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## The NYSE as State Actor?: Rational Actors, Behavioral Insights & Joint Investigations

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# The NYSE as State Actor?: Rational Actors, Behavioral Insights & Joint Investigations

## **Keywords**

State action, private entities, government actors, private actors, Self-regulatory organizations (“SRPs”), New York Stock Exchange (“NYSE”), State action doctrine, joint investigations

## ARTICLES

# THE NYSE AS STATE ACTOR?: RATIONAL ACTORS, BEHAVIORAL INSIGHTS & JOINT INVESTIGATIONS\*

STEVEN J. CLEVELAND\*\*

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## INTRODUCTION

Certain constitutional guarantees generally restrict the actions of governmental entities, not private entities.<sup>1</sup> Situations arise, however, when private entities take on the governmental mantle and thus are properly treated as the government. In such situations, the Constitution generally limits the actions of those private entities. Anything but clear is the dividing line between those situations in which private actors are simply private actors and those situations in which private actors are treated as governmental actors.<sup>2</sup> This area of law has been described as a disaster

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1. See U.S. CONST. amend. IV (“The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated . . .”); U.S. CONST. amend. V (“No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, . . . nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law . . .”); *Skinner v. Ry. Labor Executives’ Assoc.*, 489 U.S. 602, 613-14 (1989) (“The [Fourth] Amendment guarantees the privacy, dignity, and security of persons against certain arbitrary and invasive acts by officers of the Government . . . [T]he Fourth Amendment does not apply to a search or seizure, even an arbitrary one, effected by a private party on his own initiative . . .”); *San Francisco Arts & Athletics, Inc. v. U.S. Olympic Comm.*, 483 U.S. 522, 542 & n.21 (1987) (emphasizing that the Fifth Amendment applies to governmental actors); ERWIN CHERMERINSKY, *CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES* 385 (1997) (introducing the state action doctrine). One exception is the Thirteenth Amendment, which regulates private conduct. See U.S. CONST. amend. XIII, § 1 (“Neither slavery nor involuntary servitude . . . shall exist in the United States . . .”); *Edmonson v. Leesville Concrete Co.*, 500 U.S. 614, 619 (1991) (“With a few exceptions, such as the provisions of the Thirteenth Amendment, constitutional guarantees of individual liberty and equal protection do not apply to the actions of private entities.”); CHERMERINSKY, *supra*, at 387-88 (detailing that Congress may pass laws that “require that private conduct meet the same standards that the Constitution requires of the government”).

2. See CHERMERINSKY, *supra* note 1, at 388 (noting that “[b]ecause the government is involved in so much private conduct, seemingly arbitrary lines have to be drawn as to what constitutes state action”).

area<sup>3</sup> and the justices appear willing to acknowledge the attendant uncertainty.<sup>4</sup>

Courts struggle with the issue for a number of reasons. On the one hand, the constitutional text, our history, and policy rationales support the conclusion that private actors are immune from the strictures of the Constitution.<sup>5</sup> On the other hand, should private actors that take on the role of the government, with the knowledge and endorsement of the government, be immune from the constitutional strictures applicable to the government?

Hoping to benefit from protections afforded by the Constitution, parties disciplined by self-regulatory organizations (“SROs”)—such as the New York Stock Exchange (“NYSE”)—have sought to have the actions of those entities attributed to the government. Initially, courts accepted those claims, but as the “state action” doctrine evolved, such claims generally have proved unsuccessful. However, joint investigations—investigations involving both the government and SROs—may provide circumstances in which governmental influence is sufficient such that private actions may be attributed to the government.

Part I.A discusses early court decisions that attributed the actions of private SROs to the government due to their accountability to the government and its pervasive regulations. Part I.B describes the evolution of the “state action” doctrine and current bases for attributing private actions to the government. Part I.C references recent decisions in which courts generally have not attributed the actions of SROs to the government. Part II addresses the reasons why any rational SRO (independent of federal regulation, coercion, or significant encouragement) would create, police,

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3. See, e.g., *id.* (asserting that “because the government always can regulate private behavior, it is difficult to articulate principles as to when the failure to do so is a constitutional violation”); Charles Black, *The Supreme Court, 1966 Term, Foreword: “State Action,” Equal Protection, and California’s Proposition 14*, 81 HARV. L. REV. 69, 70, 95 (1967); Alan R. Madry, *Private Accountability and the Fourteenth Amendment; State Action, Federalism and Congress*, 59 MO. L. REV. 499, 500 (1994) (seeking to resolve the “quagmire” of the state action doctrine, whose problems are “far deeper” than mere lack of coherence).

4. See, e.g., *Brentwood Acad. v. Tenn. Secondary Sch. Athletic Ass’n*, 531 U.S. 288, 295 (2001) (“What [private actions are] fairly attributable [to the government] is a matter of normative judgment, and the criteria lack rigid simplicity.”); *Lebron v. Nat’l R.R. Passenger Corp.*, 513 U.S. 374, 378 (1995) (describing that deciding when a court may deem a private action an act of the state as “difficult terrain”); *Edmonson v. Leesville Concrete Co.*, 500 U.S. 614, 632 (1991) (O’Connor, J., dissenting) (“[O]ur cases deciding when private action might be deemed that of the state have not been a model of consistency.”); *Jackson v. Metro. Edison Co.*, 419 U.S. 345, 350 (1974) (recognizing that the issue of whether conduct is private or that of the state “admits of no easy answer”).

5. See CHEMERINSKY, *supra* note 1, at 389 (stating that the Constitution’s text seems to restrictively apply to the government). But see Akil R. Amar, *Fourth Amendment First Principles*, 107 HARV. L. REV. 757, 757 (1994) (claiming that as a “matter of text, history, and plain old common sense,” modern Fourth Amendment case law is “an embarrassment”).

and enforce private rules that address the two principal goals of federal securities regulation—disclosure and the prevention of fraud. Because evidence suggests that decision-making processes are not perfectly rational, Part III sets forth certain cognitive biases that may impact the decisions of SROs and their enforcement officials, and suggests that such biases may lessen any coercive influence stemming from accountability to the government. Because of the increasing frequency of joint investigations involving the government and SROs, Part IV examines joint investigations and references situations in which attribution of private actions to the government may be appropriate.

### I. STATE ACTION AND SROS

When parties have challenged the actions of an SRO on constitutional grounds, their arguments have concentrated on illegal seizures in violation of the Fourth Amendment and violations of the Fifth Amendment in the form of compelled testimony or denials of due process. Early court decisions concluded that the NYSE, the American Stock Exchange (“AMEX”), and the National Association of Securities Dealers (“NASD”) should be treated as governmental actors. The law and jurisprudence, however, evolved. Since recent evolution of the state action doctrine, courts have reversed course and now routinely conclude that the actions of NYSE, AMEX, and NASD should not be attributed to the government.

#### A. *Early Decisions Regarding SROs and State Action*

Courts that concluded that the NYSE, AMEX, and NASD should be treated as governmental actors based such conclusions either upon the nature and degree of federal regulation of national securities exchanges and registered securities associations, or on the Supreme Court’s decision in *Burton v. Wilmington Parking Authority*.<sup>6</sup> Below is a brief description of that federal regulation and a brief sampling of those decisions.

##### 1. *Federal regulation*

Congress erected a regulatory scheme for national securities exchanges and associations of brokers and dealers. The congressional scheme sets forth requirements regarding the registration processes, the rule-making processes, and the disciplinary processes of such exchanges and associations.

###### a. *Registration*

Congress effectively required the registration of exchanges by

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6. 365 U.S. 715 (1961).

prohibiting brokers and dealers from trading securities on unregistered exchanges.<sup>7</sup> By filing an application with the Securities and Exchange Commission (“SEC” or “Commission”), an exchange may be registered as a “national securities exchange.”<sup>8</sup> Congress prohibited the Commission from approving such an application unless the exchange, among other things, agreed to enforce compliance with the Securities Exchange Act of 1934 (“Exchange Act” or “‘34 Act”), its rules and regulations, and the rules of such exchange.<sup>9</sup> Moreover, Congress required that such exchange’s rules be designed to, among other things, prevent fraud and generally protect investors and the public interest.<sup>10</sup> To assist in achieving these goals, Congress required that the rules of a national securities exchange provide for the discipline of any member that violates those laws or rules.<sup>11</sup>

Following its registration as a national securities exchange,<sup>12</sup> the exchange must deny membership to any entity that is not a registered broker or dealer<sup>13</sup> or any person that is not, or is not associated with, a registered broker or dealer.<sup>14</sup> Although the Commission does not approve

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7. 15 U.S.C. § 78e (2000).

8. *Id.* § 78f(b)(1); 17 C.F.R. § 240.6a-1 (2005) (directing usage of Form 1 for the registration application for national securities exchanges). Nine exchanges are registered as “national securities exchanges”—AMEX, Boston Stock Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, International Securities Exchange, National Stock Exchange (formerly the Cincinnati Stock Exchange), NYSE, Pacific Exchange, and the Philadelphia Stock Exchange. *See* U.S. Securities and Exchange Commission, National Securities Exchanges (Aug. 16, 2004), <http://www.sec.gov/answers/exchanges.htm>. The Commission exempted from registration requirements the Arizona Stock Exchange and virtual exchange (formerly Tradepoint) due to their limited trading volume. 15 U.S.C. § 78e(2).

9. *See* 15 U.S.C. § 78f(b)(1); *see also id.* § 78o-3(b)(2) (governing registered securities associations, such as the NASD).

10. *See id.* § 78f(b)(5); *see also id.* § 78o-3(b)(6) (describing the legislative intent of laws governing registered securities associations).

11. *See id.* § 78f(b)(6); *see also id.* § 78o-3(b)(6) (governing registered securities associations); *id.* § 78f(b)(6) (authorizing expulsion, suspension, limitations, fine, censure, or any other fitting sanction).

12. *See id.* § 78s(a)(1) (describing that upon the filing of an application for registration as a national securities exchange or registered securities association, the SEC “shall publish notice of such filing and afford interested parties an opportunity to submit written data, views, and arguments concerning such application”). Within a specified time period, the SEC must either grant the application or initiate proceedings to determine whether the application should be denied. *Id.* If the SEC determines that a national securities exchange or registered securities association ceases to do business in the capacity specified in its application for registration, the SEC must cancel such registration. *See id.* § 78s(a)(3).

13. From a practical perspective, Congress requires brokers and dealers to register with the SEC. Such is the case because Congress prohibits any broker or dealer to effect, or attempt to effect, a transaction of any security by means of interstate commerce unless such broker or dealer is registered in accord with the ‘34 Act. *See id.* § 78o(a); 17 C.F.R. § 240.15b7-1 (2005). By a rule promulgated by the SEC, brokers and dealers register by filing Form BD with the NASD. 15 U.S.C. § 78o(b); 17 C.F.R. § 240.15b1-1. Even if a broker or dealer is not a member of a national securities exchange, the SEC may require any such broker or dealer that regularly effects transactions on such an exchange to comply with rules of the exchange to maintain fair and orderly markets, to ensure equal regulation or as appropriate to protect investors and the public. *See* 15 U.S.C. § 78f(f).

14. *See* 15 U.S.C. § 78f(c)(1). Such exchange may deny membership to any registered

the admission of a member to an exchange,<sup>15</sup> the Commission may deny membership to protect the public.<sup>16</sup> Additionally, the Commission may review an exchange's decision regarding an application for membership.<sup>17</sup>

*b. Rules*

Each SRO, including any national securities exchange and any registered securities associations,<sup>18</sup> must file with the Commission any proposed rule or any proposed change in, addition to, or deletion from the rules of such SRO.<sup>19</sup> Congress required the Commission, with respect to an SRO's proposed rule or amendment, to comply with a notice-and-comment procedure.<sup>20</sup> Congress, with limited exceptions,<sup>21</sup> prohibits any proposed rule or amendment from becoming effective without the Commission's approval.<sup>22</sup>

Despite congressional authorization empowering SROs to propose new rules,<sup>23</sup> Congress empowered the Commission to abrogate, add to, and delete the rules of an SRO as necessary or appropriate to ensure the fair

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broker or dealer or any natural person associated with a registered broker or dealer, if, for example, such broker or dealer does not meet the requisite standard of financial responsibility or such natural person associated with such broker or dealer does not meet the requisite standards of training, experience, and competence. *See id.* § 78f(c)(2), (3).

15. *See, e.g.,* David A. Lipton, *The SEC or the Exchanges: Who Should Do What and When? A Proposal to Allocate Regulatory Responsibilities for Securities Markets*, 16 U.C. DAVIS L. REV. 527, 538 n.42 (1983).

16. *See* 15 U.S.C. § 78f(c)(2).

17. *See id.* § 78s(d)(1); *id.* § 78s(f) (stating the procedural requirements of such review).

18. *See id.* § 78c(a)(26) ("The term 'self-regulatory organization' means any national securities exchange [or] registered securities association . . .").

19. *See id.* § 78s(b)(1).

20. *See id.*

21. *See, e.g., id.* § 78s(b)(3)(A) ("[A] proposed rule change may take effect upon filing with the Commission if designated by the self-regulatory organization as (i) constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the self-regulatory organization, (ii) establishing or changing a due, fee, or other charge imposed by the self-regulatory organization, or (iii) concerned solely with the administration of the self-regulatory organization or other matters which the Commission . . . may specify . . ."); *id.* § 78s(b)(3)(B) ("[A] proposed rule change may be put into effect summarily if it appears to the Commission that such action is necessary for the protection of investors, the maintenance of fair and orderly markets, or the safeguarding of securities or funds.").

22. *See id.* § 78s(b)(1). Within a specified period of time, the SEC shall either approve the proposed rule or rule change or initiate proceedings to determine whether the proposed rule change should be disapproved. *Id.* § 78s(b)(2). Although Congress empowered the SEC with discretion, such discretion is not unbridled as the SEC must approve a proposed rule change if consistent with the requirements of the '34 Act and the related rules. *Id.*

23. *See* S. REP. NO. 73-792, at 13 (1934) ("[T]he initiative and responsibility for promulgating regulations pertaining to the administration of their ordinary affairs remain with the exchanges themselves. It is only where they fail adequately to provide protection to investors that the Commission is authorized to step in and compel them to do so."). The intention was "one of 'letting the exchanges take the leadership with Government playing a residual role.'" *Silver v. New York Stock Exch.*, 373 U.S. 341, 352 (1963) (quoting Justice Douglas in his prior role as Chairman of the SEC).

administration of the SRO, to conform its rules to the requirements of the Exchange Act and the applicable regulations.<sup>24</sup>

*c. Disciplinary proceedings by an SRO*

Congress also required that any SRO have rules providing for the discipline of its members and associated persons for violations of the Exchange Act, the related federal rules, or the rules of such SRO.<sup>25</sup> Congress requires that the SRO (1) provide notice of a disciplinary proceeding against a member or person associated with a member as well as an opportunity to defend against such charges<sup>26</sup> and (2) support any disciplinary sanction by setting forth the violation, the specific provision or rule that was violated, and reasons for imposing the sanction.<sup>27</sup> If any SRO imposes a final disciplinary sanction, Congress requires the SRO to notify promptly the Commission.<sup>28</sup> Moreover, Congress empowered the

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24. See 15 U.S.C. § 78s(c) (requiring the Commission to comply with notice-and-comment procedures). Congress also required that any amendment to the rules of an SRO made by the Commission be considered part of the rules of such SRO, not of the Commission. However, Congress does not offer the final word. In *Lebron*, the Supreme Court stated:

If Amtrak is, by its very nature, what the Constitution regards as the Government, congressional pronouncement that it is not such can no more relieve it of its First Amendment restrictions than a similar pronouncement could exempt the Federal Bureau of Investigation from the Fourth Amendment. The Constitution constrains government action by whatever instruments or in whatever modes that action may be taken. . . . That the Congress chose to call [the entity in question] a corporation does not alter its characteristics so as to make it something other than what it actually is.

*Lebron v. Nat'l R.R. Passenger Corp.*, 513 U.S. 374, 392 (1995) (internal citations and quotations omitted).

25. See 15 U.S.C. § 78f(b)(6) (governing a national securities exchange's rules for members and associated persons who are in violation of the provisions of the statute); *id.* § 78o-3(b)(7) (governing registered securities associations). Such rules must provide a "fair procedure" for the disciplining of members and persons associated with members. See *id.* § 78f(b)(7) (governing national securities exchanges); *id.* § 78o-3(b)(8) (governing registered securities associations); see also *Silver*, 373 U.S. at 352 (describing the development of the "federally mandated duty of self-policing by exchanges").

26. See 15 U.S.C. § 78f(d)(1); *id.* § 78o-3(h)(1). But see *id.* § 78f(d)(3) (setting forth the circumstances under which a national securities exchange may summarily discipline a member or person associated with a member); *id.* § 78o-3(h)(3) (dictating the same circumstances for a registered securities association).

27. See *id.* § 78f(d)(1); *id.* § 78o-3(h)(1). Somewhat similar procedures apply to proceedings by an SRO in determining whether a person shall be denied membership, barred from becoming associated with a member, or prohibiting or limiting access to services of the SRO. See *id.* § 78f(d)(2); *id.* § 78o-3(h)(2). Under certain limited circumstances, an SRO may summarily discipline a member or person associated with a member. See *id.* § 78f(d)(3); *id.* § 78o-3(h)(3). Nonetheless, Congress required that, in certain circumstances, a person aggrieved by summary action be afforded a hearing. See *id.* § 78f(d)(3); *id.* § 78o-3(h)(3). Moreover, Congress empowered the SEC to stay any summary action on its own motion or upon application of any such aggrieved person if the SEC determines that such stay is consistent with the public interest and the protection of investors. See *id.* § 78f(d)(3); *id.* § 78o-3(h)(3).

28. See *id.* § 78s(d)(1) (mandating "the appropriate regulatory agency" to receive notice of any final disciplinary sanction and to review, among other things, an SRO's decision to

Commission to review such disciplinary action,<sup>29</sup> with those disciplined entitled to notice and a hearing.<sup>30</sup> After review,<sup>31</sup> the Commission may then affirm, modify, or set aside the sanction or remand to the SRO for further proceedings.<sup>32</sup>

*d. Federal discipline of SROs*

Congress empowered the Commission to discipline an SRO for any lapses in fulfilling federally imposed obligations. The Commission—consistent with the public interest and the protection of investors—may relieve an SRO of any responsibility under the Exchange Act to enforce compliance with any of its provisions or the related regulations.<sup>33</sup> Moreover, Congress empowered the Commission to suspend or revoke the registration of such SRO, or to censure or impose limitations upon the activities, functions, and operations of such SRO.<sup>34</sup>

*2. Early court decisions*

In the 1970 decision of *Harwell v. Growth Programs, Inc.*,<sup>35</sup> the U.S. District Court for the Western District of Texas concluded that the actions of the SRO should be attributed to the government.<sup>36</sup> In reaching its conclusion, the court focused on the federal statutory regime. The court noted Congress authorized the establishment of a regulatory association

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deny membership or prohibit or limit access to the SRO's services).

29. *See id.* § 78s(d)(2).

30. *See id.* § 78s(e)(1) (noting that the hearing “may consist solely of consideration of the record before the self-regulatory organization and opportunity for the presentation of supporting reasons to affirm, modify, or set aside the sanction . . .”).

31. *See id.* § 78s(e)(1)(A) (requiring that the Commission, in order to confirm an SRO's sanctions upon review: (1) make findings on whether such member or associated person engaged in the acts or omissions as found by the SRO; (2) determine whether such acts or omissions constitute violations of the '34 Act, the accordant rules and regulations promulgated, or the rules of the SRO; and (3) confirm that such provisions were applied in a manner consistent with the purposes of the Exchange Act).

32. *See id.* § 78s(e)(1); *see also id.* § 78y(a)(1) (“A person aggrieved by a final order of the Commission . . . may obtain review of the order in the United States Court of Appeals for the circuit in which he resides . . . by filing in such court . . . a written petition requesting that the order be modified or set aside in whole or in part.”).

A person adversely affected by a rule of the Commission promulgated pursuant to [15 U.S.C. § 78f], . . . [15 U.S.C. § 78o-3], . . . or [15 U.S.C. § 78s] of this title may obtain review of this rule in the United States Court of Appeals for the circuit in which he resides . . . by filing in such court . . . a written petition requesting that the rule be set aside.

*Id.* § 78y(b)(1).

33. *See id.* § 78s(g)(2).

34. *See id.* § 78s(h)(1) (authorizing the Commission to impose sanctions against an SRO after finding that the SRO violated or was unable to comply with any provision of the Exchange Act, the Exchange Act's rules or regulations, or the SRO's own rules).

35. 315 F. Supp. 1184 (W.D. Tex. 1970).

36. *See id.* at 1187-88 (regarding the NASD as more than an ordinary non-profit corporation, but rather a mechanism of regulation authorized by the Exchange Act).

over brokers and dealers to prevent unjust and inequitable trading in securities.<sup>37</sup> The SRO, according to the findings of the court, was “effectively a Congressionally-created regulatory organization governing conduct in the over-the-counter securities market.”<sup>38</sup> Moreover, the court referenced Congress’s bestowment on the Commission of “broad powers of review over virtually every phase of the association’s activity,” including rule-making.<sup>39</sup> To the court, it was “quite clear that [Congress] empowered the [SRO] to act—subject to pervasive supervision by the SEC—as a quasi-governmental agency charged with the responsibility of promoting, and enforcing, ‘just and equitable principles of trade’ . . . .”<sup>40</sup> The court emphasized that the SRO issued a rules interpretation only after consultation with the SEC and its express approval.<sup>41</sup> The court held that, based upon such consultation and approval, the “SEC was so deeply involved in the formulation of the interpretation, . . . [the SRO]’s rulemaking action . . . must be considered a ‘valid exercise of the rightful authority of the Government.’”<sup>42</sup>

As a consequence of the court’s holding, the protections of the Fifth Amendment applied to the SRO’s action. In reaching its conclusion, the court relied upon the federal statutory scheme, without reference to any cases addressing the issue of the circumstances under which private action should be attributed to the government.<sup>43</sup> Soon after the *Harwell* court concluded that the NASD was a governmental actor, the U.S. Court of Appeals for the Fifth Circuit turned its attention to a national securities exchange.

In *Intercontinental Industries, Inc. v. American Stock Exchange*,<sup>44</sup> the Fifth Circuit considered whether the American Stock Exchange was a governmental actor.<sup>45</sup> A company asserted the applicability of the Due Process Clause of the Fifth Amendment to the exchange’s determination to de-list the securities of that company.<sup>46</sup> Citing a host of Congressional

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37. *See id.* at 1188.

38. *Id.*

39. *Id.*

40. *Id.*

41. *Id.* at 1187.

42. *Id.* at 1191.

43. For reasons other than the issue of state action, the *Harwell* Court does cite *Handley Inv. Co. v. SEC*, 354 F.2d 64 (10th Cir. 1965), when addressing petitioner’s due process arguments, the *Handley* court writes “[l]ittle need be said.” *Handley*, 354 F.2d at 66.

44. 452 F.2d 935 (5th Cir. 1971).

45. *Id.*

46. At the time of the dispute, the “[e]xchange rules simply [did] not contain any provision governing the hearing to be conducted in connection with a delisting . . . .” *Id.* at 940. Today, however, the rules of AMEX set forth delisting procedures. *See generally* American Stock Exchange, AMEX Rule ¶ 10.379A, Section 1010, Procedures for Delisting and Removal (2005), <http://wallstreet.cch.com/americanstockexchangeamex/amexcompanyguide/part10/suspensionanddelistingprocedures100>

requirements regarding the regulation of national securities exchanges and the role of the SEC,<sup>47</sup> the court concluded that the “intimate involvement” of the SRO with the SEC “brings it within the purview of the Fifth Amendment controls over due process.”<sup>48</sup> Continuing, the court wrote that the “position that constitutional due process is not required since the Exchange is not a governmental agency is clearly contrary to [*Burton v. Wilmington Parking Authority*] . . . .”<sup>49</sup>

The *Intercontinental* decision spawned progeny. Several months after the Fifth Circuit’s decision, the U.S. District Court for the Southern District of New York was asked by Crimmins, an associated member of AMEX, to enjoin a disciplinary proceeding by the exchange.<sup>50</sup> Crimmins asserted that he was being denied counsel in violation of the Due Process Clause of the Fifth Amendment.<sup>51</sup> Rejecting the SRO’s argument that the Fifth Amendment was inapplicable, the court commented that

9,1010,1011/16260003CD.asp.

47. *Intercontinental*, 452 F.2d at 941 n.9 (

1. The Exchange must register with the Commission. (Section 6, 15 U.S.C. § 78f).
2. The Exchange’s rules must be submitted to the Commission and are subject to alteration or supplementation by the Commission. (Section 6(a), 15 U.S.C. § 78f(a); Section 19(b), 15 U.S.C. § 78s(b)).
3. The Exchange’s members are closely regulated by the Commission. (Sections 9(a), 11, 17(a) and 19(a)(3), 15 U.S.C. §§ 78i(a), 78k, 78q(a), 78s(a)(3)).
4. A security may not be delisted without application to the Commission. (Section 12(d), 15 U.S.C. § 78l(d)).
5. The Exchange may be suspended or its registration withdrawn by the Commission. (Section 19(a)(1), 15 U.S.C. § 78s(a)(1)).

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48. *Id.*

49. *Id.* (citing two cases that rely upon *Burton*: *Colon v. Tompkins Square Neighbors, Inc.*, 294 F. Supp. 134 (S.D.N.Y. 1968) and *McQueen v. Druker*, 438 F.2d 781 (1st Cir. 1971)). The reach of *Burton*, however, has been limited. See *Edmonson v. Leesville Concrete Co.*, 500 U.S. 614, 637 (1991) (O’Connor, J., dissenting) (opining that the “vitality of *Burton* beyond its facts” did not apply to the case at hand); *Jackson v. Metro. Edison Co.*, 419 U.S. 345, 358 (1974) (emphasizing that “differences in circumstances beget differences in law” and that *Burton*’s holding is limited to lessees of public property); Thomas P. Lewis, *Burton v. Wilmington Parking Authority—A Case Without Precedent*, 61 COLUM. L. REV. 1458, 1462-67 (1961) (describing the specific circumstances of *Burton* and noting the importance of the Court’s admonition limiting the scope of the decision); Thomas R. McCoy, *Current State Action Theories, the Jackson Nexus Requirement, and Employee Discharges by Semi-Public and State-Aided Institutions*, 31 VAND. L. REV. 785, 808-09 (1978) (discussing the Court’s post-*Burton* refinement of the symbiosis principle and its questioning of the decision’s viability). But see Robert F. Nagel, *The Formulaic Constitution*, 84 MICH. L. REV. 165, 199 (1985) (offering support for *Burton* and arguing that its failure to formalize a rule was not as dire as critics had made it out to be).

50. See *Crimmins v. Am. Stock Exchange, Inc.*, 346 F. Supp. 1256, 1258 (S.D.N.Y. 1972).

51. See *id.* at 1259. Today, AMEX rules provide that a respondent in disciplinary proceedings has the right to be represented by legal or other counsel throughout the proceeding. See Am. Stock Exch., AMEX ¶ 9907, Rule 7, Notice of Representation (2005), <http://wallstreet.cch.com/AmericanStockExchangeAMEX/RulesofProcedureinDisciplinaryMatters/default.asp>; Am. Stock Exch., AMEX ¶ 9910, Rule 10, Representation by Counsel (2005), <http://wallstreet.cch.com/AmericanStockExchangeAMEX/RulesofProcedureinDisciplinaryMatters/default.asp>.

[T]he day [was] long gone when a national stock exchange c[ould] be considered a private club when it conducts disciplinary proceedings against its members or their employees. When an exchange conducts such proceedings under the self-regulatory power conferred upon it by the 1934 Act, it is engaged in governmental action, federal in character . . . .<sup>52</sup>

The court supported its conclusion by relying upon *Intercontinental* (which relied heavily upon *Burton*) and the nature and degree of federal regulation of national securities exchanges.

Akin to *Crimmins*, and shortly thereafter, the court again addressed whether a national securities exchange—this time the NYSE—should be enjoined from proceeding with disciplinary hearings against associated exchange members for allegedly violating the Due Process Clause of the Fifth Amendment by denying the aid of counsel.<sup>53</sup> According to the district court, it was then “beyond dispute that the Fifth Amendment due process requirements as to federal action apply to the disciplinary hearings conducted by the Exchange.”<sup>54</sup> Like *Crimmins* before it, the district court cited *Intercontinental*.<sup>55</sup> Such attribution of private actions to the government would not continue as the jurisprudence in this area developed.

