LIMITING SRO IMMUNITY TO MITIGATE RISKY BEHAVIOR

JACLYN FREEMAN*

INTRODUCTION

Financial markets have become increasingly reliant on complex, high-speed technological systems to facilitate trading. Stock exchanges are no exception. Exchanges worldwide have used technological innovations to develop highly advanced trading systems, which are used to facilitate market transactions. Although the use of technology has benefitted markets and the investing public, markets have also experienced technological glitches that have caused major losses to investors and financial firms. Yet the exchanges that operate and profit from these complex, technological trading systems are immune from liability for any misconduct that may have contributed to the malfunctions or the losses that ensued. This creates potential for moral hazard: exchanges are motivated by profits and are more likely to engage in risky behavior to maximize profits knowing that they are shielded by

* JD/MBA Candidate 2014, University of Colorado Law School.

absolute immunity.

Underlying this moral hazard problem is the self-regulatory system of U.S. stock exchanges. Under the Securities Exchange Act of 1934, stock exchanges are considered Self-Regulatory Organizations ("SROs"), which, courts have found, affords them absolute immunity from civil damages.[1] And although all major U.S. exchanges have demutualized to become for-profit, shareholder-owned corporations, they have maintained SRO status and continue to enjoy the immunity that comes with it. Thus, SROs are motivated by profits, and may engage in risky behavior to achieve profit-maximization for shareholders, knowing that they can hide behind absolute immunity. This is further exacerbated by the increase in market competition,[2] which has put pressure on the exchanges to attract deal flow.

The potential for increasingly risky behavior by exchanges is particularly problematic in light of recent cases of technological failures that have caused major losses to investors and financial institutions. Examples of such occurrences include the 2012 Facebook IPO software malfunction and the Flash Crash of 2010. These events have made clear the importance of recognizing the potential for technical errors and taking appropriate precautions to prevent, or at least reduce, the negative effect on the market. The exchanges, however, have a reduced incentive to take caution given the immunity they enjoy as SROs. This creates the potential for risky behavior in introducing and maintaining technological trading systems, as well as in responding to malfunctions.

To mitigate risky behavior with respect to introducing new technologies and responding to system malfunctions, I propose that all conduct relating to operating trading systems, market facilitation, trade execution and order processing should not be afforded immunity. Instead, immunity should be very limited and applied only to functions the SEC itself would perform–specifically rulemaking and enforcement.

In Part I of this note, I provide an overview of the history of SROs and why stock exchanges have been given this special status. In Part II, I discuss the absolute immunity protection provided to SROs, the reasons behind it, and how the courts have applied the doctrine in actions against exchanges. In Part III, I describe the process of demutualization and argue that SROs have become more like private entities over time. I also discuss the policy implications of a system where exchanges are for-profit but still maintain SRO status and the immunity that comes with it.

In Part IV, I present a brief case study on the Facebook IPO and the

1. Securities Exchange Act of 1934, Pub. L. No. 94-29, sec. 3(6), § 3(a)(26), 89 Stat. 97, 100 (1975) (codified as amended at 15 U.S.C. § 78c(a)(26) (West 2013)).

2. Concept Release Concerning Self-Regulation, Exchange Act Release, 69 Fed. Reg. 71,256, 71,257 (Dec. 8, 2004) [hereinafter SRO Concept Release].

technical glitch the NASDAQ experienced during the IPO, which caused major losses to investors. I then analyze the NASDAQ's potential liability under the current structure. I determine that the NASDAQ may be able to invoke absolute immunity under the theory that it was acting in its "quasi-governmental" capacity, even though it may have been acting for its personal interest and not as a regulator. I argue that the ability to invoke such immunity has a negative impact on markets because it encourages risky behavior–the moral hazard problem.

Finally, in Part IV, I provide a prescription to mitigate the moral hazard problem. I propose that courts limit the activities that are considered regulatory to only the functions that the SEC itself would provide–i.e. rulemaking and enforcement. This narrow approach would exclude from "regulatory" any activity involving: (i) introducing, and running technology-driven trading platforms; (ii) executing trades; and (iii) processing orders. Thus, exchanges would not be shielded from liability with respect to these "operating" functions, and would, therefore, have incentive to take necessary precautions and limit risky behavior.

I. OVERVIEW OF SELF-REGULATORY ORGANIZATIONS

A. History of Stock Exchanges and the SRO System

Self-regulation in the securities industry is a long-standing tradition in the United States, dating back to the 1700s.[3] The "Buttonwood Agreement" of 1792 formed the first organized stock exchange in New York.[4] As the New York Stock Exchange ("NYSE") and other stock exchanges developed over time, a system of exchange rules developed as common trading practices became formalized in documents such as constitutions and bylaws.[5]

Before the stock market crash of 1929, there was very little support for federal regulation and oversight of the stock market.[6] Most investors did not consider systemic risk associated with abuse of margin financing and the low quality of information they received about the securities in which they were investing.[7] This general attitude changed when the stock market crashed and the public lost confidence in the market.[8]

After losing fortunes in the 1929 crash and the Great Depression

3. *Id.*
4. *See id.*
5. *Id.*
6. *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC. & EXCH. COMM'N, http://www.sec.gov/about/whatwedo.shtml#create (last modified June 10, 2013) [hereinafter *The Investor's Advocate*].
7. *Id.*
8. *Id.*

that followed, investors and banks began to support a regulatory regime.[9] The general consensus at the time was that public confidence in capital markets had to be restored in order for the economy to recover.[10] Congress began to consider what caused the crash and how to restore market confidence and prevent future crashes.[11]

In contemplating legislative responses, Congress directed the U.S. Senate Banking and Currency Committee to conduct hearings in an effort to examine the stock exchange practices that were prevalent in the years leading up to the crash.[12] The hearings achieved their stated purpose of "lay[ing] foundation for remedial legislation."[13] The hearings uncovered market manipulation and other deceptive practices[14] on the part of traders and investment bankers as well as investigatory failure on the part of the NYSE.[15] These discoveries further diminished the public's faith in financial institutions so as to "galvanize[] broad public support for direct federal regulation of the stock markets."[16] The Senate Committee's report on the hearings "indicted the system as a whole by demonstrating that the system had failed to impose essential fiduciary standards on persons whose responsibility it was to handle other people's money."[17]

With broad support and political momentum for financial market reform, Congress enacted two statutes—the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act" or the "Act").[18] The Securities Act and the Exchange Act, which created the Securities Exchange Commission (the "SEC" or the "Commission"), were designed to restore confidence in the capital markets by providing investors and the markets with reliable information surrounding securities and "clear rules of honest dealing."[19] The SEC, empowered with broad authority over all aspects of the securities industry, was charged with enforcing securities laws, promoting stability

9. *Id*.

10. *Id*.

11. *Id*.

12. Joseph A. Castelluccio III, *Sarbanes-Oxley and Small Business: Section 404 and the Case for a Small Business Exemption*, 71 BROOK. L. REV. 429, 434-35 (2005) (discussing the history of the Securities Act of 1933 and the Securities Exchange Act of 1934).

13. *Id*. at 435 (internal quotation marks omitted) (quoting S. REP. NO. 73-1455, at 4 (1934)).

14. *Id*. at 461.

15. Yesenia Cervantes, *Fin Rah! . . . A Welcome Change: Why the Merger Was Necessary to Preserve U.S. Market Integrity*, 13 FORDHAM J. CORP. & FIN. L. 829, 839 (2008).

16. Castelluccio, *supra* note 12, at 436 (internal quotation marks omitted) (quoting Joel Seligman, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 2 (3d ed. 2003)).

17. *Id*.

18. *Id*.

19. *The Investor's Advocate*, *supra* note 6.

in markets, and protecting investors.[20]

Under the Act, the SEC oversees SROs, defined broadly to include "any national securities exchange, registered securities association, or registered clearing agency."[21] The SROs continued to conduct day-to-day regulation and administration of U.S. stock markets under the Act[22] but were required to register with and be supervised by the SEC.[23] These regulations forced SROs to implement rules that would protect investors and prevent conduct "inconsistent with just and equitable principles of trade."[24]

The Exchange Act was seen as a compromise between the public powers of Washington and the private powers of Wall Street.[25] In passing the Act, Congress "devised an unprecedented structure of public governance over the stock exchanges, by both endorsing the continued viability of the NYSE, which already possessed a well-established tradition of self-regulation in the U.S. marketplace, while, at the same time, transforming this once exclusively private club into a government-supervised, self-regulatory body."[26] Underlying this regulatory regime was the view that "self-regulation [was] the best 'first-line' defense against unethical or illegal securities practices."[27]

Efforts to restore market confidence also entailed repairing the damaged reputations of over-the-counter ("OTC") securities dealers.[28] OTC dealers formed the Investment Bankers Code Committee in 1933, which was succeeded three years later by the Investment Bankers Conference. The organization consisted of prominent investment banks that came together "to act as a national, voluntary industry organization."[29] The SEC and the leaders of the investment banking industry felt that in order to carry out the task of self-regulation, an industry organization would need official legal status.[30] The Maloney Act of 1938 accomplished this task by amending the Exchange Act to include section 15A, which established the concept of national securities

20. *Id*.

