit, having broadened the first prong of the test for SRO immunity in *D'Alessio*, expanded the scope of the doctrine further by broadening its conception of quasi-governmental activity. In *DL Capital Group LLC v NASDAQ*,<sup>125</sup> the court held that “absolute immunity” shielded SROs accused of committing fraud.<sup>126</sup> In that case, the plaintiff suffered losses following NASDAQ’s decision to cancel certain trades due to irregular activities. The plaintiff contended that by failing to disclose its intention to cancel the trades, NASDAQ made materially misleading statements—that is, it committed securities fraud.<sup>127</sup> And since the decision of whether to announce the cancellation of the trades fell outside the scope of the regulatory function, immunity ought not attach.<sup>128</sup>

Seeing no difference between *announcing* the cancellation of trades and *deciding* to cancel trades in the first place, however, the court refused to limit the scope of immunity.<sup>129</sup> Responding to the plaintiff’s contention that immunity should not extend to fraudulent conduct, the court noted explicitly that such a result would be antithetical to the doctrine of “absolute immunity.” Since that doctrine was intended to provide blanket protection for all actions, regardless of findings of malice, the court reasoned, “[r]ejecting a fraud exception is a matter not simply of logic but of intense practicality since otherwise the SRO’s exercise of its quasi-governmental functions would be unduly hampered by disruptive and recriminatory lawsuits.”<sup>130</sup> The tension in this result ought to be apparent: while it is true that the doctrine of absolute immunity explicitly forecloses a “fraud exception,” this doctrine historically applied only to quasi-judicial activity. In importing the “no fraud exception” into the quasi-governmental test, however, the court did not suggest a return to a quasi-judicial realm. Instead, under the

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<sup>125</sup> 409 F3d 93 (2d Cir 2005).

<sup>126</sup> *Id.* at 98.

<sup>127</sup> *Id.* at 96.

<sup>128</sup> *Id.* at 98.

<sup>129</sup> *DL Capital Group*, 409 F3d at 98.

<sup>130</sup> *Id.* at 98–99 (quotation marks and citations omitted).

morphed doctrine, whenever the SRO's fraudulent action was deemed quasi-governmental, it would qualify for immunity. How courts limited their understanding of quasi-governmental activity, therefore, would determine how a so-called "fraud exception" would operate.

With SRO immunity having come to encompass even securities fraud, the transformation of the test from quasi-judicial to quasi-governmental was essentially complete. What had historically been a narrowly drawn protection intended to protect those officials engaged in quasi-judicial proceedings had become, in two decades, a near blanket protection for almost any sort of activity in which a SRO might engage.

## B. The Struggle to Define Quasi-Governmental Activity

Two decisions in 2007, one from the district court for the Northern District of California and the other from the Eleventh Circuit, indicated a pause in the Second Circuit's expansive interpretation. Though these courts sought to limit the bounds of SRO immunity, the approach they used was to reassert the distinction between what is—and what is not—"quasi-governmental." Consequently, it seems, they too accepted the broad version of the "functional comparability" test.

### 1. Reasserting the private business/regulatory function distinction.

In *Opulent Fund, LP v NASDAQ Stock Market*,<sup>131</sup> the Northern District of California concluded that NASDAQ was not entitled to immunity when negligently mispricing its index.<sup>132</sup> Reasoning that NASDAQ created its index because it "wished to create a derivatives market based on the stocks listed on its exchange," thus "profit[ing] from selling the market price data," the court concluded that absolute immunity was not warranted.<sup>133</sup> The court, moreover, found that NASDAQ was not standing in the shoes of the SEC because the "[SEC] would not create an index and volunteer to disseminate pricing data if NASDAQ did not exist."<sup>134</sup> Instead, NASDAQ was a "market facilitat[or]" whose goal was to "create a market and increase trading."<sup>135</sup>

In this case, there was clear emphasis on the distinction between regulatory function and private business found in *Sparta Surgical*, but with little discussion of larger conceptions of quasi-governmental

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<sup>131</sup> 2007 WL 3010573 (ND Cal).

<sup>132</sup> *Id.* at \*5.

<sup>133</sup> *Id.*

<sup>134</sup> *Id.*

<sup>135</sup> *Opulent Fund*, 2007 WL 3010573 at \*5.

function that marked the Ninth Circuit's opinion in that case. For instance, the district court did not even mention whether creating a market is precisely one of the authorities delegated to a SRO. The holding in this case, however, seemed to be an indication of the difficulty in distinguishing the limits of quasi-governmental activity.

## 2. The Eleventh Circuit splits with the Second and Ninth Circuits.

In *Weissman v NASD*,<sup>136</sup> the Eleventh Circuit split from the SRO-friendly approaches of the Second and Ninth Circuits. In this case, the plaintiff was an investor who lost much of his investment when WorldCom collapsed in 2002.<sup>137</sup> In his complaint, the plaintiff first alleged that the NASD violated various state laws by (1) marketing and promoting WorldCom stock without disclosing that it derived direct benefit from increased trading in the stock;<sup>138</sup> and (2) offering to sell WorldCom shares without registering as a broker.<sup>139</sup> The plaintiff further alleged that the NASD “committed common-law fraud and/or negligent misrepresentation” by making intentional false statements to induce investors to purchase WorldCom stock while deriving direct benefits from such trades.<sup>140</sup>

