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Not Just a Private Club: Self Regulatory Organizations as State Actors When Enforcing Federal Law

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NOT JUST A PRIVATE CLUB: SELF REGULATORY ORGANIZATIONS AS STATE ACTORS WHEN ENFORCING FEDERAL LAW

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I. INTRODUCTION

In the Securities Exchange Act of 1934 (the "Exchange Act"),[1] Congress enacted a comprehensive scheme for regulating the national securities markets. Pursuant to that scheme, the Securities and Exchange Commission (the "Commission") was given ultimate authority to enforce the newly enacted securities laws against market participants. The Exchange Act also creat-

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[1] 15 U.S.C. § 78a, *et seq.* (1994).

ed a prominent enforcement role for national securities exchanges ("Exchanges"), like the New York Stock Exchange ("NYSE").[2] Congress required these self-regulatory organizations ("SROs") as a condition for their continued operation to enforce, among other things, compliance by their members with the provisions of the Exchange Act and the rules and regulations promulgated thereunder.[3] The SROs were also given the power to sanction those members the SRO found to have violated federal law.[4]

The power and enforcement responsibilities conferred upon SROs under the Exchange Act raise the issue of whether constitutional protections such as due process and the right against self-incrimination apply in SRO enforcement proceedings when the SRO is enforcing federal law. The answer to that question, however, turns on whether SROs are "state actors" when enforcing federal law.[5] State action[6] is a fundamental prerequisite in cases alleging deprivation of constitutionally protected rights.[7] "[M]ost rights secured by the Constitution are protected only against infringement by governments."[8] At issue is whether SROs should be subject to the same constitu-

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[2] *See* 15 U.S.C. § 78f (1994).

[3] *Id.* § 78f(b)(1).

[4] *Id.* § 78f(b)(6).

[5] Many commentators have argued that the state action concept is neither doctrinally sound nor necessary. *See, e.g.*, Robert J. Glennon & John E. Nowak, *A Functional Analysis of the Fourteenth Amendment "State Action" Requirement*, 1976 SUP. CT. REV. 221, 232-33 [hereinafter Glennon and Nowak]; LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW §§ 18-1 to 18-7 (2d ed. 1988) [hereinafter TRIBE]. For example, Glennon and Nowak argue for a balancing approach to determine whether private actions should be subject to constitutional requirements. For Glennon and Nowak, the question is not whether there is "state action," but rather "whether it is permissible for the state to define the rights of private persons so as to allow the challenged practice to exist." Glennon and Nowak at 233. Although this theory provides a useful conceptual tool, it has not yet been adopted by the Supreme Court.

[6] As used in this Article, "state action" refers to any governmental action at whatever level, be it local, state or federal.

[7] Edmonson v. Leesville Concrete Co., 500 U.S. 614, 619 (1991) ("The Constitution's protections of individual liberty and equal protection apply in general only to action by the government."); NCAA v. Tarkanian, 488 U.S. 179, 191 (1988); Lugar v. Edmonson Oil Co., 457 U.S. 922, 936 (1982).

[8] Flagg Bros., Inc. v. Brooks, 436 U.S. 149, 156 (1978). *See* Jackson v. Metropolitan Edison Co., 419 U.S. 345, 349 (1974); The Civil Rights Cases, 109 U.S. 3, 17-18 (1883).

tional limitations as the government when they are acting in the same capacity as the government in enforcing federal law, as required of them by the Exchange Act. Despite the Supreme Court's extensive jurisprudence on the state action question, the Court has not addressed the issue of whether SROs are state actors. Lower courts have split on the question of whether SROs are state actors.[9]

The purpose of this Article is to explain why SROs should be considered state actors when enforcing federal law. The various Supreme Court precedents discussing the state action issue strongly suggest that when enforcing federal law, as they are required to do under the Exchange Act, SROs are state actors. In that situation, SROs should be subject to the same constitutional limitations as the Commission or any other government agency.

In Section II, the Article first examines the disciplinary responsibility of SROs imposed by the Exchange Act including the powers which the Commission has to coerce enforcement activity on the part of an SRO.[10] Both the statutory and regulatory frameworks are analyzed. This Section then goes on to demonstrate the symbiotic relationship that exists between the Commission and the SROs in the context of SRO rule-making. This analysis examines the Commission's role in approving rules and its authority to amend SRO rules and require SROs to adopt rules. This analysis is significant because the Commission's authority in the rule-making area effectively allows the Commission to coerce SRO action, and because it demonstrates the heavily regulated nature of SRO activity.

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[9] *Compare, e.g.*, United States v. Solomon, 509 F.2d 863 (2d Cir. 1975) (stating that New York Stock Exchange investigation of defendant did not trigger privilege against self-incrimination) *and* First Heritage Corp. v. National Ass'n of Secs. Dealers, Inc., 785 F. Supp. 1250, 1251 (E.D. Mich. 1992) (arguing that NASD is not a state actor) *with* Intercontinental Indus., Inc. v. American Stock Exch., 452 F.2d 935, 941 (5th Cir. 1971) ("The intimate involvement of the Exchange with the [Commission] brings it within the purview of the Fifth Amendment controls over governmental due process.") *and* United States v. Sloan, 388 F. Supp. 1062 (S.D.N.Y. 1975) (holding that defendant at New York Stock Exchange proceeding can invoke privilege against self-incrimination). *See also* In re Abercrombie, Exchange Act Release No. 16,285, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,342 (Oct. 18, 1979) (stating that NASD is not a federal agency for purposes of the privilege against self-incrimination).

[10] *See infra* Section II.

Section III then applies this analysis to the state action tests the Supreme Court currently employs.[11] The Supreme Court has articulated several distinct tests for determining whether state action exists. This Section addresses two of the more relevant tests: (1) the "coercion" or "encouragement" test; and (2) the "public function" test. The Section explains the history and policy considerations that underlie each of these two tests, and demonstrates that under each of these tests SROs enforcing federal law should be considered state actors.

In Section IV, the Article analyzes lower court decisions that have addressed the general topic of state action in the context of SROs.

Finally, in Section V, the Article concludes that SROs are state actors when they enforce federal law. This conclusion not only follows from the Supreme Court's extensive state action jurisprudence, but is also bolstered by the common sense argument that a dual system for enforcement of federal securities laws — one providing full constitutional protections and the other providing no such constitutional protections — is illogical. This dual enforcement system, which can lead to outcome determinative results based solely upon the prosecutorial forum, has a recognized historical foundation but is unsupported by current state action jurisprudence.

II. SROs AND DISCIPLINARY ACTIONS

In May of 1934, Congress passed the Fletcher-Rayburn Bill, regulating Exchanges and creating an enforcement agency known as the Securities and Exchange Commission (the "Commission"). This bill, now known as the Securities Exchange Act of 1934 (the "Exchange Act"), was a function of political compromise.[12] Rather than being authorized to directly regulate all aspects of trading on Exchanges, the Commission's mandate was to supervise the self-regulatory activities of the existing twenty-one Exchanges which themselves would have primary responsibility for enforcing the Exchange Act, Commission regulations, and their own rules, regulations, and policy

[11] *See infra* Section III.