21. Securities Exchange Act of 1934, 15 U.S.C.A. § 78c(a)(26) (West 2012).

22. Weissman v. Nat'l Ass'n of Sec. Dealers, Inc., 500 F.3d 1293, 1296 (11th Cir. 2007).

23. William I. Friedman, *The Fourteenth Amendment's Public/Private Distinction Among Securities Regulators in the U.S. Marketplace–Revisited*, 23 ANN. REV. BANKING & FIN. L. 727, 739 (2004).

24. *Id.* (internal quotation marks omitted) (quoting Norman S. Poser, BROKER-DEALER LAW & REGULATION § 13.04 (2d ed. 2001)).

25. *Id*. at 738.

26. *Id*. (footnote omitted).

27. *Id*. at 738-39 (internal quotation marks omitted) (quoting First Jersey Sec., Inc. v. Bergen, 605 F.2d 690, 698 (3d Cir. 1979)).

28. SRO Concept Release, *supra* note 3, at 71,257.

29. *Id*.

30. *Id*.

association SROs.[31] One such association, which formed as a result of the Maloney Act[32], is the National Association of Securities Dealers ("NASD"). The NASD is a voluntary organization of broker-dealers engaged in trading OTC stocks.[33]

The SEC has granted much autonomy and deference to the SROs. Justice William Douglas, who once served as the chairman of the SEC observed that "from the beginning of federal securities regulation the SEC allowed the exchanges to enjoy considerable autonomy . . . play[ing] an essentially passive role, [and] allowing the securities industry to govern itself in its own wisdom."[34] Justice Douglas explained that the SROs were on the front lines of regulation, and that the SEC was authorized to step in only when the SROs failed to adequately provide protection to investors.[35] Thus, the Exchange Act "represented the inception of the government's intervention in the securities markets and its establishment of a symbiotic relationship with the SROs in their joint regulation of the U.S. securities markets."[36]

B. Periodic Reexamination of the SRO System

Over time, the broad authority and autonomy granted to SROs has been reexamined, but has mostly been left intact. The effectiveness of self-regulation was "called into question by stock market abuses, especially in the OTC market."[37] In 1963, the SEC presented to Congress the Report of Special Study of the Securities Markets of the Securities and Exchange Commission[38] ("Special Study"), which evaluated the condition of the securities industry and the performance of SROs.[39] Among other things, the Special Study found that SROs have a "natural tendency to protect member firms," and that the amount of control that exchange floor members exercised over exchange regulatory operations and governance ought to be reduced.[40] The conclusion, however, was not that the SRO model of the securities industry was inherently flawed, but

31. *Id.*
32. *Id.*
33. Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J.L. BUS. & FIN. 151, 153 (2008).
34. Friedman, *supra* note 23, at 740 (internal quotation marks omitted) (quoting Poser, *supra* note 24, at § 13.01 n.33).
35. *See id*. at 740-41.
36. *Id*. at 741.
37. Karmel, *supra* note 33, at 162.
38. *Report of Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. DOC. NO. 88–95, pt. 1, at 151 (1st Sess. 1963).
39. Marianne K. Smythe, *Government Supervised Self-Regulation in the Securities Industry and the Antitrust Laws: Suggestions for an Accommodation*, 62 N.C. L. REV. 475, 485 (1984).
40. SRO Concept Release, *supra* note 3, at 71,258.

rather that self-regulation should not only be maintained, but strengthened.[41]

Self-regulation was questioned again in the early 1970s in reaction to a major market failure often referred to as the "paper crunch."[42] Until the 1970s, most securities firms had a team of clerks that handled securities transfers using a manual certificate system.[43] This was a tedious process involving a substantial amount of paperwork.[44]

As trading volumes increased during the bull market of the 1960s, it became "virtually impossible to transfer stock certificates quickly enough to keep up with ongoing trading."[45] The NYSE's daily trading volume quadrupled between 1960 and 1968, yet the industry made no serious effort to increase the efficiency of settlement activity.[46] Firms became so backed up that by 1969 unperformed obligations could range from 70% to 200% of a firm's total assets.[47] Strong cash flows allowed firms to cover short positions caused by missing securities through open market purchases.[48] But as the market took a downturn in 1970, firms' working capital took a hit, and they were forced to default.[49] The manual certificate system had paralyzed the markets while the industry idly stood by.[50]

This so-called "paper crunch" resulted in the demise of over a hundred brokerage firms, which either entered bankruptcy or were acquired by stronger competitors.[51] Moreover, the SROs leading the market had done virtually nothing to stop the crisis.[52] The response was the enactment of the 1975 Securities Reform Act (the "Reform Act").[53]

The Reform Act, among other things, gave the SEC the power to initiate and approve SRO rulemaking, expanded the Commission's role in enforcement and discipline, and allowed it to "play an active role in structuring the market."[54] The Act also eliminated the differences

41. *Id.*

42. David C. Donald, *Heart of Darkness: The Problem at the Core of the U.S. Proxy System and Its Solution*, 6 VA. L. & BUS. REV. 41, 50 (2011).

43. *Id.*

44. *Id.* ("A study performed by North American Rockwell Information Systems at that time found that brokers might use an average of 33 different forms for a single security transfer." (quoting SEC, Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. DOC. NO. 92–231, pt. 24 (1971))).

45. Emily I. Osiecki, Alabama By-Products Corp. v. Cede & Co.: *Shareholder Protection Through Strict Statutory Construction*, 22 DEL. J. CORP. L. 221, 224.

46. Donald, *supra* note 42, at 50.

47. *Id.* at 50-51.

48. *Id.* at 51.

49. *Id.*

50. Osiecki, *supra* note 45, at 224.

51. Donald, *supra* note 42, at 50.

52. *Id.* at 50-51.

53. Friedman, *supra* note 23, at 742.

54. *Id.* (internal quotation marks omitted) (quoting Roberta S.

between the SEC's oversight of the NASD and the exchanges.[55] Thus, the Reform Act did not attempt an overhaul of the SRO system of market regulation but rather maintained the self-regulatory regime while broadening SEC supervisory authority. Congress believed that although SROs had not always performed their role up to expectations, the self-regulatory system had "worked well and 'should be preserved and strengthened.'"[56]

Perhaps, as the legislative history suggests, it was not so much that the system worked well but more that Congress did not believe the federal government was capable of regulating the markets itself.[57] Congress stated as the reason for maintaining the SRO system, "the sheer ineffectiveness of attempting to assure [regulation] directly through the government on a wide scale."[58] Thus, Congress found, "it was 'distinctly preferable' to rely on 'cooperative regulation, in which the task will be 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.'"[59]

II. ABSOLUTE IMMUNITY FOR SROS

Absolute immunity is the strongest form of immunity an individual may seek, providing unconditional protection from civil liability, even where malice, corruption, and fraud are present.[60] Although "[i]t is well established that government officials are entitled to some form of immunity from suits for damages,"[61] *absolute* immunity is reserved for certain public functions that "require a greater degree of protection than qualified immunity can provide."[62] Accordingly, courts have considered the nature of the governmental functions being performed and extended absolute immunity to judges, administrative law judges, and prosecutors.[63]

Karmel, *Securities Regulation: Should the New York Stock Exchange Be Reorganized?*, 230 N.Y. L.J. 3 (2003)).

55. *Id.*

56. SRO Concept Release, *supra* note 3, at 71,258 (quoting S. REP. 94-75, at 23 (1975), *reprinted in* 1975 U.S.C.C.A.N. 179, 201).

57. *Id.* (internal quotation marks omitted) (quoting S. REP. 94-75, at 22 (1975), *reprinted in* 1975 U.S.C.C.A.N. 179, 201).

58. *Id.*

59. *Id.* at 71,257-58 (citing S. REP. NO. 94-75 (1975), *reprinted in* 1975 U.S.C.C.A.N. 179, 181).

60. Rohit A. Nafday, *From Sense to Nonsense and Back Again: SRO Immunity, Doctrinal Bait-and-Switch, and a Call for Coherence*, 77 U. CHI. L. REV. 847, 855 (2010).