#### *B. Development in State Action Jurisprudence*

Some believe that, in order to stamp out racial discrimination, courts gave less credence to arguments that would limit certain constitutional strictures to governmental actors.<sup>56</sup> Such impetus to treat private actors as

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52. *Crimmins*, 346 F. Supp. at 1259. In addition to finding support for its conclusion in the Fifth Circuit’s *Intercontinental* decision, the court cited the Supreme Court’s decision in *Silver v. New York Stock Exchange*, 373 U.S. 341 (1963). *Id.* at 1259 n.4. In *Silver*, the justices did *not* address the issue of whether the exchange was a governmental actor, but the court did detail the nature and extent of federal regulation of national securities exchanges. In so doing, the Supreme Court noted that, in the Exchange Act, Congress required exchanges to provide a “fair procedure” for the disciplining of members and persons associated with members. *See Silver*, 373 U.S. at 352-53 (citing 15 U.S.C. § 78f(b)(7)).

53. *Compare Crimmins*, 346 F. Supp. at 1258-59 (considering whether AMEX could be brought within the purview of the Fifth Amendment), *with Villani v. N.Y. Stock Exch. Inc.*, 348 F. Supp. 1185 (S.D.N.Y. 1972) (ruling on the same state-action issue with regard to the NYSE). Today, NYSE Rule 476(h) permits representation by counsel. *See New York Stock Exchange, Disciplinary Rules, Rule 476(h)* (2005), <http://www.nyse.com/regulation/construles/1098571481177.html>.

54. *Villani*, 348 F. Supp. at 1188 n.1.

55. *Id.* John J. Villani and Donald Eucker were plaintiffs in the 1972 action before the U.S. District Court for the Southern District of New York seeking an injunction to restrain the New York Stock Exchange from proceeding against them in disciplinary actions. *Id.* at 1185. In 1975, after the United States had initiated criminal proceedings against Villani and Eucker, the duo again sought to enjoin the exchange’s disciplinary proceedings against them. *See United States v. Sloan*, 388 F. Supp. 1062, 1064 (S.D.N.Y. 1975) (noting that, although the NYSE was a state actor, it was inappropriate to enjoin the proceedings because the defendants could institute a separate action against the Exchange if they were expelled and then challenge the expulsions on due process grounds).

56. *See CHEMERINSKY, supra* note 1, at 388 (“From the late 1940s through the 1960s,

governmental actors waned with the passage of the civil rights acts of the 1960s because alternative means barred the discrimination that previously led courts to interpret broadly “state action.”<sup>57</sup> In the decades following the 1961 *Burton* decision, in which the Supreme Court had liberally construed individual action as state action, the Court refined its analysis, narrowing those situations in which private actors are treated as governmental actors.

For the restrictions on the government to be applicable to private actors, there must be a close nexus between the government and the challenged action such that seemingly private behavior may fairly be attributed to the government.<sup>58</sup> In determining the fairness of any such attribution, the Court has considered whether the disputed action resulted from the government’s exercise of coercive powers, significant encouragement, willful and joint participation, delegation of a public function traditionally performed exclusively by the government, and entwinement in the management or control of the private actor to achieve governmental objectives.<sup>59</sup> The inquiry is “necessarily fact-bound”<sup>60</sup> with no single facet serving as requisite. Given the nature of the inquiry, “examples [may] work more forcibly on the mind than precepts.”<sup>61</sup>

### 1. *Coercive powers and significant encouragement*

In *Skinner v. Railway Labor Executives’ Association*,<sup>62</sup> the Supreme Court addressed whether searches by private railroads could be attributed to the government, when the government authorized—but did not require<sup>63</sup>—such searches. Ultimately, the Court attributed such searches to

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the Court often found state action in order to combat racial discrimination. Later cases, especially those concerning other constitutional rights, generally did not find state action and the tensions among the decisions never have been resolved.”)

57. See, e.g., *Edmonson v. Leesville Concrete Co.*, 500 U.S. 614, 632 (1991) (O’Connor, J., dissenting) (“[A] peremptory strike by a private litigant is fundamentally a matter of private choice and not state action.”). But see *id.* at 616-31 (concluding in the majority opinion that a private litigant in a civil suit that exercised peremptory challenges on the basis of race constituted action subject to constitutional restriction because the private litigant could not exercise such challenges without the court’s or government’s overt assistance, which significantly involved itself in the discrimination).

58. See *Brentwood Acad. v. Tenn. Secondary Sch. Athletic Assoc.*, 531 U.S. 288, 295 (2001) (finding that state action may only be found if and only if the actions in question of a seemingly private organization or individual are to be appropriately treated as having been caused by the state itself); *Jackson v. Metro. Edison Co.*, 419 U.S. 345, 351 (1974) (holding that the question is whether the entity and state are sufficiently intertwined, and that because the nature of the state’s involvement may not be immediately obvious, detailed inquiry may be required to determine the outcome of the test).

59. See *Brentwood Acad.*, 531 U.S. at 296.

60. *Lugar v. Edmonson Oil Co.*, 457 U.S. 922, 939 (1982).

61. Henry Fielding, Joseph Andrews, in *JOSEPH ANDREWS AND SHAMELA* 47, 57 (Arthur Humphreys ed., 1991) (1973); see *Brentwood Acad.*, 531 U.S. at 296 (noting that “examples may be the best teachers”).

62. 489 U.S. 602 (1989).

63. See *id.* at 615 (“The fact that the Government has not compelled a private party to

the government because the government had encouraged, endorsed, or participated in such searches.<sup>64</sup> After finding that substance abuse posed a threat to public safety, the Federal Railroad Administration (“FRA”) promulgated regulations that authorized private railroads to conduct searches in defined situations. The regulations permitted the FRA to receive samples and test results that follow searches conducted under the regulations.<sup>65</sup> Moreover, the government “removed all legal barriers to the [authorized] testing.”<sup>66</sup> The regulations prohibited a railroad from divesting or compromising by contract the authority to search, and authorized the withdrawal of services from an employee that refused to submit to permitted substance tests.<sup>67</sup> In promulgating those regulations, the government “did more than adopt a passive position toward the underlying private conduct,”<sup>68</sup> it made “plain not only its strong preference for testing, but also its desire to share the fruits of such intrusions.”<sup>69</sup> Based on these facts, the court held that the government’s encouragement and endorsement of the private searches sufficed to implicate the Fourth Amendment.<sup>70</sup>

Although the regulations at issue in the *Skinner* decision evidenced the government’s encouragement and endorsement of private searches, regulations—even extensive ones—do not necessarily convert private conduct into governmental conduct. In *Jackson v. Metropolitan Edison Company*,<sup>71</sup> the plaintiff asserted due process violations following the termination of her electric service by a privately owned and operated corporation. That corporation, which was subject to extensive regulation by the state public utility commission (“PUC”), filed a tariff with the PUC in which it reserved the right to discontinue service following notice of nonpayment. The Court reasoned that even assuming the state’s grant of monopoly power to a private party, there must be a relationship between the challenged actions of the private entity and the monopoly power; none was found.<sup>72</sup> Although the government approved the utilities’ authority to terminate service in the sense that the PUC took no action to prohibit such

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perform a search does not, by itself, establish that the search is a private one.”). In addition, the Federal Railroad Administration (FRA) did promulgate regulations that required railroads to conduct searches in certain situations; the Court had no trouble concluding that the Fourth Amendment applied to such compulsory searches even though private parties conducted the search. *See id.* at 614-15.

64. *See id.* at 615-16.

65. *See id.* at 615; 49 C.F.R. § 219.11(c) (1994).

66. *Skinner*, 489 U.S. at 615.

67. *See id.*

68. *Id.*

69. *Id.*

70. *See id.* at 615-16.

71. 419 U.S. 345 (1974).

72. *See id.* at 351-52.

authority, the government did not place it imprimatur on the decision to discontinue Jackson's electric service.<sup>73</sup> While the regulations in *Skinner* highlighted the government's preference for the disputed private searches, the government through its regulations in *Jackson* did not evidence a preference for the termination of service for those that fail to remit payment.

## 2. *Traditionally exclusive state function*

Although courts have determined that the exercise of powers by a private party traditionally reserved exclusively by the government may be cause for such private party to be subject to constitutional scrutiny,<sup>74</sup> the *Jackson* Court determined that the provision of electrical service is not one of those powers.<sup>75</sup> The Court also rejected the contention that the list of such powers should be expanded to include those businesses that affect the public interest.<sup>76</sup> To do otherwise would provide no meaningful limit, as "[d]octors, optometrists, lawyers . . . and grocer[s] selling a quart of milk"<sup>77</sup> all affect the public interest, and such status cannot convert their every action into that of the government.<sup>78</sup>

Although unsuccessfully pressed in *Jackson*, the requisites of government action were met in *Marsh v. Alabama*,<sup>79</sup> where a Jehovah's Witness was convicted in state court for trespass after refusing to cease her distribution of religious literature on the sidewalk of the downtown area of Chickasaw. In *Chickasaw*, the distribution of such material was strictly

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73. *See id.*; *see also* *San Francisco Arts & Athletics, Inc. v. U.S. Olympic Comm.*, 483 U.S. 522, 547 (1987) (finding that "mere approval of or acquiescence in the initiatives . . . is not enough" to establish the requisite nexus between the state and private entity) (internal quotations, brackets, and citations omitted).

74. *See, e.g.*, *Marsh v. Ala.*, 326 U.S. 501, 507-09 (1946) (discussing a privately owned town acting as a government agent); *Evans v. Newton*, 382 U.S. 296, 301 (1966) (describing when a privately owned park functions as a government agent); *Terry v. Adams*, 345 U.S. 461, 469-70 (1953) (regarding private elections that effectively produce public officials). The Court has mentioned other general areas that may be traditional, exclusive functions of a state or municipality—education, fire and police protection, and tax collection—but has refused to adopt a bright-line rule regarding these areas. *Flagg Bros., Inc. v. Brooks*, 436 U.S. 149, 163 (1978) (*dicta*).

75. *See Jackson*, 419 U.S. at 353 ("The [state] courts have rejected the contention that the furnishing of utility services is either a state function or a municipal duty." (citing *Girard Life Ins. Co. v. City of Philadelphia*, 88 Pa. 393 (1879); *Baily v. City of Philadelphia*, 184 Pa. 594, 39 A. 494 (1898))).

76. *See Jackson*, 419 U.S. at 353-54; *San Francisco Arts & Athletics, Inc. v. U.S. Olympic Comm.*, 483 U.S. 522, 544 (1987) ("The fact that a private entity performs a function which serves the public does not make its actions governmental action.") (internal quotes and brackets omitted).

77. *Jackson*, 419 U.S. at 354.

78. *See id.* at 353-54; *cf. Memphis Light, Gas & Water Div. v. Craft*, 436 U.S. 1, 11-12 (1978) (holding that if utilities were owned by the government, rather than a private company, then the termination of services must be preceded by notice and a hearing).

79. 326 U.S. 501 (1946).

verboden. The defendant's behavior could not have been barred by the legislative body of a community the title of which was held by a municipal corporation.<sup>80</sup> Chickasaw, however, was a private town owned by a private corporation. Nonetheless, it possessed the characteristics of a typical town—a downtown business community, residential buildings, streets and sewers. Although the privately owned downtown area was located on a private street, public streets surrounded the area.<sup>81</sup> Nothing prevented anyone—locals or visitors—from shopping in the area. The private facilities were “built and operated primarily to benefit the public and . . . their operation [was] essentially a public function.”<sup>82</sup> In balancing the rights of property owners against the rights of the people to freedom of religion, the “latter occupy a preferred position.”<sup>83</sup> Consequently, the privately owned town was treated as a governmental actor and the state conviction could not stand in light of the First and Fourteenth Amendments.<sup>84</sup>

### 3. Joint participation

In 1961 decision of *Burton v. Wilmington Parking Authority*,<sup>85</sup> the Supreme Court concluded that the state was a “joint participant” in the racially discriminatory serving practice of a privately owned restaurant. Because this restaurant was located in a parking building owned and operated by a state agency, the Court concluded that the restaurant was subject to the requirements of the Fourteenth Amendment.<sup>86</sup> The state acquired the land and erected the building by expending public funds directly or indirectly through revenue raising instruments.<sup>87</sup> Parking revenue proved inadequate to cover expenses for the structure; to make

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80. See *Marsh*, 326 U.S. at 504-05 (citing, for example, *Lovell v. Griffin*, 303 U.S. 444, 450-51 (1938) (forbidding municipalities from requiring overly restrictive permits for citizens wishing to distribute literature); *Jamison v. Texas*, 318 U.S. 413, 416 (1943) (holding unconstitutional an ordinance that prohibited distribution of religious handbills on city sidewalks); *Martin v. Struthers*, 319 U.S. 141, 148-49 (1938) (holding that a municipality cannot forbid door-to-door distribution of literature)).

81. See *Marsh*, 326 U.S. at 502.

82. *Id.* at 506.

83. *Id.* at 508.

84. See *id.* Compare *Amalgamated Food Employees Union v. Logan Valley Plaza*, 391 U.S. 308 (1968) (holding that a privately owned shopping center could not prevent individuals from picketing a store with which they had a labor dispute), with *Lloyd Corp. v. Tanner*, 407 U.S. 551 (1972) (holding that a privately owned shopping center could prevent protestors from distributing anti-war literature). Despite a logical rationale for the different outcomes—whether the content of the speech concerns the operation of the shopping center—it is difficult to explain why the determination of whether a private shopping center is a state actor for First Amendment purposes should turn on the message being expressed.” *CHEMERINSKY, supra* note 1, at 399.

85. 365 U.S. 715 (1961).

86. See *id.* at 725.

87. See *id.* at 723-24.

good on such shortfalls, portions of the property were leased. Consequently, profits derived from the discriminatory practices of the restaurant were “indispensable” to the success of the state’s venture. The restaurant benefited from certain tax exemptions afforded the state, from its location within a conveniently located parking structure, and from maintenance of the facility by the state.<sup>88</sup> By flying the state flag above the building in which the restaurant was located, the state implicitly placed its imprimatur behind the operating practices of the restaurant.<sup>89</sup> The interests of the state were so connected to the interests of the restaurant and vice versa, that the court viewed them as joint participants, leaving the restaurant subject to the dictates of the Fourteenth Amendment.<sup>90</sup>

Since 1961, members of the Court have suggested that the concept of “joint participant” should be more narrowly construed.<sup>91</sup> In *Flagg Brothers, Inc. v. Brooks*,<sup>92</sup> the Supreme Court determined that there was no joint participation between the state and a warehouseman that, following plaintiff’s eviction, sold plaintiff’s stored possessions to make good on plaintiff’s transportation and storage debts. The city manager arranged for plaintiff’s possessions to be stored with the warehouseman, and the warehouseman acted pursuant to state statute authorizing such sale. Neither the involvement of the city official nor the state statute authorizing—but not requiring—the sale of stored goods provided a sufficient nexus to hold the state attributable for the actions of the private warehouseman.<sup>93</sup>

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88. *See id.*

89. *See id.* at 725 (“The State . . . has elected to place its power, property and prestige behind the admitted discrimination.”).

90. *See id.* at 725 (“interdependence”); *cf.* *Jackson v. Metro. Edison Co.*, 419 U.S. 345, 358 (1974) (“symbiotic relationship”).

91. *See Edmonson v. Leesville Concrete Co.*, 500 U.S. 614, 637 (1991) (O’Connor, J., dissenting) (“[w]hatever the continuing vitality of *Burton* beyond its facts”); *Lugar v. Edmondson Oil Co.*, 457 U.S. 922, 950 n.7 (1982) (Powell, J., dissenting) (arguing that the term “jointly engaged” connotes engagement in a conspiracy); *Jackson*, 419 U.S. at 358 (“limiting the actual holding [of *Burton*] to lessees of public property”).

92. 436 U.S. 149 (1978).

93. *See Flagg Bros.*, 436 U.S. at 161 & n.11. *But see Lugar*, 457 U.S. at 941-42 (finding governmental action in the attachment of property by a private party due to the state-created procedural scheme, the state’s issuance of a writ of attachment, and the sheriff’s execution of the writ). Critics are wary of such distinctions. *See* CHEMERINSKY, *supra* note 1, at 407 (“In *Lugar*, state law provided the procedure for prejudgment attachment; in *Flagg Bros.*, state law provided for the self-help action. In fact, in *Flagg Bros.* involvement of the sheriff was unnecessary precisely because the state’s law allowed for repossession action without assistance of the sheriff. Therefore it can be questioned whether the distinction . . . based on the involvement of the sheriff should make such a difference.”).

#### 4. *Entwinement*<sup>94</sup>

In *Lebron v. National Railroad Passenger Corporation*,<sup>95</sup> the Supreme Court held that, despite Congress' statutory declaration that Amtrak "will not be an agency or establishment of the United States Government,"<sup>96</sup> Amtrak amounted to the government. The Court reasoned that because Amtrak was created by special law for the furtherance of governmental objectives and over which the government retained permanent authority to appoint a majority of directors, Amtrak could be considered part of the government for First Amendment purposes.<sup>97</sup> In the decades prior to Congress' creation of Amtrak, private companies that operated passenger rail service went bankrupt or faced financial distress. Congress created Amtrak because "public convenience and necessity"<sup>98</sup> required the continuance and improvement of passenger service by rail. The government controlled Amtrak through the appointment of eight members of a nine-member board of directors—the president appointed six members<sup>99</sup> and the Secretary of Treasury appointed two directors through holdings of Amtrak's preferred stock.<sup>100</sup> The government exerted control over Amtrak—a non-profit entity—as a policy-maker rather than a creditor, and there was no contemplated endpoint to that control.<sup>101</sup> Although Amtrak was a corporation organized under the laws of the District of Columbia, the Court concluded that Amtrak was the government, and that the government could not avoid the strictures of the Constitution by resorting to corporate form.<sup>102</sup>

In *National Collegiate Athletic Association v. Tarkanian*,<sup>103</sup> the Supreme Court addressed the issue of whether the actions of the NCAA constituted governmental action. The University of Nevada at Las Vegas suspended the coach of its men's basketball team—Jerry Tarkanian—following a report by the NCAA indicating that he had violated ten of its rules. The NCAA placed the UNLV basketball team on probation and ordered the

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94. *Brentwood Academy v. Tennessee Secondary School Athletic Association* speaks most clearly of entwinement and is discussed *infra* in Part IV, but the case, which was decided in 2001, post-dates a slew of decisions that conclude that the actions of SROs should not be attributed to the government.

95. 513 U.S. 374 (1995).

96. *Id.* (citing 45 U.S.C. § 541 (1994), *repealed by* Pub. L. No. 103-272, § 7(b) (1994)).

97. *See Lebron*, 513 U.S. at 400.

98. 45 U.S.C. § 501(a) (2000).

99. *Id.* § 543(a)(1)(A); *Lebron*, 513 U.S. at 397.

100. 45 U.S.C. § 544(c); *Lebron*, 513 U.S. at 385.

101. *See Lebron*, 513 U.S. at 399 (distinguishing *Reg'l Rail Reorganization Act Cases*, 419 U.S. 102 (1974), in which the Court found Conrail not to be a federal instrumentality despite presidential power to appoint a majority of the board, because the government exerted its control over Conrail to protect its interests as a creditor).

102. *See id.* at 394-95.

103. 488 U.S. 179 (1988).

school to show cause why further sanctions should not be imposed if the athletic program failed to disassociate itself from Tarkanian during the probationary period.<sup>104</sup> In state court, Tarkanian established deprivation of due process rights guaranteed under the Fourth Amendment and obtained injunctive relief and attorney's fees. Only if the NCAA's action constituted governmental action could the NCAA be bound by the state court order.<sup>105</sup> The Supreme Court determined that the necessary predicate was absent.

UNLV, a state university, is "without question" a governmental actor.<sup>106</sup> The issue is whether UNLV's compliance with NCAA rules and recommendations converted the NCAA into a state actor. As to the NCAA's rulemaking, UNLV had a voice in the passage of those rules; but UNLV is but one of approximately 1,000 members of the NCAA, the majority of which were not located in Nevada and did not act under the color of Nevada law.<sup>107</sup> UNLV could have withdrawn from the NCAA and established its own standards or it could have sought to amend those NCAA rules of which it disapproved. Adherence to the NCAA rules was the decision of UNLV and its action could not transform the actions of the NCAA into the actions of state government.<sup>108</sup>

With regard to investigation and enforcement of NCAA rules, Tarkanian contended that UNLV delegated those state functions to the NCAA. UNLV, however, hardly acted jointly with the NCAA as evidenced by UNLV's adversarial relationship with regard to the matter—UNLV preferred and attempted to retain Tarkanian as a coach. In fact, UNLV's internal investigation reached contrary conclusions to those reached by the NCAA.<sup>109</sup> The NCAA could not discipline Tarkanian. UNLV did not delegate state authority to the NCAA, so it was not a state actor.<sup>110</sup>

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104. *See id.* at 180-82.

105. *See id.* at 181-82 (describing that Tarkanian asserted a violation of section 1983 which required that the defendant have acted under the color of state law). The under-color-of-state-law inquiry under section 1983 mirrors that of the inquiry as to the presence of governmental action when determining the applicability of protection afforded by, for example, the Fourth or Fifth Amendment. *See id.* at 182 n.4. Lower courts routinely determined that the NCAA was a governmental actor prior to 1982 when the Supreme Court issued three opinions concerning "state action" on the same day, and thereafter, lower courts routinely have held to the contrary. *See id.* at n.5.

106. *See id.* at 192. *See generally* *Cleveland Bd. of Educ. v. Loudermill*, 470 U.S. 532 (1985) (viewing a county Board of Education as a state actor which must provide due process rights to its employees); *Bd. of Regents of State Colleges v. Roth*, 408 U.S. 564 (1972) (regarding a state university acting as a governmental agent in its employment relationships).

107. *See Tarkanian*, 488 U.S. at 193 n.13 (noting that the "situation would, of course, be different if the membership consisted entirely of institutions located within the same State . . .").

108. *See id.* at 194-95.

109. *See id.* at 196.

110. *See id. Tarkanian*, 488 U.S. at 199. The Court rejected arguments regarding the

C. *Recent Decisions Regarding SROs and State Action*

After the 1960s, just as courts were less willing to attribute the actions of private parties to the government generally, so too were courts less willing to attribute the actions of SROs to the government. *United States v. Solomon*<sup>111</sup> represents an early decision reversing the trend of concluding that the actions of an SRO should be attributed to the government. Because the NYSE permits the suspension or expulsion of a member for refusal to testify or provide information,<sup>112</sup> Solomon spoke with NYSE investigators and provided the requested information. This information was later transmitted to the Commission and federal prosecutors.<sup>113</sup> Solomon challenged his conviction on the grounds that he was coerced to offer testimony in violation of the Fifth Amendment protection against self-incrimination.<sup>114</sup> Contrary to early decisions,<sup>115</sup> the court rejected the argument that the NYSE was “in effect the arm of the Government in administering portions of the Securities Exchange Act,” in part because the “NYSE’s inquiry into [Solomon] was in pursuance of its own interests and obligations, not as an agent of the SEC.”<sup>116</sup> Solomon also argued that the government jointly participated in the Exchange’s enforcement actions given federal oversight. According to Solomon, the Commission benefited from the Exchange’s enforcement in a similar manner as the state benefited in *Burton*. In *Burton*, the state benefited from the profits derived from a restaurant that racially discriminated among customers. The court distinguished *Burton*, which focused on race, not self-incrimination.<sup>117</sup>

Recently, other courts have reached similar conclusions that the actions of SROs should not be attributed to the government.<sup>118</sup> No recent decision

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NCAA’s alleged usurpation of a traditional, essential, and exclusive state function. *See id.* at 197 n.18 (supporting the argument against state function (citing *San Francisco Arts & Athletics, Inc. v. U.S. Olympic Comm.*, 483 U.S. 522, 545 (1987))). The Court also rejected arguments regarding the absence of alternatives due to the NCAA’s status as a monopoly. *See id.* at 199 & n.19 (determining that alternatives, albeit unpalatable ones, existed, but regardless, state-conferred monopoly power does not convert the private recipient of such power into a state actor (citing *Jackson v. Metro. Edison Co.*, 419 U.S. 345, 351-52 (1974))).

111. 509 F.2d 863 (2d Cir. 1975).

112. *See id.* at 865 (quoting Article XIV of the NYSE Constitution).

113. *See id.* at 865-66.

114. *See id.* at 866-67.

115. *See supra* Part I.A.2 (discussing court decisions holding that similar SROs are government actors in reference to the Fourth and Fifth Amendments).

116. *Solomon*, 509 F.2d at 868-69. Courts have referenced such self-interest with little explanation. Part II explores why an SRO would create and enforce certain rules.

117. *See id.* at 871 (“Analysis of the particular constitutional provision at issue must be among the first, if not the very first, step in the process of ‘sifting facts and weighing circumstances’ needed to attribute ‘true significance’ to ‘the non-obvious involvement of the State in private conduct.’”).

118. *See D.L. Cromwell Invs. Inc. v. NASD Regulation Inc.*, 279 F.3d 155, 158 (2002) (rejecting the argument that private actions should be attributed to the government despite

has been identified that attributes the actions of a securities exchange or association to the government.<sup>119</sup>

## II. RATIONAL ACTORS

A court's inquiry into government coercion often focuses not only on the government but also on the party thought to be coerced. In the context of criminal confessions, courts examine the actions of the government (for example, depriving the defendant of sleep or food) as well as

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the SRO's providing documents to the government and the government's providing to the SRO information regarding witness interviews and investigation progress reports because the government did not require that information be shared and government did not influence the SRO's investigation); *Otto v. SEC*, 253 F.3d 960, 965 (7th Cir. 2001) (dicta) (noting that heavy governmental regulation does not convert private action into governmental action subject to Fifth Amendment due process requirements); *Desiderio v. Nat'l Ass'n of Sec. Dealers*, 191 F.3d 198, 207-08 (2d Cir. 1999) (rejecting argument that Fifth Amendment right to due process applied to NASD because there was not a close nexus between the government and the specific conduct being challenged: NASD-compelled arbitration); *Duffield v. Robertson Stephens & Co.*, 144 F.3d 1182, 1200-01 (9th Cir. 1998) (rejecting argument that due process right under Fifth Amendment was violated because NASD, not the government, required arbitration of disputes and because government approval of private rule does not amount to coercion or significant encouragement and because dispute resolution is not traditionally an exclusion governmental function); *Gold v. SEC*, 48 F.3d 987, 991 (7th Cir. 1995) (dicta) (noting that heavy governmental regulation does not convert private action into governmental action subject to Fifth Amendment due process requirements); *First Jersey Sec., Inc. v. Bergen*, 605 F.2d 690, 698 (3d Cir. 1979) (concluding, without analysis, that NASD is not a governmental actor); *Marchiano v. Nat'l Ass'n of Sec. Dealers*, 134 F. Supp. 2d 90, 95 (D.D.C. 2001) ("The court is aware of no case . . . in which NASD Defendants were found to be state actors either because of their regulatory responsibilities or because of any alleged collusion with criminal prosecutors."); *United States v. Shvarts*, 90 F. Supp. 2d 219, 222 (E.D.N.Y. 2000) (rejecting argument that Fourth and Fifth Amendments apply to NASD because "[i]t is beyond cavil that the NASD is not a government agency"); *Graman v. Nat'l Ass'n of Sec. Dealers*, 1998 WL 294022, at \*2-3 (D.D.C. Apr. 27, 1998) (mem.) (rejecting argument that due process rights denied because NASD is not a governmental actor when government did not coerce NASD into making the challenged action, NASD did not rely on government for assistance and benefits, and NASD did not perform a function traditionally performed exclusively by the government); *First Heritage Corp. v. Nat'l Ass'n of Sec. Dealers*, 785 F. Supp. 1250, 1251 (E.D. Mich. 1992) (concluding, without analysis, that NASD is not a governmental entity and thus need not comply with constitutional due process requirements); *Bahr v. Nat'l Ass'n of Sec. Dealers, Inc.*, 763 F. Supp. 584, 588-89 (S.D. Fla. 1991) (rejecting arguments that due process rights under the Fifth and Fourteenth Amendments had been violated because no action is attributable to the government when plaintiff dissatisfied with arbitration proceedings); *United States v. Bloom*, 450 F. Supp. 323, 330-31 (E.D. Pa. 1978) (rejecting argument that Fourth Amendment applied to NASD when the employer of the accused conducted the search prior to involvement by either the NASD or the government and rejecting argument that general government-imposed self-policing does not convert specific private act into action by the government); *In re Lawrence H. Abercrombie, Exchange Act Release No. 34-16285*, 18 SEC Docket 679, at \*5 (Oct. 18, 1979) (rejecting argument that Fifth Amendment applied to NASD because NASD exercised considerable discretion and was not controlled by government).

119. Although neither a national securities exchange nor a registered securities association, the Municipal Securities Rulemaking Board is an SRO and a court recently attributed its rulemaking activity to the government. See *Blount v. SEC*, 61 F.3d 938, 941 (D.C. Cir. 1995) (holding that Rule G-37 drafted by the Municipal Securities Rulemaking Board constituted governmental action).

characteristics of the defendant (for example, age or educational status).<sup>120</sup> When undertaking state action analysis, courts that focus solely on the government and its actions may be under-inclusive in their inquiries as considerations tied to the private party may also be appropriate.