[12] H.R. Rep. No. 1383, 73d Cong., 2d Sess. 15 (1934) [hereinafter House Report].

statements governing trading and member activity. William O. Douglas, the second Chairman of the Commission, described the purpose of the Exchange Act. "[The Exchange Act lets] the exchanges take the leadership with government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well-oiled, cleaned, and ready for use but with a hope it would never have to be used."[13]

More recently, Justice Stewart, in his dissenting opinion in *Silver v. New York Stock Exchange*,[14] described this self-regulation. "The purpose of the self-regulation provisions of the Securities Exchange Act was to delegate governmental power to working institutions which would undertake at their own initiative to enforce compliance with ethical as well as legal standards in a complex and changing industry."[15]

In the same case, Justice Goldberg described the relationship between the Commission and the Exchanges as a "partnership between government and private enterprise."[16] The Commission itself has described this relationship. "There are, no doubt, many other instances in which the policy of entrusting a degree of social control to "private" groups has been adopted, but securities regulation is unique in featuring self-regulation as an essential and officially sanctioned part of the regulatory pattern."[17]

This political compromise, delegating authority to the Exchanges to enforce federal law, was by no means illogical. Exchanges had already been in operation and had a history of self-governance. More importantly, there was no federal entity with expertise in the regulation of the securities market. In fact, substantial consideration was given to authorizing the Federal Trade Commission to supervise and regulate the enforcement activities of the Exchanges.[18] The ultimate delegation of authority to Exchanges was, however, by no means complete. The Commission was given supervisory jurisdiction

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[13] WILLIAM O. DOUGLAS, DEMOCRACY AND FINANCE 82 (Allen ed., 1940).

[14] 373 U.S. 341 (1963).

[15] *Id.* at 371.

[16] *Id.* at 366.

[17] SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, pt. 4, 88th Cong., 1st Sess. 501 (1963) [hereinafter SEC REPORT].

[18] House Report, *supra* note 12.

over SRO enforcement actions and authority to enforce directly violations of the Act and other federal securities laws.

The Exchange Act sets forth various statutory requirements with respect to the prosecution of disciplinary proceedings. These requirements evidence a delegation of authority to enforce federal law and a symbiotic enforcement relationship with the Commission.

A. Disciplinary Standards for Exchanges

Section 6(b) of the Act specifies the requisites for an Exchange to be registered.[19] This section states that the rules of an Exchange must provide that member firms and their associated persons will be appropriately disciplined for violations of the Exchange Act or Exchange rules. The punishments an SRO can mete out to its members include expulsion, suspension, limitation of activities, functions and operations, fine, or censure. Section 6(b)(7) requires that the rules of an Exchange must be in accordance with Section 6(d) and in general must provide a fair procedure with respect to the discipline of members and persons associated with members, the denial of membership to any person seeking membership therein, the barring of any person from becoming associated with any member firm, and the prohibition or limitation by the Exchange of any person with respect to access to or services offered by the Exchange or its members.

Section 6(d) establishes procedural protections similar to constitutional due process requirements.[20] Section 6(d) also provides that in any disciplinary proceeding the Exchange must bring specific charges, notify the member or associated person of the charges, and provide the accused an opportunity to defend against the charges. The Exchange must also maintain a record of the proceedings. Each disciplinary sanction the Exchange imposes must be supported by a statement specifying the act or practice in which the member or associated person engaged and the specific provision of the Act, the Commission rules, or the rules of the Exchange which the member or associated person is deemed to have violated. The Exchange must

[19] 15 U.S.C. § 78f(b) (1994).
[20] *Id.* § 78f(d).

also describe the sanction imposed and the reasons therefor. Exchange disciplinary proceedings are typically conducted in a hearing held before an Exchange hearing panel consisting of three persons,[21] typically members, associated persons and employees of members who are appointed by the Exchange. The hearing officers are employees of the Exchange who are usually not involved in the investigation of disciplinary proceedings.

During the prehearing phase of a disciplinary proceeding, the hearing officer is empowered to resolve all procedural and evidentiary matters relating to the hearing, though generally no formal discovery mechanisms are available to parties charged by an Exchange. Often, disciplinary officers and parties attempt to reach an informal agreement with respect to discovery. At the hearing stage, strict compliance with the formal rules of evidence is typically not required.[22] Ordinarily, the hearing officer determines all questions regarding the admissibility of testimony and documents into evidence.[23] The hearing panel typically decides by majority vote. Upon the imposition of final disciplinary action, an Exchange is required to write a notice to the Commission with sufficient information regarding the background factual basis and issues involved in the proceeding to enable the Commission to determine whether the case should be called up for review on the Commission's own motion, and to ascertain whether the Exchange was adequately carrying out its responsibilities under the Act.[24] SRO disciplinary decisions are appealable to the SRO Board of Directors[25] and then to the Commission.[26]

Commission oversight of Exchange disciplinary proceedings is more extensive than that of traditional appellate review in that Section 19(h)(1) of the Exchange Act authorizes the Commission by order to suspend for up to twelve months or to revoke the registration of a self-regulatory organization, or to censure the

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[21] David P. Doherty et. al., *The Enforcement Role of the New York Stock Exchange*, 85 NW. U. L. REV. 637, 644 (1991) [hereinafter Doherty].

[22] *Id.* at 645.

[23] *Id.*

[24] *See* Provision for Notices by Self-Regulatory Organizations of Disciplinary Sanctions, Exchange Act Release No. 13,726, [1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,225 (July 8, 1977).

[25] NYSE Rule 476(f).

[26] Exchange Act § 19(d)(2), 15 U.S.C. § 78s(d)(2) (1994).

SRO or impose limitations upon its activities, functions, and operations if the Commission, after notice and opportunity for a hearing, finds and states on the record that the self-regulatory organization has violated or is itself unable to comply with the Act or the organization's own rules, or has failed to enforce compliance with relevant laws or rules by a member, associated person or participant. Similarly, pursuant to Sections 21(e) and (f) of the Exchange Act, the Commission has the authority to apply to a federal court for an injunctive order commanding a self-regulatory organization to enforce compliance by its members with the Act, the Commission rules and the organization's own rules. The Commission thus has the coercive authority to compel disciplinary action as well as appellate review. The Commission's ability to compel the commencement of disciplinary action or to compel additional disciplinary action is a powerful tool to be used by the Commission in causing Exchanges to effect the Commission's enforcement agenda, and has resulted in an interactive disciplinary relationship where information with respect to cases and potential disciplinary actions is shared between the Commission and the SROs.[27]

B. Commission Involvement in SRO Rule-Making

By the middle of the 1960s, it became evident that the original framework envisioned in 1934 in which the SROs would be responsible for their own regulation was flawed. A special study of securities markets conducted by the Commission at the direc-

[27] *See* Vincent L. Briccetti, *Governmental Action and the National Association of Securities Dealers*, 47 FORDHAM L. REV. 585, 605 (1979); 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). Section 19(h) further authorizes the Commission to remove from office or censure any officer or director of a self-regulatory organization if the Commission finds that the officer or director, without reasonable justification or excuse, has failed to enforce compliance with the relevant laws and the rules under the Act by any member, associated person or participant. *See* In the Matter of Richard Neuberger, Exchange Act Release No. 18,428, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,091 (January 19, 1982) (finding defendant is permitted to examine Exchange Department of Enforcement attorney on issue of whether Exchange was caused or compelled to commence disciplinary action at the behest of the U.S. Attorney's office). *See also* Doherty, *supra* note 21, at 640 (stating that enforcement may also commence an investigation as result of referrals from the Commission).

tion of Congress determined that the SROs were not adequately enforcing their own rules.[28] For example, the special study staff submitted a preliminary report which stated, "[t]here can be little doubt that in the case of the American Stock Exchange the statutory scheme of self-regulation in the public interest has not worked out in the manner originally envisioned by Congress."[29]

By the 1970s, the Commission took an even more critical view of the then existing regulatory scheme. In a 1971 report, Commission Chairman Casey stated:

> The Commission's present authority over the rulemaking of the self-regulatory bodies is an illogical patchwork of provisions which falls short of giving the Commission the authority to act promptly and effectively where a rule, or a proposed rule, is or might be injurious to the public interest. . . . The Commission believes that the public interest would be better served if it had plenary authority with respect to the rules of the self-regulatory bodies.[30]

The 1973 Senate Subcommittee on Securities generally agreed with this analysis, and in 1975, Congress amended the Exchange Act.[31] The amendment greatly broadened the Commission's authority over the SROs, and generally produced a much more substantial nexus between the Commission and the SROs. This governmental interrelationship manifests itself in two distinct areas: (1) the Exchange Act's current requirement that all rules adopted by an SRO must be approved by the Commission before they can become effective, and (2) the Exchange Act's provision of "plenary powers" to the Commission to abrogate, add to and delete from existing SRO rules. This

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[28] *See* 4 SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess. 751-814 (1963) [hereinafter SPECIAL STUDY REPORT].