61. Barbara v. New York Stock Exch., Inc., 99 F.3d 49, 58 (2d Cir. 1996) (internal quotation marks omitted).

62. *Id.*

63. *Id.*

Absolute immunity has also been extended to SROs and their officers for private damages suits arising out of a SRO's discharge of its regulatory, adjudicatory, and prosecutorial authority.[64] Although stock exchanges are private, immunity doctrines may be extended to private actors when performing important governmental functions.[65] Because SROs perform a variety of governmental functions, but do not enjoy the sovereign immunity afforded to governmental agencies, they are protected by absolute immunity when performing their statutorily delegated authority.[66] This extends both to exercise and *nonexercise* of an SRO's governmental powers–its adjudicatory, regulatory, and prosecutorial functions.[67] Additionally, courts have continued to entertain the absolute immunity defense in actions against stock exchanges, even after demutualization.[68]

A. Broad Grant of Absolute Immunity for Stock Exchanges

Stock exchanges, in performing their SEC-delegated SRO duties, have commonly enjoyed immunity from suit.[69] Courts have "not hesitated to extend the doctrine of absolute immunity to private entities engaged in *quasi-public*." activities, given the regulatory nature of performing such functions.[70] Although SRO absolute immunity was initially limited to "quasi-judicial" functions, courts have expanded the doctrine over time to apply to all quasi-governmental activities, thus providing SROs with absolute immunity for not only prosecutorial and adjudicatory functions but for all regulatory functions as well.[71]

As explained by the U.S. District Court for the District of Colombia ("D.C. District Court") in a 2007 case against the NASD, absolute immunity for SROs was initially recognized only for an exchange's

64. Weissman v. Nat'l Ass'n of Sec. Dealers, Inc., 500 F.3d 1293, 1297 (11th Cir. 2007); Standard Inv. Chartered, Inc. v. Nat'l Ass'n of Sec. Dealers, Inc., 637 F.3d 112, 115 (2d Cir. 2011).

65. *Barbara*, 99 F.3d at 58.

66. *Weissman*, 500 F.3d at 1296.

67. *In re* NYSE Specialists Sec. Litig., 503 F.3d 89, 98 (2d. Cir. 2007); *Weissman*, 500 F.3d at 1296.

68. *See NYSE Specialists*, 503 F.3d at 98; *see also Standard Inv.*, 637 F.3d at 112; *Weissman*, 500 F.3d at 1293. "Demutualization" refers to the process by which stock exchanges transformed from non-profit member-owned organizations to for-profit shareholder-owned corporations. Demutualization of the stock exchanges is discussed in detail in section III below.

69. D'Alessio v. New York Stock Exch., Inc., 258 F.3d 93, 104 (2d Cir. 2001); see also *Barbara*, 99 F.3d 49; Sparta Surgical Corp. v. Nat'l Ass'n of Sec. Dealers, Inc., 159 F.3d 1209, 1215 (9th Cir. 1998); Zandford v. Nat'l Ass'n of Sec. Dealers, Inc., 80 F.3d 559, 559 (D.C. Cir. 1996); Austin Mun. Sec., Inc. v. Nat'l Ass'n of Sec. Dealers, Inc., 757 F.2d 676, 692 (5th Cir. 1985).

70. *D'Alessio*, 258 F.3d at 105.

71. Nafday, *supra* note 60, at 862.

exercise of its disciplinary function.[72] In discussing the evolution of SRO immunity, the D.C. District Court referred to a 1985 Fifth Circuit case, *Austin Mun. Sec., Inc. v. Nat'l Ass'n of Sec. Dealers, Inc.*, which involved claims against the NASD and its disciplinary arm.[73] There, as the first court to consider the "extent of immunity for disciplinary officers of a Congressionally-mandated self-regulatory organization," the Fifth Circuit performed its analysis "guided . . . by Supreme Court decisions concerning the immunity of judges, prosecutors, and executive disciplinary officials."[74] The *Austin* court concluded that the NASD and its disciplinary arm were absolutely immune "for actions within the scope of their disciplinary duties, which were essentially adjudicatory and prosecutorial in nature."[75]

Other courts followed suit, "borrow[ing] official-immunity principles to confer absolute immunity on SROs for suits arising out of their disciplinary activities."[76] In *Zandford v. Nat'l Ass'n of Sec. Dealers, Inc.*, the D.C. District Court granted absolute immunity to the NASD from liability for prosecutorial and adjudicative acts.[77] Similarly, in *Barbara v. New York Stock Exch., Inc.*, the Second Circuit, persuaded by the reasoning in *Austin*, held that the NYSE was "absolutely immune from damages claims arising out of the performance of its federally-mandated conduct of disciplinary proceedings."[78]

In finding that "absolute immunity is particularly appropriate in the unique context of the self-regulation of the national securities exchanges," the *Barbara* court placed great weight on the fact that, under the Exchange Act, stock exchanges perform many functions as SROs that would otherwise be performed by the SEC.[79] In affording this protection to SROs, the court was influenced by the nature of the SROs' "special status and connection" to the SEC.[80] The court explained that because the SEC would receive sovereign immunity protection for performance of the very same duties it delegates to the SROs, the SROs ought to receive the same protections.[81] Furthermore, allowing suits against SROs that arise out of performance of governmental duties would "'stand[ ] as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress,' namely, to encourage forceful self-

72. *In re* Series 7 Broker Qualification Exam Scoring Litig., 510 F. Supp. 2d 35, 39 (D.D.C. 2007).
73. *Id.*
74. *Id.* at 39 (citing Austin Mun. Sec., Inc., 757 F.2d at 686).
75. *Id.* at 40 (citing Austin Mun. Sec., Inc., 757 F.2d at 689-91).
76. *Id.*
77. Zandford v. Nat’l Ass’n of Sec. Dealers, Inc., 30 F. Supp. 2d 1, 16-18 (D.D.C. 1998).
78. Barbara v. N.Y. Stock Exch., Inc., 99 F.3d 49, 58 (2d Cir. 1996).
79. *Id* at 59.
80. *Id.*
81. *Id.*

regulation of the securities industry."[82]

Although *Barbara* involved claims surrounding the NYSE's *disciplinary* function, it laid the groundwork for the expansion of absolute immunity to cover all "quasi-governmental" activities.[83] In the years following the 1996 *Barbara* decision, the Ninth and Second Circuits, relying on *Barbara*, extended absolute immunity beyond the scope of an SRO's adjudicatory and prosecutorial functions to include all regulatory activities.[84]

In the 1998 action, *Sparta Surgical Corp. v. Nat'l Ass'n of Sec. Dealers, Inc.*, the Ninth Circuit granted regulatory immunity to the NASD and the NASDAQ ("National Association of Securities Dealers Automated Quotations") for claims involving the SRO's temporary de-listing and suspension of trading in the plaintiff's stock.[85] Recognizing that the activities in question were not adjudicatory or prosecutorial acts, the *Sparta* court believed that the extension of absolute immunity to an SRO's "quasi-governmental functions was consistent with the Congressional grant of "enormous discretionary authority concerning stock listing and de-listing."[86] Citing *Barbara* for the proposition that "self-regulatory organizations have been granted immunity from suit when acting in a *quasi-governmental* capacity," the Ninth Circuit held that SROs are entitled to absolute immunity whenever "they are acting under the aegis of the Exchange Act's delegated authority."[87]

The Second Circuit also relied on its *Barbara* opinion when it extended absolute immunity beyond prosecutorial and adjudicatory functions in *D'Alessio v. New York Stock Exch., Inc.*[88] There, the court rejected the plaintiff's attempt to limit absolute immunity to disciplinary functions, reading *Barbara* to stand for the broad proposition that an SRO "may be entitled to immunity from suit for conduct falling within the scope of the SRO's *regulatory and general oversight functions*."[89] The court held, therefore, that when acting in its capacity as an SRO, an exchange is entitled to immunity "when it engages in conduct *consistent* with the quasi-governmental powers delegated to it."[90]

D'Alessio not only extended absolute immunity, but also laid the groundwork for the Second Circuit's outright refusal to carve out a fraud

82. *Id.* (quoting Hines v. Davidowitz, 61 S. Ct. 399 (1941) (citations omitted)).

83. *In re* Series 7 Broker Qualification Exam Scoring Litig., 510 F. Supp. 2d 35, 41 (D.D.C. 2007).

84. *Id.*

85. Sparta Surgical Corp. v. Nat’l Ass’n of Sec. Dealers, Inc., 159 F.3d 1209, 1210 (9th Cir. 1998).

86. *Id.* at 1214.

87. *Id.* (emphasis added).

88. D’Alessio v. New York Stock Exch., Inc., 258 F.3d 93 (2d Cir. 2001).

89. *Id.* at 105 (emphasis added).

