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Analysis & Perspective

NASD

'Entwinement' and NASD Enforcement Proceedings: Reexamining NASD's State-Actor Status in the Post-Brentwood Era

By Thomas K. Potter, III and Neely S. Griffith

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Mr. Potter is a partner with Burr & Forman LLP, resident in the Nashville, Tenn. office. He has handled securities litigation and regulatory enforcement matters for over 21 years. Ms. Griffith is an associate in the New Orleans office of Jones, Walker, Waechter, Poitevent, Carrère & Denègre, L.L.P.

NASD holds an unusual position in the nation's system of securities industry self-regulation. It is a private association and, at the same time, by congressional mandate, NASD is the primary enforcer of the federal securities laws and Municipal Securities Rulemaking Board (the "Board") rules as to registered broker-dealers. Regardless of which role it is performing, NASD does not (and has not been required to) afford its members federal due process rights in enforcement proceedings.¹ Each time its members have asserted them, NASD has reflexively maintained that it is a private association--not a state actor--and therefore free from the constitutional constraints that bind the Securities and Exchange Commission and other federal agencies.²

While NASD's insistence on private-actor status largely has been accepted as conventional wisdom, a host of developments--including changes in NASD's structure and authority resulting from the 1975 Securities Reform Act, failures in industry self-regulation, expansion of the Supreme Court's state-action doctrine, and growing awareness among the courts and the Commission of NASD's "quasi-governmental authority"--suggest the need to reevaluate NASD's rationales for denying its members due process. This article examines those developments and their effect on whether, and in what circumstances, NASD should be considered a state actor required to comply with federal due process requirements.³

Part II reviews the history of securities industry self-regulation and analyzes the changes in NASD's rulemaking and enforcement authority resulting from the 1975 Securities Reform Act. Part III considers the effect of the Supreme Court's decision in *Brentwood Academy*⁴ on earlier rationales supporting NASD's assertion of private-association status. Part IV examines recent decisions recognizing NASD's quasi-governmental authority and its entwinement in the governmental policies underlying the Exchange Act. Part V discusses the effect of these developments on whether NASD acts as a state actor when enforcing its member rules, the federal securities laws, and Board rules. Finally, Part VI concludes NASD should be considered a state actor subject to due process constraints when performing its congressionally mandated obligation to enforce the federal securities laws and Board rules.

I. NASD: An Evolving Institution

Like all SROs, NASD's authority and structure is the product of political compromise.⁵ After the Crash of 1929, Congress considered federal oversight of existing securities exchanges necessary to prevent price manipulation and restore investor confidence.⁶ The entrenched power of the exchanges and the lack of

federal resources required for direct regulation, however, made a strong federal presence in the country's securities markets politically and fiscally impractical. As a compromise, the Exchange Act established the Commission in a role supervising existing exchanges while delegating to those exchanges the primary responsibility for enforcing the federal securities laws.⁷ This stratagem, termed "cooperative regulation" by the Commission's first Chairman, Joseph Kennedy, had two significant advantages: First, it allowed for a "less-invasive" regulation of the securities industry by SROs "familiar with the nuances of securities industry operations";⁸ second, it permitted a swifter response to perceived securities violations by the exchanges than would be achieved by a Commission constrained by due process.⁹

Although Congress ultimately codified the securities industry's preference for self-regulation, it did not leave the Commission powerless.¹⁰ As recognized by former Commission Chairman William O. Douglas, for self-regulation to be effective, government must "keep the shotgun, so to speak, behind the door, loaded, well-oiled, cleaned and ready for use but with the hope that it would never have to be used."¹¹ Accordingly, the Exchange Act afforded the Commission supervisory jurisdiction over SRO enforcement actions, as well as concurrent authority to enforce violations of the federal securities laws.