[29] SEC, STAFF REPORT ON ORGANIZATION, MANAGEMENT AND REGULATION OF CONDUCT OF MEMBERS OF THE AMERICAN STOCK EXCHANGE (1962), *reprinted in* SPECIAL STUDY REPORT, *supra* note 28, at 53.

[30] SEC, STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKERS AND DEALERS, H.R. DOC. NO. 231, 92d Cong., 1st Sess. 6 (1971) (discussing Casey letter of transmittal).

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

authority allows the Commission to directly regulate the activities of SROs.

Section 19(b) sets forth the procedures for Commission review of SRO rule changes, and provides that no SRO rule change can become effective unless approved by the Commission.[32] Specifically, the SRO must file copies of its proposed change with the Commission, accompanied by a description of the basis and purpose of the proposal. Notice regarding the substance of the proposed rule change is thereupon provided by the Commission. By the conclusion of the requisite 35-day comment period, the Commission must either approve the rule change or it must institute proceedings to evaluate whether the proposed rule should be disapproved. In the latter case, the Commission must once again provide both notice of its consideration of the matter and an opportunity for a hearing. Within 180 days, the Commission must reach its final determination.

Section 19(c) describes the procedural requirements for the exercise of the Commission's plenary powers to abrogate, add to and delete from SROs' rules,[33] and was designed to grant the Commission rulemaking power concerning all SRO rules.[34] The Commission must not only notify the affected SRO but it must also publish notice of the proposal in the Federal Register. The notice must include the text of the proposed amendment and a statement concerning the Commission's reasons for initiating the change. Interested parties are given an opportunity for written submissions and oral presentations. When the rule is adopted, the Commission must include a statement explaining the basis for and purpose of the rule. In addition, the process must generally comport with the Administrative Procedure Act's requirements applicable to any governmental rule-making, such as the content of the notice and the 30-day minimum time period before such rule can become effective.

This power of the Commission to affect SRO rules is not exclusive; the Commission still retains its authority to promul-

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[32] 15 U.S.C. § 78s(b) (1994).

[33] *Id.* at § 78s(c).

[34] *See* S. REP. No. 75, 94th Cong., 1st Sess. 131 (1975) ("[With the addition of Section 19(c),] the SEC would be granted the power to change the rules of a self-regulatory organization in any respect, not just with respect to certain enumerated areas.").

gate its own rules pursuant to the Act.[35] However, when the Commission acts pursuant to Section 19(c), the adopted rule becomes part of the SROs' rules rather than those of the Commission.[36]

As a result of the current rule-making regime authorized by Congress, the Commission's relationship and involvement with the SROs' rule-making process is much more extensive than it was prior to 1975, and is clearly greater than merely one of oversight. Not only are the SROs' rules subject to the affirmative approval of the Commission, the Commission also has the authority to independently change or add to the SROs' own rules. By subjecting the SROs' rule-making powers to the authority of the Commission, Congress in effect subjected the SROs to a governance structure which must strictly comport with federal statutory requirements and the regulatory interests of the Commission. The highly regulated nature of an entity's activity (while not determinative) has been an important factor in existing state action jurisprudence.[37] This factor — along with the close partnership between the Commission and the SROs, the compulsion for SROs to perform enforcement activities and the delegation of law enforcement functions to the SROs — suggests that SROs should be viewed as state actors when enforcing federal law.

III. STATE ACTION

The state action doctrine rests on important policy interests. The state action requirement is said to preserve an area of individual freedom by limiting the reach of federal law and federal judicial power.[38] Thus, it is said, courts are required to respect the limits of their own power as directed against the government and private interests.[39] Private parties are then free to structure their relations as they wish, "subject only to the constraints of statutory or decisional law."[40] The doctrine

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[35] *See id.*

[36] 15 U.S.C. § 78s(c)(4)(C) (1994).

[37] *See* Jackson v. Metropolitan Edison Co., 419 U.S. 345, 349-51 (1974).

[38] Lugar v. Edmonson Oil Co., 457 U.S. 922, 936 (1982).

[39] *Id.* at 936-37.

[40] Edmonson v. Leesville Concrete Co., 500 U.S. 614, 619 (1991).

also avoids imposing on the State responsibility for conduct for which it cannot fairly be blamed.[41]

The state action issue is implicit in almost every claim that a plaintiff has been deprived of constitutionally protected rights.[42] Theoretically, before a court may address the merits of such a constitutional claim, the court must first determine whether there is any governmental action that triggers the claimed constitutional protection.[43] In many cases, courts do not explicitly analyze the issue because state action is clear. For example, when a federal agency's action is at issue (such as a Commission regulation) or when a party challenges the constitutionality of a federal or state statute, state action is obviously present.

The Supreme Court's jurisprudence on state action derives from those cases where state action is much less clear. In those cases, some putatively private actor is the immediate cause of the complained of harm. It is in those cases where the Court must address whether governmental authority dominates "an activity to such an extent that its participants must be deemed to act with the authority of the government and, as a result, be subject to constitutional constraints."[44]

The state action issue as applied to SRO enforcement of federal law follows this typical framework. The SRO (a putatively private entity) takes some action that has harmed the plaintiff, in this case a brokerdealer who is a member of an Exchange or a person associated with such member firm.[45] This Article addresses this issue in the context of a disciplinary

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[41] *Lugar*, 457 U.S. at 937.

[42] Some constitutional rights, like the Thirteenth Amendment's prohibition against slavery, apply to individuals as well as the government and, therefore, the state action issue never arises. *See* U.S. CONST. amend. XIII; The Civil Rights Cases, 109 U.S. 3, 20 (1883).

[43] Some commentators have suggested that there is sufficient state action anytime a court (obviously a state actor) attempts to enforce rights, whether publicly or privately created. *See* Thomas D. Rowe, Jr., *The Emerging Threshold Approach to State Action Determinations: Trying to Make Sense of* Flagg Brothers, Inc. v. Brooks, 69 GEO L.J. 745, 746 (1981) [hereinafter Rowe]; William W. Van Alstyne, *Mr. Justice Black, Constitutional Review, and the Talisman of State Action*, 1965 DUKE L.J. 219 (1965). The Supreme Court may be moving toward such an approach. *See Edmonson*, 500 U.S. at 619.

[44] *See Edmonson*, 500 U.S. at 620.

[45] *See* NCAA v. Tarkanian, 488 U.S. 179, 192 (1988).

proceeding to enforce federal law against the member or associated person.[46] The aggrieved broker-dealer or associated person will claim (either in an injunction proceeding during the SRO enforcement action[47] or in an appeal from the SRO decision[48]) that the Exchange either is denying or has denied it some constitutionally protected right. The claimed constitutional right would likely involve due process, self-incrimination or double jeopardy. The initial question for the court in this scenario is "whether the State was sufficiently involved to treat that decisive conduct [of the SRO] as state action."[49]

Judging where the government sphere should end and the private one should begin, however, has proved to be an elusive task.[50] The Supreme Court has addressed this issue on numerous occasions. Nonetheless, despite the acknowledged importance of the state action doctrine, the Supreme Court cases discussing the issue have failed to yield a definitive test for state action.[51] Indeed, many commentators consider the Supreme Court's state action jurisprudence to be a "conceptual disaster area."[52] At least some members of the Court do not disagree with this assessment.[53]

Instead of a unitary principle applicable in all state action cases, the Court has essentially resorted to a case-by-case factu-

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[46] *See* 15 U.S.C. § 78f (1994).