90. *Id.* at 106 (emphasis added).

exemption from SRO immunity. In the 2005 *DL Capital* case against the NASDAQ, the plaintiffs alleged fraud in the form of a material omission on grounds that the exchange failed to timely announce that it would cancel all trades that took place during a certain period in which erroneous orders had been placed.[91] This allegedly resulted in losses to the plaintiff.[92]

In finding that absolute immunity was appropriate even in cases of fraud, the *DL Capital* court relied on *D'Alessio* for precedent, stating that, there, it had implicitly held that SROs were absolutely immune from fraud claims because it "upheld the dismissal of all the plaintiffs' claims even though one of the claims was for 'fraudulent deceit and concealment.'"[93] The court further reasoned that a fraud exemption would leave exchanges too open to litigation, giving plaintiffs a method of circumventing absolute immunity simply by alleging fraud.[94] The court then cited to *D'Alessio* again, explaining that "rejecting 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.'"[95]

The Second Circuit revisited the exemption in a 2007 case against the NYSE for its alleged complicity with regard to specialist firms'[96] market manipulation and self-dealing.[97] In *NYSE Specialists*, the court held that absolute immunity applies as long as the alleged misconduct was governmental in nature.[98] Citing *DL Capital*, the court explained that "allegations of bad faith, malice, and even fraud-all of which may be relevant to a qualified immunity analysis-cannot, except in the most unusual of circumstances, overcome absolute immunity."[99] Thus, "immunity depends only on whether specific acts and forbearances were incident to the exercise of regulatory power, and not on the propriety of those actions or inactions."[100]

91. DL Capital Grp., LLC v. NASDAQ Stock Mkt., Inc., 409 F.3d 93, 96 (2d Cir. 2005).

92. *Id.* at 96.

93. *Id.* at 98 (quoting *D'Alessio*, 258 F.3d at 97).

94. *Id.* at 99. Notably, the opinion did not discuss the strict pleading requirements for securities fraud claims that might otherwise mitigate the litigation problem. *See, e.g.*, Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 309-10 (2007).

95. *DL Capital Grp.*, 409 F.3d at 99 (quoting D'Alessio v. New York Stock Exch., Inc., 258 F.3d 93, 105 (2d Cir. 2001)).

96. "A specialist is a 'dual trader' who either brokers orders for its clients (investors) or fills orders for these clients from its own inventory. Specialists are known by different names in different markets. They are often referred to as market makers." Nan S. Ellis et al., *The NYSE Response to Specialist Misconduct: An Example of the Failure of Self-Regulation*, 7 BERKELEY BUS. L.J. 102, 105 (2010).

97. *In re* NYSE Specialists Sec. Litig., 503 F.3d 89, 101 (2d. Cir. 2007).

98. *Id.*

99. *Id.* at 101.

100. *Id.* at 98.

The *NYSE Specialists* court also clarified that SROs enjoy absolute immunity for both action and inaction, rejecting the argument that in failing to act, the NYSE abandoned its regulatory duties and was therefore not entitled to immunity.[101] Thus, absolute immunity extends even to an exchange's failure to act.

The Ninth and Second Circuits' broad reading of *Barbara* allowed the courts to expand the immunity afforded to exchanges to encompass activities well beyond the scope of disciplinary functions. "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."[102] The resulting standard is that an SRO is objectively entitled to absolute immunity for any action or inaction consistent with its delegated governmental power.

B. Immunity Analysis – Governmental v. Private Actions

Under the case law, the inquiry for an SRO's absolute immunity is whether the conduct in question is governmental or private in nature and function. Applying an objective test, courts focus on "the nature of the function performed, not the identity of the actor who performed it."[103] Thus, an SRO is not protected by absolute immunity with respect to non-governmental actions in which the entity is acting in its own interest, as a *private* entity.[104]

Additionally, given the substantial protection provided by absolute immunity, courts have cautioned that the doctrine "is of a rare and exceptional character,"[105] and, therefore, courts must consider the grant of immunity on a case-by-case basis, and the party claiming immunity–the SRO–"bears the burden of demonstrating its entitlement."[106] To invoke the shield of absolute immunity, therefore, an SRO must show that its conduct (or misconduct) was governmental in nature and function.[107]

Calling this a "burden," however, is a stretch in light of the Second Circuit's propensity to attach immunity to essentially any activity that

101. *Id.* at 97.

102. Nafday, *supra* note 60, at 868.

103. NYSE Specialists, 503 F.3d at 96 (citing Forrester v. White, 484 U.S. 219, 229 (1988)).

104. Weissman v. Nat'l Ass'n of Sec. Dealers, Inc., 500 F.3d 1293, 1297 (11th Cir. 2007).

105. Standard Inv. Chartered, Inc. v. Nat'l Ass'n of Sec. Dealers, Inc., 637 F.3d 112, 115 (2d Cir. 2011) (citing Barrett v. United States, 798 F.2d 565, 571 (2d Cir. 1986)).

106. *NYSE Specialists*, 503 F.3d at 96 (citing D'Alessio v. N.Y. Stock Exch., Inc., 258 F.3d 93, 104 (2d Cir. 2001)).

107. *See Standard*, 637 F.3d at 115-116.

relates in some way to an SRO's regulatory authority.[108] The court and others following it have allowed exchanges, as SROs, to shield themselves from liability for any action that is "incident to"[109] or "consistent with"[110] an exchange's quasi-governmental power.

Under this broad standard, the Second Circuit has granted absolute immunity to exchanges with respect to all of the following activities:

> (1) disciplinary proceedings against exchange members; (2) the enforcement of security rules and regulations and general regulatory oversight over exchange members; (3) the interpretation of the securities laws and regulations as applied to the exchange or its member; (4) the referral of exchange members to the SEC and other government agencies for civil enforcement or criminal prosecution under the securities laws; and (5) the public announcement of regulatory decisions.[111]

The Second Circuit lengthened the list in its 2011 *Standard* opinion, adding "an SRO's amendment of its bylaws where . . . the amendments are inextricable from the SRO's role as a regulator."[112] There, the claim arose out of an alleged misstatement in a proxy solicitation for votes to amend the NASD's bylaws in order to complete consolidation with the NYSE's regulatory arm to form the Financial Industry Regulatory Authority ("FINRA").[113] Recognizing that the consolidation was a regulatory act, the court found that because the amendment was necessary to achieve the regulatory act of consolidation, the proxy solicitation fell within the scope of the exchange's quasi-governmental powers, and therefore absolute immunity attached.[114] Failing to provide a clear test for or definition of quasi-governmental conduct, the court simply noted that the common thread in the activities listed is that "absolute immunity attaches where the activity 'relates to the proper functioning of the regulatory system.'"[115]

The Eleventh Circuit provided some guidance as to the private versus governmental inquiry in *Weissman v. NASD*. Nevertheless, the

108. The Second Circuit is particularly important to this discussion because it has decided the vast majority of SRO immunity cases, as the NYSE and NASDAQ are both located in the Second Circuit. *See, e.g.*, *Standard*, 637 F.3d at 112; *NYSE Specialists*, 503 F.3d at 89; DL Capital Grp., LLC v. NASDAQ Stock Mkt., Inc., 409 F.3d 93 (2d Cir. 2005); *D'Alessio*, 258 F.3d at 93.

109. *Standard*, 637 F.3d at 116.

110. *D'Alessio*, 258 F.3d at 106.

111. Standard Inv. Chartered, Inc. v. Nat'l Ass'n of Sec. Dealers, Inc., 637 F.3d 112, 116 (2d Cir. 2011) (citations omitted).

112. *Id.*

113. *Id.*

114. *Id.* at 116-17.