Despite the best intentions of its proponents, "cooperative regulation" as initially envisioned fell short of achieving the goals of the Exchange Act. "Without the 'pointed stimuli' of vigilant Commission oversight," NASD and other SROs fell victim to "the natural tendency to protect member firms [over federal regulatory interests]."¹² In response to these inefficacies, Congress enacted the 1975 Securities Reform Act.¹³ This legislation allowed the Commission to modify SRO rules by "abrogating, adding to, or deleting from such rules as it deems necessary."¹⁴ In addition, the Act gave the Commission "the authority to review SRO enforcement actions, by approving, disapproving, or modifying such sanctions on its own motion or on the motion of an aggrieved party."¹⁵

The 1975 Amendments had the effect of "greatly broadening the Commission's authority over the SROs, and generally producing a much more substantial nexus between the Commission and the SROs."¹⁶ The Commission's increased regulatory oversight has enabled it "to persuade SROs to make rule changes 'voluntarily,' without the necessity of instituting formal proceedings."¹⁷ Further, when an SRO fails or refuses to comply with the federal securities laws, the Amendments give the Commission the power to compel the SRO to take action through the imposition of sanctions against the SRO.¹⁸ Together, these developments have diminished the distinctions between Commission and SRO action.

Despite the 1975 Act's sweeping changes, problems in the self-regulatory system persisted. In 1996, the Commission instituted administrative proceedings against NASD in response to allegations of collusion in OTC market-maker pricing.¹⁹ Ultimately, the Commission found that, as a result of "undue influence of Nasdaq market makers in the regulatory processes of the NASD," NASD had inadequately enforced the rules applicable to market makers and thereby failed to detect the anticompetitive conduct.²⁰ In its Settlement Agreement with the Commission, NASD agreed to a \$75 million overhaul of its examination, surveillance, and internal audit functions, which included enhanced systems for market surveillance and increased staffing in these areas. NASD further agreed to the participation of professional hearing officers to preside over disciplinary proceedings and, also, to provide for "the autonomy and independence of the regulatory staff of the NASD and its subsidiaries."²¹ The Commission subsequently discussed its investigative findings in its 21 (a) report which detailed a range of "fundamental concerns about the operations and structure of the NASD and the Nasdaq market."²² Among its findings was the need for even greater Commission oversight of NASD proceedings to counteract the inherent conflicts problems that continued to surface in the industry.²³

Beyond greater Commission involvement in NASD rulemaking and enforcement, the trend toward joint investigative efforts between the Commission and NASD also has brought NASD increasingly under the Commission's wing. NASD readily has joined forces with the Commission in investigating and prosecuting violators of the federal securities laws.²⁴ While this arguably serves investigative efficiency, it often has resulted in multiple, overlapping enforcement and investigative proceedings having the potential to undermine due process goals.

II. Brentwood and the Expansion of Supreme Court's State-Action Doctrine

While NASD and the Commission grew less distinct, the Supreme Court expanded its state-action jurisprudence. The Fourteenth Amendment compels due process rights only where the challenged action is fairly attributable to the state and not the private sector. Thus, as a threshold matter, a claimant must establish that the alleged deprivation was the result of state-action.

Just what constitutes state-action can be an extremely difficult question. When a purportedly private entity, like NASD, is alleged to have denied an individual due process, the "state-action" issue is a critical threshold

inquiry involving a detailed analysis of the relationship between the private entity and the state. In each instance, the key consideration is whether "there is 'such a close nexus between the State and the challenged action' that the seemingly private behavior 'may be fairly treated as that of the State itself.'"²⁵

Until recently, the Supreme Court's state-action jurisprudence was a hodgepodge of rigid, seemingly inconsistent, tests to determine whether a private entity should be treated as a state actor. In its 2001 *Brentwood Academy* decision, the Supreme Court attempted to bring clarity to the "conceptual disaster area"²⁶ of its state-action jurisprudence by expanding the state-action doctrine and abandoning rigid tests in favor of a fluid, multi-factored approach.²⁷ *Brentwood* introduced the concept of "pervasive entwinement," under which a purportedly private entity becomes a state actor if its conduct is entwined in governmental policies or the government is entwined in the entity's management or control.²⁸ The Court cautioned that what constitutes state-action is "a matter of normative judgment, and the criteria lack rigid simplicity."²⁹ The Court went on to identify "a host of facts" that bear on the determination, including whether (1) the "challenged action results from the exercise of coercive power," (2) the State provides "significant encouragement, either overt or covert," (3) the private entity "operates as a 'willful participant in joint activity with the State or its agents,'" (4) the private entity is "controlled by an 'agency of the State,'" (5) the private entity has been "delegated a public function by the State," (6) the private entity is "entwined with governmental policies," and (7) the government is "entwined in [the private entity's] management or control."³⁰ While each of these factors should be weighed in the determination, the Court was careful to point out that "no one fact can function as a necessary condition across the board for finding state-action; nor is any set of circumstances absolutely sufficient."³¹