When litigants seek to attribute actions of private parties to the government, courts have searched for private rationales, independent of government coercion or encouragement, which may have motivated those private actors. Private motivations may cleanse the private actions of any purported governmental coercion or encouragement.<sup>121</sup>

Rational actor analysis may assist courts in undertaking state action analysis. Did the private actor take the challenged action due to private, rational motivations, independent of governmental influence? Private motivations would lead an exchange to achieve the two principal goals of federal securities laws. The private, rational motivations of an exchange as well as the private, rational motivations of enforcement officers may minimize any governmental coercion or encouragement, leaving the actions of the exchange and the exchange's enforcement officers private in nature.

The two principal goals of federal securities laws are the disclosure of information (upon the public issuance of securities and periodically afterwards) and the prevention of fraud.<sup>122</sup> Irrespective of federal legislation, stock exchanges would adopt rules regarding the disclosure of information and the prevention of fraud. Moreover, the exchanges would police and enforce those rules. Absent federal intervention, the information voluntarily disclosed and the vigilance of policing and enforcement may be sub-optimal. Nonetheless, arguments that an exchange is a governmental actor because the government compels an exchange to pass and enforce rules regarding disclosure and fraud are often overbroad in light of the fact that, regardless of governmental action, the exchange would pass and enforce similar rules. To prove successful, arguments of governmental compulsion must be more nuanced.

A securities exchange must account for the concerns and preferences of

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120. See, e.g., *Crooker v. California*, 357 U.S. 433, 438 (finding evidence of possible police coercion but negating this coercion because of defendant's "age, intelligence, and education" as a college graduate enrolled in law school).

121. See WAYNE R. LAFAYE, *SEARCH AND SEIZURE: A TREATISE ON THE FOURTH AMENDMENT* 196 (2d ed. 1987) (discussing *Gold v. United States*, 378 F.2d 588, 591 (9th Cir. 1967) where the court held that a search by an airline employee was a private search when: (1) the FBI never requested the search, (2) the employee received notice from the FBI that boxed goods that lacked the shipper's identity and address did not contain the contents set forth on the way bill, (3) the airline assessed shipping fees based, in part, upon the goods being shipped, and (4) the airline had a practice of opening goods to confirm that the contents matched the way bill if there were suspicions to doubt the accuracy of the way bill).

122. See FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATION LAW* 276 (1998) (discussing the two main goals of federal securities laws).

the companies whose securities are traded and the investors that are trading those securities. Exchange members earn money on trades executed on the exchange, so exchange members seek to attract many issuers of securities. An array of investment options may attract investors that will engage in trades that yield profits to exchange members. Consequently, rational exchange members and their exchange must be cognizant of, and respond to, the preferences and concerns of issuers and investors regarding disclosure and fraud.

### A. *Voluntary Disclosure*

Companies need money to, for example, introduce new products, expand production, and fund research. Companies may raise money by issuing securities. When a company issues securities, it seeks the maximum price for those securities.<sup>123</sup> Because of the concerns of the initial purchasers, the company must be concerned not only with the initial purchase price but also the price of the security in subsequent trades. Initial purchasers will be concerned about their abilities to recoup on their investments. One means of recouping the initial investment is the sale of the security. If the initial purchaser cannot identify easily one that wants to purchase the securities, then the initial purchaser would have to expend effort, time, or other resources to identify a subsequent purchaser.<sup>124</sup> Those possible expenditures may diminish the initial purchaser's value of the security. The wise initial purchaser will account for such possible diminishment by lowering her initial offer for the securities—a matter about which the issuing company cares a great deal.<sup>125</sup>

The existence of a centralized market where buyers and sellers easily can be identified increases the liquidity of the security and reduces this concern of an initial purchaser/future seller. As a general matter, we would expect

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123. Of course, price is not the sole concern of the company issuing the securities. For example, a company might choose between issuing two securities—one that afforded a particular type of preferential treatment to holders and one that did not so entitle holders. Although the first security may yield a higher price, the company may prefer to issue the second security. The company may reasonably believe that the company is not being compensated adequately for the entitlement afforded by the first security.

124. See J. EDWARD MEEKER, *THE WORK OF THE STOCK EXCHANGE* 42 (1930) (If “[t]here is no organized market . . . [y]ou must . . . spend both time and money . . . to find a buyer.”); see also WILLIAM C. VAN ANTWERP, *THE STOCK EXCHANGE FROM WITHIN* 6 (1913) (“[I]t was learned long ago that economy of time and labor, as well as a theoretically perfect market, could be best secured by an organization under one roof of as many dealers in a commodity as could be found.”); George J. Stigler, *Public Regulation of the Securities Market*, 37 J. BUS. 117, 126 (Apr. 1964) (“The basic function a market serves is to bring buyers and sellers together.”).

125. See Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 684 (1984) (“A firm that wants the highest possible price when it issues stock must take all cost-justified steps to make the stock valuable in the aftermarket . . .”).

that companies that issue securities want those securities to be traded in a liquid market.<sup>126</sup> Stock exchanges provide liquidity.

Just as issuers of securities respond to investors' preferences for liquidity, so too will issuers respond to investors' preferences for information.<sup>127</sup> Disclosure of information only at the time of issuance of securities will not appease investors. Initial purchasers become future sellers. Those future sellers want the future stock price to be high—not discounted due to uncertainty tied to a dearth of information regarding the issuer. Initial investors fear that, once their money has passed to the issuer, officials of the issuer may cease (or otherwise limit) the disclosure of information valued by investors. To combat investor fear and to elevate the initial sales price of the securities, issuers may commit to on-going disclosure.<sup>128</sup>

A company's failure to provide information may negatively impact the price of that company's securities because investors may assume the worst.<sup>129</sup> Nonetheless, the price of the securities of a non-disclosing company may be buoyed somewhat by other disclosing companies in the same market. Voluntarily disclosed information by other companies or disclosures about the industry in which the non-disclosing company operates may be considered applicable to the non-disclosing company, thereby somewhat dampening the negative impact that would otherwise result from non-disclosure. That one non-disclosing company may not suffer the full negative impact of non-disclosure can create a perverse incentive,<sup>130</sup> the classic "race to the bottom." Other companies intentionally may fail to disclose in an attempt to free ride on the disclosures of others. Disclosing companies would prefer not to bear the full cost of disclosure when non-disclosing companies benefit from such disclosure without bearing their share of the cost.<sup>131</sup> Thus, a company that

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126. See VAN ANTWERP, *supra* note 124, at 17 ("These small investors . . . require a market in which they can sell and get their money at once . . .").

127. See *id.* ("These small investors . . . must have the most accurate information . . .").

128. See Easterbrook & Fischel, *supra* note 125, at 684 ("A firm that wants the highest possible price when it issues stock must . . . make a believable pledge to continue disclosing.").

129. See *id.* at 683 ("Silence means bad news."); JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 247 (4th ed. 2004) ("[E]mpirical data supports the view that financial disclosures reduce the riskiness that surrounds the pricing of securities in the marketplace because they remove the uncertainty regarding the firm's financial position and performance."); compare *id.* at 252 (noting that non-disclosure may be good—facilitating the preservation of competitive advantage) with *id.* at 250 (noting that non-disclosure may be bad—facilitating entrenchment by incumbent management).

130. See RICHARD A. POSNER & KENNETH E. SCOTT, ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 320 (1980) (excerpting a report by William H. Beaver providing examples and analysis of corporate disclosure externalities).

131. See *id.* (highlighting market incentives to withhold information from the general public).

is willing to disclose information would be willing to align itself with other similarly motivated companies.

An exchange permits issuers of securities to list their shares for trading (providing investors with desired liquidity) after those issuers agree to make initial, as well as on-going, disclosures (providing investors with desired information). A stock exchange is comprised of members that execute trades in the securities listed on the exchange. Exchange members earn revenue on those trades. Consequently, members of a particular exchange want issuers to list their securities with their exchange. "Stock exchanges compete for listings and trades—the higher the volume of stock trades on an exchange, the higher the revenue to exchange members."<sup>132</sup>

Because the success of an exchange depends on the amount of trading, exchanges have incentives to adopt rules governing trade that operate to the benefit of investors. . . . [E]xchanges have an incentive to adopt rules that require listed firms to disclose the amount and type of information that investors demand. Competition among organized exchanges for both the listing of firms and the business of investors . . . increases the incentives of the exchanges to adopt beneficial rules.<sup>133</sup>

The arguments are not simply theoretical. The New York Stock Exchange required that listed companies disclose information for the benefit of investors in advance of federally imposed disclosure requirements. New (and relevant) information, particularly financial information, impacts the value of securities and thus is of great concern to investors.<sup>134</sup> Prior to federal involvement, the NYSE obligated listed companies to disclose information from their income statements and balance sheets.<sup>135</sup> In particular, required disclosures for original listings included:

(1) earnings for preceding five years, if available with interest charges, depreciation, and federal taxes; (2) income and surplus account of recent date for at least two years, if available; (3) balance sheets of same dates; (4) balance sheet giving effect to recent financing, if any; (5) similar accountings for predecessor, constituent, subsidiary, owned or controlled companies . . . .<sup>136</sup>

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132. DALE A. OESTERLE, *THE LAW OF MERGERS AND ACQUISITIONS* 118 (2d ed. 2002).

133. EASTERBROOK & FISHEL, *supra* note 122, at 294; *see* VAN ANTWERP, *supra* note 124, at 6 (describing that an exchange's goals are "best accomplished when the organization . . . [adopts] rules of business morality as to insure to every one who does business there, great and small, rich and poor, an absolutely square deal.").

134. *See* *Basic v. Levinson*, 485 U.S. 224, 246-47 & n.24 (1988) (discussing the efficient capital markets hypothesis); WILLIAM W. BRATTON, *CORPORATE FINANCE* 149-71 (5th ed. 2003) (same); JESSE H. CHOPER ET AL., *CASES AND MATERIALS ON CORPORATIONS* 195-203 (6th ed. 2004) (same).

135. *See* George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Act of 1934*, 63 *AMER. ECON. REV.* 132, 142 (Mar. 1973).

136. MEEKER, *supra* note 124, at 555 app.: Requirements for Original Listing.

Additionally, the application for original listing required disclosure of dividends (paid or declared) as well as the issuer's policy regarding depreciation.<sup>137</sup> The listing of additional amounts required disclosure of dividends paid and declared since the previous application, company policy regarding depreciation and depletion, and certain financial information, namely "[i]ncome account, surplus account and balance sheet of recent date . . . ."<sup>138</sup> Requisite on-going disclosures included periodic statements of earnings and, at least annually, a balance sheet, income statement and surplus account statement.<sup>139</sup>

Required disclosure extended beyond financial matters to other matters of concern to investors. The NYSE listing application included agreements that required the disclosure of any change in the general character or nature of the issuing company's business, as such changes could impact the company's worth. Because the issuance of additional securities could diminish an original investor's influence with regard to the company's operations, and because such information could be provided efficiently, the NYSE served as the collective body through which issuers could align themselves and through which collective agreements could be enforced. Hence, the listing application also included agreements that required disclosure of the "issuance or creation . . . of any rights to subscribe to . . . its securities, or of any other rights or benefits pertaining to ownership in its securities . . . [as well as the] issuance of Options or Warrants to purchase stock . . . ."<sup>140</sup> Furthermore, it was not as if the NYSE acted once, and only once, prior to the federal government imposing regulations. The NYSE continued to increase the disclosure obligations of listed companies in advance of federal requirements.<sup>141</sup>

### *B. Weaknesses in the Voluntary Disclosure Argument*

#### *1. Excessive compensation*

Scholars have noted that prior to the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934, firms paid excessive

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137. *See id.* at 555.

138. *Id.* at 557-58.

139. *See id.* at 561.

140. *Id.* at 562.

141. *See* MEEKER, *supra* note 124, at 94 (demonstrating how the NYSE's Committee on Stock List imposed requirements that became "more exacting year after year"). It may be suggested that, while the NYSE ramped up the disclosure obligations of listed companies, the increase occurred only after federal involvement was a foregone conclusion. *See* SUSAN M. PHILLIPS & J. RICHARD ZECHER, *THE SEC AND THE PUBLIC INTEREST* 114 (1975) (pointing out that "the practice of voluntary disclosure by corporations . . . was widespread before the SEC was founded . . .").

compensation to insiders and underwriters.<sup>142</sup> Federally mandated disclosure, the argument goes, reduces the threat of excessive compensation, protecting the investing public.

Reliance on voluntary disclosure will not stamp out excessive compensation to insiders, but neither will federally mandated disclosure. For example, in public filings with the SEC, Walt Disney disclosed its employment agreement with Michael Ovitz.<sup>143</sup> Disclosure did not prevent Ovitz's exceptionally generous compensation package.<sup>144</sup> Although the package may not have been impermissibly excessive under corporate law,<sup>145</sup> many have criticized the lavish package as excessive.<sup>146</sup> Even courts, which are generally reluctant to criticize the actions of corporate boards, have suggested that the package may have been over-the-top.<sup>147</sup> The Ovitz case constitutes only anecdotal evidence, but other anecdotes exist.<sup>148</sup> Scholars have spilled much ink on the large disparity between executive compensation and compensation received by the blue-collar workforce in the United States as contrasted with the smaller disparities found among companies operating in other countries.<sup>149</sup> Federally

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142. See, e.g., Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 45-51 (1983) (describing excessive compensation to insiders and underwriters as one justification for the securities acts and disclosure requirements). Insiders include directors and officers of an issuer, see 15 U.S.C. § 78p (2000), and may include large shareholders, see *id.*, as well as third parties, see *United States v. O'Hagan*, 521 U.S. 642, 647-48, 652-53 (1997) (holding that outside counsel acted deceptively in violation of federal securities laws when he appropriated non-public information from the firm's client and traded on the basis of that information). Underwriters serve as middlemen between issuers and the investing public. See 15 U.S.C. § 77b(a)(11) (defining "underwriter" as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security . . ."); *Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys.*, 468 U.S. 207, 217 n.17 (1984) (describing the role of underwriters as agents for the issuer in the distribution of securities to the general public).

143. See *Disney Enters. Inc.*, Annual Report (Form 10-K), at Ex. 10(e) (Dec. 15, 1999), available at <http://sec.gov/Archives/edgar/data/29082/0000912057-95-010655.txt> (detailing the employment arrangements of Michael Ovitz's).

144. See *id.*

145. See *Brehm v. Eisner*, 746 A.2d 244, 262-64 (Del. 2000) (noting that although it was lavish, Ovitz's compensation package was not irrational).

146. See, e.g., Bruce Orwall & Joann S. Lublin, *The Rich Rewards of a Hollywood Exit*, WALL ST. J., Dec. 16, 1996, at B1 (quoting various Disney shareholders expressing disapproval of Ovitz's compensation package as "difficult to justify" and "perverse"); Editorial, *Unearned Megabucks*, ROCKY MOUNTAIN NEWS, Dec. 21, 1996, at 63A (describing Ovitz's severance package as "outrageous" and as "an incredible sum of money for someone who does not seem to have added a penny to the value of the company").

147. See *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 350 (Del. Ch. 1998) (noting the "sheer magnitude of the severance package" and the "board's extraordinary decision to award a \$140 million severance package"); see also *Brehm*, 746 A.2d at 250 (describing Ovitz's "extraordinarily lucrative contract").

148. See Orwall & Lublin, *supra* note 146, at B1 (charting generous severance packages of numerous executives in the entertainment industry).

149. See, e.g., MELVIN A. EISENBERG, *CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES AND MATERIALS* 665 (8th ed. 2000) (citing G. CRYSTAL, *IN SEARCH*

mandated disclosure will not eliminate excessive compensation. As such, we must be willing to accept some instances of excessive compensation. Perhaps a better question might be: Does federally mandated disclosure lead to cost-effective disclosures that would not otherwise be made by companies that list their shares on a stock exchange? No clear evidence has been identified.

Although federally mandated disclosure may have accelerated the reduction in excessive compensation to underwriters and insiders, federally mandated disclosure may have been *unnecessary*. Turning first to underwriters' compensation, it is true that underwriters' compensation fell in the decades immediately after the passage of the securities acts, but underwriters' compensation had begun declining in the decades before the passage of the Securities Act of 1933.<sup>150</sup> Factors contributing to declining underwriter compensation would include, among other things, "increased sales to institutions, increased competition among underwriters, and . . . competitive bidding requirements."<sup>151</sup> Underwriters serve as middlemen between issuers and the investing public.<sup>152</sup> If there are "increased sales to institutions" such as mutual funds, then underwriters expend fewer resources to sell remaining shares to the public. Consequently, less compensation is in order. Moreover, if there is "increased competition among underwriters" or "competitive bidding," then underwriter compensation should fall.

Regardless, prior to the enactment of the 1930s federal securities laws, the NYSE had adopted rules that seemed to require disclosure of excessive compensation to both underwriters and insiders. (For now, the focus is simply the voluntary adoption of rules regarding disclosure; enforcement (or the suboptimal enforcement) of those rules will be addressed shortly.) Before Congress spoke in 1933 and 1934, the NYSE called for listed companies to disclose any disposal of property (or stock interest) if such disposal would impair that company's financial position.<sup>153</sup> Likewise,

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OF EXCESS 27, 206-09 (1991):

[B]etween CEO compensation and average salaries. The average American CEO makes 120 times the compensation of the average manufacturing worker, and 150 times the average compensation of workers in manufacturing and service industries. In contrast, the average Japanese CEO seems to make only 16 times the pay of an average Japanese industrial worker, and the average German CEO seems to make about 21 times the pay of the average German factory worker.

150. See Seligman, *supra* note 142, at 47-48 (1983) (observing that the four decade decline can be "attributed to causes other than SEC mandatory disclosures").

151. *Id.*

152. See 15 U.S.C. § 77b(a)(11) (2000) ("The term 'underwriter' means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security . . .").

153. MEEKER, *supra* note 136, at 560-61 (requiring applicants to notify the NYSE if a disposal of property or stock would "impair or materially affect its financial position or the nature or extent of its operations as theretofore conducted").

excessive compensation, payment in excess of the value of the consideration received, seemingly impairs a company's financial position. Arguably the NYSE rules required such disclosure in advance of the federal mandate.

Moreover, prior to the enactment of the 1930s federal securities laws, the NYSE rules also contemplated that investment trusts<sup>154</sup> disclose contracts with management.<sup>155</sup> Investment trusts were required to disclose "all significant provisions contained in any existing agreements or contracts which define the powers and privileges of the management and the restraints thereon,"<sup>156</sup> as well as the agreements or contracts themselves.<sup>157</sup> Additionally, investment trusts had to abide by the following:

If the investment trust is managed directly or indirectly by another individual, firm or corporation, a copy of each contract with such individual, firm or corporation must be included in the body of the application.

Each application must present full details regarding the basis on which compensation for management is computed, including direct payments, options, warrants and any other form of direct or indirect compensation either present or future.

Applicant companies must agree promptly to advise the Exchange, on behalf of themselves and of any subsidiaries which have been or may be formed, of any change in the terms or conditions of any management contracts existing at the time of listing and of the terms and conditions of contracts subsequently concluded.<sup>158</sup>

By requiring disclosure of management agreements with investment trusts, the NYSE seemingly addressed the potentiality of excessive compensation before the issue was addressed by Congress. As to commissions on trades, investment trusts could charge only the commission authorized by an exchange, and "only customary and reasonable commissions" for trades of shares of unlisted companies.<sup>159</sup>

The NYSE rules also included a catchall disclosure requirement applicable to all listed companies; listed companies agreed "[t]o furnish the New York Stock Exchange, on demand, such reasonable information concerning the company as may be required."<sup>160</sup> The NYSE could have

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154. *See id.* at 569 (defining investment trusts as including companies "engaged primarily in the business of investing and reinvesting in the securities of other corporations for the purpose of revenue and for profit, and not in general for the purpose of exercising control").

155. *See id.*

156. *Id.* at 570.

157. *See id.*

158. *Id.*

159. *Id.* at 571.

160. *Id.* at 563.

construed the catchall rule to require disclosure of excessive compensation as the Commission has subsequently done. In *In the Matter of Franchard Corp.*,<sup>161</sup> the Commission required disclosure of conflict-of-interest transactions by which a manager enriched himself at the expense of the issuer and its shareholders. The Commission also required the disclosure of information that was not specifically required to be disclosed otherwise. This was based, in part, on a generic catchall provision: Rule 408, which requires that no statements be misleading.<sup>162</sup>

As the NYSE revised its listing requirements to add disclosure obligations, there may have been adequate disclosure required of newly listed companies. Some believed, however, that the companies that had previously listed their securities could not be compelled to adhere to the new disclosure obligations.<sup>163</sup> Even with respect to those companies that entered into contracts with the Exchange to list their securities prior to new disclosure obligations, the NYSE generally required compliance with the new disclosure obligations. For example, the NYSE generally required listed companies to disclose quarterly earnings statements.<sup>164</sup> The Commission did not require quarterly disclosure until decades later.<sup>165</sup> And, as would be expected, some companies disclosed information above and beyond the requirements of the NYSE to appease investors and to counter their perception of companies that “silence-equals-a-negative.”<sup>166</sup>

Another reported weakness in a scheme of voluntary disclosure is the existence of insider trading (arguably another means by which to achieve excessive compensation). Efficiency arguments suggest that private rules regarding insider trading would be sub-optimal. Even though private

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161. Securities Act Release No. 33-4710, 42 S.E.C. 163 (1964).

162. 17 C.F.R. § 230.408 (2005) (“In addition to the information expressly required to be . . . [disclosed], there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading.”).

163. See Seligman, *supra* note 142, at 55 (quoting S. REP. NO. 73-792 (1934): “Although the exchanges have endeavored to bring about an improvement in the type of financial reports filed by corporations, they have been hampered by the terms of the listing contracts made with issuers, which they have not considered themselves entitled to modify without the consent of such issuers.”); see also MEEKER, *supra* note 136, at 581 (The Exchange “cannot attempt to repudiate [prior] agreements [that did not impose the requirement] and substitute for them others calling for quarterly earning statements.”).

164. See MEEKER, *supra* note 124, at 581 (noting that the Exchange may grant companies leniency for good reason and on a case-by-case basis).

165. Benston, *supra* note 135, at 138.

166. See MEEKER, *supra* note 124, at 581 (recognizing how the U.S. Steel Corporation has exceeded the Exchange’s listing requirements); see also OESTERLE, *supra* note 132, at 112 n.70 (noting that in response to the “financial accounting woes of Enron and Global Crossing . . . other companies, such as General Electric, rushed to put out clearer and more complete reports, beyond what GAAP (Generally Accepted Accounting Principles) [and the Commission] require” in order to restore shareholder confidence in the accuracy of their reports).

regulations may be less than ideal, governmental regulation of insider trading is not without its critics.

Governmental regulation of insider trading may be superfluous because certain arguments suggest that companies voluntarily would adopt rules that bar insider trading. First, companies routinely enter into contracts in order to prevent trading on the basis of material, nonpublic information with those who provide services and who, by providing these services, receive such information.<sup>167</sup> Such contractual restrictions pre-dated federal securities laws.<sup>168</sup> Second, companies prohibit insiders from trading freely in the company's own securities.<sup>169</sup> Some traders prefer securities that fluctuate wildly in price, allowing them opportunities to trade profitably.<sup>170</sup> Left unchecked, managerial insiders could cause their company to take actions that would create such volatility in stock price, in turn creating profitable trading opportunities for themselves.<sup>171</sup> To protect investors, and as a guard against the creation of volatility, companies voluntarily and routinely limit insiders' opportunities to trade in the company's securities.<sup>172</sup>

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167. See *United States v. O'Hagan*, 521 U.S. 642, 647 (1997) (noting that the company and its outside counsel "took precautions to protect the confidentiality" of the company's planned tender offer); *Carpenter v. United States*, 484 U.S. 19, 23 (1987) (recognizing the official policy of the Wall Street Journal of keeping the contents of a column that discussed stocks and consequently impacted the market confidential before publication). See generally *SEC v. Ginsburg*, 362 F.3d 1292, 1297 (11th Cir. 2004) (chronicling how "[a] confidentiality agreement was executed . . . and due diligence began"); *AES Corp. v. Dow Chem. Co.*, 325 F.3d 174, 176 (3d Cir. 2003) (documenting how a confidentiality agreement was "a precondition to receiving the Offering Memorandum . . ."); *Hartmarx Corp. v. Abboud*, 326 F.3d 862, 864 (7th Cir. 2003) (detailing how a confidentiality agreement was necessary before providing financing details); *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 184 (2d Cir. 2001) (noting how the companies engaged in the transaction "had entered into a confidentiality agreement and engaged in extensive due diligence . . .").

168. See *EASTERBROOK & FISCHER*, *supra* note 122, at 259.

169. See *id.*

170. See *id.* at 260; RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 459 (5th ed. 1998) (noting that managers' energies might be drawn away from their managerial duties and directed toward creating volatile stocks).

171. See *EASTERBROOK & FISCHER*, *supra* note 122, at 260; POSNER, *supra* note 170, at 459.

172. See PRESTON GATES ELLIS LLP, *NEW COMPLIANCE PROCEDURES NECESSARY TO MEET NEW FILING REQUIREMENTS FOR SECTION 16 REPORTS 1* (2002), available at <http://www.prestongates.com/images/pubs/BUS%20Enews%20Alert%20081202.pdf> ("[T]he Company's pre-clearance procedures . . . require [Company insiders] not to engage in any transactions involving the Company's securities without first obtaining pre-clearance of the transaction from the Company. Pre-clearance procedures and black-out periods help to prevent inadvertent violations of the federal securities laws prohibition on insider trading. Companies that do not have such procedures in place should consider adopting [them] as soon as possible."); NETFLIX, INC., *INSIDER TRADING COMPLIANCE PROGRAM 1-2*, [http://ir.netflix.com/downloads/2002\\_insider\\_policy.doc](http://ir.netflix.com/downloads/2002_insider_policy.doc) ("The Company has determined that all directors and officers and those other employees of the Company identified on Attachment 4 (as may be amended from time to time), shall be prohibited from buying, selling or otherwise effecting transactions in any stock or other securities of the Company or derivative securities thereof

While these arguments suggest that governmental involvement barring insider trading is unnecessary because private rules suffice, other arguments counsel against all barriers on insider trading—both governmental and private. First, allowing insiders to trade based on material, non-public information causes the market to move and reflect information that companies may not otherwise disclose.<sup>173</sup> Accurate pricing protects investors generally and increases the likelihood that goods will be allocated in an efficient manner. Second, investors arguably benefit from insider trading because firms could lower compensation to insiders with the understanding that a portion of insiders' incomes would come from insider trading profits.<sup>174</sup>

Despite arguments suggesting that private rules would curb insider trading and arguments favoring the absence of restrictions, firms are likely to concoct suboptimal disclosure rules regarding insider trading because of the high cost of their creation and enforcement.<sup>175</sup> For example, rules addressing who constitutes an "insider" and those to whom the restrictions should apply, have not been specific, which complicates their enforcement.<sup>176</sup> Furthermore, such rules apply to "material" misstatements and omissions, but a clear understanding of "materiality" in various settings has been elusive.<sup>177</sup> Individuals may evade rules prohibiting insider

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except during a [specified] trading window that will begin . . . following the date of public disclosure of the Company's financial results . . . and will end . . . on the last day of the second calendar month of the next fiscal quarter. In addition, the Company shall have the right to impose special black-out periods . . .").

173. See EASTERBROOK & FISCHER, *supra* note 122, at 256-57 (arguing that insider trading provides a valuable mechanism through which firms can disclose information and maximize the firm's worth for the benefit of insiders and shareholders alike); POSNER, *supra* note 170, at 459 (positing that allowing insider trading may not be bad thing because it would encourage otherwise risk-averse managers to take risks, which would benefit shareholders with diversified portfolios).

174. See EASTERBROOK & FISCHER, *supra* note 122, at 257-58 (pointing out the benefits of allowing managers to alter their compensation packages based on new knowledge, rather than continuously renegotiating contracts, and arguing that allowing insider trading is a good way to distinguish superior managers).

175. See *id.* at 257 (observing complete disclosure is costly and after a point, does not survive a cost-benefit analysis); POSNER, *supra* note 170, at 460 (noting the high costs of enforcement and some of the complications surrounding the issue).

176. See COX ET AL., *supra* note 129, at 854 (posing the question "Who is an Insider?"). Compare *Chiarella v. United States*, 445 U.S. 222, 231-34 (1980) (holding that the financial printer, who was retained by the acquirer, was not an insider and therefore not under a duty to disclose because he received no information from the target company and he had no special relationship with the shareholders), with *United States v. O'Hagan*, 521 U.S. 642, 647, 666-67, 676 (2000) (holding that an attorney working at a law firm retained by the acquirer was an insider and was in breach of a duty of loyalty and confidentiality when he purchased shares after misappropriating information from the acquirer, despite the absence of a relationship between the attorney and shareholders of the target).