115. *In re* NYSE Specialists Sec. Litig., 503 F.3d 89, 96 (2d. Cir. 2007) (quoting *D'Alessio*, 258 F.3d at 106).

difficulty in determining what is "quasi-governmental" is apparent in this en banc decision where an eight-judge majority found that an exchange's conduct was not "quasi-governmental," leaving four judges who thought otherwise to dissent.[116] In *Weissman*, the Eleventh Circuit excluded marketing activities from the guise of "regulatory" functions that enjoy immunity.[117] In performing its analysis, the court looked to "the objective nature and function of the activity"[118] and refused to grant immunity to the NASD for actions that the court deemed to be private.[119]

In *Weissman*, the plaintiff alleged that the NASDAQ's publication of certain advertisement fraudulently induced him to purchase WorldCom stock.[120] The court "made clear that when an SRO is 'performing duties that pertain to the exercise of those private franchises, powers, and privileges which belong to them for their own corporate benefit,' the SRO, like a for-profit corporation, will not be entitled to immunity."[121] The court then provided an immunity analysis, distinguishing regulatory actions such as "implementing and effectuating compliance with securities laws; promulgating and enforcing rules governing the conduct of its members; and listing and de-listing stock offerings," from non-governmental actions that serve private business interests such as "efforts to increase trading volume and company profit" and "daily administration and management of other business affairs."[122]

The Eleventh Circuit concluded that the NASDAQ could not invoke absolute immunity to dismiss the complaint because the allegations did not relate to the exchange's "statutorily delegated responsibility to 'prevent fraudulent and manipulative . . . practices,' 'promote just and equitable principles of trade,' 'remove impediments to and prefect the free market, or protect investors and the public interest.'"[123] And, importantly, the *Weissman* court noted that absolute immunity applies only to "activities involving an SRO's performance of regulatory, adjudicatory, or prosecutorial duties *in the stead of the SEC*."[124]

116. Weissman v. Nat'l Ass'n of Sec. Dealers, Inc., 500 F.3d 1293 (11th Cir. 2007).

117. *Id.*

118. *Id.* at 1297.

119. *Id.* at 1299.

120. *Id.* at 1294-95. *See generally* Simon Romero & Riva D. Atlas, *WorldCom's Collapse: The Overview; WorldCom Files for Bankruptcy; Largest U.S. Case*, N.Y. TIMES (July 22, 2002), www.nytimes.com/2002/07/22/us/worldcom-s-collapse-the-overview-worldcom-files-for-bankruptcy-largest-us-case.html (WorldCom, "plagued by the rapid erosion of its profits and an accounting scandal that created billions in illusory earnings," filed for bankruptcy in 2002).

121. Craig J. Springer, Weissman v. NASD*: Piercing the Veil of Absolute Immunity of an SRO Under the Securities Exchange Act of 1934*, 33 DEL. J. CORP. L. 451, 460 (2008) (citing Weissman v. Nat'l Ass'n of Sec. Dealers, Inc., 500 F.3d 1296 (11th Cir. 2007)).

122. *Weissman*, 500 F.3d at 1296.

123. *Id.* at 1299 (quoting 15 U.S.C. § 78*o*-3(b)(6) (2006)).

124. *Id.* at 1298.

In another 2007 case, *Opulent Fund v. NASDAQ Stock Mkt., Inc.*,[125] the Northern District of California also shed some light on the distinction between governmental and private conduct. There, the court agreed with the plaintiffs that pricing an index was not a "regulatory function," and therefore did not deserve absolute immunity.[126] Considering the *Weissman* court's "in the stead of the SEC" language, the court noted that the SEC "would not create an index and volunteer to disseminate pricing data if Nasdaq did not exist," and that "in choosing to create the index and disseminate the price information, Nasdaq 'represents no one but itself.'"[127] The court then explained that the NASDAQ's conduct did not serve to protect investors, which might fall within its delegated duty of "monitoring its market carefully *to protect the investing public*," but rather functioned to "create a market and increase trading."[128] Finding that the NASDAQ's conduct did not share the "same 'regulatory' character as suspending trading, banning traders, or carrying out disciplinary actions," the court held that the actions in question were *private*, and therefore not "cloaked with absolute immunity."[129]

The analyses performed by the courts in *Weissman* and *Opulent Fund* indicate a narrower standard than the Second Circuit. This stricter standard places weight on an SRO's "stepping into the shoes of the SEC," and includes consideration of whether the SEC, as a regulator, would itself have performed the actions in question. This inquiry is helpful in determining whether an action is "regulatory" in nature, and serves to limit the grant of absolute immunity to only actions the SEC itself would take.

III. ABSOLUTE IMMUNITY IN A DEMUTUALIZED SRO SYSTEM

Over time, and especially since the turn of the 21st century, stock exchanges have started to look more like private, for-profit entities, and most of them have demutualized.[130] Although the SEC continues to revisit SRO status for stock exchanges through processes such as concept releases, in which the Commission seeks comments from the public, as of the date of this note, the exchanges continue to receive the benefits of

125. Opulent Fund v. NASDAQ Stock Mkt., Inc., No. C-07-03683 RMW, 2007 WL 3010573 (N.D. Cal. Oct. 12, 2007).

126. *Id.* at 5.

127. *Id.* (quoting *Weissman*, 500 F.3d at 1299).

128. *Id.* (emphasis added).

129. *Id.*

130. Dan Mathisson, *Above the Law, What Exchanges and Kings Have in Common*, TRADERS MAGAZINE, August 2012, *available at* http://www.tradersmagazine.com/issues/25_341/rules-exchanges-ats-mathisson-110176-1.html; Nina Mehta, *Nasdaq Exchange Immunity May Limit Losses From Facebook Claim*, BLOOMBERG, (June 12, 2012, 10:00 PM), http://www.bloomberg.com/news/2012-06-13/nasdaq-exchange-immunity-may-limit-losses-from-facebook-claims.html.

SRO status.[131]

A. Demutualization

Beginning in the early 1990s, with the demutualization of the Stockholm Stock Exchange, most major stock exchanges worldwide have changed their membership structure into a share ownership structure.[132] Major American stock exchanges began demutualizing, with regulatory approval, at the turn of the 21st Century.[133] The Chicago Mercantile Exchange was first to demutualize in 2000, followed by its IPO in 2003, in which it listed its shares on the NYSE.[134] Others followed, including the NASDAQ and the NYSE.

In mid-1999, announcements by the NASDAQ[135] and the NYSE of their intentions to demutualize sparked a debate amongst regulators, academics, and members of the financial community regarding whether the markets would continue to be able to perform their SRO duties.[136] Major concerns included (1) regulation by a for-profit, shareholder-owned SRO of "entities like broker-dealers who in turn have ownership stakes in competitive rivals such as ECNs" (Electronic Communication Networks), and (2) whether "the altered economics of being a for-profit, shareholder owned exchange [would] affect an exchange's ability to effectively regulate itself."[137] Regardless of these concerns, however, both entities demutualized by 2006, with SEC approval.[138]

Initially, the NYSE decided to postpone demutualization. However, in early 2006, upon approval from the SEC, the NYSE acquired Archipelago Holdings Inc., an all-electronic exchange, and became a publicly traded company.[139] This "end[ed] the exchange's 213-year history as a member-owned association."[140] The NASDAQ, on the other

131. *See, e.g.*, SRO Concept Release, *supra* note 3.

132. PAMELA S. HUGHES & EHSAN ZARGAR, EXCHANGE DEMUTUALIZATION, May 1, 2006, at 5-7, *available at* http://www.scribd.com/doc/60628391/Paper-Exchange-Demutualization-May2006.

133. *Id.* at 7.

134. *Id.*

135. GARY SHORTER, CONG. RESEARCH SERV., RS21193, NASDAQ'S PURSUIT OF EXCHANGE STATUS AND AN INITIAL PUBLIC OFFERING 1 (2005) (The NASDAQ stock market is an all-electronic trading facility that, unlike traditional stock exchanges like the NYSE, has no trading floor and facilitates trading of over-the-counter stocks through electronically connected market makers. The NASDAQ was originally a wholly-owned for-profit subsidiary of the nonprofit SRO, the NASD).

136. *Id.* at 2.

137. *Id.*

138. Hughes & Zargar, *supra* note 132, at 9.

139. Reena Aggarwal & Sandeep Dahiya, *Demutualization and Public Offerings of Financial Exchanges*, Nov. 6, 2005, at 2, *available at* http://faculty.msb.edu/aggarwal/exchanges.pdf; Hughes & Zargar, *supra* note 132, at 9; SHORTER, *supra* note 135, at 2.

140. Hughes & Zargar, *supra* note 132, at 9.

hand, stayed its course from the beginning and in 2000, upon membership approval, the non-profit NASD spun off the for-profit NASDAQ and converted it into a shareholder-owned market.[141] Subsequently, a three-step process toward demutualization ensued: (1) issuance of privately placed stock; (2) conversion into exchange status[142]; and (3) issuance of public stock.[143] Given, among other things, the concern arising from the fact that once approved as an exchange, the NASDAQ would be its own SRO, the SEC took roughly five years to consider the NASDAQ's application to become a registered securities exchange, which it approved in January 2006.[144]

Through demutualization, "a quasi-governmental institution is transformed into a profit-oriented publicly traded company."[145] The resulting, restructured exchange is controlled by shareholders, which "effectively separates ownership from trading privileges as stockbrokers become the exchange's *customers* and are no longer required to be owners."[146] In addition to the separation of trading and membership rights, in most cases, demutualization also allows outside ownership of the exchange.[147] Introducing the possibility of outside ownership is indicative of an exchange's post-demutualization profit motive, as the exchange now has shareholders seeking profitability.[148] "Thus a demutualized exchange may be understood to have a corporate set up with profit motive."[149]

The SEC has expressed concern that as a result of increased competition among stock markets, "the markets that SROs operate will continue to come under increased pressure to attract order flow.[150] This business pressure can create a *strong conflict* between the SRO regulatory and market operations functions."[151] Moreover, due to continued growth in inter-market competition, there are increasingly more options for where to direct order flow, which may cause SRO staff to be "less inclined to enforce vigorously SRO rules that would cause large liquidity providers to redirect order flow."[152] A clear conflict exists

141. SHORTER, *supra* note 135, at 3.

142. At that point, because the NASDAQ was operated by the NASD, it was exempt from "exchange" status under the Exchange Act. *Id.* at 3.

