No. 11-381

In The Supreme Court of the United States

STANDARD INVESTMENT CHARTERED, INC., ON BEHALF OF ITSELF AND ALL OTHERS SIMILARLY SITUATED,

Petitioner,

v.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, ET AL.,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Second Circuit

BRIEF OF AMICUS CURIAE THE SECURITIES INDUSTRY PROFESSIONAL ASSOCIATION, INC. IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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INTEREST OF *AMICUS CURIAE*[1]

Formed by financial professionals who are concerned with the relationship between the regulators and the regulated, The Securities Industry Professional Association, Inc. ("The SIPA") is an advocacy and membership organization that serves as a voice for individual registered persons and small broker/dealer firms in the financial professionals services industry. The SIPA endeavors to capture and voice the concerns of individual registered persons and small broker/dealers who are directly affected by regulations. The SIPA membership is comprised of broker/dealers and registered representatives who are FINRA[2] members. In fact, the SIPA members make up almost a quarter of FINRA's membership. As part of its advocacy activities, the SIPA has played a role in the elections of the FINRA Board of Governors, including by providing a forum for candidates to express their views.

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[1] No counsel of a party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief and no person other than *amicus curiae,* its members, or its counsel made a monetary contribution to its preparation or submission. Both parties have provided written consent, on file with the clerk, to the filing of briefs in support of either, or neither, party. Counsel of record for all parties received notice from *amicus curiae* of its intention to file an *amicus curiae* brief more than 10 days prior to the due date for the *amicus curiae* brief.

[2] NASD, after acquiring the regulatory arm of NYSE, changed its name to the Financial Industry Regulatory Authority (FINRA).

The SIPA, as *amicus curiae*, respectfully submits this brief in support of Standard Investment Chartered, Inc.'s petition for a writ of certiorari seeking this Court's review of the United States Court of Appeals for the Second Circuit's ("Second Circuit") decision in *Standard Investment Chartered, Inc. v. National Ass'n of Sec. Dealers, Inc.*, No. 10-945-cv (2d Cir. Feb. 22, 2011). The SIPA respectfully submits that this Court should grant the petition. The Second Circuit's decision, not only in the standard it applies but in the application of the standard to the routine, non-regulatory corporate governance transaction at issue, implicates questions relating to the scope of state and federal authority, as well as the extent to which non-regulatory actions by a Self-Regulatory Organization ("SRO") are subject to judicial review. The SIPA submits this brief to highlight how the Second Circuit's conclusion that an SRO is absolutely immune from state law claims in the context of a non-regulatory change in form – a merger – could result in depriving SRO members of any recourse for an SRO's non-regulatory conduct in areas traditionally left to state law. As many of the SIPA members are FINRA members, the SIPA has a strong interest in FINRA, and specifically, in the Second Circuit's broad extension of SRO absolute immunity to acts merely "incident to" an SRO's regulatory authority. As discussed below, the Second Circuit's holding, combined with the limited oversight jurisdiction of the Securities and Exchange Commission ("SEC") over state

law, including matters of corporate governance, will preclude full and fair review of SRO conduct alleged to violate state law even though traditionally shareholders and members of associations have been able to seek redress in state court for such non-regulatory conduct.

SUMMARY OF ARGUMENT

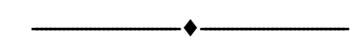
Respondent National Association of Securities Dealers ("NASD") is a private, non-profit corporation that exercises regulatory authority over its members as an SRO pursuant to the Securities Exchange Act of 1934 ("Exchange Act"). Pet. App. 3a, 11a; Standard Investment Chartered, Inc.'s Second Amended Complaint ("Complaint") at ¶ 52. NASD also acts in furtherance of its private, proprietary interests, such as in acquiring the regulatory arm of the New York Stock Exchange ("NYSE"). In order to consummate the deal to acquire NYSE, NASD had to amend its bylaws to increase the voting power of NYSE's large institutional investors. As the amendment of the bylaws required approval by NASD's membership, NASD issued a proxy statement. Pet. App. 3a-4a. Petitioner filed a state lawsuit against NASD, alleging that the proxy statement was fraudulent, as well as other violations of state law. Exchange Act Release No. 56,145, 72 Fed. Reg. 42,169, 42,175 (July 26, 2007). The Second Circuit held that SROs have absolute immunity from private litigation for any conduct, including non-regulatory acts and alleged violations