177. Selective Disclosure and Insider Trading, Securities Act Release No. 33-7881, 73 SEC Docket 3 (Aug. 15, 2000), <http://www.sec.gov/rules/final/33-7881.htm> ("[The Commission] acknowledges . . . that materiality judgments can be difficult . . ."); see COX ET AL., *supra* note 129, at 561-628 (detailing the considerations and complications of

trading, complicating detection and thus enforcement.<sup>178</sup> Even if it were true that private disclosure rules were ineffective, and that the prevention of insider trading were an unqualified good, federal anti-fraud rules that ban insider trading and federal rules requiring exchanges to enforce those bans may achieve the desired end without requiring mandatory disclosure.<sup>179</sup> Anti-fraud rules, however, speak with less force to firms' silence. So, why not a mandatory disclosure rule to counter any tendency toward silence? We have already covered this ground to a certain extent. Recall that companies that issue securities generally seek the highest price for those securities, and to achieve that end, those issuers must make initial (and commit to make on-going) disclosures.<sup>180</sup> Even a company that discloses in self-interest, however, may not make optimal disclosures due to third-party effects and the last period problem, addressed below.

## 2. *Third-party effects*

Although a company acts in its self-interest by disclosing information voluntarily, a company may not disclose the ideal amount and quality of information if it cannot reap the benefits that flow from such disclosure. For example, when Alpha Company discloses information, such information may reach Ina Investor who, based upon Alpha's disclosures, invests in Alpha's competitor, Omega Company. Investor—the third party—attached value to and benefited from Alpha's disclosure, but Alpha cannot charge Investor for the information. Omega—*Alpha's competitor*—also benefits from Alpha's disclosure. Omega was able to secure funds (Investor's investment) without making (or paying to make) the disclosure. Depending on the nature of Alpha's disclosure, Omega may learn about Alpha's business such that Omega can gain a competitive advantage over Alpha, or minimize Alpha's competitive advantage. Because such third-party beneficiaries will not compensate the disclosing firm, the disclosing

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assessing materiality).

178. See generally JAMES B. STEWART, *DEN OF THIEVES* (1991) (documenting the Wall Street insider trading scandals of the 1980s).

179. See EASTERBROOK & FISCHER, *supra* note 122, at 297 (observing that "proponents of mandatory disclosure have not established that there is a lesser incidence of fraud with disclosure rules than with antifraud legislation alone"); see also Benston, *supra* note 135, at 135-36 (noting "there is no empirical or a priori basis for an assertion that the '34 Act has had a net positive effect on the publication of fraudulent or misleading financial statements"); John C. Coffee, Jr., *Market Failure and The Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 739-40 (1984) (questioning the need for mandatory disclosure despite the difference in interests of managers and shareholders which may encourage fraud). But see Seligman, *supra* note 142, at 18 (showing that prior to the 1933 and 1934 Acts, virtually every state had adopted an anti-fraud statute regarding securities, but those statutes did not prevent widespread fraud because those state statutes only applied intrastate such that the restrictions could be evaded). Consequently, a federal anti-fraud rule may be appropriate.

180. See *supra* notes 129-133 and accompanying text.

firm will under-produce information, disclosing less than the optimal amount of information. Relative to a world without a stock exchange, an exchange may lessen such third-party effects, but they will not be eliminated.

### 3. *Last period problem*

A company's current willingness to disclose information rests, in part, on future discipline. Current investors become future sellers and those future sellers (and future purchasers) want information. Current management responds accordingly. A manager without a future—one that is in his last period<sup>181</sup>—may not be disciplined to make the desired disclosures.<sup>182</sup> An exchange seeks to remedy the matter by contract; those companies that list their securities on the exchange must provide on-going disclosure. Although the company may continue, managers in their last period have no incentive to disclose thoroughly such that their influence results in suboptimal disclosure.<sup>183</sup> A mandatory disclosure system makes silence actionable, whereas silence absent a duty to disclose (and there would be no duty in a world of voluntary disclosure) would not be actionable. Of course, if, in their last period, managers act in their self-interest and to the detriment of the shareholders at large, remaining silent in doing so, then those shareholders have a cause of action, independent of federal rules requiring disclosure.<sup>184</sup> Again, the assumption is that “[s]ilence means bad news.”<sup>185</sup> Accordingly, those not in their last period may impose pressure to disclose to protect their reputations and avoid future negative inferences by investors.

Exchanges seek to dampen the threat of non-disclosure by listed companies by requiring that these companies have independent third parties certify the accuracy of their disclosures. Accountants, underwriters, and lawyers provide such certification, and often signal the quality of an issuer. Prior to any federally imposed requirement, the NYSE required that the

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181. See CHOPER ET AL., *supra* note 134, at 566-67 (“In this ‘end game,’ there is greater reason for managers to act opportunistically . . . . Economists call this a ‘final period’ problem, referring to the fact that the agent no longer has the same incentives to serve the principal faithfully.”).

182. See POSNER, *supra* note 170, at 370 (“Reputation alone will ordinarily restrain employers, unless the employer . . . is in his last period. In that event, the employee has little to lose from being fired—by the hypothesis of a last period, the employer is about to go out of business . . .”).

183. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 864-74, 893 (Del. 1985) (discussing target management's failure to disclose information regarding the process by which target and acquirer reached the acquisition price when the individual that served as both target's chairman and chief executive officer was on the verge of retirement).

184. See *id.* at 858 (holding that target management's failure to inform itself adequately amounted to a breach of the duty of care and such breach could not be cured by shareholder approval because target's management failed to disclose how it informed itself).

185. Easterbrook & Fischel, *supra* note 125, at 683.

financial statements of listed companies be audited by independent accountants, and listed companies did not view such a requirement as an unwanted intrusion.<sup>186</sup> Investors' concerns of omissions would be quieted by third-party review certifying the accuracy of disclosures, and implicitly, the absence of material omissions. Underwriters "compel disclosure of embarrassing facts uncovered during the course of its investigation"<sup>187</sup> in order to preserve their reputations and avoid liability for fraud.<sup>188</sup> Companies that tap the public for funds seek underwriters of the highest reputation as a signal of the issuer's quality,<sup>189</sup> and because issuers seek underwriters with the best reputations,

[P]restigious underwriters reject many more candidates than they accept . . . . [T]he screening and investigative processes employed [by underwriters] . . . . should weed out those prospective issuers least likely to make productive use of publicly invested funds and should identify elements of risk in those issues which are selected and presented to the public.<sup>190</sup>

Attorneys can also signal issuer quality.<sup>191</sup> Because of potential liability stemming from their expertise in connection with issuances,<sup>192</sup> attorneys, like underwriters, may be selective as to which issuers they represent.<sup>193</sup>

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186. See MEEKER, *supra* note 124, at 573 (stating that "[t]here must be appended to all financial statements and inventories required by the Committee, the certificate of a public accountant, qualified under the laws of some state or country, which certificate shall contain a statement that no one of the items carried under the term 'Miscellaneous' in the list of Investments has been held for more than one year."); see also George J. Benston, *The Value of the SEC's Accounting Disclosure Requirements*, 44 ACCT. REV. 515, 520 (July 1969) (In 1932, "all corporations applying for a listing on the NYSE were required to have their annual statements audited by independent public accountants"); *id.* at 519 tbl.I (indicating that, in 1926, prior to federally imposed disclosure requirements, eighty-two percent of companies that disclosed financial statements were audited by certified public accountants (CPAs) whereas, after federally imposed disclosure requirements in 1934, ninety-four percent of companies that disclosed financial statements were audited by CPAs).

187. Michael P. Dooley, *The Effects of Civil Liability on Investment Banking and the New Issues Market*, 58 VA. L. REV. 776, 786 (1972).

188. See 15 U.S.C. § 77k(a)(5) (2000) (listing underwriters as liable with respect to fraud); e.g., *Norman v. Paco Pharm. Servs., Inc.*, 1989 WL 110648, at \*1, \*10 (Del. Ch. Sept. 22, 1989) (unreported) (including co-underwriters as defendants and refusing to dismiss counts of fraud and deceit).

189. COX ET AL., *supra* note 129, at 114 ("[I]ssuers seek high reputation underwriters as one of the strategies they pursue to signal the security's quality.").

190. Dooley, *supra* note 187, at 786-87; see POSNER & SCOTT, *supra* note 130, at 325 (excerpting a report by William H. Beaver observing that firms try to "signal their higher quality" by having independent third parties oversee their disclosure systems).

191. See Karl S. Okamoto, *Reputation and the Value of Lawyers*, 74 OR. L. REV. 15, 31 (1995) (suggesting that, with respect to legal opinions in registered offerings, the prestige of outside counsel bolsters the reputation of issuers and only the most elite issuers rely solely on in-house counsel).

192. See 15 U.S.C. § 77k(a)(4) (suggesting an attorney may be liable for material misrepresentations and omissions in registration statements).

193. COX ET AL., *supra* note 129, at 114 (suggesting the reputation of the lawyer can signal the "quality of the offering").

These means of certification, whether exchange-imposed or self-induced, minimize the need for federally imposed disclosure obligations.

Although “it is unquestionably true that [federal] disclosure rules have led corporations to disclose more information now than they did before 1933,”<sup>194</sup> companies made voluntary disclosures in advance of the passage of federal securities laws, and would have continued to make similar disclosures had those laws never been passed. Arguments that the NYSE constitutes a governmental actor because the government compels it to require disclosure are overbroad. Likewise, arguments suggesting the presence of encouragement or entwinement do not possess compelling force.

### C. *Anti-fraud rules*

Because market incentives may lead to sub-optimal disclosure,<sup>195</sup> rules that bar fraud may fill the void. Certainly, rampant fraud in a market will deter investors from trading in that market. As mentioned above, the absence of traders or decreased liquidity negatively impacts the value of the security at issue. Therefore, issuers would prefer to stamp out fraud.<sup>196</sup> Moreover, fewer trades yield less revenue for exchange members that execute these trades.<sup>197</sup> Consequently, the exchange members would prefer an absence of fraud. Thus, one would expect that an exchange will respond to the preferences of investors, issuers, and exchange members by proscribing fraud.<sup>198</sup> In fact, the NYSE proscribed fraud in advance of any federally imposed prohibition.<sup>199</sup> Regarding antifraud rules, the rub tends to appear, not in their adoption, but in their enforcement.

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194. EASTERBROOK & FISHEL, *supra* note 122, at 299.

195. *See id.* at 283 (reasoning that “[a]uditing, investment banking, and underwriting firms are expensive to . . . operate; . . . debt and dividends entail transaction . . . costs; managers must be paid extra . . . ; verification . . . by . . . buyers may be the most expensive of all”).

196. *See* OESTERLE, *supra* note 132, at 111 (arguing that lenient requirements for listing securities may allow some firms to act fraudulently). Companies themselves may also respond. *See* GENERAL ACCOUNTING OFFICE, HIGHLIGHTS OF GAO’S CORPORATE GOVERNANCE, TRANSPARENCY AND ACCOUNTABILITY FORUM 8 (2002) [hereinafter CORPORATE GOVERNANCE], available at <http://www.gao.gov/new.items/d02494sp.pdf> (pointing out that recent business failures have forced many companies to examine risks more closely).

197. *See* OESTERLE, *supra* note 132, at 118 (emphasizing that exchange members’ revenue increases as the volume of stock trades increases).

198. *See* EASTERBROOK & FISHEL, *supra* note 122, at 294 (explaining the incentives for exchanges to adopt rules which minimize fraudulent acts). For example, exchanges are benefited by a decrease in fraud because it encourages repeat business from investors. *Id.*

199. *See* MEEKER, *supra* note 124, at 41 (acknowledging that the NYSE has a self-imposed policy of deterring fraudulent methods by adopting and enforcing stern rules for exchange members).

#### D. Enforcement

“Unenforced rules are no rules at all.”<sup>200</sup> Rules lose meaning unless policed and enforced. The Exchange Act authorizes the Commission to suspend or revoke an SRO’s registration, censure the SRO or limit its activities, functions, and operations.<sup>201</sup> Additionally, the Commission may seek an injunction to compel compliance with those laws and rules.<sup>202</sup> Accountability influences behavior.<sup>203</sup> Consequently, some commentators have suggested that such federally imposed enforcement obligations (and, as such, federally imposed penalties for failure to enforce) convert private action into state action.<sup>204</sup>

Even absent federal intervention, the NYSE would police and enforce rules regarding disclosure and fraud because the concerns of the NYSE and federal regulators generally overlap.<sup>205</sup> Just as private incentives would lead an exchange to promulgate such rules, private incentives generally would lead an exchange to police and enforce those rules.<sup>206</sup> Of the

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200. *Toscano v. Chandris, S.A.*, 934 F.2d 383, 387 (1st Cir. 1991).

201. *See* 15 U.S.C. § 78s(h)(1) (2000) (empowering the SEC to limit operations of an SRO if, after notice and a hearing, the SEC determines that the SRO failed to enforce compliance by a member, associated person or participant with the Act, the related rules, or the SRO’s own rules).

202. *See id.* § 78u(e)-(f) (stating that the U.S. government has the power to issue writs of mandamus, injunctions, and orders commanding compliance with the rules).

203. *See* Mark Seidenfeld, *The Psychology of Accountability and Political Review of Agency Rules*, 51 DUKE L.J. 1059, 1064-65 (2001) (reasoning that accountability forces decision makers to justify their actions and suffer negative consequences for poor decisions which the decision maker wants to avoid).

204. *See* Richard L. Stone & Michael A. Perino, *Not Just a Private Club: Self-Regulatory Organizations as State Actors When Enforcing Federal Law*, 1995 COLUM. BUS. L. REV. 453, 463 (1995) (suggesting that, because SROs must enforce federal rules, they should be viewed as state actors). *See generally* 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) (same).

205. *See* U.S. SECURITIES AND EXCHANGE COMMISSION, FINAL REPORT: 2003 CONFERENCE ON FEDERAL-STATE SECURITIES REGULATION (2003), <http://www.sec.gov/info/smallbus/ffedst2003.htm> (stipulating that the concerns of the SROs considerably overlap with those of the SEC and state securities administrators).

206. *See* OESTERLE, *supra* note 132, at 111 (reasoning that enforcement of rules increases returns on investment and thus increases demand for an exchange’s listings); *Nat’l Collegiate Athletic Ass’n v. Tarkanian*, 488 U.S. 179, 196 (1988) (declaring that members of an organization all have an interest in the enforcement of standards promulgated by the organization); *United States v. Solomon*, 509 F.2d 863, 869 (2d Cir. 1975) (finding that NYSE’s investigation of an alleged violator was “in pursuance of its own interests and obligations [and] not as an agent of the SEC”); *United States v. Bloom*, 450 F. Supp. 323, 327 (E.D. Pa. 1978) (holding that a search was not a governmental search when the search served the purpose of the employer by protecting the employer from extensive civil liabilities if its employees committed wrongs while employer supervision was lax). *See generally* *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearings Before the S. Comm. Banking, Housing, and Urban Affairs*, 107th Cong. 572 (2002) (statement of Robert R. Glauber, Chairman and Chief Executive Officer, National Association of Securities Dealers, Inc.) [hereinafter *Enron Hearings*] (testifying that NASD’s members are benefited by “tough and even-handed” enforcement of the rules).

NYSE's approximately 1,500 employees, five hundred serve in enforcement positions.<sup>207</sup> Arguments that the government coerces an exchange to police and enforce its rules are overbroad because an exchange serves its interests by policing and enforcing its rules.<sup>208</sup>

### 1. Conflict

Although there may be a general overlap between the interests of the NYSE and the Commission, which may serve to dampen the impact of any purported federal coercion or encouragement, the interests of the NYSE and the Commission sometimes conflict. "Exchange regulators [may] be reluctant to take steps that would put member firms out of business or would generally reduce member firms' income."<sup>209</sup> On numerous occasions, contrary to governmental preferences, the NYSE or some other SRO furthered its own interests or the interests of its members to the detriment of the public. The congressional design calls for the Commission to protect the public against such self-interested behavior by SROs. On occasion, however, the Commission has failed to scrutinize SROs closely on an on-going basis, in part, because of limited resources.<sup>210</sup>

Instead of continuous scrutiny, the Commission, at times, has responded only after crises have erupted. At such points, factors (other than the Commission) have contributed to remedial action implemented by SROs. For reasons more fully explained below and in the following section, the requisite federal coercion, encouragement, or entwinement seems lacking for attribution of private action to the government. A few public/private conflicts are examined below.

During the mid-1960s, as the exchange members' focused on garnering more trades (and thus more income), exchange members paid inadequate attention to effecting these trades. Increased trading volume exposed exchange members' inefficiencies in effecting the trades. This resulted in,

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207. See NYSE, INC., STOCK MARKET SAVVY: INVESTING FOR YOUR FUTURE 6 (2001), available at [http://www.nyse.com/pdfs/TG\\_Mech.pdf](http://www.nyse.com/pdfs/TG_Mech.pdf) (stating that over one-third of NYSE employees are involved in regulation); U.S. SECURITIES AND EXCHANGE COMMISSION, 1997 CONFERENCE ON FEDERAL-STATE SECURITIES REGULATION: FINAL REPORT (1997), <http://www.sec.gov/info/smallbus/ffedst97.htm> (stating that, of the 500 NYSE employees involved in regulation, 250 are examiners, 120 are involved with enforcement and 100 are investigators).

208. Compare *infra* Part IV (arguing that joint investigations may entwine governmental and private actors, such that actions of SROs should be attributed to the government).

209. JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 464 (2d ed., Northeastern Univ. Press 1995).

210. See S. REP. NO. 94-29, at 34 (1975), reprinted in 1975 U.S.C.C.A.N. 179, 212 (explaining that "[t]here may have been undue deference to the self-regulatory organizations because of the cumbersomeness of the oversight mechanisms or the unavailability of appropriately focused remedies").

for example, untimely delivery of securities or funds to customers.<sup>211</sup> Piled on top of losses due to operational inefficiencies were losses due to declining trading volume that stemmed from a stock market decline.<sup>212</sup> An alarming number of NYSE members (and non-members) failed.<sup>213</sup> The exchange and its members failed to regulate themselves, and investors lost in the process. Nevertheless, this was not the finest hour for the Commission either. The Commission had received an increasing number of customer complaints regarding broker-dealer inefficiencies,<sup>214</sup> and was “aware that a crisis existed and that additional restrictions were necessary.”<sup>215</sup> The Commission, however,

[D]id not have reliable data on the seriousness of individual broker-dealer back-office or financial problems until it was too late for the Commission to prevent firm failures. Nor until it was too late did the SEC appreciate the weaknesses in New York Stock Exchange audit procedures or the extent to which the Exchange’s unwarranted optimism endangered investors.<sup>216</sup>

The Commission failed to anticipate the problems experienced by the NYSE and its members and the Commission was not focused on exchange members’ operational and financial capacities.<sup>217</sup> During and after the crisis, the Commission deferred to industry self-regulation.<sup>218</sup> Eventually, the crisis prompted Congress to act—creating the Securities Investor Protection Corporation and empowering the Commission to require SROs to examine or inspect the financial condition of members.<sup>219</sup>

In 1975, the SEC adopted a rule abolishing fixed commission rates that NYSE members charged non-members to trade on the exchange.<sup>220</sup> These

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211. See SELIGMAN, *supra* note 209, at 450-51 (explaining that, during the period of 1967-70, the NYSE intervened in the affairs of over half of the members that dealt with the public because of such operational inefficiencies).

212. See *id.* at 451 (explaining that the NYSE was forced to shorten the trading days in response to the declining market).

213. See *id.* at 452-53 (recalling that the “greatest rash” of financial firm failures in the history of Wall Street occurred during this period: “Approximately 160 New York Stock Exchange member organizations went out of business in 1969 and 1970, about 80 merging with other firms, and the other 80 . . . quietly dissolved, self-liquidated, or retired from the securities business.”).

214. See *id.* at 451 (recalling that customer complaints about broker-dealers rose by nearly 8000 between 1968 and 1969).

215. *Id.* at 463 (recalling that SEC Chairman Cohen alerted the SEC that the situation surrounding the NYSE was getting worse).

216. *Id.* at 458.

217. See *id.* at 460-61 (explaining that the Commission misunderstood and thus underestimated the NYSE’s capability of monitoring the financial integrity of its members).

218. See *id.* at 464 (terming such deference as “not fully defensible”).

219. See *id.* at 465; Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa-lll (1970) (amended 2004) (restoring to investors funds under the control of financially troubled brokerages).

220. See Adoption of Securities Exchange Act Rule 19b-3, Securities Act Release No. 34-11203, 40 Fed. Reg. 7,394 (Feb. 20, 1975) (abolishing the ability of an exchange to

rates were higher than those that would have been produced by competition, which damaged public investors. Fearing damage to their bottom line, some exchange members preferred fixed commission rates to lower rates set by rule or by competition. Other members may not have objected to unfixing rates for reasons articulated by NYSE President Robert Haack. According to Haack, because the exchange began to face competition from regional exchanges and the over-the-counter market (all of which negotiated commission fees), the NYSE was losing transactions to the other markets, which damaged the NYSE and its members. Therefore, abolishing fixed commission rates would ultimately serve the NYSE and its members.<sup>221</sup> Lower rates may have permitted greater trading volume and ultimately greater profits, which seems to have occurred.<sup>222</sup> Because the NYSE had charged fixed commission rates for one-hundred years, the SEC had “long ignor[ed] the costs to investors of the Exchange’s fixed brokerage commission rate structure.”<sup>223</sup> Unfixing the rates took decades.<sup>224</sup>

More recently, New York Attorney General Elliot Spitzer spearheaded a crusade against misdeeds by members and broker-dealers.<sup>225</sup> Allegations against NYSE members included the distribution of fraudulent “buy, sell, or hold” recommendations to investors, which were designed to attract or preserve more profitable investment banking relationships with corporate clientele.<sup>226</sup> In settling charges, members agreed, among other things, to insulate research analysts from investment bankers.<sup>227</sup> One might have suspected that the NYSE would be slow to police such misdeeds, but the Commission was “relatively slow . . . in pursuing the conflicts of

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require its members to charge a fixed rate for commission in exchange for the use of the exchange’s facilities).

221. See SELIGMAN, *supra* note 209, at 477 (arguing that fixed commission rates would have decreased the profitability of the exchanges).

222. See *id.* at 485 (explaining that lower rates lead to more players in the market, thus leading to rapid growth in the securities industry).

223. 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, 1359 (2004) (noting that the NYSE expected no intervention by the SEC because the SEC rarely interfered with its activities in the past).

224. See *id.* at 1366 (explaining that the lack of intervention by the SEC over the years left many issues to be addressed).

225. See Robin Sidel, *Wrong Number: Some Untimely Analyst Advice on WorldCom Raises Eyebrows*, WALL ST. J., June 27, 2002, at A12.

226. See DONNA M. NAGY ET AL., SECURITIES LITIGATION AND ENFORCEMENT: CASES AND MATERIALS 755 (2003) (detailing investigations into NYSE’s members stock recommendations which were “supposedly independent and objective investment advice”) (citation omitted).

227. See Press Release, Securities and Exchange Commission, SEC, NY Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement To Reform Investment Practices (Dec. 20, 2002) (on file with the American University Law Review), <http://www.sec.gov/news/press/2002-179.htm>.

interest . . . .”<sup>228</sup> The Commission could not have been “shocked, simply shocked”<sup>229</sup> that the opportunity to collect investment banking fees might have colored those members’ stock recommendations to investors. The Commission appears not to have initially identified the problem nor has it lead the path to its resolution.

Others have suggested that the role played by the Commission in overseeing the operations of SROs indicates that the actions of the SRO should be attributed to the government. At times, even when the NYSE has acted to the detriment of the public, the response of the Commission has been *other than* swift and sure. Governmental coercion, encouragement, or entwinement is not always present and hardly seems conclusive.

## 2. Individual enforcement officials

Of course, an exchange must act through natural persons.<sup>230</sup> As such, the motivations of these individuals should be considered. How might a rational SRO enforcement official behave? Many of the same arguments that suggest that an SRO may under-enforce rules also suggest that an SRO enforcement officer may not be influenced by accountability to the government. Therefore, there may be no governmental coercion and thus, no governmental action. The fact that the SRO is accountable to the Commission,<sup>231</sup> as well as the Commission’s oversight of SRO enforcement actions, has led some to believe that the acts of the SRO should be attributed to the government.<sup>232</sup> Certainly there is some truth to

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228. See NAGY ET AL., *supra* note 226, at 758. *But c.f.* Charles Gasparino & Scot J. Paltrow, *SEC Joins Pack, Opens Inquiry into Analysts*, WALL ST. J., Apr. 26, 2002, at C1 (reporting that the SEC plans to take an active role in the investigation into the practices of Wall Street analysts).

229. See CASABLANCA (Metro-Goldwyn-Mayer 1942) (“I’m shocked, simply shocked, to find that gambling is going on in this establishment.”).

230. See Phyllis Diamond, *SEC Demand for ‘Cooperation’ Seen Raising Due Process Concerns*, 36 FED. SEC. & L. REP. 1070, 1074 (2004) (“[T]he SEC assesses a company based in part on what remedial measures it has implemented . . . . [Kenneth B. Winer, former senior counsel and branch chief of the SEC Division of Enforcement, continued,] ‘It also means that relatively junior members of the SEC staff have the ability to effectively terminate careers.’”); Mark Maremont & Deborah Solomon, *Missed Chances: Behind SEC’s Failings: Caution, Tight Budget, ‘90s Exuberance*, WALL ST. J., Dec. 24, 2003, at A1 (reporting that four of five staffers in the NASDAQ Stock Market’s self-regulatory body had less than one year’s experience).

231. See *Enron Hearings*, *supra* note 206 (statement of Robert R. Glauber, Chairman and Chief Executive Officer, National Association of Securities Dealers Inc.) (stating that the SROs are accountable to the SEC in the same manner that SRO members are accountable to the NASD).

232. See Stone & Perino, *supra* note 204, at 463 (suggesting that, because of the government’s influence over SROs in the performance of enforcement duties, SROs should be considered state actors); Gillian E. Metzger, *Privatization as Delegation*, 103 COLUM. L. REV. 1367, 1423 n.198 (2003) (suggesting that, because SROs play a significant role in the federal regulation of securities and because the role of the federal government may be more residual, SROs may be state actors in light of the privatization of enforcement responsibilities).

the assertion that accountability to the government will influence an enforcement officer. A rational actor analysis, however, suggests that the purported influence of Commission review on SRO enforcement actions is overstated.

First, the employee is accountable to the employer. A rational employee generally would act to serve the employer's interests. To serve their own interests, rational SRO enforcement officers would seek to further the interests of the SRO itself by exercising discretion in requiring disclosure to facilitate liquidity in the market and in stamping out fraud. So, as suggested by the *Solomon* court,<sup>233</sup> enforcement furthers the SRO's own private interests and such private actions generally should not be attributed to the government.

Looking beyond the broad influences on the decision-making process of an SRO enforcement officer, the degree to which an SRO decision maker is influenced by governmental oversight must be considered in light of the frequency with which the government exerts influence and the magnitude of such influence.<sup>234</sup>

*a. Enforcement is infrequent*

The Commission, under the Securities Exchange Act of 1934, possesses the power to suspend or revoke the registration of an exchange that has failed to enforce compliance with the exchange's own rules and federal law and rules,<sup>235</sup> but the Commission has exercised the power only once, withdrawing the registration of the San Francisco Mining Exchange.<sup>236</sup> In that one instance, however,

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233. See *United States v. Solomon*, 509 F.2d 863, 868-69 (2d Cir. 1975) (indicating, without elaboration, that self-interest motivates SRO enforcement).

234. See Herbert Simon, *A Behavioral Model of Rational Choice*, 69 Q.J. ECON. 99, 111-13 (1955). Such officers exercise discretion regarding, among other things, whom to investigate, whom to charge, with what to charge them, and what sanctions to seek. When exercising discretion, the NYSE enforcement officer operates with imperfect information as to the potential outcomes that will follow from such decisions and their likelihood of occurrence. Rational actors gather information to enable them to estimate accurately the likelihood of those potential outcomes. Initially, additional nuggets of information enable actors to make decisions that are more informed. The rational actor, however, will not gather every possible datum that could impact the determination of the likelihood of the event under scrutiny. One acts with "bounded rationality." Even if every piece of information were available, no decision maker would attempt to obtain every such nugget. At some point, it becomes difficult to locate new pieces of information and these additional nuggets of information may add little to the competence of the decision maker—diminishing returns, or marginal decreasing utility. The rational actor is not presumed to know all.