Brentwood's expanded criteria for determining state-action undermines NASD's long-standing position that it remains merely a private association regardless of the role it is performing. In the past, NASD could assert its failure to satisfy the rigid criteria of the Supreme Court's pre-*Brentwood* state-action tests as grounds for retaining its status as a private association,³² but *Brentwood* now requires that the totality of circumstances surrounding the challenged action be considered.

III. A 'Quasi-Governmental Agency': Recent Decisions Support Finding Entwinement

Recent decisions indicate that both courts and the Commission increasingly recognize NASD's quasi-governmental authority and its entwinement with the government and its policies under the Exchange Act.

In its Dec. 13, 2005 decision in *NASD, Inc. v. SEC*, the United States Court of Appeals for the District of Columbia examined the relationship between NASD's dual roles as professional association and enforcer of the federal securities laws.³³ In *NASD, Inc.*, NASD initiated enforcement proceedings against two NASD members accused of engaging in a manipulative scheme in violation of Section 10(b) of the Exchange Act and Rule 10b-5, as well as various NASD conduct rules. An NASD hearing panel concluded that the two members had violated NASD conduct rules, but that NASD enforcement had produced insufficient evidence to prove the federal charges. The National Adjudicatory Counsel ("NAC") reversed the hearing panel's decision, in part, finding that the members had violated both the Exchange Act and NASD conduct rules. The members appealed to the Commission which, after conducting an independent review of the record, reversed the NAC's decision and dismissed the federal charges.³⁴

NASD sought judicial review of the Commission's determination pursuant to Section 25(a) of the Exchange Act, which permits "[a] person aggrieved by a final order of the Commission... [to] obtain review of the order in the United States Court of Appeals."³⁵ The District of Columbia Circuit held that NASD, acting in its role as a "first-level adjudicator" of Exchange Act violations, was not "a person aggrieved" under Section 25(a) and therefore had no right to seek judicial review of an adverse decision of the Commission.³⁶ In so holding, the court was careful to distinguish between NASD's "two institutional hats":

"By virtue of its statutory authority, ... [NASD] serves [both] as a professional association, promoting the interests of its members; [and] as a quasi-governmental agency, with express statutory authority to adjudicate actions against members who are accused of illegal securities practices and to sanction members found to have violated the Exchange Act or Securities and Exchange Commission ... regulations issued pursuant thereto."³⁷

In this latter role, the court observed, "NASD is the private equivalent of an ALJ, and "its enforcement process essentially supplants an enforcement action that might otherwise start with a hearing before an ALJ."³⁸ Thus, the court held, "NASD has no more authority than would an ALJ to seek review of a Commission decision under 25(a)," and it denied NASD's appeal for lack of jurisdiction.³⁹

The District of Columbia Circuit's opinion recognizes that, when performing its obligation to enforce the

federal securities laws, NASD acts as the Commission's surrogate.⁴⁰ Because of NASD's status as "a quasi-government agency"--or state actor--the Court concluded that it cannot be considered a private party entitled to an appeal of an adverse Commission decision under Section 25(a).⁴¹ *NASD v. SEC* explicitly recognized that NASD is entwined with the government and its policies when exercising its congressionally delegated adjudicatory and enforcement power under the Exchange Acts.

The Ninth Circuit's decision in *Credit Suisse First Boston Corp. v. Grunwald*⁴² illustrates the Commission's entwinement in NASD's management and control, as well as NASD's entwinement in federal policy. *Grunwald* decided NASD's Commission-approved arbitration procedures⁴³ preempted California's ethics standards for the selection of neutral arbitrators,⁴⁴ because they conflicted with NASD rules.⁴⁵ The Ninth Circuit's analysis rested in part on the extensive Commission oversight of NASD rulemaking, including the high level of cooperation between the Commission and NASD in developing NASD rules.⁴⁶ Observing that "approval of a proposed SRO rule reflects the Commission's determination that the proposed rule is consistent with the purposes of the Exchange Act," the Ninth Circuit held that those state laws which conflicted with Commission-approved NASD⁴⁷ rules were preempted as contrary to the goals of the Act.⁴⁸