of state law, that are "incident to" their regulatory activities. Pet. App. 2a. The question presented is whether SROs are entitled to absolute immunity for unlawful conduct that is "incident to" their regulatory powers, including conduct that implicates corporate governance issues and the relationship between an SRO and its members that traditionally are regulated under state law, but does not involve performance of any regulatory duty on behalf of the government. If it does, there exists an enforcement gap in which the NASD, or any SRO, cannot be held accountable for its private activities, or for its acts in violation of state law, that are in any broad sense "incident to" to its actual regulatory authority, either in a court or through SEC oversight.

When acting outside its regulatory realm, an SRO and its members have a relationship that implicates matters governed by state law. For example, the NASD manages its own affairs, including by entering into contracts and collecting and holding funds obtained from members. Under the Second Circuit's broad application of absolute immunity to claims without any direct and concrete link to NASD's regulatory functions, many of NASD's acts in furtherance of NASD's private interests and related to its corporate governance, which traditionally are regulated by the states, may be found to be "incident to" NASD's regulatory authority. Under the Second Circuit's holding, NASD would enjoy absolute immunity from suit in court for these incidental, non-regulatory acts. The Second Circuit's extension of SRO absolute immunity

to non-regulatory activities is inconsistent with the fact that the Exchange Act is aimed solely at enforcement of federal law (rather than state law). Moreover, the SEC's authority over SROs is limited to ensuring adequate performance of SROs' actual delegated regulatory duties. As a result, the SEC has refused to consider state law claims, such as Petitioner's state law fraud claim based on the misrepresentations contained in NASD's proxy statement. Thus, the Second Circuit's holding creates an enforcement gap in which an NASD member cannot hold NASD accountable for its private activities in violation of state law.

The present case exemplifies the flaw inherent in the Second Circuit's holding. The SEC's Approval Orders expressly declined to reach Petitioner's state law claims, confirming that the SEC's authority to regulate an SRO does not extend to considerations of state law outside of the SEC's delegated regulatory authority. Because the SEC will not consider whether NASD's proxy statement violates state law, it is incumbent upon the courts to do so. But the Second Circuit's holding precludes court review in this case, and in any case, where NASD acts in furtherance of its private interests or violates state law and those acts are deemed to be somehow "incident to" NASD's regulatory authority.



ARGUMENT

I. DUAL ROLES OF SROs

Under the Exchange Act, Congress established a system of regulation over the securities industry, which relies on private SROs to conduct the day-to-day regulation and administration of the United States' stock markets, under the supervision of the SEC. *Weissman v. NASD*, 500 F.3d 1293, 1296 (11th Cir. 2007). For example, the Commission approves of all SRO rule changes, however minor, 15 U.S.C. § 78s(b), and may amend the SRO rules itself if deemed necessary, 15 U.S.C. § 78s(c). If an SRO does not comply with the Exchange Act, the SEC rules, or its own rules, as required by 15 U.S.C. § 78s(g), it faces the suspension or revocation of its SRO registration, as well as other sanctions. *See In re Series 7 Broker Qualification Exam Scoring Litig.*, 510 F. Supp. 2d 35, 38 (D.D.C. 2007). The Exchange Act does not provide the SEC with limitless oversight authority over SROs, however. Rather, the Exchange Act allows the SEC to oversee SROs in the performance of their regulatory duties. *See, e.g.*, 15 U.S.C. §§ 78s(d)(1), (2).