[47] *See, e.g.*, Villani v. New York Stock Exch., 348 F. Supp. 1185 (S.D.N.Y. 1972).

[48] *See supra* notes 25-27 and accompanying text.

[49] *Tarkanian*, 488 U.S. at 192.

[50] *See* Jackson v. Metropolitan Edison Co., 419 U.S. 345, 349-50 (1974) ("[T]he question of whether particular conduct is 'private,' on the one hand, or 'state action,' on the other, frequently admits of no easy answer."); Moose Lodge No. 107 v. Irvis, 407 U.S. 163, 172 (1972).

[51] *Compare, e.g.*, Lugar v. Edmonson Oil Co., 457 U.S. 922, 937-39 (1982) (setting forth a two-part test for state action, while recognizing that "the Court has articulated a number of different factors or tests in different contexts. . . .") *with* San Francisco Arts & Athletics, Inc. v. United States Olympic Comm., 483 U.S. 522, 542-47 (1987) (failing to apply *Lugar* test).

[52] Charles L. Black, Jr., *The Supreme Court 1966 Term — Forward: "State Action," Equal Protection, and California's Proposition* 14, 81 HARV. L. REV. 69, 95 (1967). *But see* LAURENCE H. TRIBE, CONSTITUTIONAL CHOICES 248 (1985) (arguing state action doctrine is "considerably more consistent and less muddled than many have long supposed").

[53] *Edmonson*, 500 U.S. at 632 (O'Conner, J., dissenting) (stating Supreme Court decisions regarding state action "have not been a model of consistency.").

al analysis.[54] The court has often repeated that "[o]nly by sifting facts and weighing circumstances can the nonobvious involvement of the State in private conduct be attributed its true significance."[55] Recently, the Supreme Court has organized this factual inquiry around two conditions it has found necessary for a finding of state action. To constitute state action: (1) "the deprivation must be caused by the exercise of some right or privilege created by the State or by a rule of conduct imposed by the State or by a person for whom the State is responsible," and (2) "the party charged with the deprivation must be a person who may fairly be said to be a state actor."[56]

In the case of SROs enforcing federal law, the first condition seems to be satisfied by the "rule of conduct" Congress has imposed on the SROs.[57] Under the Exchange Act, SROs are required to enforce the provisions of the Exchange Act.[58] Where the SRO conducts a hearing and determines that such a violation has occurred, the Exchange Act requires that it impose a penalty against the broker-dealer.[59] As a result, when constitutional rights are denied in an SRO disciplinary proceeding, the broker-dealer's injury derives directly from the rule of conduct the Exchange Act imposes on the SRO.

The second part of the analysis is not as simple. In determining whether a private party can fairly be described as a state actor, the Supreme Court applies the facts of a given case to "certain principles of general application" that it has developed in its state action cases.[60] These general principles are essentially categories of state action. Under its current mode of analysis, if the Court finds that the challenged activity falls within one of these categories, then it will find that state action exists. For example, state action will be found if the government has coerced or encouraged the private actor to engage in

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[54] Burton v. Wilmington Parking Auth., 365 U.S. 715, 722 (1961).

[55] *Id.*; *see* Lugar v. Edmonson Oil Co., 457 U.S. 922, 939 (1982); Moose Lodge No. 107 v. Irvis, 407 U.S. 163, 172 (1972).

[56] *Lugar*, 457 U.S. at 937. *See* Georgia v. McCollum, 505 U.S. 42, 50-51 (1992); *Edmonson*, 500 U.S. at 620; West v. Atkins, 487 U.S. 42, 49 (1988).

[57] *See Lugar*, 457 U.S. at 937, 941 (holding scheme created by statute satisfied first prong of test).

[58] *See* 15 U.S.C. § 78f(b)(1) (1994) and discussion *infra* Section IV.

[59] *See* 15 U.S.C. § 78f(b)(6) (1994).

[60] *Edmonson*, 500 U.S. at 621.

the complained of activity.[61] Likewise, if a private actor is performing certain delegated "public functions" it will be subject to constitutional restrictions.[62] Although focusing on somewhat different facts, both of these tests address the essential question of whether the government is responsible in some way for the conduct of which plaintiff complains.[63] In other words, constitutional "liability attaches only to those wrongdoers 'who carry a badge of authority of a State and represent it in some capacity.'"[64] As discussed below, under both the "coercion/encouragement" test and the "public function" test, the SROs, when enforcing federal law, should be considered state actors.

A. The Coercion or Encouragement Test

Merely because the government has some connection with the actions of a private entity does not mean those actions will be considered state actions. Extensive regulation of a private actor does not, in and of itself, transform the actions of the regulated entity into those of the government.[65] Thus, even though the Commission has extensive authority with respect to SRO rule-making, this alone does not convert SRO activity into state action. Likewise, mere approval of, or acquiescence in, a private party's initiatives is typically insufficient to establish state action.[66] However, these factors do not describe the entire relationship between the Commission and the SROs.

What is required (and, what exists with respect to SROs) is a showing that the State is specifically responsible for the particular activity of which the plaintiff complains.[67] Such responsibility is shown where the government "has exercised coercive power or has provided such significant encouragement, either

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[61] *See* discussion *infra* Section III.A.

[62] *See* discussion *infra* Section III.B.

[63] Blum v. Yaretsky, 457 U.S. 991, 1004 (1982); *Edmonson*, 500 U.S. at 632 (O'Conner, J., dissenting).

[64] NCAA v. Tarkanian, 488 U.S. 179, 191 (1988) (quoting Monroe v. Pape, 365 U.S. 167, 172 (1961)). *See Edmonson*, 500 U.S. at 632 (O'Conner, J., dissenting).

[65] *See* San Francisco Arts & Athletics, Inc. v. United States Olympic Comm., 483 U.S. 522, 544 (1987); Jackson v. Metropolitan Edison Co., 419 U.S. 345, 350 (1974).

[66] *Blum*, 457 U.S. at 1004-05.

[67] *Id.* at 1004.

overt or covert, that the choice must in law be deemed to be that of the [government]."[68] Such coercion will exist where a private actor is commanded to perform the complained of actions in a statutory or regulatory scheme.[69] That situation does not involve mere approval or acquiescence; rather, it is the State which is ultimately the responsible actor because the State has "put its own weight on the side of the proposed practice by ordering it."[70] Fairness requires that the State be held responsible when it has ordered or significantly encouraged private parties to impair the important rights of others.[71]

The Court discussed these issues in some depth in *Jackson v. Metropolitan Edison Co.*[72] In *Jackson*, a customer brought suit against a privately owned and operated utility seeking damages under the Civil Rights Act[73] for termination of her electric service, allegedly before she was afforded notice, a hearing and the opportunity to pay any amounts found due. Under a provision of the utility's general tariff filed with the State, the utility had the right to discontinue service to any customer on reasonable notice of nonpayment of bills. Plaintiff argued, in part, that the utility's monopoly status and the State's approval of the utility's general tariff created state action.[74]

The Court acknowledged that determining whether state action exists in any particular case "frequently admits of no easy answer."[75] The Court was clear that State regulation of a business, even if that regulation is extensive and detailed, does not by itself convert private action into that of the State.[76] Nonetheless, the Court did not completely reject the relevance

[68] *San Francisco Arts & Athletics, Inc.*, 483 U.S. at 546 (quoting *Blum*, 457 U.S. at 1004); Rendell-Baker v. Kohn, 457 U.S. 830, 840 (1982).

[69] Albert v. Carovano, 851 F.2d 561 (2d Cir. 1988). *See also* Powe v. Miles, 407 F.2d 73, 81 (2d Cir. 1968) (Friendly, J.) ("State action would be similarly present here with respect to all the students if New York had undertaken to set policy for the control of demonstrations in all private universities. . . .").

[70] Jackson v. Metropolitan Edison Co., 419 U.S. 345, 357 (1974).