143. *Id.*

144. Hughes & Zargar, *supra* note 132, at 9; SHORTER, *supra* note 135, at 4.

145. Hughes & Zargar, *supra* note 132, at 6.

146. *Id.* at 7 (emphasis added).

147. Subhashish Saha, Stock Exchange Demutualization and Self Regulation, Indian Institute of Capital Markets 9th Capital Markets Conference Paper, 5 (Sept. 5, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=877806.

148. *Id.*

149. *Id.*

150. SRO Concept Release, *supra* note 3, at 71,261.

151. *Id.* at 71,261-62 (emphasis added).

152. *Id.* at 71,262.

between an SRO's responsibility to maximize profits for shareholders while at the same time discharging their regulatory duties.

Furthermore, over time, many of these regulatory duties are no longer performed by the exchanges themselves, who now rely on FINRA to regulate.[153] As of July 2012, "every exchange except BATS outsources all or most of its regulatory responsibilities to [FINRA]."[154] These demutualized, shareholder-controlled, profit-seeking entities, having delegated away their regulatory responsibilities, are more akin to for-profit corporations than their predecessor non-profit, member-owned SROs.[155]

The transformation of exchanges into private, for-profit entities calls into question whether they should maintain their status as SROs.[156] In the aftermath of the 2012 Facebook IPO software malfunction, Christopher Nagy, former head of order-routing for TD Ameritrade and now a consultant to brokers and exchanges, commented, "this raises once again the question of whether our nation's exchanges should be allowed to operate as for-profit, publicly traded companies rather than public utilities, as they historically had been run."[157] To date, however, the exchanges have not been stripped of their SRO status, thus maintaining[158] "absolute immunity from private damages suits in connection with the discharge of their regulatory responsibilities."[159]

B. Policy Implications

Demutualization of the exchanges presents the issue of "whether a commercial entity carrying on the business of running an exchange and seeking to protect and promote its business can continue to support the integrity and efficiency of the trading markets by setting and enforcing appropriate regulations in the public interest."[160] The SEC has warned that "SRO demutualization raises the concern that the profit motive of a shareholder-owned SRO could detract from proper self-regulation."[161]

153. Mathisson, *supra* note 130; Stephen J. Nelson, *Commentary: FINRA's NYSE Reg Takeover – The End of an Era?*, TRADERS MAGAZINE (June 9, 2010), http://www.tradersmagazine.com/news/nyse-regulation-finra-richard-grasso-sec-105812-1.html.

154. Mathisson, *supra* note 130.

155. *See id.*; *see also* Nelson, *supra* note 153.

156. *See* Mehta, *supra* note 130; *see also* Mathisson, *supra* note 130.

157. Jacob Bunge, *Citi, in Letter to SEC, Blasts Nasdaq on Facebook,* WALL ST. J. (Aug. 22, 2012, 6:59 PM), http://online.wsj.com/article/SB10000872396390444270404577605714235711588.html.

158. Mathisson, *supra* note 130; *see also* Nelson, *supra* note 153.

159. Standard Inv. Chartered, Inc. v. Nat'l Ass'n of Sec. Dealers, Inc., 637 F.3d 112, 115 (2d Cir. 2011).

160. Roberta S. Karmel, *Turning Seats Into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 HASTINGS L.J. 367, 420 (2002).

161. SRO Concept Release, *supra* note 3, at 71,263.

This conflict is intensified by a continued increase in inter-market competition, which puts pressure on SROs to attract deal flow.[162] As noted above, this business pressure creates a "strong conflict" between the regulatory and market operation functions of an SRO.[163]

The conflicted role of demutualized exchanges has brought about much debate regarding an overhaul of the SRO system. That issue, however, is not the focus of this paper.[164] Instead, in this section, I take as given that the self-regulation will remain, and argue that the immunity granted to SROs should be limited in order to balance the need for self-regulation with the conflicted incentives of profit-seeking, shareholder-owned SROs.

Demutualization has altered the motivations of stock exchanges. Because SROs are now for-profit, shareholder-owned organizations, they must act in the best interest of shareholders and seek to maximize profits and increase earnings.[165] At the same time, the exchanges are still charged with self-regulation and continue to enjoy the absolute immunity that they were granted in the pre-demutualization era.

Allowing demutualized exchanges to remain SROs creates a moral hazard problem. As SROs, the exchanges have been afforded broad absolute immunity for all quasi-governmental activities.[166] At the same time, the demutualized SROs, facing an increasing inter-market competition, are under pressure to attract deal flow and maximize profits for shareholders.[167] This combination creates a moral hazard in that the exchanges, with their absolute immunity in mind, will engage in excessively risky behavior in order to maximize profits, knowing that they will not face any liability as long as the conduct falls within the SRO's quasi-governmental powers.

The Second Circuit has held that an exchange, when acting in its capacity as an SRO, is "entitled to immunity from suit when it engages in conduct consistent with the quasi-governmental powers delegated to it pursuant to the Exchange Act and the regulations and rules promulgated thereunder."[168] An examination of the Exchange Act, therefore, is

162. *Id.*

163. *Id.* at 71,261-62.

164. For discussion of the SRO system, *see* SRO Concept Release, *supra* note 3; Onnig H. Dombalagian, *Self and Self-Regulation: Resolving the SRO Identity Crisis*, 1 BROOK. J. CORP. FIN. & COM. L. 317 (2007); Ellis, *supra* note 96; Saule T. Omarova, *Rethinking the Future of Self-Regulation in the Financial Industry*, 35 BROOK J. INT'L L. 665 (2010).

165. SRO Concept Release, *supra* note 3, at 71,263; *Computerized Trading Venues: What Should the Rules of the Road Be?: Before the S. Comm. on Banking, Housing, and Urban Affairs, Subcomm. on Securities, Insurance, and Investment*, 112th Cong. 11 (2012) (written testimony of Daniel Mathisson, Head of U.S. Equity Trading, Credit Suisse).

166. DL Capital Grp., LLC v. NASDAQ Stock Mkt., Inc., 409 F.3d 93, 99 (2d Cir. 2005).

167. SRO Concept Release, *supra* note 3, at 71,261-62.

168. D'Alessio v. N.Y. Stock Exch., Inc., 258 F.3d 93, 106 (2d Cir. 2001).

informative. Under the Exchange Act, SROs are charged with the following "statutorily-delegated" duties: (1) to prevent fraudulent and manipulative acts and practices; (2) to promote just and equitable principles of trade; (3) to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities; (4) to remove impediments to and perfect the mechanism of a free and open market and a national market system, and (5) in general, to protect investors and the public interest.[169]

This broad list of powers coupled with the Second Circuit's "incident to" and "consistent with" language almost ensures that an exchange's actions will be protected by absolute immunity, especially given the objective nature of the analysis. As long as an exchange can show that the "function and nature" of the conduct underlying a claim is consistent with discharging any of the very general duties listed above, it will be able to invoke the absolute immunity shield, escaping liability in the preliminary stages of an action.

This system is flawed because it allows exchanges to engage in risky behavior without the threat of civil damages, thereby reducing the incentive to take important precautions. This is especially dangerous with respect to the exchanges' use of complex, high-speed technology to operate their trading systems. These innovations have vastly increased the amount of trading that goes on in a given second, which means not only more participants, but more transactions. As such, even one small error or glitch can have a major effect on the market, and can cause huge losses in a matter of minutes, as exhibited in the numerous malfunction disasters of the past few years.