Respondent NASD is registered as an SRO with the SEC as a national securities association pursuant to the Exchange Act. Pet. App. 3a. This dual public-private regulatory system requires the SRO to register with the SEC, enact rules to protect investors, and discipline their members. *See, e.g.*, 15 U.S.C. 78o-3, §§ 78s. As an SRO, NASD "serves as

a quasi-governmental agency in the exercise of its delegated government power . . . to enforce . . . the legal requirements laid down in the Exchange Act." *See In re Series 7 Broker Qualification Exam Scoring Litig.*, 510 F. Supp. 2d at 38 (internal citations omitted). As an SRO, NASD exercises regulatory authority over its members' activities in securities markets. In exercising its regulatory functions, "SROs effectively 'stand in the shoes of the SEC' because they perform regulatory functions that would otherwise be performed by the SEC." *See, e.g.*, *DL Capital Group, LLC v. Nasdaq Stock Mkt., Inc.*, 409 F.3d 93, 95 (2d Cir. 2005) (quoting *D'Alessio v. New York Stock Exchange, Inc.*, 258 F.3d 93, 105 (2d Cir. 2001)). Because they perform a variety of vital governmental functions, but lack the sovereign immunity that governmental agencies enjoy, SROs are protected by absolute immunity when they perform their statutorily delegated adjudicatory, regulatory, and prosecutorial functions. *Weissman v. NASD*, 500 F.3d at 196 (citing *Barbara v. New York Stock Exch.*, 99 F.3d 49, 59 (2d Cir. 1996)).

Both FINRA's Annual reports and its description of itself on its website set forth its regulatory functions:

> With 2,800 employees, FINRA augments and deepens the reach of the federal securities laws with detailed and enforceable ethical rules and a host of comprehensive regulatory oversight programs. FINRA regulates the population of both firms and

> individuals in the industry; regulates securities markets and provides market information; adopts and enforces rules to protect investors and the financial markets; examines broker-dealers for compliance with its own rules as well as federal securities laws and rules of the Municipal Securities Rulemaking Board (MSRB); informs and educates the investing public; provides industry utilities; and administers the largest dispute resolution forum for investors, registered firms and firm employees.

See FINRA 2008 Year in Review and Annual Financial Report, *Reforming Regulation to Better Protect Investors* at p. 8 ("2008 Annual Report").[3]

> FINRA touches virtually every aspect of the securities business – from registering and educating industry participants to examining securities firms; writing rules; enforcing those rules and the federal securities laws; informing and educating the investing public; providing trade reporting and other industry utilities; and administering the largest dispute resolution forum for investors and registered firms. We also perform market regulation under contract for the major U.S. stock markets, including the New York Stock Exchange, NYSE Arca, NYSE Amex,

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[3] FINRA's 2008 Annual Report may be found at http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p119061.pdf.

> The NASDAQ Stock Market and the International Securities Exchange.

http://www.finra.org/AboutFINRA/.

NASD also wears another hat. NASD also regularly attends to its private, proprietary interests. Indeed, NASD is registered with the State of Delaware as a privately-held, non-profit corporation. NASD manages its financial accounts and investment portfolio, issues an Annual Report and Bylaws, rents and owns property, hires employees, advertises, borrows money, acquires assets, conducts elections, pays bonuses and other incentive-based compensation to its management and employees, provides pension, contributory savings and medical plans, and otherwise deals with matters of corporate governance. *See, e.g.*, 2008 Annual Report. It has also traditionally engaged in private revenue-gathering enterprises, including the for-profit NASDAQ stock exchange that it created and ultimately spun off in an initial public offering that raised $1.5 billion in equity. *See* Complaint at ¶ 58. In recognition of these proprietary interests, FINRA's corporate charter declares that one of its purposes is "[t]o transact business and to purchase, hold, own, lease, mortgage, sell, and convey any and all property, real and personal, necessary, convenient, or useful for the purposes of the Corporation." *See* Restated Certificate of Incorporation of FINRA, Inc. at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4589. In this case, the transaction at issue implicates several of NASD's proprietary, non-regulatory interests, such as

increasing its revenue base. In this regard, Standard Investment Chartered's Second Amended Complaint expressly alleges that NASD's acquisition of NYSE, served NASD's proprietary objectives and implicated NASD's proprietary and corporate governance functions, including triggering substantial bonuses for NASD officers. *See* Complaint at ¶¶ 14-15.