[71] *See* Peterson v. City of Greenville, 373 U.S. 244, 248 (1963).

[72] 419 U.S. 345 (1974).

[73] Pub. L. No. 96-170, *codified at* 42 U.S.C. § 1983 (1979).

[74] *Jackson*, 419 U.S. at 351, 354-55.

[75] *Id.* at 350 (citing Burton v. Wilmington Parking Auth., 365 U.S. 715, 723 (1961); Moose Lodge No. 107 v. Irvis, 407 U.S. 163, 172 (1972)).

[76] *Jackson*, 419 U.S. at 350.

of extensive regulation. Instead, it held that those and other factors were part of a larger inquiry:

> It may well be that acts of a heavily regulated utility with at least something of a governmentally protected monopoly will more readily be found to be 'state' acts than will be the acts of an entity lacking these characteristics. But the inquiry must be whether there is a sufficiently close nexus between the State and the challenged action of the regulated entity so that the action of the latter may be fairly treated as that of the State itself.[77]

Such an inquiry will often be "detailed" because the true nature of the State's involvement may not be immediately obvious.[78] In our context, the intimate relationship between SROs and the Commission, as manifested through both the rule-making process and the existence of interactive enforcement activity, is an important factor that helps establish that SRO action can be fairly treated as that of the State.

In *Jackson*, however, the Court found no such nexus.[79] In particular, the Court "reject[ed] the notion that Metropolitan's termination is state action because the State 'has specifically authorized and approved' the termination practice."[80] The Court down-played the significance of the fact that the utility was required to file its general tariff (which contained the termination provision at issue) with the State.[81] That provision had never been the subject of a hearing or other scrutiny by the State. Moreover, the Court questioned whether the State legitimately would have had the power to disapprove it. For these reasons the Court found that the case did not concern an:

> imprimatur placed on the practice of Metropolitan about which petitioner complains. The nature of the governmental regulation of private utilities is such that a utility may frequently be required by the state regulatory scheme to obtain approval for

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[77] *Id.* at 350-51 (citations omitted).

[78] *Id.* at 350.

[79] The Court did not consider whether all of the factors taken together supported a finding of state action, even though each factor was insufficient in and of itself. *See The Supreme Court, 1974 Term*, 89 HARV. L. REV. 47, 140-41 (1975) (criticizing seriatim approach).

[80] *Jackson*, 419 U.S. at 354.

[81] *See id.* at 354-55.

> practices a business regulated in less detail would be free to institute without any approval from a regulatory body. Approval by a state utility commission of such a request from a regulated utility, where the commission has not put its own weight on the side of the proposed practice by ordering it, does not transmute a practice initiated by the utility and approved by the commission into "state action." At most, the Commission's failure to overturn this practice amounted to no more than a determination that a Pennsylvania utility was authorized to employ such a practice if it so desired. Respondent's exercise of the choice allowed by state law where the initiative comes from it and not from the State, does not make its action in doing so "state action" for purposes of the Fourteenth Amendment.[82]

In *Jackson*, unlike in the case of SROs, there was no statute ordering the supposedly private entity to engage in the complained of activity. The State did not order Metropolitan Edison to cut off Ms. Jackson's power. The *Jackson* Court thus distinguished between State acceptance and State commandment. It is not enough for a finding of state action if the private action at issue results from private initiative and occurs merely because the State has not affirmatively prohibited it.[83] Such tacit acceptance does not implicate constitutional concerns.

The decision in *Albert v. Carovano*[84] demonstrates the same distinction. In *Albert*, Hamilton College and certain of its officers were sued by students who claimed that the college's filing of certain disciplinary rules and regulations pursuant to the Henderson Act[85] constituted "a rule of conduct imposed by the State"[86] that rendered the college a state actor in connection with its disciplinary actions. The Second Circuit found, however, that since the Henderson Act did not require any specific disciplinary action and because the State's only role was to keep such rules and regulations on file, the finding of state action was not justified. By contrast, if a private actor is regulated and those regulations provide that an actor is explicitly required to perform certain functions or engage in certain activ-

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[82] *Id.* at 357 (footnote omitted).

[83] *See id.*

[84] 851 F.2d 561 (2d Cir. 1988).

[85] N.Y. Educ. Law § 6450 (McKinney 1985).

[86] *Albert*, 851 F.2d at 568 (quoting Lugar v. Edmonson Oil Co., 457 U.S. 922, 937 (1982)).

ities, then a "sufficiently close nexus" is created to find state action.[87] In that case, the State has taken the "initiative" by "ordering" the private actor to engage in the complained of activity.[88] It is that situation (typified by the Exchange Act's treatment of SROs) which gives rise to state action and constitutional protections.

The Supreme Court highlighted this distinction between acquiescence and commandment in *Flagg Bros., Inc. v. Brooks*.[89] In *Flagg Bros.*, the Court determined that a private warehouseman's sale of goods as a remedy for unpaid storage fees did not involve state action, even though such sales were permitted under New York's Uniform Commercial Code. The Court found no state action because the statute in question only permitted the remedy under certain circumstances, it did not compel the warehouseman to exercise that remedy.[90] In essence, the statute was nothing more than an indication of state "inaction," that is, an indication that the State would not interfere with private self-help remedies to the extent that they conformed to the statutory requirements.[91] The "State is responsible for the . . . act of a private party when the State, by its law, has compelled the act."[92]

In reaching this result, the *Flagg Bros.* Court relied not only on *Jackson* but also on *Moose Lodge No. 107 v. Irvis*.[93] In *Moose Lodge*, plaintiff, an African-American, brought suit under the Civil Rights Act after he was refused service by Moose Lodge, a local branch of a private fraternal organization located in Pennsylvania.[94] Plaintiff claimed that because the Pennsylvania liquor board had issued Moose Lodge a license that authorized the sale of alcoholic beverages, the refusal to serve him was state action.[95] As in its later cases, the Court in *Moose Lodge* held that the mere existence of pervasive regulation was

[87] *See id.*; Jackson v. Metropolitan Edison Co., 419 U.S. 345, 351 (1974).
[88] *Albert*, 851 F.2d at 568.
[89] 436 U.S. 149, 164-66 (1978).
[90] *Id.* at 165-66.
[91] *Id.* at 164-66.
[92] *Id.* at 164 (quoting Adickes v. S.H. Kress & Co., 398 U.S. 144, 170 (1970)).
[93] 407 U.S. 163 (1972).
[94] *Id.* at 164-65.
[95] *Id.* at 165.

not enough to create state action.[96] The State's regulations did not encourage racial discrimination. In that situation, "where the impetus for the discrimination is private" there will be no finding of state action unless the State "significantly involved itself with the invidious discriminations."[97]

The Court in *Moose Lodge* did, however, find state action with respect to a liquor board regulation requiring that "[e]very club licensee shall adhere to all of the provisions of its Constitution and ByLaws." [98] Moose Lodge's constitution required racial discrimination. Even though the State regulation was "neutral in its terms, the result of its application in a case where the constitution and bylaws of a club required racial discrimination would be to invoke the sanctions of the State to enforce a concededly discriminatory private rule."[99] As in *Jackson* and *Flagg Bros.*, in order to find state action the *Moose Lodge* Court also required that the State put its weight on the side of a particular practice by ordering it.[100]

The Supreme Court found coercion sufficient for state action to exist in *Skinner v. Railway Executives' Ass'n*,[101] a case which is particularly relevant to the determination that SROs are state actors. Both situations involve the State ordering private actors to perform specified functions. *Skinner* concerned the Federal Railroad Safety Act of 1970,[102] which authorized the Secretary of Transportation to "prescribe, as necessary, appropriate rules, regulations, orders, and standards for all areas of railroad safety."[103] The Federal Railroad Administration (the "FRA") determined that alcohol and drug abuse by railroad employees posed a serious threat to safety. Pursuant to its statutory authority under the Railroad Safety Act, the FRA promulgated regulations that mandated blood and urine tests of

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[96] *Id.* at 173, 176-77. *See* Chan v. City of New York, 1 F.3d 96 (2d Cir. 1993).