The district court, invoking the Ninth Circuit's conception of “private business,” concluded that the NASD was not entitled to absolute immunity because advertisement and promotion of WorldCom stock was not quasi-governmental activity.<sup>141</sup> The Eleventh Circuit panel affirmed in part and reversed in part, with one judge dissenting. In doing so, it distinguished the NASD's “dissemination of WorldCom's fraudulent financial statements,”<sup>142</sup> which *did* comport with its regulatory mandate and hence were entitled to protection, and its other advertising and promoting activities, which were “for-profit commercial activity” and thus not so entitled.<sup>143</sup>

Following the panel decision, the Eleventh Circuit granted rehearing and vacated the panel opinion.<sup>144</sup> Sitting en banc, the Eleventh Circuit, in a fractured opinion, affirmed the panel decision. Explicitly

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<sup>136</sup> 468 F3d 1306 (11th Cir 2006), vacd, 481 F3d 1295 (11th Cir 2007), reinstated in part, 500 F3d 1293 (11th Cir 2007) (en banc).

<sup>137</sup> *Weissman*, 468 F3d at 1308.

<sup>138</sup> *Id.*

<sup>139</sup> *Id.* at 1309.

<sup>140</sup> *Id.* at 1309–10.

<sup>141</sup> *Weissman*, 468 F3d at 1310.

<sup>142</sup> *Id.* at 1311 (quotation marks omitted).

<sup>143</sup> See *id.* at 1311–12.

<sup>144</sup> *Weissman*, 481 F3d at 1295.

rejecting “consistency with quasi-governmental power” as too broad, the court adopted much stricter language for the first prong, namely whether the activity involved “an SRO’s performance of regulatory, adjudicatory, or prosecutorial duties in the stead of the SEC.”<sup>145</sup> Applying that, the court concluded the NASD was not immune from suits resulting from its placement of advertisements “that by their very nature serve the function of promoting certain stocks that appear on its exchange in order to increase trading volume, and as a result, company profits.”<sup>146</sup> The plaintiffs were thus allowed to proceed on a theory that the exchange fraudulently induced “investors to purchase shares of WorldCom.”<sup>147</sup>

### C. Recent Developments: The Second Circuit Revisits Its Broad Conception of Immunity

The Second Circuit returned to the subject of SRO immunity in late 2007, after the Eleventh Circuit issued its en banc opinion in *Weissman*. In a recent decision, *In re NYSE Specialists Litigation*,<sup>148</sup> the Second Circuit considered whether SRO complicity in the illegal schemes of others ought to qualify for immunity.<sup>149</sup> The lead plaintiffs in this class action accused the New York Stock Exchange of a wide range of misconduct with regard to specialist firms, which are each assigned a portion of the securities listed on the Exchange and charged with creating a market for and actually executing the trades in their assigned securities.<sup>150</sup> In addition to facilitating trades for investors, these specialist firms are also permitted to buy and sell securities as principals, ostensibly to ensure liquidity in the market.<sup>151</sup>

The fact that these firms both control the trading in a particular security and simultaneously are permitted to trade in it themselves creates an obvious opportunity for market manipulation, which is precisely what the lead plaintiffs in the case alleged. The plaintiffs further alleged that the NYSE had been complicit in the specialist firm’s self-dealing, either willfully ignoring or actively encouraging such activi-

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<sup>145</sup> *Weissman*, 500 F3d at 1298 (en banc).

<sup>146</sup> *Id* at 1299.

<sup>147</sup> See *id* at 1294–95.

<sup>148</sup> 503 F3d 89 (2d Cir 2007), cert denied, 128 S Ct 1707 (2008).

<sup>149</sup> 503 F3d at 99–103.

<sup>150</sup> *Id* at 91–92.

<sup>151</sup> *Id* at 92. For instance, if an investor executes a buy order when there is no corresponding sell order, the firm was permitted to fulfill the order by selling stock from its own account. See *id*.



ties, as well as later concealing evidence of the firms' misconduct and obstructing the SEC's investigations.<sup>152</sup>

Unmoved, the Second Circuit once again concluded that the SRO was immune, both for actions it engaged in affirmatively and those it failed to engage in at all. Noting that "[t]he power to exercise regulatory authority necessarily include[d] the power to take no affirmative action," the court refused to limit the doctrine solely to the SRO's affirmative actions.<sup>153</sup> The consistency inquiry, moreover, was limited to consistency with regulatory power, not consistency with the law itself.<sup>154</sup> Thus, though the NYSE's alleged actions may have been inconsistent with the law, they were nevertheless consistent with its regulatory function, and hence, entitled to immunity.<sup>155</sup>

In a second claim, however, the lead plaintiffs accused the NYSE of making repeated public misrepresentations about the operation of the specialist firms upon which the plaintiffs had relied to their detriment, thereby constituting securities fraud.<sup>156</sup> Determining that the district court erred in holding that the plaintiffs did not have standing to sue the NYSE for its alleged misrepresentations,<sup>157</sup> the Second Circuit vacated the district court's dismissal of the fraud claim under Rule 10b-5<sup>158</sup> and remanded for a determination of whether the NYSE enjoys immunity for the alleged misrepresentations.<sup>159</sup> In particular, the Second Circuit directed the district court to consider in the first instance the arguments of the majority and dissent in the panel opinion in *Weissman*.<sup>160</sup>

As it stands now, therefore, all circuits to opine on the subject have concluded that SRO immunity is broader than merely shielding individuals involved in adjudicatory activities. In other words, all agree that the proper inquiry is a broader version of the first prong of "functional comparability"—not which activities are quasi-judicial, but which are quasi-governmental. The disagreement is over what is—and is not—quasi-governmental.<sup>161</sup> Put otherwise, the doctrinal basis for SRO immunity has now completely shifted from absolute to sovereign immunity.