The SEC has commented on SROs' status as both quasi-regulators and private businesses: "[a]s competition among markets grows, the markets that SROs operate will continue to come under pressure to attract order flow. This business pressure can create a strong conflict between the SRO regulatory and market operations functions." *Weissman v. NASD*, 500 F.3d at 1296, n.4 (quoting SEC Exchange Release No. 34-50700, Concept Release Concerning Self-Regulation, 69 Fed. Reg. 71,256, 71,261-62 (Dec. 8, 2004)).

II. PETITIONER HAS ASSERTED STATE LAW CLAIMS THAT THE SEC EXPRESSLY DECLINED TO "DEFINITIVE[LY] DETERMINE"

Petitioner alleges claims under state law arising from a merger. In 2006, NASD sought to purchase the regulatory arm of the NYSE. As a condition to agreeing to the sale, the NYSE insisted that NASD amend its bylaws to abandon its "one member, one vote" system in favor of a new voting system that assigned votes based upon the size of the member firm. Pet. App. 3a-4a. The bylaw amendment required NASD member approval. Thus, NASD, through a proxy

solicitation, offered smaller members, including Petitioner, a one-time "special member payment" of $35,000 in exchange for their support of the bylaw amendment. Pet. App. 4a. The proxy solicitation represented that "a larger payment is not possible" due to IRS limitations. Petitioner alleges that NASD misrepresented in the proxy statement that $35,000 was the maximum possible payout allowed by IRS rules, as well as other misrepresentations and omissions, including the proxy statement's failure to apprise NASD members that NASD officers had a major financial incentive for promoting the bylaw change in the form of hundreds of thousands of dollars in bonuses. Complaint at ¶¶ 15-16.

Petitioner alleges that unaware of the misrepresentations and omissions, NASD members voted to approve the bylaw amendment on January 19, 2007. Pet. App. 4a. On March 8, 2007, Petitioner filed a class action Complaint in the United States Court for the Southern District of New York challenging the pending regulatory consolidation of NASD and NYSE. On March 19, 2007, NASD filed the proposed rule change to amend the bylaws of NASD with the SEC for its approval, as required by Section 19 of the Exchange Act. The SEC published the proposed rule change for comment in the Federal Register on March 26, 2007. The Commission received 80 comment letters from 72 commenters, including Petitioner, on the proposed rule change. The SEC did not solicit comments on NASD's proxy statement. *See* Exchange Act Release No. 34-55495, 72 Fed. Reg. 14,149 (March 20,

2007) (containing no reference at all to NASD's proxy statement and stating, "The Commission is publishing this notice to solicit comments on the proposed *rule change* from interested persons."). NASD filed a response to comments on May 29, 2007 and a supplemental response to comments on July 16, 2007. Exchange Act Release No. 56,145, 72 Fed. Reg. 42,169 (July 26, 2007) ("Approval Order"). Several commenters, including Petitioner, questioned the calculation and origin of the $ 35,000 one-time payment to the NASD members. *Id.* at 42,117. In fact, shortly after the SEC invited comment on the proposed rule change, Petitioner filed an Amended Complaint against the NASD, three NASD officers, and the NYSE, alleging seven state law claims.[4] *Id.* at 42,175. Petitioner also forwarded to the SEC certain documents and

[4] Petitioner's Amended Complaint alleged the following: (1) That the individual Defendants breached fiduciary duties to the proposed class in negotiating the proposed Transaction and failing to disclose all material facts in the proxy statement; (2) that the Defendants engaged in negligent misrepresentation with respect to the proxy statement; (3) that the NYSE and the individual Defendants will be unjustly enriched by the Transaction; (4) that NASD members have been denied their right to elect Governors of the NASD in violation of Section 211 of the Delaware General Corporation Law, 8 Del. C. § 211(a); (5) that the Defendants have improperly converted or, if the Transaction is effected, will have taken the prospective class members' assets and/or "Member's Equity"; (6) that the Defendants have caused a substantial diminution in the value of NASD membership, with imminent completion of such diminution; and (7) that the Defendants have deprived the prospective class members of their voting membership. *Id.* at 42,175 n.81. A Second Amended Complaint was filed on October 20, 2009.

pleadings relating to the lawsuit it filed against NASD. *Id.* at 42,175 n.81; Complaint at ¶¶ 76-80.