[97] *Moose Lodge*, 407 U.S. at 173 (quoting Reitman v. Mulkey, 387 U.S. 369, 380 (1967)).

[98] *Id.* at 177 (quoting Regulations of the Pennsylvania Liquor Control Board § 113.09 (June 1970 ed.)).

[99] *Id.* at 178-79.

[100] *Id.* at 172-73; Jackson v. Metropolitan Edison Co., 419 U.S. 345, 357 (1974); Flagg Bros., Inc. v. Brooks, 436 U.S. 149, 164 (1978).

[101] 489 U.S. 602 (1989).

[102] 84 Stat. 971, *codified at* 45 U.S.C. § 1 *et seq.* (1988).

[103] *Id.* at § 431(a).

employees who were involved in certain train accidents.[104] The FRA also adopted regulations that authorized, but did not require, the railroads to administer breath and urine tests to employees who violated certain safety rules.[105] The state action question presented in the case was whether these regulations implicated the Fourth Amendment, given that the railroads who were actually administering the tests were theoretically private parties.[106]

The Court found that state action existed when a railroad performed the mandatory tests prescribed in the FRA regulations. These regulations amounted to "compulsion of sovereign authority" and implicated the Fourth Amendment.[107] Likewise, the Court found that the regulations authorizing the railroads to perform breath and urine tests after certain safety violations had occurred also implicated the Fourth Amendment. "Whether a private party should be deemed an agent or instrument of the Government . . . necessarily turns on the degree of the Government's participation in the private party's activities."[108] In *Skinner*, the content of the regulations made plain that the searches were not the "result of private initiative."[109] The government had clearly indicated in the relevant regulations "not only its strong preference for testing, but also its desire to share the fruits of such intrusions." This encouragement, endorsement and participation in the private activity created state action.[110]

Similarly, in *Little v. Streater*,[111] the Supreme Court reviewed a Connecticut statute which provided that in paternity actions the cost of blood grouping tests was to be borne by the party requesting them. The Court was asked whether the statute violated the Fourteenth Amendment when applied to deny such tests to indigent defendants.[112] The plaintiff in the ac-

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[104] *Id.*

[105] *Id.*

[106] Skinner v. Railway Executives' Ass'n, 489 U.S. 602, 614 (1989) ("[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. . . .").

[107] *Id.*

[108] *Id.*

[109] *Id.* at 615.

[110] *Id.* at 615-16.

[111] 452 U.S. 1 (1981).

[112] *Id.* at 3.

tion was the unmarried mother of a child who, as a condition stemming from her child's receipt of public assistance, was required to identify the child's father.[113] The Connecticut Department of Social Services provided the mother with an attorney to bring a paternity suit against the alleged father to establish his liability for the child's support.[114] The father's legal aid attorney moved the trial court to order blood grouping tests on the mother and child and, because the father was indigent, to order the State to pay for the tests.[115] The trial court granted the father's request for the tests, but denied the request that the State pay for them.[116] The tests were not performed, allegedly because the father could not afford to have them done. The father then lost the paternity suit and appealed.

The father argued that "unlike a common dispute between private parties, the State's involvement in this paternity proceeding was considerable and manifest, giving rise to a constitutional duty."[117] The Supreme Court agreed, finding that state action had "undeniably pervaded" the case.[118] State action derived from Connecticut's statutory scheme of public assistance. As a recipient of public support, Connecticut had compelled the mother "to disclose the name of the putative father under oath and to institute an action to establish the paternity of the said child."[119] In other words, just like the SRO, a statute required a supposedly private party to enforce the requirements of a statutory scheme against a private party. In both cases, the State used a potent threat to assure compliance with

[113] *Id.*
[114] *Id.*
[115] *Id.* at 3-4.
[116] *Id.* at 4.
[117] *Id.* at 9.
[118] *Id.*
[119] *Id.* (quoting Conn. Gen. Stat. § 46b-169 (1981)).

its edict. That State compulsion[120] sets these cases apart from "ordinary civil litigation between private parties."[121]

State commandment through statutory enactment is such a strong basis for finding state action that a court is likely to find state action even if the private actor would have taken the same action independently of the existence of the statute. In *Peterson v. Greenville*,[122] ten African-Americans were arrested for trespass after participating in a sit-in at a department store lunch counter in Greenville, South Carolina. Prior to their arrest, the manager of the store had asked the protesters to leave because integrated service was "contrary to local customs" and in violation of a Greenville city ordinance requiring segregation in restaurants.[123]

The Supreme Court found that the existence of the city ordinance was sufficient to find state action even if the private actor "would have acted as he did independently of the existence of the ordinance."[124] By enacting the ordinance, the State had reserved for itself the decision as to whether restaurants would be operated on a segregated basis.[125] The Court held that:

> When the State has commanded a particular result, it has saved to itself the power to determine that result and thereby "to a significant extent" has "become involved" in it, in fact, has removed that decision from the sphere of private choice. It has thus effectively determined that a person owning, managing or controlling an eating place is left with no choice of his own but must segregate his white and Negro patrons. The [store] manage-

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[120] The Court also relied on the following factors: (i) the State's Attorney General automatically became a party to the action; (ii) any settlement agreement required the approval of the Attorney General and the Commissioner of Human Resources or the Commissioner of Income Maintenance; (iii) the State referred the paternity suit to a lawyer and paid his fees; and (iv) the State was to receive the monthly support payments. *Id.* These factors support a finding that the mother and state were joint actors, possibly a separate basis for establishing state action apart from the state coercion ground. *See* Burton v. Wilmington Parking Auth., 365 U.S. 715, 721-26 (1961).

[121] *Little*, 452 U.S. at 9-10.

[122] 373 U.S. 244, 245 (1963).

[123] *Id.* at 246.

[124] *Id.* at 248.

[125] *Id.* at 247-48.

> ment, in deciding to exclude Negroes, did precisely what the city law required.[126]

The State commandment thus overwhelmed the question of private choice such that the private actor's actions, whatever their motivation, would be deemed that of the State.[127]

The enforcement of federal law by SROs falls neatly into those cases finding state action as a result of statutory commandments. Clearly, SROs are heavily regulated. Pursuant to the Exchange Act, their organization and operations are subject to statutory requirements and substantial Commission oversight and approval. However, SROs enforcing federal law are not merely another heavily regulated entity;[128] instead, they are entities that have been ordered to perform a particular function — to enforce the Exchange Act. The SROs did not take the initiative in instituting that function. Rather, it was the government that "has put its weight on the side of the proposed practice by ordering it."[129]

The Exchange Act compels a particular result — it requires the SROs, as a condition of their continued existence, to enforce compliance by their members with provisions of the Exchange Act and with the rules and regulations promulgated thereunder.[130] Like the mother in *Little v. Streater*, the SRO must bring actions against private parties.[131] This statutory mandate is strictly enforced pursuant to Sections 19(h) and 21(e) which require the Commission to sanction SROs and their officials if they fail to properly enforce federal law through the disciplinary process. The Commission can go so far as to seek an injunction requiring appropriate disciplinary action. Usually, the informal interaction between the Commission and the SROs is sufficient to obtain appropriate enforcement activity; but, clearly the coercive impact of Sections 19(h) and 21(e) are sufficient to compel enforcement of federal law.

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[126] *Id.* at 248.

[127] *Id.*

[128] *See* San Francisco Arts & Athletics, Inc. v. United States Olympic Comm., 483 U.S. 522, 544 (1987).

[129] *See* Jackson v. Metropolitan Edison Co., 419 U.S. 345, 354-55 (1974).

[130] 15 U.S.C. § 78f(b)(1) (1994).

[131] *See Little*, 452 U.S. at 3-4.