235. See 15 U.S.C. § 78s(h) (2000) (empowering the SEC to limit operations of an SRO if, after notice and a hearing, the SEC determines that the SRO failed to enforce compliance by a member, associated person or participant with the Act, the related rules or even the SRO's own rules).

236. See *generally* *San Francisco Mining Exch. v. SEC*, 378 F.2d 162 (9th Cir. 1967) (upholding an SEC determination withdrawing the registration of the San Francisco Mining Exchange due to violations of regulations by members of the Exchange).

[T]here had been *numerous and repeated violations of statutes and regulations* involving members and officials of the Exchange and issuers of securities listed on the Exchange; . . . the Exchange had *not made any effort to force issuers or members to comply with the Act or to force them to comply with its own rules . . . ; . . . [and] the Exchange had been a vehicle for evading and circumventing provisions of the statutes and regulations* designed for the protection of investors . . . .<sup>237</sup>

A nuclear sanction that results from pervasive enforcement problems at the exchange may enter the decision-making calculus of the exchange and thus may indirectly impact the decision-making process of an individual SRO enforcement officer. However, the direct, marginal impact of nuclear sanctions for pervasive problems on the decision-making process of an individual SRO enforcement officer (who handles a relatively small portion of the SRO's overall enforcement caseload) would be small.<sup>238</sup>

In 1975, Congress amended the Exchange Act to expand the Commission's ability to discipline SROs. The amendments included censure and limitations on the activities, functions, and operations of an SRO.<sup>239</sup> Even with less draconian disciplinary options than suspension or revocation of registration, enforcement actions against SROs have been few in number.<sup>240</sup> Because the Commission has imposed such lesser sanctions so few times, those sanctions are unlikely to influence an SRO enforcement official to any great degree.

If the Commission almost never intervenes formally, then the actions of the SRO may frequently be in line with the Commission's preferences. An SRO may behave this way because it is compelled to do so. However, it may also behave this way because the interests of the Commission and the interests of the SRO are aligned. Of course, if the government is not compelling the behavior, that is, if the SRO enforces the laws and rules to

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237. *Id.* at 164 (emphases added).

238. See Richard A. Posner, *The Probability of Catastrophe*, WALL ST. J., Jan. 4, 2005, at A12 (contending that elected officials with limited terms of office are not likely to be influenced by "low-risk disaster possibilities").

239. See 15 U.S.C. § 78s(h) (empowering the SEC to suspend or revoke the registration of an SRO in the name of public interest if the SRO does not comply with any of the rules and regulations set forth in the Act).

240. See, e.g., Midwest Clearing Corp., Exchange Act Release No. 31,416, 52 SEC Docket 2384 (Nov. 6, 1992) (censuring the Midwest Clearing Corporation for violating the requirements of the Exchange Act); Chicago Bd. Options Exch., Exchange Act Release No. 26,809, 43 SEC Docket 1267 (Nov. 6, 1992) (censuring the Chicago Board Options Exchange for violating its own rules); Philadelphia Stock Exch., Exchange Act Release No. 16,648, 19 SEC Docket 876 (Mar. 13, 1980) (censuring the Philadelphia Stock Exchange for failing to enforce compliance with the Exchange Act by its members); Boston Stock Exchange & Boston Stock Exchange Clearing Corporation, Exchange Act Release No. 17,183, 21 SEC Docket 22 (Oct. 1, 1980) (censuring the Boston Stock Exchange for failing to monitor properly its members); see also Deborah Solomon et al., *SEC Prepares to Charge the NYSE*, WALL ST. J., Jan. 13, 2005, at C3 (reporting that the NYSE will soon be charged with violating the Exchange Act by failing to monitor properly specialists).

further its own interests (independent of governmental influence), then the argument that the SRO amounts to a governmental actor is weakened. Although evidence of their common interests abounds,<sup>241</sup> representatives of the federal government have stated their personal beliefs that SROs do not adequately enforce laws and rules. Competition may be the principal source for deviation from the ideal level of enforcement (from the perspective of the federal government) and the SRO's actual level of enforcement.<sup>242</sup>

For example, the NYSE faces competition from the American Stock Exchange and NASDAQ; such competition may negatively impact enforcement.<sup>243</sup> For example, competition may cause the NYSE to allocate resources away from enforcement of anti-fraud rules because such rules are difficult to craft with precision and because detection of violations is difficult. Moreover, an SRO may under-enforce because of the fact that the federal government independently enforces anti-fraud laws<sup>244</sup> and investors privately enforce those laws.<sup>245</sup> Because SRO enforcement may fail or may otherwise be supported by governmental and private enforcement actions, SROs may not enforce the relevant laws and rules with the optimal level of vigilance.<sup>246</sup> Instead, SROs may allocate resources away from enforcement

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241. See U.S. SECURITIES AND EXCHANGE COMMISSION, FINAL REPORT: 2003 CONFERENCE ON FEDERAL-STATE SECURITIES REGULATION (2003), <http://www.sec.gov/info/smallbus/ffedst2003.htm> (illustrating that the concerns of the SROs considerably overlap with those of the SEC and state securities administrators); U.S. SECURITIES AND EXCHANGE COMMISSION, 1997 CONFERENCE ON FEDERAL-STATE SECURITIES REGULATION: FINAL REPORT (1997), <http://www.sec.gov/info/smallbus/ffedst97.htm> (suggesting that duplicative examination may be avoided by encouraging information sharing between the SROs and the SEC). The Report also states that the SEC wishes to combine surveillance and enforcement work with the SROs. *Id.*

242. See Annette L. Nazareth, Director of Division Market Regulation, Remarks at an Options Industry Conference (Apr. 23, 2004), <http://www.sec.gov/news/speech/spch042304.htm> (theorizing that pressure from competitors leads to lessened regulatory policies). *But see Enron Hearings, supra* note 206 (statement of Robert R. Glauber, Chairman and Chief Executive Officer, National Association of Securities Dealers Inc.) (stating that SROs are able to use private expertise where the government may not due to the availability of funding in the private sector).

243. See CHOPER ET AL., *supra* note 134, at 580 (explaining that NASDAQ and American Stock Exchange are able to compete with the NYSE by offering less restrictive eligibility criteria); James D. Cox, *Brands v. Generics: Self-Regulation by Competitors*, 2000 COLUM. BUS. L. REV. 15, 15 (2000) (explaining that, in addition to competing in the securities markets, both NYSE and NASDAQ also compete with electronic communications networks).

244. See, e.g., *United States v. O'Hagan*, 521 U.S. 642, 642-43 (1997) (holding that a person who violates anti-fraud rules may be held criminally liable); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 839-42 (2d Cir. 1968) (en banc) (holding that a company may be held liable for violation of anti-fraud rules). *But see NAGY ET AL., supra* note 226, at 435 (arguing that the SEC may overlook smaller cases of fraud, allowing those cases to be addressed in civil actions or by other regulatory agencies).

245. See COX ET AL., *supra* note 129, at 717 (noting that private enforcement is an "indispensable component" of the design of federal securities law).

246. See Seligman, *supra* note 142, at 54 (arguing that the NYSE's efforts at enforcing its listing requirements were minimal).

to areas that yield more “bang for the buck.” This is not to say that a race to the bottom will result in SROs’ providing no enforcement whatsoever because investors and exchange members would not tolerate such circumstances. Consequently, SROs’ view of the ideal level of self-enforcement will be less than the government’s view of the ideal level of SRO self-enforcement. Given a disparity between these views, why doesn’t the Commission intervene more frequently?

Rather than near perfect alignment of SRO and Commission interests, the general absence of intervention by the Commission may stem from fact that the costs of intervention exceed the benefits of intervention. Because there are many points of alignment between the interests of the Commission and the interests of the SROs, the Commission may elect to devote precious resources elsewhere. This may result in infrequent intervention in SRO enforcement actions. Infrequent intervention by the Commission into SRO enforcement matters may lead an individual SRO enforcement official to discount the influence of Commission oversight.

Intervention, in fact, seems infrequent.<sup>247</sup> “The ideal asks [government officials] to be perfectly selfless, perfectly faithful agents of the public interest. The reality is much more complex.”<sup>248</sup> Time is a precious commodity. Intervention by governmental staff would be more time consuming than deference to SRO enforcement. Each staff member of the Commission faces choices—spend Saturday playing golf or spend Saturday in the office. A Commission staff member’s salary is not linked to the number of successful enforcement actions or the complexity of filings reviewed.<sup>249</sup> Commission employees have no immediate financial stake in any enforcement action.<sup>250</sup> At some point, a Commission staffer that shirks his responsibilities would jeopardize his continued employment. Relative to the private sector, however, it is difficult to terminate poor-performing governmental employees.<sup>251</sup>

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247. Cf. CORPORATE GOVERNANCE, *supra* note 196, at 8 (testimony of David Walker, Comptroller General, U.S. Accounting Office) (stating that the most effective means for regulation is aggressive oversight of SROs by regulators).

248. Stephanos Bibas, *Plea Bargaining Outside the Shadow of Trial*, 117 HARV. L. REV. 2463, 2470 (2004).

249. See Maremont & Solomon, *supra* note 230, at A1 (reporting that Commission staffers pick small filings that are easy to review in order to meet their goals for number of reviewed filings). Maremont and Solomon also report that staffers have the option of ordering more time-consuming, complex reviews but are given little incentive to do so. *Id.*

250. There may be future rewards for diligent, successful work, but those future rewards must be discounted to a lesser present value. See Frank Ackerman & Lisa Heinzerling, *Pricing the Priceless: Cost-Benefit Analysis of Environmental Protection*, 150 U. PA. L. REV. 1553, 1559-60 (2002) (explaining that future rewards are discounted to a lesser present value).

251. See Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. ILL. L. REV. 1, 27 (arguing that “governmental employees are often harder to fire if they perform poorly”).

Ours is a government not only of limited powers, but also of limited resources. Governmental agencies have limited budgets so officials must exercise judgment in the proper allocation of those limited resources.<sup>252</sup> “[L]imited resources have forced the SEC to be selective in its enforcement activities. . . .”<sup>253</sup> “[N]obody ha[s] time to . . . prospect[] for new matters.”<sup>254</sup> Although governmental intervention may result in greater sanctions than imposed solely by SRO enforcement,<sup>255</sup> governmental officials may allocate precious resources elsewhere in hopes of better fulfilling its goal of serving the public’s interest.<sup>256</sup> Deference to an SRO enforcement action does provide benefits. Specifically, it frees up limited resources to pursue other enforcement actions or other rulemaking.

Theory is borne out in practice. In 2002, the NYSE undertook two hundred fifty-five disciplinary actions. As the appointed regulatory agency,<sup>257</sup> the Commission—on its own motion or upon application by the

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252. See Cass R. Sunstein, *Bad Incentives and Bad Institutions*, 86 GEO. L.J. 2267, 2273-74 (1998) (explaining that public officials must make judgments based on political and media pressures); Marenton & Solomon, *supra* note 230, at A1 (conceding that the SEC’s Division of Enforcement “sometimes has to make tough choices about what to pursue”).

253. GEN. ACCOUNTING OFFICE, PROTECTING THE PUBLIC INTEREST: SELECTED GOVERNANCE, REGULATORY OVERSIGHT, AUDITING, ACCOUNTING, AND FINANCIAL REPORTING ISSUES 25 (2002) (testimony of David Walker, Comptroller General, U.S. Accounting Office) [hereinafter SELECTED GOVERNANCE] (stating that the imbalance between staff resources and the SEC’s workload has resulted in great strain on the Commission); *see id.* at 19 (indicating that the SEC must prioritize cases as it is not capable of prosecuting every case); COX ET AL., *supra* note 129, at 773 (stating that the SEC’s “trial staff is too small to handle more than a fraction of the cases being investigated”). Not only must SEC enforcement staff be concerned about the agency’s own resources, but they may be unable to ignore administrative and judicial resources. “Judges want us to settle, and if we don’t, they are not happy campers. They don’t have the resources to try these cases.” Rachel McTague, *High Court Ruling on Secondary Liability For Securities Fraud Tested*, *Lawyer Says*, 36 SEC. REG. & L. REP. 2059 (2004) (quoting private attorney Melvyn I. Weiss).

254. Marenton & Solomon, *supra* note 230, at A1 (quoting Richard Sauer).

255. See COX ET AL., *supra* note 129, at 773 (arguing that settlements allow SEC enforcement staff to claim victory without subjecting the defendant to harsh punishment because the defendant may consent to an injunction without admitting or denying a claim); Bibas, *supra* note 248, at 2471 (arguing that prosecutors are encouraged to settle cases which may ultimately end up in harsher penalties than those imposed via a plea-bargain). “Many NYSE enforcement actions are resolved by plea-bargain.” See, e.g., NYSE, Inc., Interactive Brokers LLC, Exchange Hearing Panel Decision 04-2 (Jan. 13, 2004), available at <http://www.nyse.com/pdfs/04-002.pdf> (censuring and fining defendant \$170,000); NYSE, Inc., Helfant Group, Inc., Exchange Hearing Panel Decision 04-3 (Jan. 13, 2004), available at <http://www.nyse.com/pdfs/04-003.pdf> (censuring and fining defendant \$225,000); NYSE, Inc., The Williams Capital Group, L.P., Exchange Hearing Panel Decision 04-4 (Jan. 13, 2004), available at <http://www.nyse.com/pdfs/04-004.pdf> (censuring and fining defendant \$25,000); NYSE, Inc., SGCowen Securities Corporation, Exchange Hearing Panel Decision 04-5 (Jan. 13, 2004), available at <http://www.nyse.com/pdfs/04-005.pdf> (censuring and fining defendant \$60,000).

256. See Sunstein, *supra* note 252, at 2274-80 (contrasting the limited budget of a typical prosecutor with the budget of the Independent Counsel that appears to be less constrained).

257. See 15 U.S.C. § 78c(a)(34)(E) (2000) (identifying the Commission as overseer of national securities exchanges and registered securities associations).

person aggrieved—was empowered to review the merits and sanction imposed by the NYSE in any such disciplinary action.<sup>258</sup> The SEC formally reviewed only a handful of the two hundred fifty-five disciplinary actions and those reviews seemed to be favorable to the NYSE.<sup>259</sup> However, despite the typical absence of formal review, one should not conclude that the Commission conducts no review of NYSE disciplinary actions. If the results of any such informal review are not communicated to the NYSE or its enforcement officials,<sup>260</sup> then the NYSE essentially receives silence as feedback. From the perspective of the SRO official, silence is a good thing;<sup>261</sup> silence means the absence of embarrassing rebuke by the government. Limited intervention by the government—in light of the SRO's and Commission's mutual interests—undermines any argument that the government compels such enforcement and counsels against the general treatment of the SRO as a governmental actor.

SROs (and their representatives) generally make enforcement decisions without consulting federal representatives and without federal specification about how SRO discretion should be exercised. Therefore, general arguments of entwinement between SROs and the government seem overbroad.<sup>262</sup>

*b. Enforcement is slow*

Just as infrequent governmental intervention in SRO enforcement actions undermines arguments that the government compels such

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258. See *id.* § 78s(d)-(e) (granting the Commission power to review any disciplinary actions imposed by an SRO).

259. See *In the Matter of the Application of Stephen Michael Sommer and Spyder Sec. Inc.*, Exchange Act Release No. 49,052, 81 SEC Docket 3256 (Jan. 12, 2004) (affirming findings of violations and sanctions of NYSE Disciplinary Action); *In the Matter of the Application of Anthony A. Adonnino and Thomas Cannizzaro*, Exchange Act Release No. 48,618, 81 SEC Docket 709 (Oct. 9, 2003) (affirming findings of violations and sanctions of NYSE Disciplinary Action, but terming the sanctions as “lenient”); see also *In the Matter of the Application of Calvin David Fox*, Exchange Act Release No. 48,731, 81 SEC Docket 1511 (Oct. 31, 2003) (remanding to the NYSE for additional findings without suggesting any view as to the outcome). There would be little cause for review if the NYSE's enforcement post-dated the Commission's enforcement action, as sometimes occurred. NYSE Exchange Hearing Panel Decision 02-92 (Apr. 24, 2002).

260. See William R. McLucas et al., *A Practitioner's Guide to the SEC's Investigative and Enforcement Process*, 70 TEMPLE L. REV. 53, 56 (1997) (noting that public disclosure regarding informal investigations is “exceptionally rare,” but permitted by 17 C.F.R. § 202.5(a) (1996)); see also *SEC v. O'Brien*, 467 U.S. 735, 744 n.14 (1984) (stating that “virtually all” investigations by the Commission are not made public).

261. Silence arguably amounts to approval by the government. See Peter Tiersma, *The Language of Silence*, 48 RUTGERS L. REV. 1, 1 (1995) (“Silence is consent.”). One might question the wisdom of giving argumentative force to inaction by the Commission. See *Chisom v. Roemer*, 501 U.S. 380, 406 (1991) (Scalia, J., dissenting) (questioning the “wisdom of assuming that dogs will bark”).

262. Compare accompanying text, with Part IV (arguing that joint investigations may entwine governmental and private actors, such that actions of SROs should be attributed to the government).

enforcement, so too does lengthy delay between original decisions by SRO enforcement officers and government review. Intervention by the government in NYSE enforcement actions may be slow.<sup>263</sup> In the disciplinary action against Sohmer/Spyder Securities, the NYSE Hearing Panel issued its decision on July 25, 2002. The Board of Directors of the NYSE affirmed the decision of the hearing panel on April 3, 2003 and the SEC issued its release affirming the findings of violations and sanctions imposed by the NYSE on January 12, 2004.<sup>264</sup> Such length of time between the initial action by an SRO and the Commission's review are not anomalous.<sup>265</sup>

The point here is *not* to criticize the length of time that it took for the NYSE's board or the Commission to issue their decisions; such criticism likely would be misplaced as those bodies awaited written submissions from the parties. The point is that, despite that, in the judicial arena, the passage of less than two years from hearing to appeal may be considered lightning quick, lengthy delay in governmental review of SRO enforcement matters lessens the influence of such intervention on the discretion originally exercised by SRO enforcement officials. Moreover, as governmental influence on such SRO discretion lessens, arguments of governmental coercion or encouragement lose force.

The passage of time lessens the influence of governmental review because of discounting and SRO turnover. A rational actor will consider the consequences of her actions, but the magnitude of those consequences will vary depending on the time at which those consequences are realized. One should discount future harms to some current value when deciding whether to take an action that could produce those harms.<sup>266</sup> An example may make plain the concept. A debt (harm) of \$100 today is worse than a debt (harm) of \$100 one year from today. With an annual interest rate of

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263. See SELECTED GOVERNANCE, *supra* note 253, at 25-26 (theorizing that enforcement investigations may be lengthened due to the limited resources available to the Commission); *id.* at 8 (arguing that effective enforcement requires time); COX ET AL., *supra* note 129, at 782 (arguing that the overcrowding of federal court dockets results in "considerable delays" in having cases heard).

264. NYSE, Inc., In the Matters of Stephen Michael Sohmer and Spyder Sec., Inc., Requests for Review of Exchange Hearing Panel Decisions 02-156, 02-157 (Apr. 3, 2003), available at <http://www.nyse.com/pdfs/02-156-157sec.pdf>.

265. See NYSE, Inc., In the Matter Calvin David Fox, Exchange Hearing Panel Decision No. 02-110 (Oct. 31, 2003), available at <http://www.nyse.com/pdfs/02-110sec.pdf> (indicating that approximately 15 months passed between the NYSE hearing panel's decision and the SEC's release on the matter); NYSE, Inc., In the Matter of AFC Partners, LLC et al., Requests for Review of Exchange Hearing Panel Decisions 02-12, 02-13, 02-14 (Oct. 3, 2002), available at <http://www.nyse.com/pdfs/02-012-014SEC.pdf> (indicating that approximately twenty-one months passed between the NYSE hearing panel's decision and the SEC's release affirming the findings of violations and sanctions).

266. See Ackerman & Heinzerling, *supra* note 250, at 1559-60 (illustrating how economists discount future costs and benefits).

five percent, a debt (harm) of \$100 payable in one year amounts to a debt (harm) of about \$95 today. The further in the future that the \$100 debt (harm) is payable, the smaller that debt (harm) is today.

Because governmental review will occur in the future and because any rebuke that would follow from such governmental review will occur in the future, the negative impact stemming from any governmental rebuke must be discounted to a lesser current value. Such discounting lessens the influence of governmental review and weakens arguments that SROs act due to governmental compulsion.<sup>267</sup>

Aside from the fact that slow feedback lessens the disciplinary impact of governmental review, turnover at the NYSE may lessen the impact of governmental review. The NYSE official that made the original decision subsequently reviewed by the Commission may have left the NYSE.<sup>268</sup> Of course, the Commission's intervention may influence others at the NYSE, but those others may easily distance themselves from the decision that resulted in the Commission's intervention. Hindsight is 20/20.<sup>269</sup> Additionally, lawyers, in particular, possess expertise in analogizing and distinguishing one case from another. Lawyers may distinguish themselves and their decisions from the decision that resulted in Commission intervention. This ability to distinguish one scenario from another lessens the influence of governmental review.<sup>270</sup> Even if the SRO still employs the original decision maker, that decision maker similarly may distinguish the prior episode. "Nearly all failures can be ascribed, if observers are so inclined, to intervening and unforeseen situational factors rather than flaws

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267. Rational individuals discount future risks, but intelligent individuals may be more likely to discount at the appropriate rate than those of less intelligence. See Bibas, *supra* note 248, at 2506 (linking impulsiveness with overly high discount rates and indicating that impulsiveness is negatively correlated with intelligence); Gary S. Becker, Editorial, . . . *And the Economics of Disaster Management*, WALL ST. J., Jan. 4, 2005, at A12 ("[E]ducated persons take a much longer time perspective in their personal decisions.")

268. Turnover at SROs has been high. See DIV. OF TRADING AND MKTS., COMMODITY FUTURES TRADING COMM'N, REVIEW OF THE FINANCIAL AND SALES PRACTICE COMPLIANCE PROGRAM OF THE CHICAGO MERCANTILE EXCHANGE (1988), <http://www.cftc.gov/tm/tmcm/erer092998.htm> ("As of December 31, 1994, CME's 23 auditors had an overall average experience of 3.9 years. At March 31, 1998, the average experience for CME's 17 auditors decreased by 25 percent, to 2.9 years, largely due to staff turnover. The number of audit staff 'on-board' also declined by 25 percent."); Maremont & Solomon, *supra* note 230, at A1, A5 ("In 1999 inspection of the National Association of Securities Dealers, the NASDAQ Stock Market's self-regulatory body, four of the five staffers on the task had less than a year's experience . . . . Then the lead attorney on the exam left, and the case was assigned to another attorney, who left two months later." (referencing a report authored by consultants McKinsey & Co.)).

269. *Graham v. Connor*, 490 U.S. 386, 396 (1989) ("20/20 vision of hindsight."); *Barker v. Wingo*, 407 U.S. 514, 534 n.39 ("Hindsight is, of course, 20/20 . . .").

270. See Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions*, 59 J. BUS. 251, 274 (1986) (arguing that unique decisions "provide little opportunity for learning"); *id.* ("[V]ariability in the environment degrades the reliability of the feedback, especially where outcomes of low probability are involved . . .").

in the decision.”<sup>271</sup>

Because the federal government formally intervenes infrequently, “the primary means by which the SEC has exercised regulatory authority over the exchanges has . . . been . . . through informal communication, interaction, and persuasion.”<sup>272</sup> Such “regulation by raised eyebrow”<sup>273</sup> does not amount to governmental compulsion or significant encouragement, nor does it constitute entwinement in the SRO’s exercise of discretion, as the SRO may ignore the federal agency’s suggestion.<sup>274</sup>

*c. Enforcement is unclear*

The influence of accountability is impacted by the ability of decision makers to surmise the outcome preferences of the audience to whom they are accountable.<sup>275</sup> “When individuals are accountable to an audience whose preferences are known, these individuals . . . alter the outcome of their decisions to come closer to an outcome that would satisfy their audience . . . . Individuals who are accountable to an audience with unknown views are significantly more self-critical while making their decisions.”<sup>276</sup> Because federal preferences may be unclear, SROs and SRO enforcement officials may be less likely to be influenced by federal intervention, and arguments of governmental compulsion or encouragement become overbroad. Federal preferences may be unclear because the federal government generally does not intervene in SRO enforcement actions, and when it speaks, it does not always speak clearly.

If, as suggested above, silence is the predominant form of feedback that the government provides SROs, then it becomes more difficult for an SRO, or an individual SRO enforcement officer, to discern federal preferences. Whether the Commission even reviews an SRO enforcement action is uncertain,<sup>277</sup> and even if review were certain, SRO enforcement officers

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271. Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (And Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 151 (1997).

272. 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, 483 (1984); see Douglas C. Michael, *Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act*, 47 BUS. LAW. 1461, 1501 (1992) (noting that the Commission has used subtle pressure to achieve its goals).

273. Michael, *supra* note 272, at 1501.

274. See CHOPER ET AL., *supra* note 134, at 579-85 (discussing SROs’ refusal to adopt a “one share, one vote” rule despite governmental pressure).

275. See Seidenfeld, *supra* note 203, at 1064-65.

276. *Id.* at 1066.

277. 15 U.S.C. § 78s(d)(2) (2000) (providing for review only on a motion by the SEC or application by the subject of the enforcement action); see Maremont & Solomon, *supra* note 230, at A1, A5 (“Richard Sauer, who left the [SEC’s Enforcement] division earlier this year, says, ‘Because resources were so stretched, nobody had time to go around prospecting for new matters.’”).

may not know the preferences of their audiences. An SRO line officer cannot know the particular Commission staffer who might review the enforcement action.<sup>278</sup> Arguably, the SRO could equate the views of the Commission to every Commission staffer. The number of issues that arise in any particular enforcement action ensures that some issues arise for which the Commission has not spoken clearly.<sup>279</sup> For these issues, the SRO must predict the position that the Commission would adopt. Nonetheless, like predictions in any other arena, predictions regarding the Commission's position may not be easy, and poor predictions may result.

Certain facts may contribute to poor predictions. First, the Commission seeks to achieve multiple goals, which may lead to inconsistent views on a particular issue.<sup>280</sup> Second, the Commission is *not* headed by a single person, with whose views we might associate the Commission, had the Commission's organizational structure been more akin to the CEO of a popular company.<sup>281</sup> With the Commission headed by five people,<sup>282</sup> however, the attribution of the views of a group of leaders to the organization becomes more difficult. Third, no more than three of the five commissioners may be members of the same political party,<sup>283</sup> further complicating predictions as one's views do not always follow party lines.<sup>284</sup>

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278. See Seidenfeld, *supra* note 203, at 1074 ("An agency is unlikely to know the identity of the particular OIRA desk officer who will be assigned to review the regulatory impact analysis for a proposed rule.")

279. See Frank H. Easterbrook, *Judicial Discretion in Statutory Interpretation*, 57 OKLA. L. REV. 1, 3 (2004) ("[S]tatutes are ambiguous, . . . it is reasonable or even inevitable for agencies to exercise discretion when interpreting laws, . . . there is just no right answer . . .").

280. See Maremont & Solomon, *supra* note 230, at A1, A5 ("[The Commission] has sometimes been pulled between its not-always-consistent missions of protecting investors and keeping U.S. financial markets globally competitive.")

281. Sometimes, a leader of an organization embodies that organization, for example, Jack Welch and General Electric. Welch's approach "involves a personal ideology that he indoctrinates into GE managers through speeches, memos, and confrontations . . . Welch makes pronouncements . . . and he institutes programs . . . that become the GE party line . . . GE managers must either internalize his vision, or they must leave." Michael Maccoby, *Narcissistic Leaders: The Incredible Pros, the Incredible Cons*, HARV. BUS. REV. Jan. 2004, at 92, 100; see Dawn C. Chmielewski, *Board Confident in Temporary Chief*, SAN JOSE MERCURY NEWS, Aug. 3, 2004, at 1C, 4C ("[Steve] Jobs is the quintessential Silicon Valley chief executive—an entrepreneur whose strong personality and evangelical passion have come to embody his company."); Susan Vinella, *IMG: New Faces, New Era*, THE PLAIN DEALER, May 8, 2004, at D1 ("Few chief executive officers embody their companies the way Mark McCormack did with IMG."); Jeanne Cummings, *Wal-Mart Sets Up Shop In Washington to Bring Its Goals to the Counter*, WALL ST. J. EUROPE, Mar. 24, 2004, at A1 (Wal-Mart embodied by Sam Walton's "down-home style"). The Chairman, however, may be the "unitary head" of the Commission. See Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 1050-51 (2005) ("unitary head").

282. 15 U.S.C. § 78d(a).

283. *Id.*

284. See Deborah Solomon, *Tough Tack of SEC Chief Could Relent*, WALL ST. J., Jan. 12, 2005, at C1, C5 ("[SEC Chairman Donaldson] has come under fire from fellow Republicans for pursuing a regulatory agenda that some say is out of sync with his party's

So, one may not always be able to attribute a single view to the Commission.