The United States District Court for the Southern District of New York, on May 2, 2007, dismissed Petitioner's Amended Complaint, holding that Petitioner had failed to exhaust administrative remedies by failing to challenge the bylaw amendment before the SEC. The Petitioner submitted its substantive claims to the SEC, asserting that NASD had obtained approval of its bylaw changes through a fraudulent proxy statement and other misleading statements and omissions, in violation of state law. Petitioner repeatedly asked the SEC to review documents bearing on NASD's fraudulent misrepresentations in its proxy statement, but the SEC refused to do so. Complaint at ¶¶ 76-80. Instead, the SEC ultimately approved the bylaw amendments without consideration of the proxy-related claims, explaining that it "ordinarily does not make determinations regarding state law issues." Exchange Act Release No. 56,145, 72 Fed. Reg. 42,169 at 42,188.

After Petitioner appealed the SEC's Approval Order to the United States Court of Appeals for the Ninth Circuit, the SEC requested a remand to allow it to clarify its order. On remand, the SEC clarified and amended its Approval Order, explaining that its approval of NASD's bylaw change was "not a definitive adjudication under state law" concerning Petitioner's "claim that the proxy statement was misleading," that it was "not purporting to decide a question of state law," and that it did "not intend

that its determination regarding the NASD's uncontradicted prima facie showing before the Commission that the proxy statement was not misleading be binding on a court in a claim based on state law." Exchange Act Release No. 56145A, 73 Fed. Reg. 32,377 (May 30, 2008). Rather, the SEC clarified that its Approval Order only found that the "NASD complied with its Certificate of Incorporation and By-Laws with respect to the proxy approval process and that the proposed amendments to its By-Laws were properly approved by NASD members." *Id.*

Petitioner then renewed its action in the Southern District of New York. Following a line of decisions in the Second Circuit that SROs are entitled to absolute immunity for "acts and forbearances . . . incident to the exercise of regulatory power," the district court dismissed Petitioner's Amended Complaint, holding that NASD and its officers were entitled to absolute immunity. Pet. App. 11a. Concluding that the consolidation of NASD and NYSE into FINRA, on its face, is "an exercise of the SRO's delegated regulatory functions and thus entitled to absolute immunity," the Court reasoned:

> Although the shareholder vote for which the proxy statement was issued did not constitute a vote on the regulatory consolidation itself, the approval of the by-law amendments was not only a necessary prerequisite to the completion of the that consolidation, but also was promoted as such in the proxy itself. . . . . Moreover, amendment of the

> by-laws itself falls within the parameters of NASD's statutory rulemaking authority. To focus on the fact that amendment to the by-laws also encompassed a financial component would be to miss the entire purpose of the reorganization – a regulatory purpose to which immunity applies.

Pet. App. 12a.

The Second Circuit affirmed. The Second Circuit identified the issue as "whether the proxy solicitation regarding amendments to the bylaws, which was incident to the consolidation itself, also constituted an exercise of NASD's regulatory function." The Second Circuit agreed with the district court that the proxy statement was "incident to" the exercise of regulatory authority because it was a "prerequisite to the completion of [the] consolidation." Pet. App. 7a. The Second Circuit also found it "significant" that "NASD cannot alter its bylaws without approval from the SEC, that the SEC is authorized to develop its own procedure for receiving input on new rules from those affected by any proposed change, and that the SEC retains discretion to amend the rules of any SRO." Pet. App. 8a (internal citations omitted).