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<sup>152</sup> Id at 100.

<sup>153</sup> *NYSE Specialists*, 503 F3d at 97.

<sup>154</sup> Id at 98.

<sup>155</sup> See id at 99–101.

<sup>156</sup> Id at 94.

<sup>157</sup> *NYSE Specialists*, 503 F3d at 102.

<sup>158</sup> 17 CFR § 240.10b-5.

<sup>159</sup> *NYSE Specialists*, 503 F3d at 102–03.

<sup>160</sup> See id.

<sup>161</sup> Indeed, there is some evidence that the notion of quasi-governmental activity remains as broad as ever in the Second Circuit, as demonstrated by a recent decision in the Southern District of New York. In *Standard Investment Chartered, Inc v NASD*, 2010 US Dist LEXIS 19174

### III. A RETURN TO THE ROOTS

The dramatic metamorphosis of the SRO immunity doctrine in recent years, and the subsequent circuit split over how broadly it ought to be drawn, highlights the difficulty in adapting ancient doctrines to a modern regulatory system. The doctrine of absolute immunity, as originally conceived, only protected actors undertaking traditional judicial functions. Sovereign immunity, meanwhile, protects all governmental activity, but only in limited and very specific circumstances. SRO immunity does not seem entirely consistent with either doctrine. Whether this broad version is a result of a flawed logic, or the normative judgment of courts that all (or most) SRO activities ought to be shielded from civil liability, the modern grant of SRO immunity is difficult to reconcile with the conceptual roots of absolute immunity as set forth in *Butz*, *Bradley*, and the English common law.

This Part argues, first, that expanding the “functional comparability” test to encompass all quasi-governmental activity rather than only quasi-judicial activity is unwarranted under *Butz*; and second, that the broad “functional comparability” test is neither the best conceptual basis for extending absolute immunity, nor consistent with notions of sovereign immunity. Third, it argues that the SRO immunity doctrine ought to be returned to its narrow conception of solely protecting adjudicatory activities. This approach, the Part concludes, would return the SRO immunity doctrine to logical—and legal—coherence.

#### A. The Shift from Quasi-Judicial to Quasi-Governmental Was Unwarranted

As noted in Part I.B, the doctrine of absolute immunity has evolved over centuries in the common law tradition from protecting solely judges; to encompassing other judicial actors such as prosecu-

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(SDNY), the plaintiffs, members of the NASD at the time it consolidated with the regulatory arm of the NYSE to form FINRA, asserted that there had been material misrepresentations in the proxy statement that solicited NASD shareholder votes for by-law amendments necessary for consolidation. *Id.* at \*3. Furthermore, since the misrepresentations pertained to financial, not regulatory, functions of the NASD, the plaintiffs contended that absolute immunity did not apply. *Id.* at \*5. The court, however, found the attempt to distinguish financially related statements from regulatory related statements both “artificial and unconvincing,” and instead granted the defendants’ motion to dismiss on the basis of absolute immunity. *Id.* The reasoning again encompassed an expansive conception of regulatory power: since the proxy statement was necessary to consolidation, a regulatory function, and moreover, since amendment to by-laws is itself regulatory, immunity protected such activity regardless of whether the statements themselves pertained to regulatory or proprietary functions. *Id.* at \*5–6. Even after *NYSE Specialists*, therefore, courts in the Second Circuit seem to be conceiving of regulatory power more broadly than did the Eleventh Circuit in *Weissman*.

tors, grand jurors, and public defenders; to shielding individuals working for private entities; and eventually, private entities such as securities and commodities SROs themselves. The original logic used by courts in the late nineteenth and early twentieth centuries to extend the absolute immunity privilege to various actors in judicial proceedings—that similarity in function requires similarity of protection—is unimpeachable. But the usefulness of this approach has lost its potency as the doctrine has increasingly been applied to non-state actors performing few, if any, judicial or even quasi-judicial functions. Simply because a functional comparison makes good sense when it comes to judicial activities, such as disciplinary hearings, does not make functional comparison viable regardless of the type of activity.

Adoption of the broader “functional comparability” test has resulted in a confused body of law. In response to difficulties in determining how the meaning of quasi-governmental ought to be bounded, courts have become far too committed to a (perhaps meaningless) descriptive inquiry—in the hypothetical world where SROs do not exist, would the government engage in this activity? At the same time, they have ignored the very real possibility that the premise underlying the leap from quasi-judicial to quasi-governmental is wrong in the first place. *Butz* and *Austin* only granted absolute immunity to quasi-judicial functions—a logical extension of the absolute immunity doctrine. The same logic may not warrant a further extension to quasi-governmental functions. If the qualities of quasi-judicial activities are not conceptually identical (or similar enough) to the qualities of quasi-governmental activities, moreover, then blindly expanding the first prong of the “functional comparability” analysis will be of no avail. The two critical questions here are as follows: (1) whether the doctrine of absolute immunity is even appropriate in this context; and (2) even if not, whether there is some *legal* basis for extending *sovereign*, as opposed to absolute, immunity to SROs.

1. *Butz* and *Austin* do not support a broad version of SRO immunity.