May 6, 2010, the day of the infamous "Flash Crash," saw a breakdown in the market triggered by computer-trading system errors that caused stocks to plunge 10%.[170] Two years later, after months of planning and anticipation, a technical glitch at BATS Global Markets forced the exchange operator to withdraw its own IPO.[171] In early 2013, BATS was again plagued by technology, when a single programming error caused execution at the wrong price for some 435,000 trades, resulting in $420,000 in losses to traders.[172]

169. Securities Exchange Act of 1934, *supra* note 1, at § 78f(b)(5).

170. Scott Patterson, *Breakdown: A Glimpse Inside the 'Flash Crash'*, WALL ST. J. (June 10, 2012, 5:56 PM), http://online.wsj.com/article/SB10001424052702303296604577454330066039896.html.

171. Michael J. De La Merced, *BATS Chief on Friday's Troubles: 'My Stomach Sank'*, N.Y. TIMES DEALBOOK (Mar. 26, 2012, 12:11 AM), http://dealbook.nytimes.com/2012/03/26/bats-chief-on-fridays-meltdown-my-stomach-sank.

172. Nathaniel Popper, *Errors Mount at High-Speed Exchanges in New Year*, N.Y. TIMES (Jan. 10, 2013), http://www.nytimes.com/2013/01/11/business/in-new-year-errors-mount-at-high-speed-exchanges.html.

In May 2012, the NASDAQ suffered a glitch in the trading software it introduced to conduct Facebook's IPO, allegedly causing hundreds of millions of dollars in losses to traders.[173] A few months later, in August 2012, market-maker[174] Knight Capital had to be bailed out by financial firms, when a computer malfunction bombarded the equity exchanges with erroneous orders, resulting in losses of $457.6 million.[175] The Knight disaster was apparently attributable to "one line of code,"[176] a phrase that sums up the major effects trading software malfunctions can have on the market.

These examples illustrate the fact that technology glitches in trading software occur and can have a serious impact on the market, causing delay, confusion, and ultimately losses. While non-exchanges like Knight Capital must bear the burden of their losses,[177] exchanges like BATS, the NYSE, and the NASDAQ are protected by absolute immunity from civil damages, leaving them with less incentive to refrain from risky behavior with respect to computerized trading systems. Thus, exchanges may be less inclined to take all necessary precautions when introducing new trading technologies and may fail to respond properly to malfunctions. Why not take a risk when there is no potential for liability?

III. FACEBOOK IPO CASE STUDY

In this section, I examine the Facebook IPO software malfunction and the potential for liability. I first explain what actually happened on the day of the IPO. Next, I examine whether the NASDAQ might be liable under the current case law. I find that although the NASDAQ was acting in its own, *private* self-interest, it may be able to invoke absolute immunity by showing that its behavior was consistent with its statutorily delegated duties under the Exchange Act. I propose that because technological malfunctions can wreak havoc on markets, exchanges should be encouraged to act with utmost caution and care in

173. Mehta, *supra* note 130.

174. A market-maker is a "broker-dealer firm that accepts the risk of holding a certain number of shares of a particular security in order to facilitate trading in that security. Each market maker competes for customer order flow by displaying buy and sell quotations for a guaranteed number of shares. Once an order is received, the market maker immediately sells from its own inventory or seeks an offsetting order. This process takes place in mere seconds." *Market Maker Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/m/marketmaker.asp#axzz2MWv5n32C (last visited Sept. 6, 2013).

175. Whitney Kisling, *Knight Capital Reports Net Loss After Software Error*, BLOOMBERG (Oct. 17, 2012, 9:58 AM), http://www.bloomberg.com/news/2012-10-17/knight-capital-reports-net-loss-as-software-error-takes-toll-1-.html.

176. Scott Patterson et al., *SEC Nixed Knight's Plea for a Do-Over*, WALL ST. J. (Aug. 6, 2012, 11:26 AM), http://online.wsj.com/article/SB10000872396390444246904577571113923528168.html.

177. Knight had to be bailed out by other firms. *Id.*

implementing and maintaining these systems and in responding to glitches. Therefore, the exchanges should face potential civil liability for negligence in operating, maintaining, and responding to malfunctions in the electronic trading systems they use to facilitate market transactions. The grant of absolute immunity for SROs fails to do this.

A. What happened with the Facebook IPO?[178]

After battling with NYSE for the listing, the NASDAQ won what was anticipated to be the biggest technology IPO in history–that of social media giant Facebook, Inc.[179] The company went public on May 18, 2012.[180] That morning, trading was supposed to begin at 11 A.M., but technical malfunctions, said to be caused by a "design flaw in Nasdaq's IPO auction mechanism," forced the NASDAQ to delay the IPO.[181]

The NASDAQ's system was set up to accept last-second modifications to orders.[182] As the orders kept coming in, the system reset the price over and over again.[183] Some of these orders were blocked while the NASDAQ tried to fix the system, and therefore were not executed, while others were placed at prices other than the opening bid price.[184] The effort to fix the system also prevented confirmations from being sent immediately to brokers, leaving many unsure of their position, i.e. how many shares they held.[185] As one market-maker put it, traders "were flying blind."[186]

Eventually, the NASDAQ manually overrode the system and switched to a backup server, and shares began trading at 11:30 A.M.—thirty minutes after the planned opening.[187] Over two hours later, confusion arose once more, as traders saw a sell order of roughly eleven million shares, which caused the stock price to drop from $42 to $40 in a

178. The description in this section is a simplified version of the complicated issues that took place during the Facebook IPO. For a more detailed description of the events, *see* Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Order Instituting Proceedings To Determine Whether To Approve or Disapprove Proposed Rule Change To Amend Rule 4626—Limitation of Liability, Exchange Act Release No. 68,115, 77 Fed. Reg. 66,197 (Nov. 2, 2012).

179. Comment Letter from Citigroup Global Markets Inc. to the SEC 5 (Aug. 22, 2012), *available at* http://www.sec.gov/comments/sr-nasdaq-2012-090/nasdaq2012090-5.pdf [hereinafter "Citi Comment Letter"].

180. Mehta, *supra* note 130.

181. *Id.*; Ben Protess et al., *As Facebook Seeks Answers, S.E.C. Investigates Exchanges*, N.Y. TIMES DEALBOOK (June 21, 2012), http://dealbook.nytimes.com/2012/06/21/as-facebook-seeks-answers-s-e-c-investigates-exchanges.

182. Protess et al., *supra* note 181.

183. *Id.*

184. *Id.*; Mehta, *supra* note 130.

185. Protess et al., *supra* note 181.

186. *Id.*

187. *Id.*

matter of minutes.[188] This was the result of shares being dumped back into the market as the NASDAQ started to process trades that were backed up in the system.[189]

The NASDAQ OMX Group CEO Robert Greifeld has attributed the debacle to "a malfunction in the trading-system's design for processing order cancellations."[190] Although admitting "[t]his was not [the NASDAQ's] finest hour"[191] two days after the fiasco, Greifeld called the IPO "quite successful" overall, claiming that the technical issues did not affect the price of Facebook shares, which closed at $38.23 on opening day, roughly where it started.[192]

Regardless of whether the technical malfunctions affected the *price* of Facebook's stock—a debate that will continue for some time—the malfunctions caused order processing failures that resulted in investors and market-makers losing hundreds of millions of dollars.[193] While the NASDAQ has proposed settlements with the market-maker firms that trade on the exchange, retail investors have not been included in these proposals.[194] Additionally, the affected parties claim that the proposed payout is entirely insufficient to compensate losses.[195] Meanwhile, a class action suit has been filed on behalf of those whose retail orders, trades, and cancellations were mishandled, and who did not receive execution at accurate and fair prices or suffered other losses as a result of the NASDAQ's alleged negligence.[196]

B. Absolute Immunity Analysis

Industry experts say that the NASDAQ should have delayed the IPO until the software was properly tested, or, at least when faced with the malfunction, should have "halted, solved the problem and recommenced trading."[197] Regardless of this hindsight, industry experts believe that the exchange will be protected from civil damages by its SRO absolute

188. *Id.*
189. *Id.*
190. Jenny Strasburg et al., *Nasdaq's Facebook Problem; Exchange Says Glitches Affected Millions of Shares; IPO System to be Redesigned*, WALL ST. J. (May 21, 2012, 8:02 AM), http://online.wsj.com/article/SB10001424052702303610504577416530447015656.html.
191. *Id.*
192. Protess, *supra* note 181.
193. Mehta, *supra* note 130 (reporting estimates from $200M to over $350M).
194. Michael J. De La Merced & Nathaniel Popper, *Nasdaq Sets Aside $40 Million to Settle Facebook Claims*, N.Y. TIMES DEALBOOK (June 6, 2012, 2:08 PM), http://dealbook.nytimes.com/2012/06/06/nasdaq-sets-aside-40-million-to-settle-facebook-trading-claims.
195. *Id.*; Citi Comment Letter, *supra* note 179.
196. *See* Amended Class Action Complaint, Goldberg v. NASDAQ OMX Group, Inc., No. 12-CV-4054 (S.D.N.Y. June 12, 2012), 2012 WL 2365297.
197. Mehta, *supra* note 130.