III. WHEN COMBINED WITH THE SEC'S LIMITED AUTHORITY, THE SECOND CIRCUIT'S BROAD EXTENSION OF ABSOLUTE IMMUNITY TO THE CLAIMS IN THIS CASE ARISING FROM A MERGER, AND NOT FROM ANY REGULATORY ACTION, CREATES AN ENFORCEMENT GAP FOR NON-REGULATORY ACTS THAT VIOLATE STATE LAW

A. The Internal Affairs of Corporations Is Governed By State Law

As this Court consistently has made clear, state law governs the internal affairs of corporations. "Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law *expressly* requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation." *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 479 (1977) (emphasis in original, quoting *Cort v. Ash*, 422 U.S. 66, 84 (1975)). "No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations. . . ." *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 89 (1987) (citing Restatement (SECOND) of Conflict of Laws § 304 (1971)). "As we have said in the past, the first place one must look to determine the powers of corporate directors is in the relevant State's corporation law. . . . Corporations are creatures of state law, . . . and it is state law which is the font of corporate directors'

powers. By contrast, federal law in this area is largely regulatory and prohibitory in nature – it often limits the exercise of directorial power, but only rarely creates it." *Burks v. Lasker*, 441 U.S. 471, 478 (1979) (internal quotations omitted).

These principles are equally applicable to SROs. The management and practices of SROs are a part of the internal corporate governance traditionally regulated by States. For this reason, the SEC lacks authority under section 19 of the Exchange Act to regulate the governance and structure of SROs. *See, e.g.*, *The Business Roundtable v. SEC,* 905 F.2d 406, 408, 411-13, 415 (D.C. Cir. 1990).

State law cases confirm that issues of corporate governance, including challenges by Exchange members against SROs under state law, are to be decided under state law and not by the SEC. *See, e.g.*, *In re New York Stock Exchange/Archipelago Merger Litig*, 824 N.Y.S.2d 764, 2005 N.Y. Misc. LEXIS 3184 (N.Y. Sup. Ct. Dec. 5, 2005); *Ginsburg v. Philadelphia Stock Exchange, Inc.*, Civ. A. No. 2202-N (Del. Ch. Dec. 7, 2006); *Wey v. The New York Stock Exchange, Inc.*, No. 602510/05 (N.Y. Sup. Ct. April 10, 2007).

B. The SEC Lacks Authority to Resolve Matters of Corporate Governance or Other State Law Issues

The SEC would be invading the "firmly established" state jurisdiction over corporate governance issues, *see CTS Corp.*, 481 U.S. at 89, by deciding

non-regulatory issues concerning corporate governance that are only "incident to" NASD's regulatory activities. The Exchange Act is aimed solely at enforcement of federal law (rather than state law) and limits the SEC's authority over SROs to ensuring adequate performance of their actual delegated regulatory duties. *See, e.g.*, 15 U.S.C. §§ 78s(d)(1), (2). As a result, the SEC consistently has refused to consider state law claims, such as Petitioner's state law fraud claim based on the misrepresentations contained in NASD's proxy statement. *See, e.g.,* Exchange Act Release No. 51,252, 70 Fed. Reg. 10,442, 10,444 (Feb. 25, 2005) ("the Commission is not purporting to decide a question of state law"). Nothing in the Exchange Act provides the SEC with authority to oversee SROs with respect to private activities or matters concerning state law, including issues related to corporate structure and governance.

Recognizing the limits of its power and the appropriate jurisdiction of courts, the SEC approved the bylaw amendment without consideration of Petitioner's state law claims based on NASD's proxy statement, which it expressly left to the courts to decide, explaining that it "ordinarily does not make determinations regarding state law issues." *See* Exchange Act Release No. 56,145, 72 Fed. Reg. 42,169, 42,188 (July 26, 2007). Notably, the SEC clarified its approval of the bylaw amendment in this regard, stating that its approval is not the same as the definitive determination of state law issues that would be made at trial. *See* Exchange Act Release No. 56,145A,