The seminal cases of *Butz* and *Austin*, from which SRO immunity derives, do not address the expansive views adopted by later courts. The holdings in both these cases are narrowly tailored and specific to adjudicatory activities. The logical extension from roles in Article III adjudicatory proceedings to those in proceedings outside Article III is reasonable and uncontroversial. No matter the label attached to an adjudicatory activity, whether it is a “trial” or “disciplinary proceeding,” the ill effects and perverse incentives faced by the individuals

involved and the available systemic safeguards will be similar. In this sense, there seems to be little reason to protect one and not the other.

By contrast, the basis for the jump in *Sparta Surgical* and *D'Alessio* from quasi-judicial to quasi-governmental is hardly obvious or uncontroversial. For one, while absolute immunity as conceived in *Butz* and *Austin* protects actors engaged in certain *judicial* functions, the later visions of SRO immunity seem to protect entities undertaking *governmental* actions broadly. Though the Second Circuit in *D'Alessio* asserted that cases involving SRO immunity in a disciplinary context stood for the "broader proposition" that "regulatory and general oversight" functions may also be shielded,<sup>162</sup> that conclusion does not necessarily follow. The discussion in *Barbara*, for instance, regarding "regulatory" activities was premised on notions of *sovereign*, not absolute, immunity.<sup>163</sup> Attributing these "broad propositions" to the absolute immunity doctrine, therefore, seems misguided.

From a historical perspective, moreover, using absolute immunity to protect all "quasi-governmental" functions seems erroneous. As Judge Learned Hand noted,<sup>164</sup> the doctrine is premised on a normative judgment that the aggregate cost to society of allowing civil liability would outweigh the benefit to those who suffer at the hands of individuals who, by definition, wield enormous power. The second and third prongs of the "functional comparability" test encapsulate the traditional justifications that tip the cost-benefit analysis in favor of denying complete redress, namely, (1) that there is a likelihood of recriminatory lawsuits by parties involved, and (2) that there are systemic safeguards in place to protect against abuse that make the threat of civil liability less necessary. Neither justification is particularly availing when considering all quasi-governmental SRO activity. Recrimination is likely not the appropriate term to describe incentives in this context, and systemic safeguards are dampened.

As to recrimination, in the context of quasi-judicial activities the likelihood of such behavior by losing parties is obvious. Since disciplinary hearings and the like are adversarial proceedings, there will be,

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<sup>162</sup> 258 F3d at 105.

<sup>163</sup> Compare *Barbara*, 99 F3d at 59 ("Under the [34] Act, the Exchange performs a variety of regulatory functions that would, in other circumstances, be performed by a government agency. Yet government agencies, including the SEC, would be entitled to sovereign immunity from all suits for money damages") with *D'Alessio*, 258 F3d at 105 ("Thus, although the immunity inquiry in *Barbara* was confined to the NYSE's conduct in connection with disciplinary proceedings, *Barbara* stood for the broader proposition that a SRO . . . may be entitled to immunity from suit for conduct falling within the scope of the SRO's regulatory and general oversight functions.").

<sup>164</sup> See Part I.B.1.

by definition, a losing party who has every incentive to attack the efficacy of the process itself, regardless of her own guilt or innocence. This same logic does not necessarily follow in the quasi-governmental context. The key difference goes to the meaning of “recrimination,” which means “counteraccusation” or “retaliation.”<sup>165</sup> Certainly the SROs, as quasi-governmental actors, are capable of harming the parties with whom they interact. But the harm they cause often will not occur in an adversarial situation,<sup>166</sup> depriving “recrimination” of its meaning in these instances. Take, for example, allegations that a SRO engaged in securities fraud. To call an injured party’s suit for redress “recriminatory” in this context is to abuse the term. It could only be considered “retaliatory” in the sense that *all* civil litigation is a means of retaliation. The discussion in the older absolute immunity cases, however, makes clear that the term “recriminatory” in the “functional comparability” test speaks to a more serious concern over retaliation than ordinary lawsuits; it is concerned with the particular nature of a judicial actor’s role that makes meritless retaliation much more likely.<sup>167</sup>

As to systemic safeguards, in the quasi-judicial context they are both plentiful and meaningful. Noteworthy among these protections is the significant statutory oversight power granted to the SEC and the right of first administrative and then judicial appeal.<sup>168</sup> In the quasi-governmental context, however, the SEC’s statutory authority is more tenuous. With SRO quasi-governmental activities that occur outside the adversarial context, moreover, appeal is not a meaningful option. The ’34 Act provides no general private right of action (outside the §§ 10 and 14 contexts<sup>169</sup>), and the best an injured party can hope for is that it can convince the SEC to take action against the SRO.<sup>170</sup> The twin concerns of inadequate ability to voice problems and institutional inertia, however, ought to make it clear that this sort of safeguard is

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<sup>165</sup> *The New Oxford American Dictionary* 1425 (Oxford 2d ed 2005) (noting that “recrimination” originates from the medieval Latin word “recriminat,” which meant “accused in turn”).

<sup>166</sup> And when the danger of retaliatory suits does exist, the SRO’s quasi-governmental actions could likely be recharacterized as regulatory adjudications of one sort or another. See, for example, *Sparta Surgical*, 159 F3d at 1214.

<sup>167</sup> See, for example, *Bradley*, 80 US at 348:

Controversies involving not merely great pecuniary interests, but the liberty and character of the parties . . . are being constantly determined in those courts . . . . It is this class of cases which impose upon the judge the severest labor, and . . . [y]et it is precisely in this class of cases that the losing party feels most keenly the decision against him, and most readily accepts anything but the soundness of the decision in explanation of the action of the judge.

<sup>168</sup> See notes 22–26, 34–42, and accompanying text.