Indeed, the SROs are in no different position than the railroad companies in *Skinner* that were required to perform drug tests on their employees.[132] In fact, it can be argued that the coercion of the Commission exercised pursuant to the Exchange Act is greater than that exercised by FRA in *Skinner*. As in *Skinner*, the legal scheme imposed by the federal government requires the so-called private actor to engage in specified activities — drug testing in *Skinner*, enforcement of federal securities laws in the SRO context. But, under the Exchange Act, the SROs are not only required to ferret out violations of federal law, they are also required to punish the violators. Both legal schemes amount to "compulsion of sovereign authority" and implicate constitutional protections.[133]

This compulsion distinguishes the SROs acting pursuant to the requirements of the Exchange Act from the private warehouseman in *Flagg Bros.* In *Flagg Bros.*, the Court made plain the fact that the State had not "compelled the sale of the bailor's goods."[134] The Uniform Commercial Code merely gave the bailor a mechanism, which it could use or ignore.[135] The SROs have no such choice; they must enforce federal law or risk being put out of business.

That threat is not an idle one. In fact, in 1966 pursuant to Section 19(a)(1) of the Exchange Act, the Commission withdrew the registration of the San Francisco Mining Exchange, a national securities exchange, as a result of its failure to enforce compliance with various sections of the Exchange Act. This drastic sanction was upheld by the Court of Appeals for the Ninth Circuit in *San Francisco Mining Exchange v. Securities and Exchange Commission*[136] and provides clear evidence of the Commission's power to coerce the SROs to enforce federal law.

For these reasons, the SROs should be considered state actors when they are enforcing federal law. By enacting the Exchange Act, Congress has removed from the private sphere the decision whether the SROs should act to punish violations of

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[132] *See Skinner*, 489 U.S. at 614.
[133] *See id.*
[134] *Flagg Bros.*, 436 U.S. at 165.
[135] *See id.*
[136] 378 F.2d 162 (9th Cir. 1967).

federal law.[137] Congress has "effectively determined" that an SRO has "no choice" but to do so.[138] In all such cases, state action exists and constitutional safeguards should come into play.

It is no response to argue, as the court in *United States v. Solomon*[139] suggested, that the Exchange Act does not turn securities exchanges into state actors because "this is but one of many instances where government relies on self-policing by private organizations to effectuate the purposes underlying federal regulating statutes."[140] As a preliminary matter, the self-regulatory model used in securities and commodities regulation is unique in the extent to which self-regulation is used.[141] Moreover, even to the extent the relationship is not unique, that fact alone does not explain why State coercion does not amount to state action.

State coercion thus provides a basis for finding state action on the part of SROs enforcing federal law.

B. The Public Function Test

Like other aspects of state action jurisprudence, the public function concept has a long and variegated history in Supreme Court cases. The essential principle is easily stated. If a private actor is engaged in inherently governmental functions, or if the government delegates the operation of one of its traditional and quintessential functions to a private actor, then the private actor will be deemed to be a state actor subject to constitutional limitations.[142]

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[137] *See* Peterson v. Greenville, 373 U.S. 244, 248 (1963).

[138] *See id.*

[139] 509 F.2d 863 (2d Cir. 1975).

[140] *Id.* at 869.

[141] *See* Sam S. Miller, *Self-Regulation of the Securities Markets: A Critical Examination*, 42 WASH. & LEE L. REV. 853, 853 n.1 (1985); SEC REPORT, *supra* note 17.

[142] NCAA v. Tarkanian, 488 U.S. 179, 195 (1988); Flagg Bros., Inc. v. Brooks, 436 U.S. 149, 163-64 (1978); Jackson v. Metropolitan Edison Co., 419 U.S. 345, 349-50 (1974); Evans v. Newton, 382 U.S. 296, 299 (1966) ("[W]hen private individuals or groups are endowed by the State with powers or functions governmental in nature, they become agencies or instrumentalities of the State and subject to its constitutional limitations."); Marsh v. Alabama, 326 U.S. 501, 506 (1946).

The rationale for the doctrine is equally clear. "The fact that the government delegates some portion of [its] power to private [actors] does not change the governmental character of the power exercised."[143] Without the public function doctrine, the government could circumvent constitutional proscriptions on its power merely by delegating important governmental functions to theoretically private entities.[144] The public function doctrine thus requires the courts to look behind the State's decision to provide such services through a private entity.[145] Because the State cannot be allowed to shed so easily its constitutional limitations, the private actor functions as a sort of substitute State.[146] In a very real sense, the private actor, when performing a public function, becomes an agent of the State.[147]

Despite its seeming simplicity, the doctrine has been difficult to apply. It has narrowed and broadened considerably since its initial appearance in Supreme Court jurisprudence. The Court's struggle with the doctrine has been definitional — which government functions are "so intimately associated with our concept of sovereignty that the state ought not be permitted to authorize [their] exercise by a private party without the same degree of protection that would apply if the sovereign itself were conducting [the function?]"[148]

The cases addressing this issue not only fail to define the exact contours of the doctrine, they are also nearly impossible to reconcile with each other.[149] This inconsistency has made predicting which governmental functions will be considered to fall within the scope of "public functions" difficult. Nonetheless, even under the Supreme Court's narrowest conception, an SRO

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[143] Edmonson v. Leesville Concrete Co., 500 U.S. 614, 626 (1991).

[144] Georgia v. McCollum, 112 S. Ct. 2348, 2356-57 (1992). *See The Supreme Court, 1974 Term*, *supra* note 79, at 150-51 (1975).

[145] *Jackson*, 419 U.S. at 371 (Marshall, J., dissenting).

[146] Rowe, *supra* note 43, at 757.

[147] West v. Atkins, 487 U.S. 42 (1988).

[148] *The Supreme Court, 1977 Term*, 92 HARV. L. REV. 57, 128 (1978). Some prominent commentators condemn this as a fruitless inquiry. *See* Glennon and Nowak, *supra* note 5, at 232 (claiming public function doctrine is "hollow"); TRIBE, *supra* note 5, § 18-5 at 1706 ("[N]o satisfactory criteria currently exist to determine what is or is not inherently governmental for this purpose.").

[149] *Compare* Flagg Bros., Inc. v. Brooks, 436 U.S. 149, 163-64 (1978) *with* Edmonson v. Leesville Concrete Co., 500 U.S. 614, 618-20 (1991).

enforcing federal law is exercising a delegated public function subject to constitutional limitations.[150]

To demonstrate this point, it is necessary to examine some of the Court's more prominent public function cases. In its early incarnation, the Court determined that if a private actor was performing all of the functions of a sovereign, then it must be considered a state actor. For example, in *Marsh v. Alabama*,[151] the Supreme Court used the public function doctrine to prevent the owner of a company town from prohibiting a religious group from distributing leaflets in the town's business district. The Court took the view that in those situations where private property has taken on "all the characteristics of [a] town" and the private actor is performing all the necessary municipal functions, then the private actor will have taken on the mantle of the State and will be subject to the same constitutional restrictions as the State.[152] In other cases, the Court overturned lower court decisions that permitted the use of putatively private entities as a mechanism to exclude African-Americans from participating in primary elections in Texas.[153]

In the 1970s, the Court significantly narrowed the delegated public function concept in two opinions authored by then Justice Rehnquist.[154] The first of those cases was *Jackson v. Metropolitan Edison Co.*[155] In addition to arguing that the heavy regulation of the utility and its monopoly status created state action, the customer who had her electric service terminated in that case claimed that under state law she had an entitlement to reasonably continuous electrical service to her home. She argued that the utility's termination of her service for alleged nonpayment constituted "state action" depriving her of property in violation of the Fourteenth Amendment's guaran-

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[150] *See* U.S. CONST. art. II, § 3 (stating enforcement of federal law is a power delegated to the Executive branch of the federal government); *see also* TRIBE, *supra* note 5, at § 4-11 (discussing Executive branch duties of law enforcement).