As mentioned, lawyers possess expertise in analogizing and distinguishing factual scenarios. So, with regard to legal matters, lawyers may be more capable prognosticators than the populace at large. Nonetheless, governmental review may have less impact *ex ante* with regard to decision making when the decisions under review are subject to ambiguous standards that are highly fact-specific.<sup>285</sup> Certainly, the government—the Commission, the U.S. Attorney—wants to further the public interest,<sup>286</sup> but how the public interest is defined in a particular case of enforcement may not always be clear.<sup>287</sup> Reasonable people may disagree. SRO enforcement actions may present similar uncertainties. Should the securities violator be barred for a term of months, years, or permanently? If the government sends a rebuke, the rebuke may be so situation specific that it may only marginally impact future decisions. If governmental preferences are unclear *ex ante*, then the influence of governmental review on an SRO decision maker is lessened, weakening arguments of governmental compulsion, encouragement, or entwinement.

### III. BEHAVIORAL PSYCHOLOGY & COGNITIVE BIASES

Recent decades have brought valuable insight into the decision-making process. Research reveals that individuals' cognitive processes do not always proceed in perfectly rational fashion. Cognitive "biases are sufficiently well-accepted in both the theoretical and empirical literature that we should take them seriously as behavioral risks, even if we cannot determine their exact role in any given setting or estimate how often they

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pro-business stance. He has pushed through significant proposals on mutual-fund governance and hedge-fund regulation with the backing of only the SEC's two Democrats. He has also clashed with his two fellow Republican commissioners on some enforcement issues.").

285. Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 COLUM. BUS. L. REV. 71, 95-96 (2002).

286. COX ET AL., *supra* note 129, at 779 ("A common feature of most of the provisions under which the Commission derives its authority to discipline certain persons is that any resulting sanction must be 'in the public interest.'"); *id.* at 790-92 (considering whether the public interest is sufficiently at stake to merit a formal enforcement proceeding).

287. See John R. Emshwiller & Kara Scannell, *Enron Prosecutors Find No One Case Is Like Another*, WALL ST. J., Sept. 29, 2004, at C1 (

Six people are on trial here for helping to strike a deal between Enron Corp. and Merrill Lynch & Co. that federal prosecutors say was a blatant attempt to manipulate earnings . . . . Yet a strikingly similar transaction between Enron and Citigroup Inc. has yet to produce criminal charges. The fact that one transaction produced felony counts and a like one didn't demonstrates the vagaries of criminal investigations and the difficulties prosecutors face when deciding whether laws have been broken rather than just bent in corporate suites.

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will apply in general.”<sup>288</sup> Some of these cognitive biases may enhance any influence that the government may have on the behavior of a private actor—bolstering the argument that the actions of an SRO should be attributed to the government—and other cognitive biases may lessen any influence that the government may have on the behavior of private actors—undermining the argument that the actions of an SRO should be attributed to the government. Several cognitive biases are examined below.

#### A. *Risk & Loss Aversion*

A rational decision maker might be expected to take action after weighing the “pros” and “cons.” In weighing those pros and cons, the decision maker would not simply tabulate the number of pros against the number of cons. Instead, before making the comparison, the decision maker would assign some weight or value to each of those pros and the cons. Although one might expect the comparison to be made rationally, research indicates that cognitive biases arise and undermine the premise of a perfectly rational decision maker. Risk aversion and loss aversion seemingly enhance the accountability effect of governmental review on the decision-making processes of SRO enforcement officials. Generally, people are averse to risks and losses.<sup>289</sup> A loss deflates more than a gain of equal magnitude elates.<sup>290</sup>

In effect, the government will either approve or disapprove of conclusions attendant to an SRO’s enforcement actions. Approval may yield benefits to SRO staffers—“boost [their] egos, their esteem, their praise by colleagues, and their prospects for promotion and career advancement.”<sup>291</sup> Disapproval may draw the wrath of supervisors and the

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288. Langevoort, *supra* note 271, at 134.

289. See Daniel Kahneman et al., *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325, 1326 (1990); Roger G. Noll & James E. Krier, *Some Implications of Cognitive Psychology for Risk Regulation*, 19 J. LEGAL STUD. 747, 752 (1990); Cass R. Sunstein, *Behavioral Analysis of Law*, 64 U. CHI. L. REV. 1175, 1179 (1997). People are not only loss averse but also risk averse—preferring a sure thing to a gamble that offers an equal expected value. Daniel Kahneman & Dan Lovallo, *Timid Choices and Bold Forecasts: A Cognitive Perspective on Risk Taking*, 39 MGMT. SCI. 17, 22 (1993) (“Decision makers become more risk averse when they expect their choices to be reviewed by others . . .”). There are exceptions to the general preference for risk aversion. Buying lottery tickets is a prime example. *Id.* at 18.

290. See Kahneman et al., *supra* note 289, at 1326; Sunstein, *supra* note 289, at 1179; Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCI. 453, 454 (1981) (“The displeasure associated with losing a sum of money is generally greater than the pleasure associated with winning the same amount, as is reflected in people’s reluctance to accept fair bets on a toss of a coin.”); Jennifer Arlen, Comment, *The Future of Behavioral Economic Analysis of Law*, 51 VAND. L. REV. 1765, 1771 (1998) (“[T]he disutility associated with giving up an object is greater than the utility gained by acquiring it . . .”); Bibas, *supra* note 248, at 2508 (quoting tennis great Jimmy Connors: “I hate to lose more than I like to win.”).

291. Bibas, *supra* note 248, at 2471.

public; personal embarrassment may unduly favor a route involving less risk.<sup>292</sup> And to the extent that the preferences of the government are identifiable, an SRO decision maker may follow the path of least resistance so as to avoid rebuke and professional embarrassment. Such an incentive structure may pressure one to ensure that the job is done well as recognized by those to whom one is accountable. “The evidence indicates that the pressures of accountability and personal responsibility increase . . . manifestations of loss aversion.”<sup>293</sup>

Moreover, people generally are risk averse to small probabilities of loss.<sup>294</sup> As mentioned above, there is only a small probability that the government will review an SRO enforcement action, and thus only a small probability for the government to rebuke the decisions of an SRO enforcement official, and thus only a small risk of rebuke or embarrassment.<sup>295</sup> Because people generally are risk averse to small probabilities of loss, one would expect SRO enforcement officials to behave in a manner to avert risk, which would be consistent with the preferences of the government. Such behavior would enhance the impact of governmental review.

It may be that a job well done will yield rewards; on the other hand, expectations may exist such that a job well done is expected. In a setting with high expectations, the only result that may garner attention is performance that fails to meet those expectations.<sup>296</sup> Success may not be rewarded, but failure may result in punishment. Facing those choices, one may take excessive or irrational risks.<sup>297</sup> In the enforcement arena, expectations may be high. The Commission obtains favorable settlements in over ninety percent of its enforcement proceedings.<sup>298</sup> U.S. Attorneys obtain convictions in approximately ninety percent of criminal charges brought in court.<sup>299</sup> If NYSE enforcement officials confront similar

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292. *See id.* at 2471-72.

293. Kahneman & Lovallo, *supra* note 289, at 22.

294. Bibas, *supra* note 248, at 2508 n.189.

295. *See* Part II.D.2.a.

296. *See generally* David Diehl, Editorial, *Solich Deserves the Boot After 9-3 Regular Season*, DAILY NEBRASKAN, Dec. 3, 2003, available at <http://www.dailynebraskan.com/news/display.v/ART/2003/12/03/3fcd7e12df400> (stating that the termination of Nebraska football coach Frank Solich, after a season in which his team won seventy-five percent of its games, “reinforced the mantra of ‘meet expectations, or get out.’”). Solich followed Hall of Fame coach Tom Osbourne who whose teams, between 1993 and 1997, went 60-3 and won two national championships. *Big Shoes to Fill*, CNN SPORTS ILLUSTRATED, Dec. 27, 1998, [http://sportsillustrated.cnn.com/football/college/1998/bowls/holiday/news/1998/12/27/nebraska\\_solich](http://sportsillustrated.cnn.com/football/college/1998/bowls/holiday/news/1998/12/27/nebraska_solich).

297. *See* Noll & Krier, *supra* note 289, at 752 (“[P]eople are risk averse as to gains but risk taking as to losses.”); *id.* at 758 (“[W]hen faced with the certainty of some loss, they may be excessively prone to take actions involving a reasonably large chance of a catastrophic outcome.”).

298. COX ET AL., *supra* note 129, at 773.

299. BUREAU OF JUSTICE STATISTICS, U.S. DEP’T OF JUSTICE, COMPENDIUM OF FEDERAL

expectations, then those officials may become risk-seekers. Risk may be sought in different forms, but risk-seeking would be consistent with a lack of concern of the results of review by the Commission. If true, governmental review would have little impact on SRO decision making. Although this spin on risk and loss aversion may “cut the other way,” risk and loss aversion seemingly enhance the impact of governmental review on SRO decision making.

Just as certain cognitive biases seemingly enhance the influence of governmental review on the behavior of a private actor, there are cognitive biases that may lessen the influence of the government on a private actor. Such behavioral biases include the availability bias, overconfidence bias, and the fairness bias. Groups may perpetuate or magnify or minimize these individual biases.<sup>300</sup>

### B. Availability Bias

A rational decision-making process typically is described as involving the consideration of the likelihood and magnitude of each of the benefits and costs related to (in)actions. Consideration of the magnitude of a certain consequence isolated from its likelihood of occurrence would be irrational.<sup>301</sup> Individuals may not accurately assess the likelihood of events. Individuals’ estimation of the likelihood of the occurrence of a particular event is tainted by their ability to recall the occurrence of such an event. If the actual occurrence of an event is “available” to their memory, then they tend to overestimate the likelihood of the occurrence of such an event in the future.

For example, one study indicated that people believe that a page of text

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JUSTICE STATISTICS, 2002 2 (2002), available at <http://www.ojp.usdoj.gov/bjs/pub/pdf/cfjs02.pdf> (“The proportion of defendants convicted in the Federal courts increased from 81% during 1990 to 89% during 2002. . . . The conviction rate was . . . 91% [for] property defendants . . . and 88% [for] public-order defendants.”); Bibas, *supra* note 248, at 2471 (“[E]very plea bargain counts as a win but trials risk being losses. The statistic of conviction, in other words, matters much more than the sentence.”) (footnotes omitted).

300. See Cass R. Sunstein, *What’s Available? Social Influences and Behavioral Economics*, 97 NW. U. L. REV. 1295, 1305-08 (2003) (discussing the evidence and reasons for increased risk taking by individuals when they are grouped together); Chip Heath et al., *Cognitive Repairs: How Organizational Practices Can Compensate for Individual Shortcomings*, 20 RES. ORG. BEHAV. 1 (1998) (describing the various biases common to individuals and ways of correcting them through group interaction).

301. See Tversky & Kahneman, *supra* note 290, at 454 (“In expected utility theory the utility of an uncertain outcome is weighted by its probability; in prospect theory the value of an uncertain outcome is multiplied by a decision weight  $\pi(p)$ , which is a monotonic function of  $p$  but is not a probability.”). For example, take rain. No one wants to be doused by rain. One might consider the idea of spending time in wet clothing to be unbearable. The costs of failing to carry an umbrella may be high, but if Al Roker estimates the likelihood of rain to be negligible, then one might not carry an umbrella to work. High costs may be diminished by their likelihood of occurrence.

will include more words ending with the letters “ing” than words that have “n” as the second to last letter.<sup>302</sup> Gerunds and words that rhyme with “sing” are readily available for the mind to recall. Typically, one’s brain does not categorize words by the second to last letter, leaving words that have “n” as the second to last letter less available for recall. Researchers conclude that one’s estimation of the likelihood of the appearance of such words is affected by one’s ability to recall similar words. The more available, the higher the estimated likelihood—even if one’s estimates do not withstand scrutiny. The number of words that have “n” as the second to last letter must equal or exceed (but never be less than) the number of words that end with “ing.”

Relatedly, individuals place excessive emphasis on extreme or vivid evidence.<sup>303</sup> People overestimate the likelihood of tornados—vivid media coverage accompanies tornados and their extreme power for devastation—and underestimate the likelihood of less vivid events—such as heart disease.<sup>304</sup> Perhaps, the extreme or vivid nature of the evidence enhances the mind’s ability to recall events like tornados; such evidence enhances their availability.

The availability bias suggests that people may tend to overestimate the likelihood of fraudulent conduct by corporations.<sup>305</sup> Recent instances of corporate misconduct are readily available to the minds of the populace. Enron repeatedly appeared on newspapers’ A1 top fold and received extended coverage by television networks. The public’s exposure to misconduct by Enron, Global Crossing, and WorldCom leave such behavior readily available to the public’s recall. Additionally, Enron, for example, provided extreme, vivid evidence of the consequences of large-scale misconduct as its stock price fell precipitously towards zero in the span of less than a year.<sup>306</sup> The precipitous fall resulted in a loss of billions

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302. Amos Tversky & Daniel Kahneman, *Extensional Versus Intuitive Reasoning: The Conjunction Fallacy in Probability Judgment*, 90 *PSYCHOL. REV.* 293, 295 (1983).

303. Heath et al., *supra* note 300, at 17-18.

304. JONATHAN BARON, *THINKING AND DECIDING* 218 (2d ed. 1994).

305. In recent years, there may in fact, have been an increase in corporate fraud. There have been increases in disciplinary actions brought by the NYSE & SEC. See generally NYSE.com, Enforcement, <http://www.nyse.com/regulation/howregworks/1022221394131.html> (last visited Oct. 6, 2005) (stating that the NYSE set a new record for number of proceedings against member firms in 2003 more than double the preceding year and that total monetary sanctions in 2004 were double those of 2003); see also *id.* (noting that a “significant number of actions were brought jointly . . . [with] other regulators, including the SEC . . .”). Nonetheless, an increase in disciplinary actions is not a perfect measure for an increase in the underlying conduct.

306. Complaint of Plaintiff, SEC v. Causey, Civil Action No. H-04-0284 (S.D. Tex. Jan. 22, 2004), <http://www.sec.gov/litigation/complaints/comp18551.htm> (“In early 1998, Enron’s stock traded at approximately \$30 per share. By January 2001, even after a stock split in August 1999, Enron’s stock was trading at over \$80 per share . . . . On December 2, 2001, Enron filed for bankruptcy, making its stock, which less than a year earlier had been trading at over \$80 per share, virtually worthless.”).

of dollars in shareholder wealth.<sup>307</sup> Other companies experienced tremendous losses of value.<sup>308</sup> Such extreme and vivid examples may cause the public to overestimate the likelihood of future events.<sup>309</sup>

In response to readily available instances of extreme, vivid corporate misconduct, the public may demand more vigorous enforcement of existing regulation or new regulation to combat misconduct.<sup>310</sup> A stock exchange cannot be oblivious to the public's demand.<sup>311</sup> If the public loses confidence in the quality of the companies traded on an exchange, then the public may channel its investment dollars to other than companies listed on that exchange. Fewer invested dollars correlates with fewer stock trades. NYSE members earn money on executed trades.<sup>312</sup> So as the number of trades decreases, the exchange members earn less income.<sup>313</sup> Consequently, the exchange members will encourage the exchange to enforce existing rules or create new rules to combat misconduct, consistent with investor demand. There appears to be an incentive for the exchange to

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307. According to the cover page of Enron's Form 10-K for fiscal 2000, filed with the Commission on April 2, 2001, Enron had a market capitalization of over \$60 billion. See Enron Corp., Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Fiscal Year Ended December 31, 2000 (Form 10-K), at Cover Page, <http://sec.gov/Archives/edgar/data/1024401/0001024401015>

00010/ene10-k.txt ("Aggregate market value of the voting stock held by non-affiliates of the registrant, based on closing prices in the daily composite list for transactions on the New York Stock Exchange on February 15, 2001, was approximately \$60,207,479,342.").

308. Jonathan Weil, *WorldCom's Ex-Directors Pony Up: Agreement in Principle to Pay Out Personal Funds Creates Liability Precedent*, WALL ST. J., Jan. 6, 2005, at A3 (reporting that WorldCom overstated earnings by \$11 billion, contributing to the company's collapse and eventual bankruptcy.); Milt Freudenheim, *McKesson Agrees to Settle an Accounting Fraud Suit*, N.Y. TIMES, Jan. 13, 2005, at C2 ("McKesson shareholders lost \$8.6 billion in one day, April 28, 1999, nearly half the value of their holdings.").

309. Although estimates of the frequency of corporate misconduct on a large scale may have been low prior to the downfall of, for example, Enron, it would seem that post-Enron estimates of the likelihood of large scale misconduct may be high.

310. See Noll & Krier, *supra* note 289, at 771 ("The intensity of demand for policies to ameliorate risks will tend to be higher for low-probability risks and lower for high-probability risks than is predicted by conventional decision theory.").

311. Arlen, *supra* note 290, at 1785 ("[R]egulators may respond to public pressure for protection from certain well-publicized risks by imposing excessive regulations.").

312. In 2003, Goldman Sachs reported revenues of over \$8 billion dollars with regard to its trading and principal investments. GOLDMAN SACHS, ANNUAL REPORT FOR 2003 68 (2004), available at [http://www.goldmansachs.com/our\\_firm/investor\\_relations/financial\\_reports/annual\\_reports/2003/pdf/GS03AR\\_completeannual.pdf](http://www.goldmansachs.com/our_firm/investor_relations/financial_reports/annual_reports/2003/pdf/GS03AR_completeannual.pdf). Some portion of that \$8 billion in revenue is attributable to "floor-based and electronic market making as a specialist on U.S. equities and options exchanges and [the] clear[ance of] customer transactions on major stock, options and futures exchanges worldwide." *Id.* at 73. The mention of those services in Goldman Sachs' annual report suggests that their contribution to the company's revenue stream is non-trivial.

313. James D. Cox, *Brands v. Generics: Self-Regulation by Competitors*, 2000 COLUM. BUS. L. REV. 15, 16-17 (2000) ("[L]isting fees . . . are surpassed by the amounts . . . [received] in trading fees and revenues related to the sale of market trading information . . .").

address the investing public's demands, irrespective of any demands by the government.<sup>314</sup>

### C. Overconfidence

While the NYSE may respond to the investing public's demand for enhanced enforcement of existing rules or the creation of new rules, thereby lessening the impact of governmental review, NYSE decision makers may be overconfident in their assessments, believing their decisions to be the right ones, such that the impact of any subsequent governmental review would have less effect. Studies indicate that individuals tend to be overconfident in their assessments with regard to risk. For example, ninety percent of a polled group believed that, relative to the others in the group, they were above-average automobile drivers.<sup>315</sup> "Overconfidence is . . . exceptionally strong when people have some control: they are overly optimistic about how well they can exercise that control to avoid bad outcomes."<sup>316</sup> Staying with the theme of automobile drivers, studies also

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314. Exchange members preference for regulation and enforcement is not without limit. Langevoort, *supra* note 271, at 115 ("[I]t would not be surprising to find situations in which trading off credibility with (perhaps even the risk of liability to) investors for some profit-enhancing gain in some other area could be a rational choice.") (footnotes omitted). As the demands on those companies listed on an exchange increase, the costs of listing on the exchange increase. Companies voluntarily list with exchanges; and alternatives to listing exist. Exchange members cannot require "too much" in terms of regulation and enforcement or companies will de-list. See TWENTIETH CENTURY FUND, INC., THE SECURITY MARKETS 236 (1935) ("[I]f [an exchange] makes its requirements too high, corporations simply will not list their securities there, but list them on other exchanges where less information is required, or will not list them at all."); see also J. EDWARD MEEKER, THE WORK OF THE STOCK EXCHANGE 97 (1930) ("If its regulations with regard to listing should become excessive and inequitable, they would soon prove valueless, since the corporations would refuse to list their securities there."); Silvia Ascarelli, *Citing Sarbanes, Foreign Companies Flee U.S. Exchanges*, WALL ST. J., Sept. 20, 2004, at C1, C16 ("Many European companies are disenchanted by the cost of listing shares in the U.S. . . . [A]s a result of the 2002 law [Sarbanes-Oxley] . . . [German e-commerce software firm] Intershop was faced with an extra . . . \$600,000 annually in extra accounting and lawyers' fees. To escape, Intershop announced plans . . . not just to withdraw share trading in the U.S. but to . . . deregister[] with the U.S. Securities and Exchange Commission . . ."); *id.* (charting number of voluntary listings versus number of voluntary de-listings—2001: 51 versus 1; 2002: 33 versus 1; 2003: 16 versus 2; 2004: 8 versus 1). If a company is de-listed, then members will lose a source of income for trades of that company's shares. There may be an overall decrease in the number of trades, with a diminishment in income for exchange members. Related to a company's decision to de-list, another company may never elect to list on the exchange in the first instance. In such circumstances, exchange members lose out on the prospect of income on trades of the company's securities. It is possible that the de-listing of a company constitutes a signal of quality to the market, resulting in increased trades in other companies that offset lost trades in the de-listed company. See TWENTIETH CENTURY FUND, INC., *supra*, at 236-37; RUDOLPH L. WEISSMAN, THE NEW WALL STREET 105 (1939) ("[T]he Exchange, on its own initiative, took steps to delist the stock of an investment trust[, which] . . . had no asset value . . . . The volume of trading is reduced by delisting and possible commissions are likewise reduced. In the long run the confidence of the public will be gained by these sacrifices.").

315. Sunstein, *supra* note 289, at 1183.

316. Bibas, *supra* note 248, at 2501.

indicate that people tend to underestimate the likelihood that they will be involved in an auto accident when they perceive themselves as having some control over the situation.<sup>317</sup> The perception of control itself may be one of overconfidence. Many accidents occur when the driver is not at fault; additionally, many passengers are injured in auto accidents and passengers clearly are not in control.<sup>318</sup> An individual's perception of control may be misplaced, heightening the degree of overconfidence.

Decision makers may be overconfident in their assessments and may improperly view themselves as in control. Securities enforcement may appear to be a controllable event. Although the SROs lack subpoena power, the SROs may impose sanctions against exchange members and those associated with exchange members for failure to comply with SRO investigators, such that SROs have tremendous control over certain aspects of the investigatory process.<sup>319</sup> Additionally, a trial may look like a controllable event, one can: (a) choose one's witnesses; (b) select the evidence to be submitted; (c) cross-examine the other party's witnesses; and (d) emphasize favorable facts, arguments, and case law.<sup>320</sup> The sense of control, however, may be illusory.<sup>321</sup> Even if one is assumed to have influence over the input received by a judge or jury, one does not control their output.<sup>322</sup> Trials provide plenty of opportunity to overestimate oneself and underestimate the other party; the more complex the case, the more room for overconfidence.<sup>323</sup>

NYSE decision makers may be overconfident in their handling of enforcement actions. Overconfidence may arise in numerous settings, including the identification of individuals against which to pursue disciplinary actions (and those not to pursue),<sup>324</sup> the causes of action to pursue (and not to pursue),<sup>325</sup> and the sanctions to seek (and not seek).<sup>326</sup> If

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317. David M. DeJoy, *The Optimism Bias and Traffic Accidents Risk Perception*, 21 ACCIDENT ANALYSIS & PREVENTION 333, 336-37 & tbl.2 (1989); *id.* at 336 tbl.1.

318. Cass R. Sunstein, *Cognition and Cost-Benefit Analysis*, 29 J. LEGAL STUD. 1059, 1081 (2000).

319. See NYSE, Inc., Rule 476(a)(11) (“[R]efusing or failing to comply with a request by the Exchange to submit his or its books and records . . . or to furnish information to or to appear or testify before the Exchange . . .” may result in disciplinary sanctions). Courts generally have concluded that an SRO is not the government, so the protections afforded by the Fifth Amendment are inapplicable—speak or suffer negative consequences. See *supra* Part I.

320. Bibas, *supra* note 248, at 2501.

321. Kahneman & Lovallo, *supra* note 289, at 27 (“[A] pervasive optimistic bias [is] . . . an illusion of control . . . People . . . exaggerate their control over events . . .”).

322. Kahneman & Lovallo, *supra* note 289, at 17 (“[I]dealized self-image is . . . a prudent and determined agent, who is in control of both people and events”); *id.* (“optimistic denial of uncontrollable uncertainty”).

323. See Bibas, *supra* note 248, at 2501.

324. See Sunstein, *supra* note 252, at 2273 (detailing that technical violations of the law are not always subject to investigation or prosecution).

325. See *id.* at 2282 (“[A]n ordinary prosecutor has a menu of possible crimes to

the NYSE decision makers are overconfident in their conclusions about those factors, then it would seem that those conclusions generally are less likely to be altered to any great degree by their considerations of the government and its review of their conclusions. If the government does not impact to any great degree the NYSE decision maker's conclusions, then the government hardly compels the NYSE's decision and such governmental review does not seem to entwine the government with the NYSE decision-making process.<sup>327</sup>

#### D. Fairness

A preference to be viewed as acting fairly may mute some of the influence on SROs that may otherwise follow from governmental review. In certain circumstances, one may sacrifice economic gain to be perceived as behaving fairly.<sup>328</sup>

A study involving a game provides anecdotal evidence that people make financial sacrifices to be viewed as acting fairly.<sup>329</sup> The ultimatum game involves two players, one of whom is given a sum of money and must offer some portion of that sum to the second player. If the second player accepts the offered sum, the second player keeps that sum and the first player retains the residual amount. If the second player rejects the offered sum, neither player collects any of the original amount. The players cannot negotiate; the second player simply accepts or rejects the first player's offer. If the second player were a rational actor that desired to maximize her economic welfare, then she would accept the offered amount, no matter how small. Such is the case because if the second player rejected the offered amount, she would collect nothing. A rational, profit-maximizing actor would prefer a small amount of money to none at all. Knowing this, the first player—if also a rational, profit-maximizing actor—should offer no more than the smallest amount.

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pursue.”).

326. See, e.g., NYSE, Inc., Rule 476(a) (noting that sanctions may include “expulsion; suspension; limitation as to activities, functions, and operations, including the suspension or cancellation of a registration in, or assignment of, one or more stocks; fine; censure; suspension or bar from being associated with any member or member organization; or any other fitting sanction”).

327. Consideration of other cases may minimize the cognitive bias of overconfidence. See Kahneman & Lovallo, *supra* note 289, at 25 (identifying greater bias from the “inside view” than from the “outside view”).

328. The appearance of fairness, rather than actual fairness, appears to be the key. Colin Camerer & Richard H. Thaler, *Anomalies: Ultimatums, Dictators and Manners*, 9 J. ECON. PERSP. 209, 212 (1995). Pursuit of the appearance of fairness mutes actions of self-interest to some degree, but because actual fairness does not appear to be the goal, “self-interested behavior is alive and well, even in ultimatum games.” *Id.*; see Amar Bhidé & Howard H. Stevenson, *Why Be Honest if Honesty Doesn't Pay*, HARV. BUS. REV. 121 (Sept.-Oct. 1990).

329. See Camerer & Thaler, *supra* note 328, at 210; Sunstein, *supra* note 289, at 1186-87.

Studies suggest that reality does not reflect such rational, profit-maximizing behavior. Studies indicate that offerors participating in the ultimatum game tend to offer between thirty and forty percent of the original amount, and offerees tend to reject offers of less than twenty percent of the original amount.<sup>330</sup> Frequently the parties divide the original amount in half.<sup>331</sup> Studies further suggest that the desire to be perceived as fair, even at one's financial expense, becomes stronger when the first party knows that the game will be repeated.<sup>332</sup>

Some suggest that the government compels the SRO to act due to governmental review of SRO enforcement actions.<sup>333</sup> An SRO's desire to be perceived as fair when making enforcement decisions may minimize the influence of governmental review, muting any influence from governmental review.

The SRO may consider the perception of various constituencies: the party being disciplined, other members (and persons associated with members), the government, and the public. From the perspective of the party being disciplined, a "fair" level of enforcement may be less vigorous than the ideal (whatever that ideal happens to be).<sup>334</sup> If, from the perspective of the disciplined party, the SRO acts fairly, then the disciplined party is less likely to seek governmental review of the disciplinary action.<sup>335</sup> If the disciplined party does not seek governmental review, then one means by which the government may be spurred to act goes by the wayside.<sup>336</sup>

From the perspective of the other members of the SRO, a "fair" level of enforcement may constitute more vigorous enforcement than is preferred by the party being disciplined. Although, to a certain extent, members generally may prefer more limited rules and enforcement, once the members have been complying with the rules, those members do not want

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330. Camerer & Thaler, *supra* note 328, at 210.

331. A 50-50 split is often the mode. *Id.* There are exceptions to the outcomes discussed above. Although the "results cut across the level of the stakes," Sunstein, *supra* note 289, at 1186, at some point, the amount at stake reaches a magnitude at which point an offeree accepts the offered amount, even if only a small fraction of the original sum. Camerer & Thaler, *supra* note 328, at 211 n.2.