<sup>169</sup> See note 192 and accompanying text.

<sup>170</sup> See Karmel, 14 Stan J L, Bus & Fin at 172 (cited in note 67).

unlikely to check SRO abuse. Often, the SRO will be a large corporation while the person harmed will be an individual or small company. As a practical matter, the latter will most likely lack the resources to convince the SEC to take action against the SRO.

In short, sovereign and absolute immunities are distinct doctrines with differing scopes; conflating the two for application to SROs cannot be considered sound jurisprudence. And while arguments could be made as to why SROs ought to enjoy protection as broad as sovereign immunity (more on this next), it is by no means clear that the *Butz* “functional comparability” test is the best (or even an appropriate) mechanism for extending this sort of protection to SROs.

## 2. Sovereign immunity as currently conceived does not reach SRO activities.

While the historical foundations of the absolute immunity doctrine may not support the current scope of the SRO immunity doctrine, the expansion would still be potentially justifiable if sovereign immunity provided a separate basis for the protection courts offer SROs today. That, however, does not appear to be the case. Two possible conceptions of the SRO exist, wherein it might qualify for sovereign immunity: the SRO as a government contractor, or the SRO as an arm of the government itself. Neither conception, however, provides a basis for extending sovereign immunity.

Even if—counterfactually—SROs were to be conceived of as some sort of permanent statutory “contractor” that provided regulatory “services” in the way military contractors provide “equipment,” it is doubtful that the full gamut of their activities would qualify for protection under *Boyle*. The broad version of the SRO immunity doctrine, it seems, has come to reach farther than even the cloak of sovereign immunity offered to private entities.

To review, the government contractor defense articulated in *Boyle* is limited to instances where the federal government approved reasonably precise specifications, the product (or, in this counterfactual, service) conformed to those specifications, and the government was warned of any dangers that may arise from the product (or, again, service).<sup>171</sup> The SRO activities considered in most of the SRO immunity cases would seem to fail on either the first or second prongs. Arguably, the SEC does “approve” the contours of regulatory “service” provided by SROs through statutory mechanisms in the ’33 and ’34 Acts, though

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<sup>171</sup> See Part I.C.2.

whether these statutory provisions allow for “reasonably precise” specifications to satisfy *Boyle* is uncertain. But even taking the first prong as satisfied, most fact patterns discussed in Part II would almost certainly fail the second prong—fraud, for instance, could never be considered to be conforming to the SEC’s specifications. Nor, for that matter, would misinterpreting securities laws or engaging in duplicitous conduct be conforming to specifications. Thus, the government contractor defense as crystallized in *Boyle* is not a particularly good fit in these sorts of cases.

Even if the SRO was asserted to be an “arm of the government” rather than a contractor, sovereign immunity would likely not apply. There is no precise test for determining whether a corporation is operating as such in the federal context,<sup>172</sup> but for purposes of extending sovereign immunity to private entities, the Supreme Court has long held that the totality of the circumstances matter.<sup>173</sup> In particular, the question of who the judgment would operate against is a relevant consideration.<sup>174</sup> Put otherwise, if the government would be responsible for paying a judgment from its coffers in the case where a private entity was sued, then the private entity would be considered an “arm of the government.” Additional relevant factors identified by the General Accounting Office include, among others: (1) government ownership; (2) government control; (3) nonprofit or for-profit status; (4) funding sources, and in particular, whether the entity receives government appropriations; and (5) how some fifteen federal laws that generally govern the operation of federal agencies apply to the private entity.<sup>175</sup>

SROs as currently conceived seem to fail most, if not all, the above factors. A judgment against the SRO would not be paid by the US Treasury since the latter makes no financial guarantees to the former; it would instead be paid by the corporation itself, which operates as a private entity. Furthermore, SROs like the NYSE are (1) privately owned and controlled, (2) operate for profit, (3) are entirely privately funded, and (4) do not come under any of the statutes that apply to federal agencies. The argument that SROs ought to be treated as an arm of the government under current law, therefore, is a difficult one to make.<sup>176</sup>

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<sup>172</sup> See General Accounting Office, *Government Corporations: Profiles of Existing Government Corporations* 2 (Dec 1995).

<sup>173</sup> See *In re New York*, 256 US 490, 500 (1920) (“[I]t is now established that the question is to be determined not by the mere name of the titular parties but by the essential nature and effect of the proceeding, as it appears from the entire record.”).

<sup>174</sup> *Id.* at 500–01.

<sup>175</sup> *Government Corporations* at \*5 figure 1 (cited in note 172).

<sup>176</sup> In a related context, the Second Circuit has agreed that SROs are not state actors:

The broad conception of the SRO immunity doctrine as used by circuit courts today, therefore, suffers from two different flaws. First, it is unsupported by clear legal reasoning, because the cases that define the broad version of the test rely upon a rationale that conflates two distinct doctrines, namely sovereign and absolute immunity. Second, it is unsound in principle, since there does not appear to be a theoretical justification for using *either* of the two doctrinal extensions of sovereign immunity—“government contractor” or “arm of the government”—in this context. Neither doctrine, applied independently, shields all quasi-governmental SRO activity from civil liability.

#### B. Sovereign Immunity Is Untenable and Undesirable for SRO Activities

Having concluded that expansion of the SRO immunity doctrine may have been unwarranted as a matter of law, the Comment now briefly turns to the normative inquiry: *should* SRO actions outside the quasi-judicial context be shielded from liability?<sup>177</sup> Returning the SRO immunity doctrine to its roots would of course narrow the protection that SROs have come to expect. The question then arises whether and on what basis SRO activities outside the quasi-judicial context ought to be protected.