Grunwald's emphasis on Commission oversight of NASD rulemaking in the wake of the 1975 Securities Reform Act suggests that NASD may be "entwined" in governmental policies even when implementing and enforcing its own member rules. If NASD indeed is a mere private membership association, then it could not preempt any state's laws. Instead, all rules adopted by the NASD carry the imprimatur of the federal government exercised through the Commission's notice and comment rulemaking. Though the Ninth Circuit's opinion cited policy considerations, it nonetheless rested squarely on the Commission's express entwinement with NASD's rulemaking function.

Support for NASD's status as a state actor when enforcing the federal securities laws can also be found in recent Eleventh Amendment jurisprudence. In *Weissman v. NASD*, the Eleventh Circuit held that NASD and its subsidiary, Nasdaq, enjoy absolute immunity from civil damages for conduct undertaken as a part of their "statutorily delegated adjudicatory, regulatory, and prosecutorial authority," but not when undertaking "for-profit commercial activity" which is "unsuited to an actor like the Securities and Exchange Commission."⁴⁹ In reaching its holding, the Eleventh Circuit observed that NASD and Nasdaq act as extensions of the Commission, or quasi-governmental agencies, when performing their delegated prosecutorial, regulatory, or enforcement functions.⁵⁰

Federal courts are not alone in recognizing NASD's dual roles as private association and quasi-government agency. The Commission also recently affirmed the notion that its cooperation with NASD may render NASD a state actor. In *Matter of Frank P. Quattrone*, the Commission held that enforcement activities by NASD during a joint investigation with the Commission could, in some instances, constitute state action implicating the Fifth Amendment privilege against self-incrimination.⁵¹ *Quattrone* involved a joint investigation by the Commission, NASD, and NYSE into allegations of spinning and research-analyst conflicts at twelve investment firms. NASD led the investigation of four of the investment firms, including Credit Suisse First Boston ("CSFB"), where Quattrone was employed.⁵² During the NASD investigation, the United States Attorney's Office for the Southern District of New York and the New York Attorney General's Office targeted Quattrone for possible improper document destruction at CSFB.⁵³ Shortly after this criminal investigation began, Quattrone received an NASD Rule 8210 Request to appear for an on-the-record interview. The request did not mention the document destruction investigation and contained the file number of the research analyst joint investigation.⁵⁴ About the same time, Quattrone received a letter from the Commission emphasizing the joint nature of NASD's investigation of Quattrone and the need for all three regulators to participate in any settlement.⁵⁵

Quattrone invoked his Fifth Amendment rights and refused to submit to NASD's on-the-record interview. NASD initiated enforcement proceedings against Quattrone, claiming that his refusal to testify violated NASD procedural and conduct rules.⁵⁶ Quattrone opposed NASD's motion for summary disposition, arguing a genuine issue of fact existed as to whether the Rule 8210 request constituted "state action" by virtue of NASD's joint investigation with the Commission. The hearing panel granted NASD's motion for summary disposition without affording Quattrone a hearing on the state-action issue, and the NAC affirmed.⁵⁷

On appeal, the Commission reversed, finding that the hearing panel erred in not affording Quattrone a hearing on the state-action issue. Although "the burden of demonstrating joint activities sufficient to render NASD a state actor [is] high," the Commission observed, "NASD should not have summarily dismissed the claim that, on the facts of this case, the Rule 8210 Request constituted state-action."⁵⁸ Not only was NASD admittedly leading a joint investigation into Quattrone's activities at CSFB at the time it issued the 8210 request, the Commission noted, but the Commission had also sent a letter to Quattrone shortly after NASD issued the request emphasizing the joint nature of the investigation.⁵⁹ This was enough to satisfy the

Commission that Quattrone had raised a genuine fact issue of joint action with the Commission, entitling him to a hearing on his Fifth Amendment claim. ⁶⁰