332. See Camerer & Thaler, *supra* note 328, at 213-14 (commenting that, in the context of the dictator game, offers shrink as the "social distance" between the parties increases).

333. Stone & Perino, *supra* note 204, at 460; Friedman, *supra* note 204, at 743-44; Metzger, *supra* note 232, at 1423 & n.198.

334. Jennifer Arlen, *Comment: The Future of Behavioral Economic Analysis of Law*, 51 VAND. L. REV. 1765, 1776 (1998) ("[P]eople tend to have a self-serving assessment of what is fair.").

335. 15 U.S.C. § 78s(d) (2000) (describing the procedure for seeking governmental review of an enforcement action).

336. Maremont & Solomon, *supra* note 230, at A1 ("In the 1980s, says Mercer Bullard, a former staffer in SEC's Investment Management unit, the attitude was, 'Show me an abuse, and I'll put a stop to it.');" *id.* at A1 (noting that the SEC generates only a third of the cases it handles (referencing a report authored by consultants McKinsey & Co.)).

other members (or persons associated with members) to break those rules. The members agreed to the rules in the first place in order to send a signal of quality to counter the lemon effect.<sup>337</sup> The members that are complying with the rules are bearing the costs.<sup>338</sup> Moreover, the members do not want others to achieve the benefit of appearing to have complied with the rules without bearing the costs of compliance as well.<sup>339</sup> Third, the members do not want others to free ride on their efforts.<sup>340</sup> Similarly, the members do not want others to achieve a competitive advantage through noncompliance. Hence, once a rule is in force, complying members want that rule enforced. Thus, the SRO faces pressures to enforce existing rules with which other members have complied.<sup>341</sup>

Undoubtedly, there is some truth to the belief that SROs consider, among other things, the reaction by the government (or the public) in making decisions regarding enforcement actions, as espoused by those that believe that SROs constitute the government. However, it seems that the influence of governmental review may be overstated. The SRO may strive to treat disciplined parties fairly, despite the existence of governmental statutes requiring fairness and despite governmental review to ensure that such fairness is attained in SRO enforcement actions.<sup>342</sup> As the influence of governmental review wanes, arguments of coercion, encouragement, and entanglement become weaker, as does the argument that the SRO is a

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337. See George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970); see also FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 280-83 (1991) (applying Akerlof's theories to securities markets); James D. Cox, *Brands v. Generics: Self-Regulation by Competitors*, 2000 COLUM. BUS. L. REV. 15, 19 (2000) ("If the NYSE and NASDAQ wish to preserve their brands, they can do so through self-regulatory efforts so that issuers who list their shares on the NYSE or NASDAQ further signal to the investment community their commitment to ensure transparency, fair treatment of shareholders, and efficient execution of securities trades. That is, the NYSE and NASDAQ can preserve their franchises through strong self-regulatory efforts that preserve, and even enhance, the reputational gains of their listed companies.").

338. See generally Kip Betz, *NYSE's Thain Sees No Need for Added Reporting, Governance Reforms*, 36 FED. SEC. & L. REP. 1024 (2004) ("Sarbanes-Oxley Act rules and other new disclosure requirements, including those of the NYSE . . . come at a cost—both in the expenses companies must incur and in senior management time and effort to comply with the new rules.").

339. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 407 (5th ed. 1998) ("An individual margarine producer may be reluctant to advertise the low cholesterol content of his product because his advertising will benefit his competitors, who have not helped defray its expense.").

340. Cox, *supra* note 337, at 18 ("Perhaps [electronic communication networks] may even enjoy a competitive advantage if, as a result of not being burdened by a fair share of the costs for regulatory oversight, they have more funds to invest in technology to enhance their efficiency than the NYSE or NASDAQ.").

341. Members may prefer non-enforcement of a rule, even a rule with which they have already borne costs of compliance, in situations when the benefits of future non-enforcement are large enough.

342. See *supra* Part I.A.1.c.

governmental actor.

The fairness bias exemplified by the ultimatum game—a bias away from the outcome predicted under a rational, profit-maximizing theory—may not translate perfectly to the SRO enforcement arena. In the ultimatum game, the second party receives unambiguous, immediate feedback on the first party's decision; and the first party knows that such is the case. In the ultimatum game, the perception of fairness (or lack thereof) occurs immediately after a single transaction; there may be no subsequent transactions. By contrast, an SRO handles hundreds of enforcement actions each year. In those enforcement actions, SROs presumably strive to be perceived as fair across the board. An SRO could achieve such a perception of fairness across-the-board by being fair in every instance of enforcement, but achieving that across-the-board perception allows for deviations in individual enforcement actions.<sup>343</sup> Therefore, although an SRO may strive for fairness in every enforcement action, deviations in individual enforcement actions may not preclude others' perceptions of that SRO as treating disciplined parties fairly. The fairness bias may mute the influence of governmental review on SRO decision making.

#### *E. Cognitive Cures*

Individual biases may be minimized or eliminated by learning and by competition. Additionally, an organization may take steps to minimize or eliminate the cognitive biases of individual decision makers through the adoption of cultural norms and a decision-review process.

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343. See Camerer & Thaler, *supra* note 328, at 215 (discussing Rabin's "fairness equilibrium" and his 1993 study in which intentional acts of meanness are punished but inadvertent acts of meanness are tolerated (citing Matthew Rabin, *Incorporating Fairness into Game Theory*, 83 AM. ECON. REV. 1281 (1993))). An across-the-board view may conflict with another cognitive bias—narrow framing, which suggests that "people tend to make decisions one at a time, and in particular that they are prone to neglect the relevance of future decision opportunities." Kahneman & Lovallo, *supra* note 289, at 23. Of course, a decision maker might account for certain cognitive biases. If others' perceptions are susceptible to the availability bias, then one might "go the extra mile" to ensure that a vivid, extreme case is handled fairly. If the vivid, extreme case is handled fairly, then others might extrapolate from such anecdotal evidence.

Expertise may mute cognitive biases.<sup>344</sup> “Counsel, as repeat players, can spot and offset some of these psychological biases and heuristics . . . . Skillful lawyers may largely neutralize them, while poor or overburdened ones may not.”<sup>345</sup> Additionally, favorable conditions for learning—conditions that allow for feedback that is “clear, frequent, and quick”<sup>346</sup>—“rarely apply in business settings.”<sup>347</sup> One scholar compares weathermen—who get clear, frequent, and quick feedback and thus learn to make good forecasts that are less likely subject to cognitive biases—against CEOs and policy makers who do not enjoy the same quality of feedback.<sup>348</sup> NYSE decision makers do not always enjoy frequent, quick, and clear feedback, at least from the government.<sup>349</sup>

One might also argue that the market will adapt to weed out those individual decision makers that suffer from cognitive biases.<sup>350</sup> Such biases, however, are not easily eliminated. For example, when playing the ponies, the market that a favorite will “win” is efficient, but the market that the favorite will “place” or “show” is inefficient as bettors underestimate the likelihood of such outcomes.<sup>351</sup> One would expect, given the level of expertise at the tracks and given the arbitrage opportunity for profits, that

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344. Arlen, *supra* note 334, at 1768-69; Bibas, *supra* note 248, at 2502 (“[K]nowledge and experience[] may limit . . . overconfidence.” (citing Douglas A. Hershey & Jo A. Wilson, *Age Differences in Performance Awareness on a Complex Financial Decision-Making Task*, 23 *EXPERIMENTAL AGING RES.* 257, 268-69 (1997)); Jeffrey J. Rachlinski & Cynthia R. Farina, *Cognitive Psychology and Optimal Government Design*, 87 *CORNELL L. REV.* 549, 579 (2002) (“[C]areer staff provide an ongoing repository not only of substantive knowledge but also of decision-making experience, so that agencies . . . need not reinvent the wheel . . . .”).

Nonetheless, even experts are potentially subject to the same biases as lay people. Arlen, *supra* note 334, at 1784. In one study, seven internationally renowned civil engineers predicted (and set a fifty percent confidence interval around) the height at which a structure would cause its foundation to fail. “The results were quite sobering: not one engineer correctly predicted the true failure height within his or her confidence interval. Evidently, the civil engineers thought that they knew more than they did . . . .” Heath et al., *supra* note 300, at 4 (discussing the overconfidence bias).

345. Bibas, *supra* note 248, at 2498. Skill, however, may only come with time. As referenced above, *see generally* Langevoort *supra* note 271, high turnover rates at SROs may inhibit the acquisition of the relevant expertise.

346. Colin Camerer, *Comment on Noll and Krier*, “Some Implications of Cognitive Psychology for Risk Regulation,” 19 *J. LEGAL STUD.* 791, 794 (1990).

347. Langevoort, *supra* note 271, at 133-34 n.111 (collecting sources).

348. Camerer, *supra* note 346, at 794.

349. *See supra* Part II.C.

350. *See* Langevoort, *supra* note 271, at 148 (“[S]hould we not expect those firms with unrealistic belief systems that do not learn from their errors to disappear, leaving only those that have successfully countered the problem of cognitive bias?”); Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions*, 59 *J. BUS.* 251, 275 (1986) (“[I]t is sometimes argued that failures of rationality in individual decision making are inconsequential because of the corrective effects of the market.”).

351. Tversky & Kahneman, *supra* note 350, at 275; *see* Richard H. Thaler & Cass R. Sunstein, *Market Efficiency and Rationality: The Peculiar Case of Baseball*, 102 *MICH. L. REV.* 1390 (2004).

the market would move toward efficiency, but it has not done so.<sup>352</sup> Even though irrational decision making by individuals may have large economic effects, the market may not weed out such irrationality (1) if the decision errors have little effect on the individual, and (2) if there is no opportunity for arbitrage.<sup>353</sup> In the SRO enforcement arena, the effect on the individual of an irrational decision may be small. Certainly the impact of irrational decisions could be large—termination may result. If, however, the challenged decision is anomalous, which would be expected given minimal intervention by the federal government, the effect may be small. Decisiveness and aggressiveness may be viewed as positives, with confidence and optimism evident of persuasiveness,<sup>354</sup> an important characteristic for enforcement officials. Moreover, in the enforcement arena, there seems to be little opportunity for arbitrage. “The claim that the market can be trusted to correct the effect of individual irrationalities cannot be made without supporting evidence, and the burden of specifying a plausible corrective mechanism should rest on those who make this claim.”<sup>355</sup>

Organizations may cure the cognitive biases of individual decision makers.<sup>356</sup> Although “low-level” individuals—who lack experience and thus may be more subject to cognitive biases—may make initial decisions regarding enforcement matters, the organization within which those individuals operate may institute mechanisms to minimize or cure those cognitive biases. First, the organization may institute cultural norms that lead to better decision making.<sup>357</sup> An organization may hire people that behave consistent with the norm.<sup>358</sup> If an organization signals that a certain

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352. Tversky & Kahneman, *supra* note 350, at 275; see also Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 639-40 (1995) (arguing that some portion of new participants in the market are overconfident).

353. George A. Akerlof & Janet L. Yellen, *Can Small Deviations from Rationality Make Significant Differences in Economic Equilibria?*, 75 AM. ECON. REV. 708, 719 (1985); Tversky & Kahneman, *supra* note 350, at 275.

354. Langevoort, *supra* note 271, at 153-54.

355. Tversky & Kahneman, *supra* note 350, at 275.

356. Arlen, *supra* note 334, at 1769.

357. Langevoort, *supra* note 285, at 132 (“But few doubt that, on average . . . , these belief systems are powerful normative influences once a coherent culture evolves.”); *id.* at 152 (“Put simply, there is reason to suspect that firms that inculcate certain types of belief systems may in many settings be competitively superior to those that are more doggedly ‘realistic.’”); *id.* at 104 (“Recent years have brought an explosion of interest in so-called ethics or integrity based systems that seek to persuade rather than command employees to act in a manner consistent with the firm’s best interests, without introducing a strong dose of costly and intrusive monitoring.”).

358. *Id.* at 83 (“Supervisors should, by all accounts, hire agents carefully . . . . There is a crudely accurate assumption that good compliance starts with good hiring.”). Those doing the hiring may have difficulty discerning the characteristics tied to the exercise of discretion. *E.g., id.* Screening devices may aid the hiring process, but such devices are not foolproof. Moreover, once applicants are aware of the characteristic, applicants may feign that trait.

trait is valued, employees will take the cue. If co-workers signal adherence to a particular policy, then others, who otherwise might have deviated from the policy, sense pressure to conform and, ultimately, do conform.<sup>359</sup>

Second, the organization may have a review process for those initial or preliminary decisions of low-level individuals. Organizations may acquire, retain, and retrieve information better than an individual; organizations may learn.<sup>360</sup> Although governmental review of enforcement decisions by individual SRO officials may be infrequent, slow, and unclear (minimizing the *ex ante* influence of the government on those decisions), review of such decisions within the organization may provide a disciplining force. Organizational review may provide more fertile ground for learning, as such review would be more frequent, quicker, and clearer.

The opportunity for dialogue regarding individual enforcement matters between an initial decision maker and an experienced supervisor seems better suited to provide meaningful feedback that would facilitate learning than governmental review. Unlike governmental review, such internal dialogues may occur with frequency. Unlike governmental review, internal feedback may be quick; a supervisor may offer on-the-spot advice or commentary. Unlike governmental review, the feedback from an internal review may be clear. The confidential nature of an internal review may allow for direct feedback that is more honest than feedback that becomes known publicly. To protect the target of criticism, public reprimands may obscure any criticism, such that clarity is lost. Additionally, internal review may allow for consideration of the relevant information at one time, such that feedback does not trickle-in over a lengthy period of time, jeopardizing clarity.<sup>361</sup>

While organizational review may mute some cognitive biases that arise in individual decision making, it may not eliminate such biases, as organizations themselves are also subject to cognitive biases.<sup>362</sup> “Information is highly decentralized in business organizations.”<sup>363</sup> Low-level decision makers have the bulk of the information and must report information upward for review at the next level. Some investigations may generate mountains of information, not all of which can be communicated to a supervisor.<sup>364</sup> In certain respects, the upward flow of selected

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*Id.* at 84 (“[It is] not hard for clever people to mimic.”).

359. *Id.* at 104.

360. James P. Walsh, *Managerial and Organizational Cognition: Notes from a Trip Down Memory Lane*, 6 *ORG. SCI.* 280, 292, 295 (1995).

361. Langevoort, *supra* note 285, at 136. Information regarding extended investigations and enforcement proceedings, however, may trickle in over time.

362. Kahneman & Lovalló, *supra* note 289, at 22 (“Loss aversion is not mitigated when decisions are made in an organizational context.”).

363. Langevoort, *supra* note 271, at 119.

364. See Edward J. Joyce & Gary C. Biddle, *Anchoring and Adjustment in Probabilistic*

information may inhibit effective decision making.<sup>365</sup> The information in the hands of the low-level decision maker may not be quantifiable,<sup>366</sup> and thus may be malleable. The investigators and enforcement officials job is to knit together facts and arguments—mold the malleable to suit one’s view—that compel hearing panels to reach favorable conclusions while eliminating doubts. As these individuals present information upward to superiors, they may present their cases using such skills.<sup>367</sup> In so doing, the initial decision maker may, without any nefarious intent, unduly emphasize the good (the facts, law and policies that are favorable to the position adopted by the initial decision maker) and de-emphasize the bad (the facts, law and policies that are unfavorable to the position adopted by the initial decision maker).<sup>368</sup> True, superiors—who presumably have more experience—should be amply qualified to identify decisions that do not further the pursuit of idealized goals. Nonetheless, subjective judgments must be made with regard to enforcement matters. Superiors may recognize that they lack familiarity with information regarding the particular enforcement matter under review.<sup>369</sup> In addition, because they

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*Inference in Auditing*, 19 J. ACCT. RES. 120, 120 (1981) (Auditors “use their professional judgment to determine the type and amount of information to collect . . .”).

365. Langevoort, *supra* note 271, at 119 & n.60. In other respects, the upward flow of selected information may encourage effective decision-making. For example, top officials cannot be saddled with every decision or else paralysis may result, so some discretion may be delegated downward, with only selected information percolating upward. *See generally* DEL. CODE ANN. tit. 8, § 141(a) (2005) (“The business and affairs of every corporation organized under this chapter shall be managed by *or under the direction of* a board of directors . . .”) (emphasis added).

366. The number of units sold may be quantified but quantification comes less easy for “customer reactions to new products [or] how well products are proceeding through the research and development pipeline.” *See* Langevoort, *supra* note 271, at 119. Even where information may be quantified, such reviewable information is not fool-proof. Financial statements reflect quantifiable concepts but those figures may be malleable. *See* LEOPOLD A. BERNSTEIN & JOHN J. WILD, FINANCIAL STATEMENT ANALYSIS: THEORY, APPLICATION, AND INTERPRETATION 63 (6th ed. 1998) (

Preparation of financial statements requires judgment. Judgment is imperfect, yielding variability in the quality and reliability of accounting numbers. Since financial statements are general-purpose presentations, preparers’ judgments are affected by the their view of a typical user’s requirements and expectations. These requirements and expectations do not necessarily coincide with those of a user with a specific task in mind. Accounting is also a social science and, therefore, is at least partially determined by human factors, including incentives.

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367. *See* Martha S. Feldman & James G. March, *Information in Organizations as Signal and Symbol*, 26 ADMIN. SCI. Q. 171, 176 (1981) (“Often, information is produced in order to persuade someone . . .”).

368. *See* Langevoort, *supra* note 271, at 122 (individual incentives and quest for advancement may lead one to “accentuate the positive and to distort bad news”).

369. *See id.* at 121 (“The employees with the most immediate access to basic information are almost always line personnel . . .”); *see* Walsh, *supra* note 360, at 280 (“The most fundamental challenge faced by managers, however, is that their information worlds are extremely complex, ambiguous, and munificent.”).

may have operational as well as monitoring responsibilities,<sup>370</sup> those superiors may defer to the reasoned judgment of those most intimately familiar with that information—the lower-level individuals that made the initial decision.<sup>371</sup>

Furthermore, supervisors' perceptions may be colored by the initial conclusions of lower-level decision makers. The initial conclusion of a lower-level decision maker may serve as an anchor which a supervisor experiences difficulty overcoming. Experiments indicate that "an original 'anchor' . . . may be hard to dislodge."<sup>372</sup> For example, in one experiment, one group of accountants was asked two questions: (1) does the incidence of significant management fraud exceed one percent? and (2) what is your estimate of the percentage of firms that have significant management fraud?<sup>373</sup> A second group of accountants was asked the same questions except that the first question set the anchor at twenty percent.<sup>374</sup> In response to the second question, the first group placed the estimate at 1.6 %; the second group placed the estimate at 4.3 %.<sup>375</sup>

Just as supervisors may be slow to question the initial decisions of lower-level officials, when challenged, those lower-level officials may defend their decisions in sub-optimal fashion. "When there is accountability for decisions, people tend to construe information in ways that bolster their prior commitments . . . . [W]hen a decision has been made and the decision-maker has to answer for it, there tends to be a shift toward rationalization, both to oneself and others."<sup>376</sup> Because of a commitment

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370. See Langevoort, *supra* note 285, at 93 ("[I]t is possible to get inadequate monitoring from even professional auditors. Particularly if the monitors are given too much work . . ."); Langevoort, *supra* note 271, at 137-39 ("[G]roups can attend to even less information than individuals . . . . [E]ven if a group member privately wonders whether some bit of information is troubling, the very fact that other group members do not appear to be concerned is a reason to let the matter drop—groupthink . . . to preserve internal solidarity . . .").

371. See Langevoort, *supra* note 285, at 88 ("A supervisor with many team members and a host of other line responsibilities can readily fall prey to [a bias in favor of the status quo] even if not inclined toward wishful thinking."); *id.* at 87-88 ("Once an impression is gained, it is insufficiently revised to reflect new information.").

372. Sunstein, *supra* note 289, at 1188 ("Often people make probability judgments on the basis of an initial value, or 'anchor,' from which they make insufficient adjustments. The initial value may have an arbitrary or irrational source.") (note omitted).

373. Joyce & Biddle, *supra* note 364, at 123.

374. *Id.*

375. *Id.* at 125.

376. Langevoort, *supra* note 285, at 87. When reviewing a prior decision, one tends to review evidence asymmetrically. One attributes positive consequences to one's skill; one attributes negative consequences to outside circumstances. See Langevoort, *supra* note 271, at 139. After committing to a course of action, one tends to resist evidence that the chosen course of action was worse than alternatives. See *id.* at 142; Langevoort, *supra* note 285, at 87; Rachlinski & Farina, *supra* note 344, at 605 ("People find it difficult to come to believe that their initial decisions were mistaken."). "Self-confidence and external image are threatened both by introducing a troubling awareness of the possibility of mistake and by raising the need to consider a reversal of one's position, which, in turn, calls into question

bias,<sup>377</sup> the low-level, initial decision maker may resist a change in, or an adaptation of, her original position.

Intermediate superiors may also recognize that there are levels of monitoring beyond them. Those lower-level officers will present enforcement actions to hearing panels, and decisions by hearing panels are subject to review by the NYSE and the Commission.<sup>378</sup> Superiors may not scrutinize (at the idealized level) the decisions of low-level officials in light of the additional levels of review, which can correct any wrongs not identified by the supervisors. Any such correction by a hearing panel, the NYSE or the Commission arguably reflects negatively on the intermediate supervisor, who should be incented to conduct the internal review appropriately. Nonetheless, such rebuke may be a reflection more of the lower-level advocate than the advocate's intermediate supervisor. Even in the presence of an appropriate internal review, an individual will exercise discretion post-review,<sup>379</sup> such that a supervisor may distance herself from those post-review actions of the lower-level official.

To protect the morale of the supervised, a supervisor may face incentives against intrusive review.<sup>380</sup> The quest for a favorable working environment and the avoidance of confrontations may impede the flow of information and cause the decision-making process to suffer.<sup>381</sup> Moreover, supervisors

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one's reputation for consistency." Langevoort, *supra* note 271, at 142. Relatedly, given ambiguity, one interprets the ambiguity consistent with one's self-interest, as opposed to a challenge to one's exercise of discretion. *See id.* at 144; Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1094 (2000) ("[P]laintiffs (and defendants) will systematically anticipate their trial prospects as being better than defendants (and plaintiffs) believe."). Of course, these biases operate at the fringe; unambiguous evidence will not be ignored.

377. Langevoort, *supra* note 271, at 142 n.142 ("[O]ne cannot be sure that commitment is necessarily a bias; a rational actor might remain committed to a course of action if she fears that discovery of the mistake will lead to termination.").

378. See Appendix A (Hearing Panel, Commission, U.S. Court of Appeals, U.S. Supreme Court).

379. *See* Langevoort, *supra* note 285, at 86 (stating that "apart from the simple unobservability of many of the agent's actions" there are other psychological tendencies that make the supervisor ignorant of the employee's actions).

380. *See* Langevoort, *supra* note 271, at 123 (describing the moral hazard problem where a supervisor may want to avoid responsibility by asking others not to share certain information); *see also* Langevoort, *supra* note 285, at 86 ("people tend to interpret data in a way that avoids aversive inference, subconsciously giving the agent an excessive benefit of the doubt"); Langevoort, *supra* note 271, 138-39 (noting that a "group of senior managers [may] unconsciously deflect[] threatening information [in order] to preserve internal solidarity"); Kahneman & Lovallo, *supra* note 289, at 26 ("[F]acing the facts [of the potential for failure] can be intolerably demoralizing . . . [T]he [unfavorable] forecast was quietly dropped from active debate . . ."); Tversky & Kahneman, *supra* note 270, at 274 ("Incentives do not operate by magic: they work by focusing attention and by prolonging deliberation. Consequently, they are more likely to prevent errors that arise from insufficient attention and effort than errors that arise from misperception or faulty intuition.").

381. CHRIS ARGYRIS, OVERCOMING ORGANIZATIONAL DEFENSES 14-31 (1990);

themselves are accountable to those senior to them. Poor decisions by low-level officers may reflect negatively on their immediate supervisors. A supervisor's ignorance of poor decisions by low-level officers may be preferred because it allows those supervisors to deny plausibly responsibility for those poor decisions.<sup>382</sup> Perhaps, a supervisor could be compensated in a manner that leads to the idealized level of supervision.

Designing such a compensation scheme would prove difficult. Somehow, one must identify the appropriate level of enforcement, which would not be easy. Penalties for judgments of "not liable" may lead supervisors to recommend that line officials be less aggressive<sup>383</sup> and under-enforcement may result. Rewards for judgments of "liable" may lead supervisors to recommend that line officials proceed to trial on slam-dunk cases. Precious judicial and administrative resources may be squandered. More significant enforcement actions—where victory is not assured—may receive inadequate attention or may be settled in non-deterrent fashion. Any compensation system tied to outcome may skew results away from the ideal.

#### IV. JOINT INVESTIGATIONS

Based on the foregoing, in the vast majority of the situations in which one is investigated, subjected to proceedings, or disciplined by the NYSE, the actions of the NYSE should not be attributed to the government.<sup>384</sup>

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Langevoort, *supra* note 271 (desiring "internal solidarity," managers may distribute inaccurate information).

382. See Langevoort, *supra* note 271, at 123 (arguing that a supervisor's initial failure to probe a subordinate's position preserves a supervisor's subsequent claim of ignorance regarding the subordinate's position).

383. Compare Bibas, *supra* note 248, at 2471 ("Self-interest, in short, may discourage prosecutors from investing enough work in plea-bargained cases, in which more work might lead to heavier sentences . . . They may further their careers by racking up good win-loss records, in which every plea bargain counts as a win but trials risk being losses."), with Langevoort, *supra* note 285, at 85-86 ("[I]n the securities [trading] business, this problem is sufficiently well recognized that it is often dealt with explicitly in the supervisor's contract: there are penalties for agent misconduct charged to the supervisor.").

384. The result may seem anomalous, as courts typically have found SROs immune from civil liability because the enforcement function that they provide is governmental in nature. *E.g.*, *Barbara v. New York Stock Exch., Inc.*, 99 F.3d 49, 58-59 (2d Cir. 1996) (collecting cases for the proposition that individuals acting as public enforcers are immune from civil liability); Nagy, *supra* note 226, at 978 (noting that Congress granted the PCAOB immunity from civil liability); Friedman, *supra* note 197, at 762-67.

Even if, in joint investigations, private actions seemingly should be attributed to the government, attribution may be inappropriate in certain situations. *Brentwood Acad. v. Tennessee Secondary Sch. Athletic Ass'n*, 531 U.S. 288, 303 (2001) ("Even facts that suffice to show public action . . . may be outweighed in the name of some value at odds with finding public accountability in the circumstances."). An epidemic of federal litigation resulting from attribution "might" counsel against attribution. *Id.* at 304 (concluding that no such epidemic would occur under the facts presented without addressing the broad argument).

Nonetheless, courts should not rely blindly on a stream of other courts' decisions concluding that the NYSE is not a governmental actor, particularly because the issue of attributing the actions of a private actor to the government is fact intensive.<sup>385</sup> Joint investigations involving an SRO and the government merit close attention.

As the general public channels more of its investment dollars into the securities markets, the general public becomes more concerned with securities fraud.<sup>386</sup> In the wake of the dramatic incidents of corporate fraud of late, the general public cried for remedial action and Congress responded with the Sarbanes-Oxley Act of 2002.<sup>387</sup> Congress, however, painted with a broad brush and, in certain respects, deferred to the expertise of the relevant administrative agency, the Commission.<sup>388</sup> Greater enforcement is expected of the Commission. Having placed greater demands on the Commission, Congress allocated greater resources to the Commission.<sup>389</sup> Despite increased resources, the Commission cannot investigate and prosecute every alleged bad actor.<sup>390</sup>

Congress and the Commission are not the only ones responding to the public's concern about integrity in the securities markets. The SROs did and will continue to respond.<sup>391</sup> In response to pressures, the Commission

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385. *Brentwood Acad.*, 531 U.S. at 298 (finding that such decisions necessitate a fact-based investigation).

386. *CHOPER ET AL.*, *supra* note 134, at 15 ("As of 1998, some 84 million U.S. citizens owned stocks (either directly or through ownership of mutual funds), and . . . the median U.S. shareholder . . . had a family income of \$57,000 . . . . [T]his extensive participation by the middle class in the stock market in the United States . . . explains why issues of market fairness make it on to the national political agenda (and may also explain why the Sarbanes-Oxley Act of 2002 passed both Houses of Congress by overwhelming majorities.") (notes omitted).

387. *Id.*; *see* CORPORATE GOVERNANCE, *supra* note 196, at 1 ("Many believe that the decline of Enron and other instances of financial statement earnings restatements and bankruptcies have resulted in a general decline in investor confidence in our financial markets . . . .").