These questions are significantly more difficult to answer—and ideally, ones answered by the legislature, *not* courts. Indeed, if we are to subscribe to normative judgments of costs and benefits that guide immunity analysis, then the former—whether such activities ought to be protected—is in essence an empirical question, and this Comment leaves it to one side. But regardless of empirics, this Comment concludes for two independent reasons that sovereign immunity should not be the mechanism for protecting SROs.

1. The lack of a limiting principle for quasi-governmental SRO activities.

Even if somehow sovereign immunity *could* be extended to SROs, it is by no means clear that the *Butz* test should be the means of

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[The NASD] is a private corporation that receives no federal or state funding. Its creation was not mandated by statute, nor does the government appoint its members or serve on any NASD board or committee. Moreover, the fact that a business entity is subject to “extensive and detailed” state regulation does not convert that organization’s actions into those of the state.

*Desiderio v NASD*, 191 F3d 198, 206 (2d Cir 1999).

<sup>177</sup> Since current law is unlikely to provide a basis for extension of sovereign immunity, this Part focuses on whether its extension would be desirable through legislative action by Congress.



accomplishing this goal. In order for the “functional comparability” test to retain meaning, courts must be able to comprehend—and articulate—the baseline activities to which they are comparing SRO activities in the first prong. In other words, there must be an understanding of what it means for an activity to be, say, “judicial” or “governmental.” Without this understanding, any sort of comparison would be rendered meaningless.

What constitutes “judicial activity” is relatively well defined. Our understanding is guided by a number of factors, including history, precedent, and tradition—and therefore, limited.<sup>178</sup> While reasonable minds may quibble over whether a prosecutor’s decision to implement a system of disseminating information is within the ambit of judicial function,<sup>179</sup> very few would seriously argue that mispricing a stock index is somehow quasi-judicial activity.

Governmental activities, on the other hand, enjoy no such intrinsic guiding factors. What is within the ambit of state power is more a philosophical question than a legal inquiry, and largely outside the scope of judicial competence. Even if the inquiry were drawn more narrowly, say to activities that are “quasi-regulatory,” limitations are hard to find. Whether a stock exchange advertising companies listed on the exchange is a quasi-judicial activity is a simple question to answer—decidedly, it is not. Whether such advertising is *regulatory* or *governmental*, on the other hand, is a question with no easy answers and over which reasonable people may disagree.<sup>180</sup> Answering it requires addressing a number of preliminary normative or hypothetical questions that would not be necessary if applying the narrow test. Should “perfect[ing] . . . a free . . . market”<sup>181</sup> be considered a delegated governmental power? If the ’34 Act did not delegate this responsibility to SROs, would Congress have granted this power to the SEC? No one knows the answers to these sorts of questions, least of all courts.

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<sup>178</sup> See notes 73–76 and accompanying text.

<sup>179</sup> See *Van de Kamp v Goldstein*, 129 S Ct 855, 863 (2009). Then again, maybe reasonable people cannot even quibble over this: the Supreme Court’s decision in this case was unanimous.

<sup>180</sup> Compare *Weissman*, 500 F3d at 1299 (“The particular advertisements alleged by the complaint were in no sense coterminous with the regulatory activity contemplated by the [’34] Act.”) with *id* at 1301 (Pryor concurring in part and dissenting in part) (“Contrary to the conclusion of the majority, the allegations about the content of the advertisement in *The Wall Street Journal* describe an action by NASDAQ that objectively advanced delegated governmental functions.”) and *id* at 1314 (Tjoflat dissenting) (“SRO immunity is worthless if it does not extend so far as to cover the SRO’s public announcements—in whatever form they may take—of what are ultimately its quintessentially regulatory functions.”).

<sup>181</sup> *Id* at 1301 (Pryor concurring in part and dissenting in part) (quotation marks omitted).

The fundamental problem may be semantic. For centuries, the legal system has had some notion of what is “judicial.”<sup>182</sup> No such parallel exists for what is “governmental,” at least not with respect to securities and commodities markets. The system, by its very design, blurs the distinction.<sup>183</sup> And because no such understanding seems forthcoming, relying upon comparison in the context of quasi-governmental function, much as we do in the case of quasi-judicial function, is unlikely to be a productive enterprise. More insidiously, the lack of an intrinsic limiting principle in the term quasi-governmental is much more likely to lead to doctrinal deviations to which original justifications no longer apply. With a protection as expansive as sovereign immunity, where the injured party is left no redress as a *matter of law*, such unreasoned and unjustified doctrinal expansion is particularly troublesome.

2. The desirability of blanket protection for SRO activities is dubious.

More generally, outside the adjudicatory context, it is hardly clear that offering SROs blanket protection—the equivalent of sovereign immunity—for most sorts of mischief conceivably deemed “governmental” is desirable. The cost-benefit analysis in this case is much less likely to tip in favor of completely denying redress, for two reasons. First, whereas disciplinary proceedings are statutorily mandated, association on an exchange is not. There is less need for a default rule of sovereign or absolute immunity provided by the law, as those injured in such contexts have voluntarily associated and may have other means of protecting themselves. This notion is discussed further in Part IV.