Likewise, in *Matter of the Application of Justin F. Ficken*, the Commission remanded to NASD an appeal filed by a former Wachovia broker who was barred from the industry after invoking his Fifth Amendment rights at an on-the-record interview on the grounds that the information sought by NASD was being forwarded to the Commission to assist the latter in an ongoing late-trading investigation against him. As in *Quattrone*, the Commission held that the NAC's summary rejection of the broker's Fifth Amendment argument without allowing him adequate opportunity to conduct discovery on the state-action issue constituted reversible error. ⁶¹

By expressly recognizing NASD's "quasi-governmental authority" when acting as enforcer of the federal securities laws, and the Commission's extensive involvement in NASD rulemaking, the courts and the Commission have acknowledged NASD's "entwinement"--at least in some instances--in the governmental policies underlying the Exchange Acts. These decisions compel reevaluation of the traditional rationales invoked by NASD to argue its status as a private association.

IV. NASD as State Actor

Although *Brentwood* and recent decisions suggest that NASD enforcement proceedings implicate due process concerns, they leave open the question of what type of NASD enforcement activities are so "entwined" with governmental policies as to trigger a finding of state-action. Under *Brentwood*, NASD is most entwined in governmental policies when it is carrying out its congressionally mandated obligation to enforce the federal securities laws and Board rules.

Though a dramatic departure from prior decisions, one could argue from *Grunwald* that the Commission's extensive oversight of, or "entwinement" in, NASD rulemaking as a result of the 1975 Reform Act renders NASD a state actor *whenever* it initiates enforcement proceedings of any sort. More likely, however, the Commission's mere approval of NASD member rules does not, under *Brentwood*, render NASD's enforcement of mere member rules state action. Even assuming the Commission's "entwinement" in NASD rulemaking, other factors--such as the absence of direct Commission coercion or encouragement with regards to the implementation and enforcement of NASD member rules, and NASD's historical (albeit waning) autonomy in implementing and enforcing its member rules--weigh against a finding of state action in such instances.

The situation is markedly different, however, when NASD is seeking to enforce the federal securities laws. In this capacity, NASD acts not merely as a private association promoting its members' interests, but rather as the Commission's surrogate carrying out a congressional mandate to ferret out and prosecute violations of federal law. As the *NASD v. SEC* court aptly observed, NASD's authority to enforce federal law is "entirely derivative" of the Commission, rendering NASD, in effect, "a quasi-governmental agency" when performing this public function. Viewed along with (1) the Commission's power to sanction NASD for its failure to enforce the federal securities laws, (2) the Commission's increased involvement in NASD's management and control as a result of the enactment of the 1975 Reform Act, and (3) the increased sharing of information between NASD and the Commission as a result of integrated enforcement efforts, NASD's statutorily delegated authority to enforce the federal securities law renders it deeply "entwined" in the governmental policies underlying the Exchange Acts. Accordingly, *Brentwood* requires that NASD be treated as a state actor when enforcing the federal securities laws.

NASD's enforcement of MSRB rules presents the most compelling case for state action. As regulator of the municipal securities markets, the Board was established directly by Congress⁶² to promulgate rules designed to implement the purposes of the Exchange Act in the underwriting, trading, and selling of municipal securities.⁶³ Although the scope of the Board's *rulemaking* authority is broad, Congress chose to delegate responsibility for the enforcement of Board rules for securities dealers solely and directly to NASD. Additionally, Congress *prohibited* NASD from promulgating its own rules governing municipal securities. This unique statutory arrangement--which carves out a role for NASD as the exclusive enforcer of those rules governing the municipal securities market--renders NASD integrally entwined in federal policies when enforcing Board rules.⁶⁴

Whether NASD can be considered a state actor in the post-*Brentwood* era depends in large part on the function it is performing, the level of Commission oversight of its challenged conduct, and the importance of that conduct in fulfilling the objectives of the Exchange Acts. While all of NASD's enforcement functions are critical to industry self-regulation, some of those functions--NASD's enforcement of the federal securities laws and Board rules--are more integral to governmental policies underlying the Exchange Act than others. Accordingly, when NASD is engaged in enforcement of the federal securities laws or Board rules, it should be considered a state actor subject to the constraints of federal due process.