388. *E.g.*, 15 U.S.C. § 7241(a) (2000) ("The Commission shall, by rule, require . . . ."); *id.* § 7242(a) ("It shall be unlawful, in contravention of such rules and regulations as the Commission shall prescribe . . . ."); *see* WILLIAM N. ESKRIDGE, JR. ET AL., *CASES AND MATERIALS ON LEGISLATION: STATUTES AND THE CREATION OF PUBLIC POLICY* 59 (3d ed. 2001) ("Distributed benefits/concentrated costs: Because the proposal will be opposed by organized interests, the best legislative solution is to draft an ambiguous bill and *delegate to agency regulation* . . . .").

389. Rachel McTague, *SEC Clear Winner in Spending Bill, With 47 Percent Funding Increase*, 35 SEC. REG. & L. REP. 307 (2003). One might, however, want to consider change over a longer time period, instead of, for example, year over year. Maremont & Solomon, *supra* note 232, at A1 ("The SEC, once a premier employer, began losing staff as pay fell behind soaring private-sector salaries. . . . About 14% of the SEC's staff left in 1999 and a like number in 2000, double the federal government average.")

390. *See* COX ET AL., *supra* note 129, at 641 ("By all accounts, the SEC does not have the resources to police the securities markets comprehensively; private rights of action have long been seen as a necessary adjunct to the public enforcement effort."); GENERAL ACCOUNTING OFFICE, *SEC OPERATIONS: INCREASED WORKLOAD CREATES CHALLENGES* 19 (2002) ("SEC Officials said that they cannot prosecute every case . . . .").

391. Aaron Lucchetti, *Investors Get Shortchanged On Interest*, WALL ST. J., Feb. 17,

and SROs will emphasize enforcement to discipline bad actors and to deter others from so acting. Coordination among public and private regulators, which may be on the rise,<sup>392</sup> is advisable to prevent public regulators from duplicating the efforts of private regulators, and vice versa.<sup>393</sup> Such coordination has given rise to joint investigations involving both private and public regulators.<sup>394</sup>

Such coordination and joint investigations presents questions regarding whether the government and private actors are “jointly participating” or “entwined” in their enforcement efforts in a manner that private actions should be attributed to the government. Encouragement, coercion, and entwinement may occur at the policy-making level or at the foot-soldier level and convert private conduct into state action.<sup>395</sup>

In some situations, however, private actors may facilitate governmental enforcement actions in ways that do not arouse suspicion. Brief attention is

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2005, at D2 (“To avoid conflicts of interest, the exchange separated Mr. Ketchum and the regulatory unit from the rest of the NYSE executives. Mr. Ketchum, the exchange’s chief regulatory officer, reports directly to an independent committee of the NYSE board.”); *id.* (“The warning is part of an effort [by the NYSE] to become more aggressive in the face of criticism about its policing efforts in recent years.”). See generally CORPORATE GOVERNANCE, *supra* note 196, at 9 (“Many entities today are taking a closer look at their own governance and risks in light of recent high profile business failures.”). See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 34,44969, 76 SEC Docket 220 (Oct. 23, 2001) (refusing to take action against parent company despite misconduct by an officer of a subsidiary because of parent’s response to the misconduct); *id.* (“When businesses seek out, self-report and rectify illegal conduct, and otherwise cooperate with Commission staff, large expenditures of government and shareholder resources can be avoided and investors can benefit more promptly.”).

392. See generally Tom Gilroy, *Companies Still Have Work to Do on MD&A, Senior SEC Official Says*, 36 FED. SEC. & L. REP. 1049, 1050 (2004) (“While the number of actual financial reporting fraud cases the SEC has brought has risen steadily over the past five or six years, so too has the trend toward coordinating prosecution with federal and/or state criminal authorities, [Susan G.] Markel [Chief Accountant, Division of Enforcement, SEC] told the audience.”).

393. See *United States v. Clegg*, 509 F.2d 605, 610 (5th Cir. 1975) (“[T]he government has not used a private party to circumvent anything except, perhaps, work.”); U.S. SECURITIES AND EXCHANGE COMMISSION, 1997 CONFERENCE ON FEDERAL-STATE SECURITIES REGULATION: FINAL REPORT (1997), <http://www.sec.gov/info/smallbus/ffedst97.htm> (“encourage information-sharing and avoid unnecessary duplication of examinations”); *id.* (“The SEC seeks to share its surveillance efforts with state and SRO officials.”); *id.* (“attempt to coordinate and divide the respective [SEC & NASD] enforcement workloads”).

394. See, e.g., Press Release, U.S. Securities and Exchange Commission, SEC Release No. 2004-103, SEC and NYSE File Settled Action Charging Fidelity Brokerage Services for Violating Federal Securities Laws and NYSE Rules in Connection with Document Alteration and Destruction (Aug. 3, 2004) (on file with American University Law Review, <http://www.sec.gov/news/press/2004-103.htm> (“In a joint investigation, the SEC and the NYSE found that between January 2001 and July 2002, Fidelity Brokerage violated the broker-dealer record-keeping requirements of the federal securities laws . . . .”).

395. See generally *Brentwood Acad. v. Tenn. Secondary Sch. Athletic Ass’n*, 531 U.S. 288, 300 (2001) (referencing entwinement from the “top down” and the “bottom up”).

given to these situations. For example, cross training may evidence coordination of the sort that should not be troubling. The federal government and SROs may coordinate their training to develop overlapping expertise. The government may recognize that SRO officials possess expertise that may be lacking in government officials and those government officials may be trained by SRO representatives.<sup>396</sup> Similarly, the SROs may recognize that government officials possess expertise that may be lacking in SRO personnel. To make up for such shortcomings, SRO enforcement officials may seek federal training. That each may attempt to learn from the other, including the other's investigative techniques, may amount to coordination of skill sets. The requisite encouragement, coercion, or entwinement, however, seems lacking. The federal government does not compel such coordination; the SROs seek to expand their expertise in pursuit of their self-interest—elimination of fraud and the like.

Additionally, the enforcement powers of an SRO are lacking relative to the federal government. The jurisdiction of an SRO is more limited than that of the federal government.<sup>397</sup> Unlike an SRO, the Commission may issue subpoenas in formal enforcement actions. In addition to investigative tools like wiretaps, search warrants, and subpoenas, the U.S. Attorney, unlike an SRO, may seek criminal sanctions.<sup>398</sup> An SRO may commence

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396. *Organized Crime in the Securities Markets: Hearings Before the Subcomm. On Finance and Hazardous Materials of the House Commerce Comm.*, 106th Cong. 259 (Sept. 13, 2000) [hereinafter *Organized Crime Hearings*] (statement of Barry R. Goldsmith, Executive Vice President, NASD Regulation, Inc.) (“NASD Regulation has also been very active in providing training on securities issues to prosecutors and investigating agencies. In each of the last three years, the FBI has held a weeklong training program on securities cases at its facility in Quantico, Virginia; CPAG and NASDR’s Market Regulation Department have taught agents as part of this program every year . . . . Representatives of NASDR’s Enforcement Department frequently provide training to prosecutors and agents, including recent sessions in Boston, Miami, and San Francisco. NASDR’s New York district office regularly provides various levels of training to agents and prosecutors . . . .”); *id.* (“[NASD] Market Regulation staff regularly take part in SEC training to develop investigative techniques . . . .”). The government’s purchase of private contract services does not convert the service providers into governmental actors. *Brentwood Acad.*, 531 U.S. at 299; *Rendell-Baker v. Kohn*, 457 U.S. 830, 839-43 (1982).

397. See generally NYSE, Inc., NYSE Constitution art. IX, § 1, <http://rules.nyse.com/NYSE/Constitution/> (“The Board shall adopt such rules as it deems necessary or appropriate for the discipline of members, member organizations, allied members, approved persons, and registered and non-registered employees of members and member organizations for the violation of the Act, the rules of the Exchange and for such other offenses as may be set forth in the rules of the Exchange.”); 15 U.S.C. § 78j (2000) (“It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentalities of interstate commerce . . . .”); *id.* § 78c(a)(17) (defining “interstate commerce”).

398. U.S. SECURITIES AND EXCHANGE COMMISSION, FINAL REPORT: 2003 CONFERENCE ON FEDERAL-STATE SECURITIES REGULATION (2003), <http://www.sec.gov/info/smallbus/ffedst2003.htm> (“In a growing number of instances, available civil remedies do not stop some of the people behind today’s frauds. Criminal prosecution and resulting jail time does . . . . The SEC representatives noted an increase in the number of U.S. Attorney’s

an investigation and, recognizing (1) a lack of jurisdiction, (2) the severity of the conduct at issue, or (3) the lack of investigative tools at its disposal, refer the matter to the federal government.<sup>399</sup> While the investigation may be termed “joint,” in that each of the SRO and federal government participated, the participation may not have overlapped. Absent such overlap, there seems little reason to suspect federal encouragement, coercion, or entwinement. The SRO acts in its own self-interest by recommending federal intervention.

Even simple overlapping of governmental and SRO enforcement actions need not result in the attribution of private actions to the government. The federal government and an SRO may agree to share independently developed information regarding their respective investigations.<sup>400</sup> Certainly, there should be no attribution if an SRO, of its own volition, shared independently developed information from one of its completed investigations with the federal government. In those circumstances, arguments of encouragement, coercion or entwinement would miss the mark. Even an *ex ante* agreement to share independently developed information should not be troubling. If the agreement deals only with information sharing, then the federal government and the SRO undertake investigations independently along different tracks.<sup>401</sup> Those tracks may run parallel to one another,<sup>402</sup> but the federal government does not

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Offices around the country that were actively seeking to prosecute securities fraud cases.”).

399. See *Organized Crime Hearings*, *supra* note 396 (statement of Barry R. Goldsmith, Executive Vice President, NASD Regulation, Inc.) (“There are . . . a very small number of violations that are so pernicious or are committed by such hardened securities law recidivists that they can only be dealt with criminally.”). “[W]e . . . refer the most serious of these matters to criminal law enforcement officials. It is the criminal authorities who are best positioned to fully prosecute those involved in these cases.” *Id.* But see *COX ET AL.*, *supra* 129, at 774 (“When the subjects are members of self-regulatory organizations, such as an exchange or the NASD, the Commission may forward the information it has gathered to the appropriate SRO, if the information suggests that the SRO’s rules have been violated, so that the SRO can take appropriate disciplinary action.”).

400. The Privacy Act of 1974 permits disclosure of information obtained by federal agencies for “routine use,” such as the coordination of enforcement activities conducted by federal law enforcement and SROs. 5 U.S.C. § 552a(b)(3) (2000). See *generally id.* § 552a; U.S. Securities and Exchange Commission, SEC Form No. 1662, Supplemental Information for Persons Requested to Supply Information Voluntarily or Directed to Supply Information Pursuant to a Commission Subpoena (2004), available at <http://www.sec.gov/about/forms/sec1662.pdf>. There are limits on the government’s ability to share information with an SRO. See *generally* FED. R. CRIM. P. 6(e)(2) (noting a general prohibition on disclosing matters occurring before the grand jury).

401. *D.L. Cromwell Invs., Inc. v. NASD Regulation, Inc.*, 279 F.3d 155, 158 (2d Cir. 2002) (refusing to attribute private actions to the government despite the SRO providing documents to the government and the government providing to the SRO information regarding witness interviews and progress reports of its investigative efforts); see *United States v. Clegg*, 509 F.2d 605, 609 (5th Cir. 1975) (“[The telephone company] and the FBI were conducting separate investigations.”).

402. *Cromwell*, 279 F.3d at 162-63 (refusing to attribute private actions to the government when the SRO and the government “pursued similar evidentiary trails because their independent investigations were proceeding in the same direction”). Regarding

encourage or coerce the SRO to take any particular action in carrying out its investigation and its own enforcement actions, nor can it be said that the federal government has become entwined with the SRO's exercise of discretion regarding investigative or enforcement decisions.<sup>403</sup> The information sharing allows each entity to conserve resources. And, in some situations, the SRO may investigate less and depend more on the federal government for information.

Coordinated investigations, however, may present situations for which actions of an SRO should be attributed to the government. Coordination may occur in designing the investigative strategy—coordination at the policy-making level. Such coordination would seem to amount to significant encouragement or entwinement, resulting in state action in the execution of such strategies or policies. For example, the facts of *Brentwood Academy* indicate that representatives of the state government dominated the policy-making positions of the entity-in-question, contributing to the Court's holding that actions of that entity should be attributed to the state.<sup>404</sup> By way of contrast, in *Tarkanian*,<sup>405</sup> where the NCAA was the alleged state actor whose rulings led the State of Nevada to take the disputed action, the actions of the NCAA were not attributable to Nevada, in part, because most of the members of the NCAA had no

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parallel proceedings, see *Jones v. SEC*, 115 F.3d 1173, 1183 (4th Cir. 1997) (noting that the Double Jeopardy Clause prohibits successive governmental criminal prosecutions and successive governmental punishments for the same conduct and that it is doubtful that NASD is a governmental agency).

403. *Cromwell*, 279 F.3d at 163 (“demands [of the accused] issued directly from [SRO] as a product of its private investigation, and that none of its demands were generated by governmental persuasion or collusion”); see *Clegg*, 509 F.2d at 609 (refusing to attribute private actions to the government when “[the telephone company] kept [the FBI] informed of the status and to some degree the results of [its] investigation, [because] there [was] no indication. . . that [the telephone company] acted at the behest or suggestion, with the aid, advice or encouragement, or under the direction or influence of the FBI”).

Such joint investigations arguably implicate the Supreme Court's *Burton* decision in which the Court attributed private actions to the government. See *supra* note 47 and accompanying text. As noted above, however, *Burton* involved racial discrimination and was a decision of the 1960s that pre-dated federal civil rights legislation. Subsequently, *Burton*'s reach has been limited and the decision criticized. See *supra* note 47.

404. See *Brentwood Acad. v. Tenn. Secondary Sch. Athletic Ass'n*, 531 U.S. 288, 300 (2001) (“[P]ublic school officials . . . control [and] overwhelmingly perform all but the purely ministerial acts” of the purported private entity in question; “State Board members . . . serve as members of the board of control and legislative council” of the purported private entity in question); see also *Desiderio v. NASD, Inc.*, 191 F.3d 198, 206 (2d Cir. 1999) (holding that the NASD is not a governmental actor, in part, because the government does not serve on any NASD board or committee); *United States v. Shvarts*, 90 F. Supp. 2d 219, 222 (2000) (holding that the NASD is not a governmental actor, in part, because no governmental official or appointee serves as a director of NASD); *Nagy*, *supra* note 226, at 2 (arguing that the Public Company Accounting Oversight Board, which was created under the Sarbanes-Oxley Act of 2002, is a state actor based, in part, on the fact that the SEC appoints the Chairperson and its four other members).

405. 488 U.S. 179 (1988).

connection to Nevada.<sup>406</sup> An absence of such entwinement at the strategic or policy-making level counsels against attributing the actions of the SRO to the federal government. Such absence was seen in *Cromwell* where one SRO enforcement officer may have been an agent of the federal government, but, from the get-go, that SRO officer was “walled off”<sup>407</sup> from other SRO enforcement officials,<sup>408</sup> counseling against attribution of the actions of those other SRO enforcement officials to the government.<sup>409</sup> Because those other SRO enforcement officials were not in contact with the government, the government did not coerce or encourage them to take any action, nor did the government become entwined in their exercise of discretion.

Thus, courts should consider the identities of those making strategic decisions in a joint investigation. One federal governmental official coupled with numerous SRO officials may counsel against attributing the disputed actions to the government. If, however, one or a few federal officials control the investigation, despite the presence of numerous SRO officials, then attribution seems more likely to be appropriate.<sup>410</sup> Regardless of the power of numbers, federal leadership may be expected as, relative to the SROs, the Commission is viewed as having the final word regarding securities regulation.<sup>411</sup> Moreover, in criminal

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406. *See id.* at 193 (“Those institutions, the vast majority of which were located in States other than Nevada, did not act under color of Nevada law. It necessarily follows that the source of the legislation adopted by the NCAA is not Nevada but the collective membership, speaking through an organization that is independent of any particular State.”).

407. *Cromwell*, 279 F.3d at 163.

408. *See id.* (dealing with an SRO officer who worked for NASDR’s CPAG). “CPAG is the first unit within a self-regulatory organization to be devoted to working directly and exclusively on criminal investigations and prosecutions involving securities-related crimes.” *Organized Crime Hearings*, *supra* note 396 (Statement of Barry R. Goldsmith, Executive Vice President, NASD Regulation, Inc.).

409. *Cromwell*, 279 F.3d at 163.

410. *See Brentwood Acad. v. Tennessee Secondary Sch. Athletic Ass’n*, 531 U.S. 288, 300 (2001) (referencing control of an entity by public officials as counseling in favor of attributing resulting actions to the government); *id.* at 301 n.4 (same). Perhaps other caveats are in order—pretext, *United States v. Szur*, 1998 WL 661484 (S.D.N.Y. Sep. 24, 1998), and collusion, *Marchiano v. NASD, Inc.*, 134 F. Supp. 2d 90, 95 (D.D.C. 2001), may result in attribution. Pretext and collusion, however, suggest bad faith on the part of federal officials, who may be acting to circumvent wrongfully constitutional protections. Presumably, such wrongful behavior by federal officials occurs in a small set of cases, and, thus, is not a focus of this Article.

411. Testifying before a congressional committee regarding the residual role to be played by the Commission in light of self-regulation of the stock market, Chairman Douglas said, “Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.” JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 185-86* (Aspen Pub. 3d ed. 2003); *see* Richard Hill, Senate Banking Leadership Lauds State Securities Regulators at Hearing, 36 FED. SEC. & L. REP. 1035 (2004) (“[T]he [SEC] is the primary securities regulator . . .” (quoting Richard Shelby, Chairman of the Senate Banking Committee Hearing of the Senate Banking Committee) (internal quotations omitted)).

prosecutions, SRO officials may be more even likely to defer to federal prosecutors as SROs lack the power to proceed criminally.

Generally, little or no public information is available regarding the allocation of decision-making authority in joint investigations. More information would guard against speculation. Even in the absence of cause to attribute private actions to the government because of an absence of top-down coercion, encouragement, or entwinement, the necessary coercion, encouragement, or entwinement may occur from the bottom-up. Federal investigators may coerce or encourage SRO investigators, or otherwise become entwined in SRO investigations, such that attribution to the government is appropriate.<sup>412</sup>

Federal involvement that leads private actors to take action that otherwise would not have occurred may justify attributing private actions to the government, so long as those private actions were reasonably foreseeable.<sup>413</sup> In joint investigations, federal concerns may deviate from an SRO's concerns. In a joint investigation, NYSE investigators and federal investigators may seek different information given different evidentiary burdens in connection with their respective enforcement proceedings. For example, although the NYSE is to enforce federal laws and rules in addition to its own comparable rules, the NYSE may focus upon the enforcement of its own rules. The necessary proof to enforce its own rules may be less demanding than that required to enforce federal rules.

The NYSE may elect to enforce NYSE Rule 476(a)(6) or Rule 476(a)(7)—which do not appear to require proof of scienter—instead of Section 10(b) of the Exchange Act or Rule 10b-5 promulgated by the Commission—which do require proof of scienter.<sup>414</sup> Leaders of the NYSE

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412. Harvey L. Pitt et al., *SEC Enforcement Actions: an Overview of SEC Enforcement Proceedings and Priorities*, C700 ALI-ABA 167, 268 (1991) (“If, however, a federal official actively participates in the unlawful seizure of a document, . . . the federal government is implicated and cannot accept the benefits of the document.”); see LAFAVE, *supra* note 121, at 178-98.

413. Comment, *Police Bulletins and Private Searches*, 119 U. PA. L. REV. 163, 170 (1970); LAFAVE, *supra* note 121, at 198 (“This approach has considerable appeal. It certainly would product more rational results in those cases where the assumption seems to be that a [governmental] request is operative only if explicit and specific rather than implicit and general.”); see *id.* at 211 (“Many [courts] take an unduly limited view of what will suffice as the requisite government encouragement.”).

414. Section 10(b) and Rule 10b-5 generally prohibit fraud and the complaining party must establish that the defendant acted with scienter. *SEC v. Aaron*, 446 U.S. 680, 680-81 (1980) (governmental action for injunction); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (private action for damages). Instead of proceeding under NYSE Rule 476(a)(5) which prohibits fraud, the Exchange may proceed under Rule 476(a)(6), which prohibits “conduct . . . inconsistent with just and equitable principles of trade,” or Rule 476(a)(7), which prohibits “acts detrimental to the interest or welfare of the Exchange.” NYSE Rule 476 (Dec. 13, 1978).

A recent search of the NYSE's webpage yielded twelve hits for “scienter.” See

acknowledge the disparity of proof. In comments delivered at Fordham, Richard G. Ketchum, Chief Regulatory Officer of the NYSE, referenced one of the benefits of self-regulation: “the ability to impose non-scienter-based ethical standards that would be inappropriate to be imposed by Federal Government.”<sup>415</sup> In a joint investigation, might federal influence alter the normal course of an SRO’s investigation such that attribution of private actions to the government is appropriate?

As discussed above, outside the realm of joint investigations, the possibility of federal review of SRO enforcement actions generally would not seem to color the discretion exercised by SRO officials because, among other things, such federal review is unlikely and slow, and any message conveyed thereby may be unclear. In joint investigations, however, such review appears to be more likely and quick, and the message conveyed thereby more clear.

*Likely:* In a joint investigation, an SRO official will work closely with federal officials. SRO officials seem to be playing an increasingly larger role in federal enforcement actions. In *United States v. Gangi*, the NASDR’s Criminal Prosecution Assistance Group (“CPAG”) provided hundreds of hours of assistance to the Commission and prosecutors.<sup>416</sup> In *United States v. Copp*, CPAG provided “extensive”<sup>417</sup> assistance over an eighteen-month period.<sup>418</sup> In June 2000, federal officials and the NASDR

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<http://www.nyse.com>. One hit was the Ketchum quote cited in the following footnote; references of “scienter” appeared in ten NYSE hearing panel decisions: one in 1983, one in 1986, one in 1996, and seven in 2004. Each of those seven enforcement actions in 2004 resulted from joint investigations involving the Commission and the Exchange. See SEC Press Release No. 2004-99, Settlement Reached With Two Specialist Firms For Violating Federal Securities Laws And NYSE Regulations (July 26, 2004) (on file with American University Law Review); SEC Press Release No. 2004-42, Settlement Reached With Five Specialist Firms For Violating Federal Securities Laws and NYSE Regulations (Mar. 30, 2004) (on file with American University Law Review). Even in those actions, the member firms were not alleged to have acted with scienter; instead, those firms settled allegations that they violated, among other rules, NYSE Rule 342 by failing to establish adequate policies that would be expected to detect fraudulent conduct and by failing to supervise specialists with a view to preventing violations of federal securities laws. See, e.g., NYSE, Inc., Fleet Specialist, Inc., Exchange Hearing Panel Decision 04-49 (Mar. 29, 2004), available at <http://www.nyse.com/pdfs/04-049.pdf>.

415. NYSE, Inc., Public Statement, The Self Regulatory Compact—Remarks of Richard G. Ketchum, Chief Regulatory Officer, The New York Stock Exchange from the Sommer Lecture at Fordham University Law School (Nov. 9, 2004), <http://www.nyse.com/content/articles/1100303421648.html>.

416. *Organized Crime Hearings*, supra note 396, (Statement of Barry R. Goldsmith, Executive Vice President, NASD Regulation, Inc.).

417. *Id.*; *Organized Crime on Wall Street: Hearings Before the Subcomm. on Finance and Hazardous Materials of the House Commerce Comm.*, 106th Cong. 124 (Sept. 13, 2000) [hereinafter *Crime on Wall Street Hearings*] (Statement of Richard H. Walker, Director, Division of Enforcement, U.S. Securities & Exchange Commission) (“The charges stemmed from a year-long investigation by the SEC the U.S. Attorney’s Office, the FBI, and the New York Police Department with assistance of NASD Regulation.”).

418. *Organized Crime Hearings*, supra note 396 (Statement of Barry R. Goldsmith, Executive Vice President, NASD Regulation, Inc.).

jointly announced the results of a one-year undercover operation: the U.S. Attorney indicted 120 individuals involving fraud in connection with the trading of the securities of nineteen companies; the Commission sued sixty-three individuals; and the NASD previously had filed a complaint against eighteen individuals and an entity.<sup>419</sup> Given the apparent close-working relationship in such investigations, an SRO official is likely to receive feedback—whether explicit or by raised eyebrow. With greater likelihood of federal feedback, SRO officials are more likely to color their decisions and actions to appease federal officials.<sup>420</sup>

*Quick:* Outside the realm of joint investigations, federal feedback may be delayed for months or years as is the norm in the Commission's review of SRO enforcement actions. In a joint investigation, however, feedback may come much more quickly. In light of the "extensive" assistance and the witness interviews conducted by CPAG in *United States v. Coppa*,<sup>421</sup> one would expect that the federal prosecutors were offering feedback on an on-going basis. In a joint investigation that spanned many months, one might expect direction and feedback to be on-going.

*Clear:* And if feedback is offered quickly, the message is more likely to be clear. If feedback is quickly offered, the message is less likely to become garbled by intervening events or other white noise. Clear feedback may accentuate the effects of accountability and risk aversion.

Frequent, quick, and clear feedback lessens the effect of self-criticism and leads actors to color their decisions and actions toward the audience's preferences.<sup>422</sup> Frequent, quick, and clear feedback would influence the decision making of a rational actor; the rational actor may attempt to appease the audience and avoid negative repercussions from displeasing the audience. Moreover, such feedback enhances risk aversion.<sup>423</sup> SRO enforcement officials may be more likely to effect the will of those running the joint investigation—which, given Congress' allocation of authority, may more likely be federal officials. The actions of SRO enforcement officials, who may deviate from the normal course to appease federal

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419. *Crime on Wall Street Hearings*, *supra* note 417 (Statement of Richard H. Walker, Director, Division of Enforcement, U.S. Securities & Exchange Commission).

420. Kahneman & Lovallo, *supra* note 289, at 17, 22 ("Decision makers become more risk averse when they expect their choices to be reviewed by others . . .").

421. *Organized Crime Hearings*, *supra* note 396 (Statement of Barry R. Goldsmith, Executive Vice President, NASD Regulation, Inc.).

422. Seidenfeld, *supra* note 203, at 1066 ("When individuals are accountable to an audience whose preferences are known, these individuals . . . alter the outcome of their decisions to come closer to an outcome that would satisfy their audience . . . Individuals who are accountable to an audience with unknown views are significantly more self-critical while making their decisions.").

423. Kahneman & Lovallo, *supra* note 289, at 22 (claiming that decision makers are more risk averse when their choices will be reviewed and do not want to accept responsibility for any failures that result).

officials to whom they are accountable and whose reaction to such review is reasonably foreseeable, should be attributable to the government.<sup>424</sup>

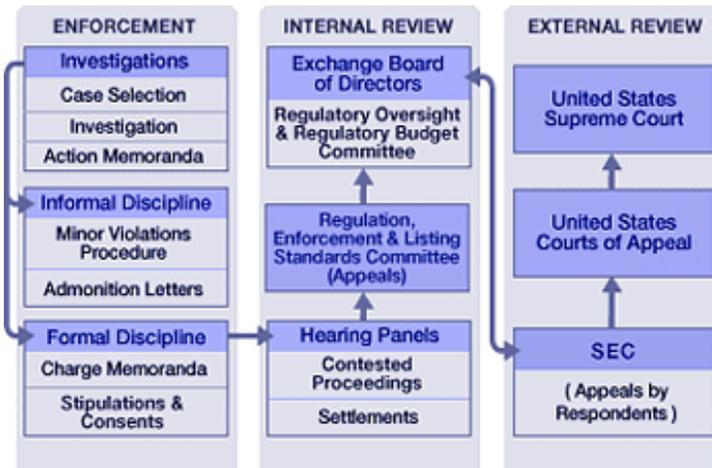
#### CONCLUSION

Generally, when creating, policing, and enforcing rules, SROs do not constitute governmental actors because, even absent federal compulsion or encouragement, SROs would take such actions. SROs act in their self-interest by creating, policing, and enforcing rules that protect investors' interests; actions taken in self-interest cleanse those actions of federal influence. Research suggests that decision makers do not always act rationally, but several of these cognitive biases seemingly lessen the influence of the federal government on the decision-making processes of SRO enforcement officials, muting the impact of federal influence and undermining arguments of state action. When federal and SRO officials jointly investigate bad actors, however, attribution of private actions to the government may be appropriate.

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424. See Comment, *supra* note 413, at 170 (arguing that police should only be responsible for foreseeable consequences based on their requests). LAFAVE, *supra* note 121, at 198 ("This approach has appeal . . .").

APPENDIX A<sup>425</sup>



425. <http://www.nyse.com/regulation/howregworks/1022221392411.html>