Second, the private nature of SROs cuts against treating them as though they are government actors. They are not, and a meaningful difference exists between them and a government agency like the SEC. The political process does not significantly restrict these organizations,<sup>184</sup> and the risk of legal liability for tortious activities may be the most powerful check against private sector actors. As private entities, moreover, SROs are subject to different incentive structures (for ex-

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<sup>182</sup> See, for example, *Burns v Reed*, 500 US 478, 486 (1991) (listing cases in which functional comparability has been applied in the prosecutorial context).

<sup>183</sup> See Part I.A.2.

<sup>184</sup> The SEC, though an independent agency, is responsive to political pressure. And through it, some of the SROs’ most egregious misconduct may be checked. But this is a tenuous restraint on SROs at best, given the two layers—Congress and the SEC—that separate the body politic from the SRO.

ample, profit-seeking) than is a government agency; these differences may not always be easy to disentangle. For instance, there is a distinction between an administrative agency such as the SEC committing fraud as a result of some rogue or malicious actors, and a SRO doing the same, perhaps because it stands to profit from this fraud (as was alleged in *NYSE Specialists*). Whereas the former as an *administrative agency* gains no benefit from such fraud, the latter as a *for-profit corporation* may very well derive tangible benefits—for example, when it comes time to report quarterly earnings. These differences make broad analogies suspect and functional comparability difficult. Normatively, therefore, it seems there is less support for protecting SROs broadly than there is for protecting them in some limited circumstances (such as in the quasi-judicial context).

#### IV. REPLACING BROAD SRO IMMUNITY WITH CONTRACTUAL IMMUNITY

Having argued that the expansion of the SRO immunity doctrine to its broad manifestation is unjustified, this Comment now suggests its contraction. Considering the difficulties, both normative and descriptive, with protecting quasi-governmental activities broadly, it seems a return to the roots (that is, only shielding quasi-judicial activity) would be the best way to resolve the unsoundness currently endemic to the doctrine.

But with the prospect of unmeritorious litigation driving up costs for SROs a very real threat, it is not unreasonable to think the protections courts have afforded SROs to date, albeit incoherently, ought to be retained in some logically defensible manner. To this end, this Part suggests one possible approach under which SROs might protect themselves in the absence of legislative action: contractual immunity.

Such an approach, however, requires dividing the world into two parts—one composed of those people and companies in privity with the SRO and one of those who are not. Any immunity provided for by contract, after all, would only be effective against those in privity. But, as argued in Part IV.B, the remainder—those not in privity—are not likely to present a large problem, especially given the new federal pleading standards.<sup>185</sup> They would be unlikely to get beyond the motion to dismiss stage without demonstrating particularly egregious

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<sup>185</sup> See *Ashcroft v Iqbal*, 129 S Ct 1937, 1950 (2009); *Bell Atlantic Corp v Twombly*, 550 US 544, 556 (2007).

conduct (and those suits in which the plaintiff is able to allege egregious contact might be worth allowing).

#### A. Members and Others in Privity with the SRO

SROs are required to conduct disciplinary proceedings against their own members by statute, and members operating on the exchange (or an association), therefore, cannot escape such proceedings or contract around them. Since members in this context have every incentive to sue over decisions with which they disagree, a background rule of absolute immunity for these quasi-judicial proceedings makes sense to protect the incentives of SROs to undertake their disciplinary duties properly—just as it makes sense in the traditional application of absolute immunity to judicial actors.

The decision to join an exchange or over-the-counter market, on the other hand, is *voluntary*. Though under both the securities and commodities regimes, most trading is regulated by statute,<sup>186</sup> competition exists among the various SROs for membership, thus diminishing concerns about statutory monopolies. In this circumstance, therefore, the power of private negotiation might make a default rule of immunity imposed by courts less valuable.

In a world without broad SRO immunity, therefore, exchanges desiring protection from civil liability for, say, negligent mispricing of a stock index could contract for this protection. Considering that there is competition among SROs within the US and that the SEC maintains the authority to abrogate any rule it deems to be burdensome,<sup>187</sup> concerns over unequal bargaining power are diminished. The fact that those contracting with the SROs are sophisticated business entities or people makes it highly unlikely that the immunity waiver would be found unenforceable *ex post*. Further, the presence of market forces should function to reduce the concern of SROs propagating contracts that a court might consider unconscionable—if one SRO was doing this, members could migrate to another.

When considered from behind the veil of ignorance, participants may even be inclined to agree to waive their rights to sue, since the value they derive from SRO membership would likely outweigh the risk of their being adversely affected by a negligent (or even mali-

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<sup>186</sup> There are some exceptions, such as those found in Regulation D, but they are limited to a small number of circumstances. See, for example, 17 CFR § 230.501 *et seq* (detailing exemptions from regulation in limited offerings and sales of securities).

<sup>187</sup> See, for example, 15 USC § 78f(c)(4).

cious) action by the SRO. Empirical evidence seems to support this intuition. For instance, studies have shown that there is a significant premium for listing on US exchanges, even after the passage of the Sarbanes-Oxley Act (which some considered likely to diminish the attractiveness of US exchanges to foreign firms).<sup>188</sup> Thus, in situations such as *Sparta Surgical* (negligent mispricing of stock index), a listing company might be willing to take the chance that a suspension of an IPO occurs due to some negligence of the SRO, because the value derived from listing outweighs the risk of mischief or incompetence.