73 Fed. Reg. 32,377, 32,377 (May 30, 2008) ("This finding as to NASD compliance and members" [sic] approval is not a definitive adjudication under state law, such as a trial court would make after an evidentiary hearing. . . . [T]he Commission is not purporting to decide a question of state law. The Commission does not intend that its determination regarding the NASD's uncontradicted prima facie showing before the Commission that the proxy statement was not misleading be binding on a court in a claim based on state law."). Nor may the SEC, when NASD acts outside of its regulatory authority, definitively resolve state law issues the way a court would. *See, e.g.*, *McDermott, Inc. v. Lewis*, 531 A.2d 206, 215 (Del. 1987) ("The internal affairs doctrine requires that the law of the state of incorporation should determine issues relating to internal corporate affairs."). While the SEC enforces the Exchange Act and SROs compliance with the Exchange Act, it does not enforce compliance with state law. Petitioner's claims related to the proxy statement do not allege any violations of the Exchange Act.

C. The Second Circuit's Holding Leaves An Enforcement Gap When An SRO's Actions Implicate State Law or Corporate Governance Issues Incident to An SRO's Regulatory Powers

The Second Circuit's application of absolute immunity to the claims in this case misconstrues the SEC's limited authority. In effect, the Second Circuit's

decision expands the SEC's authority beyond its limit, implicitly delegating to the SEC the authority to review state law, non-regulatory claims. The Second Circuit held that SROs enjoy absolute immunity from private damages suits for any acts that are "incident to" the exercise of their regulatory authority, including conduct in which the SRO acts pursuant to its private, proprietary interests and/or in violation of state law. In so holding, the Second Circuit attached significance to the fact that the SEC (1) must approve bylaw changes, (2) is authorized to develop its own procedures for receiving comments on new rules, and (3) retains discretion to amend an SRO's rules. Pet. App. 8a. The clear significance, to the Second Circuit, of this delegation of authority is that the SEC's oversight may serve as a surrogate for private litigation, allowing members to hold SROs accountable through SEC oversight.

But the Second Circuit based its decision on a view of the SEC's scope of authority at odds with the actual inability of the SEC to resolve state law claims. The obvious problem with reliance on SEC oversight is evident in the procedural history of the present case: The Second Circuit found absolute immunity for acts incident to NASD's regulatory authority, including Petitioner's fraud and other state law claims premised on NASD's proxy statement, thus closing the door to a private damages suit by NASD members; meanwhile, the SEC expressly refused to review NASD documents relating to the truth of the information contained in NASD's proxy statement

and refused to decide Petitioner's state law claims. As a result, NASD has been left free to defy state law without concern for a private suit or government action.

This enforcement gap that the Second Circuit has created, however, is not limited to the present case. Combining the Second Circuit's extension of the absolute immunity doctrine with the SEC's limited authority over corporate governance and state law leads to a scenario where any time an SRO is found to be acting "incident to" its regulatory authority, even where as here, the claims relate to matters of corporate governance traditionally left to the states, and commits a violation of state law, members will be unable to seek either a governmental or private remedy for the SROs violation. For instance, what if the claims in this case involved NASD's use and management of money it collects from its members? Under the Second Circuit's application of absolute immunity, substantial doubt exists whether a member could bring a claim under state law alleging misappropriation of such funds to the extent the funds were collected in some way "incident to" the NASD's regulatory authority. Based on the fact that regulatory fees fund regulatory activities, *see* 2008 Annual Report at pp. 11, 45, it is arguable that any claims concerning misappropriation or mismanagement of such fees could be found to be "incident to" regulatory activities, and thus, insulated from suit. At a minimum, the Second Circuit's holding creates uncertainty for lower courts over the circumstances in

which other SROs may be held accountable when acting outside of their regulatory capacity and what is meant by "incident to the exercise of regulatory powers."

IV. NASD MEMBERS NEED TO BE ABLE TO HOLD NASD ACCOUNTABLE FOR ITS NON-REGULATORY CONDUCT

If NASD members (or members of any SRO) cannot seek redress in court when NASD attends to matters relating to corporate governance, or issues regulated by state law, the members are, in fact, left without any recourse at all.