immunity.[198] Attorney George Simon explains that while one could argue that demutualization makes the premise behind limiting liability no longer relevant, SRO immunity rules "are still in effect and courts . . . have honored them."[199] He further proclaims, "[i]f I were a betting person, I'd bet in favor of Nasdaq."[200] Moreover, the class action suit was filed in the Second Circuit, which has approached this issue broadly in favor of SROs retaining absolute immunity.[201]

If the case proceeds, given the Second Circuit's position that "immunity depends only on whether specific acts and forbearances were incident to the exercise of regulatory power, and not on the propriety of those actions or inactions,"[202] whether the NASDAQ acted negligently is not relevant to whether it will be shielded by absolute immunity. The question, rather, is whether the NASDAQ's alleged misconduct with respect to the Facebook IPO falls within the scope of the NASDAQ's quasi-governmental duties as an SRO.[203]

There appear to be two aspects to the NASDAQ's potential liability: first, the NASDAQ's introduction of new software to conduct an IPO, and second, the NASDAQ's response to the software malfunction. In attempting to invoke a shield of absolute immunity, an exchange such as the NASDAQ would argue that its conduct was consistent with its quasi-governmental duties pursuant to the Exchange Act. Given the Exchange Act's broad language, this may not prove a difficult task.

New IPO software, and trading software in general, could have numerous potential purposes. The software may increase speed, which allows more trades, making markets more efficient and accessible. Thus, the exchange could claim that because it improves efficiency and accessibility, the software was consistent with its duty to "remove impediments to and perfect the mechanism of a free and open market and a national market system" or its duty to "foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities."[204]

Similarly, an exchange's conduct in responding to a software malfunction could be shown to fall within the scope of its duties, as delegated by the Exchange Act. Given the potential harm a malfunction could cause to investors and the market, an exchange could easily claim that responding to a glitch is consistent with its duty to "remove

198. *Id.*
199. *Id.*
200. *Id.*
201. *See* Nafday, *supra* note 60, at 864.
202. *In re* NYSE Specialists Sec. Litig., 503 F.3d 89, 98 (2d Cir. 2007).
203. *See id.* at 96.
204. Securities and Exchange Act of 1934, 15 U.S.C.A. §78f(b)(5) (West 2012).

impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest." [205] Additionally, absolute immunity would attach to a decision *not* to suspend trading when a glitch occurs, as a failure to act receives the same protection as an action.[206]

This result is problematic considering the incentives of a demutualized exchange. Because an objective test is applied in an absolute immunity analysis, an exchange's motives are not considered. Thus, if introducing new trading software is quasi-governmental under the reasoning provided above, then it would not matter that an exchange was entirely motivated by profits in introducing the software. Furthermore, because the inquiry stops at whether the conduct was governmental, there is no evaluation of the propriety of the conduct. Thus, an exchange could introduce software prone to problems without facing potential liability for taking such a risk.

Similarly, if responding to a malfunction is quasi-governmental, the motives behind and propriety of the exchange's conduct in doing so are not subject to scrutiny. It would matter only that the function of responding to a malfunction is governmental, and therefore entitled to absolute immunity. A court would not even consider that the exchange decided how to respond to the malfunction with an eye on maximizing profits rather than removing impediments to the free and open market or protecting investors. Without subjecting such decisions to judicial review and potential liability, an exchange may engage in risky behavior, such as allowing trading to continue on a malfunctioning system. As illustrated by the Facebook IPO, this would lead to major losses for traders, who may not be able to overcome a motion to dismiss on grounds of absolute immunity.

It is worth noting that there are some forces in place that mitigate risky behavior. First, the markets are increasingly competitive. Although not facing liability, exchanges could face losing deal flow. At the same time, however, increased competition also puts pressure on the exchanges to attract deal flow, which may encourage risky behavior. Second, exchanges derive profits from the execution of trades. If an exchange has to cancel trades because of a malfunction, they will also lose the profits derived from those trades. These losses, however, might be negligible when compared with potential damages in a civil case where numerous investors could lose millions of dollars. Thus, liability is still a necessary deterrent in mitigating risky behavior.

V. PRESCRIPTION FOR LIMITING IMMUNITY TO MITIGATE RISKY

205. *Id*.
206. *NYSE Specialists*, 503 F.3d at 97.

BEHAVIOR

In recent Congressional testimony, Credit Suisse's head of U.S. equity trading, Dan Mathisson, warned that "[i]t is a dangerous situation when a for-profit enterprise can cause half a billion dollars of losses for others, and not have the risk of being held legally liable."[207] This danger is moral hazard–exchanges have no incentive to guard against risky behavior if there is no potential downside to balance the upside. Without the potential for civil damages, an exchange may not think twice about introducing faulty software or failing to exercise caution in responding to a malfunction in hopes of increasing profits for shareholders in a highly competitive market.

The Second Circuit's broad quasi-governmental standard does not properly mitigate the moral hazard problem created by granting absolute immunity to demutualized exchanges, especially given the exchanges' reliance on highly complex technology and the potential losses to investors caused by the malfunction of these systems. To reduce the moral hazard problem, courts should adopt the test implied in *Weissman* and implemented in *Opulent Fund*, and limit absolute immunity to apply to only those actions that the SEC would itself engage in as a regulator. This test remains true to the premise that an SRO is entitled to immunity for activities involving its regulatory, adjudicatory, or prosecutorial functions, but limits the scope of what is "regulatory," moving away from the overly broad and undefined quasi-governmental standard.

Prosecutorial and adjudicatory functions are at the heart of the absolute immunity grant, and are not particularly affected by the changed incentives of demutualized exchanges.[208] Disciplinary activities do not yield profits, and, more importantly, FINRA, which is not a for-profit exchange, has taken on these disciplinary tasks on behalf of many of the exchanges. Accordingly, absolute immunity for prosecutorial and adjudicatory functions remains appropriate in a demutualized system.

The Second Circuit's extension of the absolute immunity doctrine to encompass regulatory actions, without limiting what is regulatory in nature and function, led to an overly broad grant of immunity to all activities deemed consistent with an SRO's quasi-governmental powers. As discussed above, this grant is too broad, especially in light of the Exchange Act's general language in its delegation of regulatory authority to SROs. This broad language allows exchanges too much latitude in invoking the absolute liability shield.

Instead, "regulatory" should be limited to only those actions the

207. *Computerized Trading Venues*, *supra* note 165, at 7.

208. The SEC did note that there is a potential increased incentive for inaction if disciplining a certain broker-dealer would somehow reduce deal flow, but did not find this to be a significant problem. SRO Concept Release, *supra* note 3, at 71,261-62.

SEC would take, since immunity is granted on the premise that when SROs step into the shoes of the SEC, they deserve the same protections afforded to the agency.[209] Thus, a court should consider whether the SEC would engage in the activity. Accordingly, because the SEC is charged with enforcement and rulemaking, any activities falling outside that scope should not be protected by absolute immunity. Therefore, because the SEC would not engage in facilitating markets, absolute immunity should not extend to exchanges for claims arising out of activities such as creating, operating, and maintaining trading software, processing orders, and executing trades. Such a test would mitigate the moral hazard by opening exchanges for liability with respect to activities, providing exchanges with an incentive to act with appropriate caution and care.

CONCLUSION

As innovation continues to improve technology and increase its presence in financial markets, technological issues will continue to occur. If the stock exchanges that facilitate market transactions are not held responsible for the operation and maintenance of the trading systems, as well as the handling of glitches that come along with those activities, investors will continue to bear losses while the exchanges continue to engage in risky behavior.

To date, stock exchanges have enjoyed absolute immunity from liability for their regulatory activities as SROs. Now that nearly all exchanges have transformed from being non-profit, member-owned organizations to for-profit, shareholder-owned, demutualized entities that outsource most of their governmental duties, an overhaul of the SRO system and the immunity that comes with it may be in order. In the meantime, however, courts and regulators must limit the grant of absolute immunity to truly prosecutorial, adjudicatory, and regulatory actions. Thus, courts should evaluate whether the SEC would engage in the conduct in question. If the answer is no, then the stock exchange was not acting in its governmental capacity, and must therefore face liability in its capacity as a corporation acting in its own self-interest. This would serve to better incentivize stock exchanges to take proper precautionary measures with respect to technological systems used to facilitate transactions, which in turn would protect investors from undue losses.

209. D’Alessio v. New York Stock Exch., Inc., 258 F.3d 93, 105 (2d Cir. 2001).