Similarly, in the case of other actors that share a contractual relationship with the SRO, market-based contract approaches might again be superior to judicial protections. Parties who are repeat players in the securities world, such as floor brokers and the like, may be less inclined to bring vexatious suits against SROs. Doing so would naturally increase their transaction costs in the next iteration, and might very well render them unable to participate with any SRO in the future.<sup>189</sup>

Finally, there is some indication that SROs have already begun migrating to just such a solution. SROs often mandate compulsory arbitration among member firms and between member firms and their employees as a condition of joining the exchange or association.<sup>190</sup> The SEC, moreover, approved of such arbitration facilities as consistent with the '34 Act.<sup>191</sup> Adding provisions that compel arbitration in some neutral venue for disputes arising between the member firms and the SRO itself would not be a great leap from what exists today.

## B. Litigants Not in Privity with the SRO

The question of how to deal with private plaintiffs unaffiliated with the SRO who allege harm due to some SRO activity is more difficult. Since these individuals or entities do not contract with the SRO directly, no private contractual solution would be appropriate here. Moreover, since most claims would likely arise under theories of securities fraud, where the Supreme Court has acknowledged an implied

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<sup>188</sup> Craig Doidge, G. Andrew Karolyi, and Rene M. Stulz, *Has New York Become Less Competitive in Global Markets? Evaluating Foreign Listing Choices over Time* \*5 (NBER Working Paper No 13079, May 2007), online at <http://papers.nber.org/papers/w13079> (visited Apr 25, 2010). See also Craig Doidge, G. Andrew Karolyi, and René M. Stulz, *Why Are Foreign Firms Listed in the U.S. Worth More?*, 71 J Fin Econ 205, 207 (2003).

<sup>189</sup> A similar argument is made in the arbitral context in Peter B. Rutledge, *Toward a Contractual Approach for Arbitral Immunity*, 39 Ga L Rev 151, 171–72 (2004).

<sup>190</sup> Karmel, 14 Stan J L, Bus & Fin at 181 (cited in note 67).

<sup>191</sup> *Id.* at 183.

private right of action,<sup>192</sup> it is not clear that SROs deserve some special protection over other entities accused of the same behavior. While litigation in the securities arena is particularly problematic, so too is the notion that the very organizations managing the exchanges or over-the-counter markets are committing fraud. Congress addressed some of the problems associated with private securities suits with the Private Securities Litigation Reform Act of 1995<sup>193</sup> (PSLRA); presumably, it will do so again if the problems remain as bad as some commentators suggest.<sup>194</sup> In this case, singling out SROs as somehow different when they too are ultimately private entities is a questionable proposition.

If the cases on the subject are any indication, moreover, the problem of litigants not in privity with the SRO may not be as significant of a burden on the SROs. Most of the cases discussed in Part II, for instance, were brought by individuals somehow in privity with the SRO. And given both the heightened pleading standards for pleading fraud under the PSLRA and the broader movement to higher pleading standards in all civil contexts, it seems that in the vast majority of situations, meritless suits will be properly thrown out at the motion to dismiss stage for lack of a viable cause of action, without the court having to turn to a consideration of immunity. The few that survive, in turn, should not be acutely burdensome. While not providing complete protection to SROs, therefore, this approach would nonetheless be more legally defensible than the present approach.

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Retaining a default rule of liability for SRO activities outside the ambit of the quasi-judicial activities provides a couple of benefits. First, it forces parties to bargain *ex ante* and, at least theoretically, to arrive upon some agreement over how much liability the SRO will face. Second, when the SRO does behave maliciously or illegally, it offers injured parties some redress for the harms caused by the SROs. Since all SRO quasi-governmental activities, unlike specific quasi-judicial activities, do not necessarily result in a losing party with an

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<sup>192</sup> *Ernst & Ernst v Hochfelder*, 425 US 185, 196 (1976) (“Although § 10(b) does not . . . create an express civil remedy . . . and there is no indication that Congress, or the Commission when adopting Rule 10b-5, contemplated such a remedy, the existence of a private cause of action for violations of the statute and the Rule is now well established.”).

<sup>193</sup> Private Securities Litigation Reform Act of 1995, Pub L No 104-67, 109 Stat 737, codified in various sections of Title 15.

<sup>194</sup> See, for example, A.C. Pritchard, *Stoneridge Investment Partners v. Scientific-Atlanta: The Political Economy of Securities Class Action Reform*, 2007-2008 *Cato S Ct Rev* 217.

incentive to sue, the concern over litigation in this regard should be less than in the context of disciplinary proceedings. Ultimately, the question of whether—and how—to protect SROs for non-judicial functions may have to be decided by Congress. In the meantime, however, courts can simplify the legal basis for SRO immunity by returning it to its historical roots.

#### CONCLUSION

The scope and contour of SRO immunity remains an open question. The struggle for courts in part emanates from the difficulty in adapting a centuries-old protection historically afforded to judges and others involved judicial proceedings to a relatively modern system of regulation involving private entities that have been delegated governmental authority with the mandate to enforce rules and regulations. The Second and Ninth Circuits have adopted radically expansive views of the SRO immunity doctrine, while the Eleventh Circuit recently attempted to impose limits, even while accepting the broader conception based on sovereign, not absolute, immunity. The Eleventh Circuit's attempt notwithstanding, the law on the subject remains muddled and incoherent.

The incoherency, this Comment argues, is the result of an unwarranted expansion of the first prong of the *Butz* “functional comparability” test to encompass not only quasi-judicial activities, but quasi-governmental ones as well, which is neither sound in principle nor supported in law or history. In light of these difficulties, this Comment argues for a return to the doctrine's narrow origins, namely shielding only quasi-judicial activities, and proposes an alternative—contractual immunity—whereby SROs may shield themselves from liability outside the adjudicatory context.