The Second Circuit's holding threatens the long-standing tradition of state regulation of corporate law and the states defining the relationship between organizations and their shareholders or members. Where SROs engage in non-regulatory acts that result in issues traditionally governed by state law, those acts now are absolutely immune from private litigation so long as the acts are even remotely connected with the SROs regulatory conduct. But when this occurs, members cannot count on the SEC's oversight of the SROs.

Even private organizations, such as the Chamber of Commerce, have expressed concern with the lack of FINRA's accountability to its members:

> Nongovermental organizations' influence has grown dramatically over the past few decades, but their level of accountability to

> their constituents has not kept pace. . . . FINRA's shift away from the traditional notions of a member-owned and controlled self-regulatory organization to a more governmental role has not brought with it the traditional checks and balances placed on government agencies. Transparency into FINRA's governance, compensation, and budgeting practices is extremely limited and superficial.

See Center for Capital Markets Competitiveness, U.S. Capital Markets Competitiveness: *The Unfinished Agenda*, Summer 2011,[5] pp. 21, 23.

Without the ability to seek redress against NASD (or any SRO) concerning violations of state law through private litigation, SROs can act without accountability to their members. It requires little imagination to list the number of non-regulatory acts that may be in some theoretical way connected with an SRO's regulatory functions.

NASD members have a prominent interest in a wide variety of non-regulatory acts by NASD, such as managing the millions of dollars in its investment portfolio (which comes from its members payment of fees and assessments, *see* 2008 Annual Financial Report at pp. 11-12), handling the elections of its Board of Governors and compensating its officers, that may be found "incident to" NASD's regulatory powers, and

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[5] *See* http://www.uschamber.com/sites/default/files/reports/1107_UnfinishedAgenda_WEB.pdf.

thus, subject to absolute immunity. For example, NASD manages an investment portfolio worth hundreds of millions of dollars. *See, e.g.*, 2008 Annual Report at pp. 6, 13, 33.

Similarly, NASD has maintained a line of credit agreement that provides it with the option of borrowing up to $100 million. *See* 2008 Annual Report at p. 59. This is not regulatory conduct, but the borrowed money could be used for a purpose "incident to" NASD's regulatory authority. Along the same lines, NASD pays large bonuses and incentive compensation to its officers. *See, e.g.*, 2008 Annual Report at pp. 15, 35. If any of these types of payments to officers were made "incident to" a regulatory activity, such as the substantial bonuses for NASD officers triggered by NASD's acquisition of NYSE, *see* Complaint at ¶ 14, NASD members would be prohibited from bringing a breach of fiduciary duty claim against NASD in state court, but would also receive no chance for relief before the SEC.

The claims in this case fall squarely on the non-regulatory, proprietary state law side of the ledger. Nothing in the Exchange Act required NASD to acquire the assets of a competitor. The bylaw amendment at issue may have been necessary for the acquisition of NYSE, but it was not regulatory action. Nor did either the SEC or the lower courts find the bylaw amendment to be regulatory action. Rather, the Complaint alleges that the bylaw amendment was the negotiated product of a business arrangement designed to appease one of the parties. Issuing a proxy statement, let alone one that violates state law, is not

regulatory action. It is not something that the SEC could have done. "SROs effectively 'stand in the shoes of the SEC' because they perform regulatory functions that would otherwise be performed by the SEC." *See, e.g.*, *DL Capital Group*, 409 F.3d at 95 (quoting *D'Alessio*, 258 F.3d at 105). The SEC, in fact, did not even review or approve the proxy statement, or consider NASD documents relating to the truth of the proxy statement. Petitioner alleges it asked the SEC to review documents related to NASD's misrepresentations, but the SEC refused to do so. Complaint at ¶¶ 76-80.

CONCLUSION

For these reasons, and for the reasons expressed in the petition of Standard Investment Chartered, Inc., this Court should grant the petition for a writ of certiorari and review the Second Circuit's decision in this case.

Respectfully submitted,

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