V. Conclusion

Brentwood, coupled with the significant changes in the system of securities industry self-regulation in the years following the 1975 Reform Act, dramatically undermined the conventional wisdom that NASD remains a private association regardless of its function, the source of its authority, or the importance of its actions in carrying out the objectives of the Exchange Acts. By introducing the concept of "entwinement," *Brentwood* requires the courts and the Commission to look beyond formalistic distinctions and to examine the degree of NASD's entwinement in governmental policies when determining the question of state-action. That analysis shows that NASD is more deeply entwined in the governmental policies underlying the Exchange Act--and therefore should be considered a state actor--when it is fulfilling its congressionally mandated obligation to enforce the federal securities laws and Board rules.

¹ See, e.g., *D.L. Cromwell Investments, Inc. v. NASD Regulation, Inc.*, 279 F.3d 155, 162-163 (2d Cir. 2002) (NASD not required to afford members Fifth Amendment due process rights when carrying out its investigatory function); *Graman v. NASD*, 1998 WL 294022, *2-*3 (D.D.C. 1998) (NASD not constrained by federal due process in implementing and enforcing its Code of Arbitration Procedure against its members); *Desiderio v. NASD, Inc.*, 191 F.3d 198, 206-207 (2d Cir. 1999) (NASD is a private corporation, not a state actor, and therefore not required to afford its members federal due process rights).

The state-action issue and the applicability of federal due process rights is implicated in other SRO enforcement proceedings, including those initiated by the NYSE. See, e.g., *Richard J. Galuska v. NYSE*, 200 U.S. App. LEXIS 6370 (Apr. 3, 2000) (NYSE not a state actor for purposes of application of federal due process rights). For the sake of analytical simplicity, however, this article focuses exclusively on the issue of whether due process rights should apply in NASD proceedings, though, arguably, many of the considerations raised in this article with regards to NASD's state actor status apply with equal force to the NYSE and other SROs.

² See *id.* But NASD inconsistently claims governmental immunity when sued for its regulatory actions. See generally L. Orenstein, *The NASD and the Constitutional Right to Remain Silent*, 34 Rev. Sec. Comm. Reg. 225 (Oct. 2001).

³ The issue of NASD's state actor status, both before and after *Brentwood*, has been the subject of much scholarly debate. See, e.g., Sarah Rudolph Cole, *Fairness in Securities Arbitration: A Constitutional Mandate?* 26 Pace L. Rev. 73 (Fall 2005); 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 (2004); Richard L. Stone and Michael A. Perino, *Not Just a Private Club: Self Regulatory Organizations as State Actors When Enforcing Federal Law*, 1995 Colum. Bus. L. Rev. 453 (1995).

⁴ *Brentwood Academy v. Tennessee Secondary School Athletic Association*, 531 U.S. 288 (2001).

⁵ Stone & Perino, *supra* note 3, at 457.

⁶ See Friedman, *supra* note 3, at 728.

⁷ See Stone & Perino, *supra* note 3, at 457.

⁸ See SEC Release No. 34-50700 (Nov. 18, 2004), at *4.

⁹ See Joel Seligman, *Cautious Evolution or Perennial Irresolution: Stock Market Self-Regulation During the First Seventy Years of the Securities and Exchange Commission*, 59 Bus. Law 1347, 1361 (August 2004).

¹⁰ See Stone & Perino, *supra* note 3, at 457-458.

¹¹ Seligman, *supra* note 9, at 1361 (quoting Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* 439 (Aspen Pub. 3d ed. 2003)).

¹² See SEC Release No. 34-50700 at *4.

¹³ Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97, 108 (1975).

¹⁴ See Friedman, *supra* note 3, at 742 (quoting 15 U.S.C. 78s(c) (2002); Pamela Rogers Chepiga, *The Right to Exercise Fifth Amendment Privilege in Exchange and SRO Investigations: A Time for Reexamination*, 648 P.L.I./CORP 797, 808 (1989)).

¹⁵ See Friedman, *supra* note 3, at 743.

¹⁶ *Id.* at 744-745.

¹⁷ *Id.* at 742 (quoting Norman S. Poser, *Broker-Dealer Law & Regulation* §13.01 (2d ed. 2001); Stone & Perino, *supra* note 3, at 460).

¹⁸ See Friedman, *supra* note 3, at 744 (quoting Poser, *supra* note 17, §13.04; 15 U.S.C. §78u(d)).

¹⁹ See SEC Release No. 34-37538 (August 8, 1996).

²⁰ See *id.* at *2.

²¹ See *id.* at *3-*4.

²² Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market (Aug. 1996) at 1, *passim* (hereinafter, "21(a) Report").

²³ See 21(a) Report at 9-11.

²⁴ See Friedman, *supra* note 3, at 751-752.

²⁵ See *id.* (quoting *Jackson v. Metro. Edison Co.*, 419 U.S. 345, 351 (1974)); see also *Brentwood Acad. v. Tenn. Secondary School Athletic Ass.*, 531 U.S. 288, 295 (2001).

²⁶ Stone & Perino, *supra* note 3, at 465 (quoting Charles L. Black, Jr., *The Supreme Court 1966 Term, Forward: "State-action," Equal Protection, and California's Proposition 14*, 181 Harv. L. Rev. 69, 95 (1967)).

²⁷ See *Brentwood Acad.*, 531 U.S. 288 (2001). Prior to *Brentwood*, the Supreme Court's state-action jurisprudence was dominated primarily by two narrow, fairly inflexible tests. See Stone & Perino, *supra* note 3, at 466-467. Under the "coercion or encouragement" test, a private entity would be deemed a state actor for constitutional due process purposes if the claimant established that the challenged action was the result of coercion or encouragement by the State. See *id.* Extensive regulatory oversight of a private entity, without more, was rarely enough to warrant a finding of state action. See *id.* Nor was it sufficient for the State to merely "acquiesce" in the challenged conduct. See *id.* at 471 (citing *Flagg Bros, Inc. v. Brooks*, 436 U.S. 149, 164-166 (1978)). Rather, the complainant was required to establish the existence of coercion or encouragement to such a degree that it could be fairly said that "the state [was] specifically responsible for the particular activity of which the plaintiff complain[ed]." *Id.* at 467 (citing *Jackson v. Metropolitan Edison Co.*, 419 U.S. 345 (1974)).

Alternatively, a claimant could establish state action by showing that the challenged action arose from a delegated public function. See *id.* at 479. Under the public function test, "if a private actor [was] engaged in inherently governmental functions, or if the government delegates the operation of one of its traditional and quintessential functions to [the] private actor, then the private actor [would] be deemed to be a state actor subject to constitutional limitations." *Id.* (citing *NCAA v. Tarkanian*, 488 U.S. 179, 195 (1988)). "[O]nly those activities or functions that [were] operated almost exclusively by the government [were considered to be] state-actions." *Id.* at 482 (citing *Terry v. Adams*, 345 U.S. 461 (1953); *Smith v. Allwright*, 321 U.S. 649 (1944); *Nixon v. Condon*, 286 U.S. 73 (1932)).

²⁸ See Michael A. Culpepper, *A Matter of Normative Judgment: Brentwood and the Emergence of the "Pervasive Entwinement" Test*, 35 U. Rich. L. Rev. 1163, 1164 (2002). See also *Tancredi v. Metro. Life Ins. Co.*, 378 F.3d 220, 230 (2d Cir. 2004) (*Brentwood* "effectively broadened the state-action test to include 'entwinement' for the first time. In so doing, the Supreme Court acknowledged the flexibility of the test and observed that state-action existed even though 'the facts would not [have] support[ed] a finding of state-action under various criteria applied in other cases.'").

²⁹ See *Brentwood Acad.*, 531 U.S. at 295.

³⁰ See *id.* at 297.

³¹ See *id.* at 296.

³² For example, in both *D.L. Cromwell Investments, Inc. v. NASD Regulation, Inc.* and *Desiderio v. NASD*, NASD succeeded in showing that it did not qualify as a state actor under the formulaic tests that characterized the Supreme Court's pre-*Brentwood* state-action jurisprudence. See *D.L. Cromwell Investments, Inc.*, 279 F.3d 155, 206-207 (2d Cir. 2002) (NASD did not qualify as a state actor under either the coercion or encouragement test or the traditional public function test) (citing *Blum v. Yaretsky*, 457 U.S. 991, 1004-1005 (1982); *Jackson v. Metro. Edison Co.*, 419 U.S. 345, 351 (1974)); *Desiderio v. NASD*, 191 F.3d 198, 206-207 (2d Cir. 1999) (NASD did not qualify as a state actor under the "coercion" test) (citing *Blum v. Yaretsky*, 457 U.S. 991, 1004-1005 (1982)).

³³ See *NASD, Inc. v. SEC*, 431 F.3d 803 (D.C. Cir. 2005).

³⁴ See *id.*

³⁵ See *id.* at 809 (quoting 15 U.S.C. §78y(b)(1)).

³⁶ See *id.* at 812.

³⁷ *Id.* at 804.

³⁸ *Id.* at 812.

³⁹ *Id.* Notably, the court expressly reserved judgment on the issue "whether NASD can be a 'person aggrieved' in its capacity as a *professional association* with a cognizable stake in a SEC decision overruling a enforcement decision." *Id.* at 810 (emph. added).

⁴⁰ See *id.* at 811 ("The authority that NASD exercises in this realm as a first-level adjudicator of enforcement actions ultimately belongs to the SEC. ... '[S]elf-regulatory organizations have no authority to regulate independently of the SEC's control.") (quoting S. Rep. No. 94-75, at 23 (1975), as reprinted in 1975 U.S.C.C.A.N. 179, 201)).

⁴¹ See *id.* at 804.

⁴² 400 F.3d 1119 (9th Cir. 2005).

⁴³ The NASD standards were approved pursuant to 15 U.S.C. §78s(b), which requires Commission approval of all SRO rule changes. See 15 U.S.C. §78s(b).

⁴⁴ See 400 F.3d at 1121. The California standards set forth more stringent disclosure and disqualification requirements than the NASD arbitration rules. See *id.* at 1122 (citing Ethics Standards for Neutral Arbitrators in Contractual Arbitration, Cal. Rules of Court, Appen., Div. VI).

⁴⁵ See *id.* at 1128 ("Because the NASD arbitration rules at issue here were approved by the Commissions and because the California Ethics Standards conflict with the NASD arbitration disclosure rules, the California Ethics Standards are preempted by the NASD rules").

⁴⁶ See *id.* at 1132.

⁴⁷ The Ninth Circuit exempted from its holding NASD's "housekeeping" rules which do not require Commission approval and, in the court's view, were not adopted in furtherance of the purposes of the Exchange Act. See *id.* at n. 18 (citing 15 U.S.C. §78s(b)(3)(C)).

⁴⁸ See 400 F.3d at 1137. See also *NASD Dispute Resolution Inc. v. Judicial Council of California*, No. 02-17413 (9th Cir. May 30, 2007)(vacating appeal of prior suit as moot in light of *Grunwald* opinion); *Jeune v.*

Superior Court, 111 P.3d 954 (Cal. 2005)(same holding as *Grunwald*).

[49](#) 468 F.3d 1306, 1313 (11th Cir. 2006), *rehearing en banc granted* 481 F.3d 1295 (11th Cir. 2007)(vacating panel opinion pending rehearing).

[50](#) *See id.* at 1312-1313.

[51](#) *See* SEC Release No. 34-53547, at *6 (March 24, 2006).

[52](#) *See id.* at *1.

[53](#) *See id.* at *2.

[54](#) *See id.* at *2-*3.

[55](#) *See id.* at *3.

[56](#) *See id.*

[57](#) *See id.* at *4.

[58](#) *See id.* at *5-*6.


[59](#) *See id.* at *5.

[60](#) *See id.* at *6.

[61](#) *See id.* at *12. The Commission reached the same conclusion in *Matter of the Application of Warren E. Turk*, Rel. No. 34-55942 (June 22, 2007), remanding that proceeding to the NYSE.

[62](#) MSRB is a direct statutory creation of the government and, unlike the pre-Commission exchanges, not a preexisting membership organization.

[63](#) *See* 15 U.S.C. §78o-3(f).

[64](#) Because adherence to Board rules is a congressionally mandated condition to participation in a municipal securities career, courts have recognized that Board rules have the effect of federal law. *Blount v. SEC*, 61 F.3d 938, 941 (D.C. Cir. 1995) ("As a government-enforced condition to any participation in a municipal securities career, Rule G-37 constitutes government action of the purest sort."). Thus, when NASD enforces Board rules, its enforcement also must be regarded as "governmental action of the purest sort." 

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