[151] 326 U.S. 501 (1946).

[152] *Id.* at 502.

[153] Terry v. Adams, 345 U.S. 461 (1953); Smith v. Allwright, 321 U.S. 649 (1944); Nixon v. Condon, 286 U.S. 73 (1932).

[154] Jackson v. Metropolitan Edison Co., 419 U.S. 345 (1974); Flagg Bros., Inc. v. Brooks, 436 U.S. 149 (1978).

[155] 419 U.S. 345 (1974).

tee of due process of law because of the importance of electrical service.

The Court was not persuaded by this argument. It was not enough that the utility provided an essential public service or that its activity was "affected with the public interest."[156] In rejecting these claims, the Court narrowed the scope of the public functions test. Instead of encompassing all "traditional" government functions, the Court now held that public functions were only those "exclusively" reserved to the State.[157] The utility was not performing a public function in *Jackson* because the State was not obligated to provide utility services to its citizens.[158] Since private companies had historically provided such services, the Court took the view that supplying such services "is not traditionally the exclusive prerogative of the State . . . ."[159] It is only where a private entity exercises powers traditionally and exclusively reserved to the government that state action is present.

Four years later, the Court once again focused on the exclusivity requirement in *Flagg Bros., Inc. v. Brooks*.[160] In *Flagg Bros.*, the Court examined the state action requirement in the context of the sale of goods by a private warehouseman for nonpayment of fees. No state officials were involved in the sale. Rather, New York State allowed private sales as part of its Uniform Commercial Code.[161] In support of her claim that the sale violated her due process and equal protection rights, respondent contended that New York had delegated to Flagg Brothers a traditional function exclusively reserved to the State — the power to resolve private disputes.[162] The Court disagreed, finding no state action.

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[156] *Jackson*, 419 U.S. at 620. *See also* Rendell-Baker v. Kohn, 457 U.S. 830, 842 (1982).

[157] *See Jackson*, 419 U.S. at 352 (citing Nixon v. Condon, 286 U.S. 73 (1932) (election); Terry v. Adams, 345 U.S. 461 (1953) (election); Marsh v. Alabama, 326 U.S. 501 (1946) (company town); Evans v. Newton, 382 U.S. 296 (1966) (municipal park)).

[158] *Jackson*, 419 U.S. at 620.

[159] *Id.* This view became clear in later cases. *See* Blum v. Yaretsky, 457 U.S. 991, 1008-09 (1982); *Rendell-Baker*, 457 U.S. at 2770-72.

[160] 436 U.S. 149 (1976).

[161] *Id.* at 151-52 (citing New York U.C.C. § 7-210 (McKinney 1964)).

[162] *Id.* at 157.

In so holding, the Court once again focused on the "exclusivity" requirement of public functions. It held that "[w]hile many functions have been traditionally performed by governments, very few have been 'exclusively reserved to the State.'"[163] The Court noted that traditionally private arrangements played an important part in ordering relationships in the commercial world.[164] As a result, the Court found that "the settlement of disputes between debtors and creditors is not traditionally an exclusive public function."[165] According to the Court, this result was clear from its earlier cases, where only private actors who performed all of the functions of the sovereign[166] or who performed such exclusive functions as conducting elections[167] were state actors.

The Court, however, did not limit public functions to those it had found to exist in its previous cases. Instead, it indicated that:

> [W]e would be remiss if we did not note that there are a number of state and municipal functions not covered by our election cases or governed by the reasoning of *Marsh* which have been administered with a greater degree of exclusivity by States and municipalities than has the function of so-called "dispute resolution." Among these are such functions as education, fire and police protection, and tax collection. We express no view as to the extent, if any, to which a city or State might be free to delegate to private parties the performance of such functions and thereby avoid the strictures of the [Constitution].[168]

After *Jackson* and *Flagg Bros.*, it seemed clear that it was not enough that a public function could be performed by the State. Apparently, only those activities or functions that are traditionally associated with the government, and are operated almost exclusively by the government, are state actions.[169]

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[163] *Id.* at 158 (quoting Jackson v. Metropolitan Edison Co., 419 U.S. 345, 352 (1974)).

[164] *Id.* at 160.

[165] *Id.* at 161.

[166] *Id.* at 158-162 (citing Marsh v. Alabama, 326 U.S. 501 (1946)).

[167] *Id.* (citing Terry v. Adams, 345 U.S. 461 (1953); Smith v. Allwright, 321 U.S. 649 (1944); Nixon v. Condon, 286 U.S. 73 (1932)).

[168] *Id.* at 163-64.

[169] *See id.*

Thus, after *Flagg Bros.*, the Court found that neither the provision of education to troubled high school students[170] nor the operation of nursing homes[171] were exclusive public functions. The Court in *West v. Atkins*[172] did, however, find that a physician who is under contract with the State to provide medical services to inmates at a state prison on a part-time basis was a state actor when he treated an inmate. There, the Court reasoned that the doctor in a collaborative effort with the hospital staff was fulfilling the State's obligation to provide adequate medical care under the Eighth Amendment to incarcerated persons and thus that he was fulfilling a constitutionally mandated obligation.

> We now make explicit what was implicit in our holding in *Estelle*: Respondent, as a physician employed by North Carolina to provide medical services to state prison inmates, acted under color of state law for purposes of § 1983 when undertaking his duties in treating petitioner's injury. Such conduct is fairly attributable to the State.[173]

Even under the strict view of the public function doctrine evidenced by *Jackson* and *Flagg*, SROs enforcing federal law under the Exchange Act are state actors. Like the doctor in *West*, SROs are engaged in a collaborative effort with the Commission; indeed, that relationship has been poignantly described by the Supreme Court as a "partnership."[174] That partnership requires the SRO to perform a law enforcement function pursuant to explicit federal statutory delegation.[175] Congress has delegated the power and responsibility to enforce the federal securities laws to the SROs. In a sense, Congress has deputized the SROs, giving them "a badge of authority of a state."[176] The SROs, as a condition for their continued existence, are required to seek out and investigate such violations.[177] Moreover, not only do the SROs conduct enforcement functions, they

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[170] Rendell-Baker v. Kohn, 457 U.S. 830, 842 (1982).
[171] Blum v. Yaretsky, 457 U.S. 991, 1012 (1982).
[172] 487 U.S. 42 (1988).
[173] *Id.* at 54.
[174] Silver v. New York Stock Exch., 373 U.S. 341, 366 (1963).
[175] *See* 15 U.S.C. § 78f (1994).
[176] NCAA v. Tarkanian, 488 U.S. 179, 191 (1988).
[177] *See id.*

also are required to levy fines and other punishments against those they find have violated federal law. Thus, Congress has also delegated investigatory and adjudicatory functions to the SROs.

These functions are intimately associated with our concept of the sovereign.[178] Indeed, they are within the traditional and exclusive public functions contemplated in the Supreme Court's public function cases. For example, even in *Flagg*, the Supreme Court's narrowest conception of the public function doctrine, the Court intimated that a private party might be a state actor when exercising power delegated by the State to provide police protection.[179] Likewise, the enforcement of federal law, and the imposition of penalties (especially penalties not available in civil litigation) for such violations, are quintessential government functions.[180] A finding of state action is bolstered by the interactive disciplinary relationship that exists between the Commission and the SROs. The sharing of information with respect to cases and potential disciplinary proceedings demonstrates the existence of a partnership to perform the law enforcement function.

The fact that Exchanges existed prior to the adoption of the Exchange Act, and therefore have a long history of enforcing rules against their members, does not alter this result. That history does not support a finding that the SROs are currently exercising a non-exclusive public function. While it is true that oversight of the Exchanges has not rested exclusively with the State, enforcing private rules is an altogether different activity from enforcing federal law at the demand and under the direct supervision of the federal government. The requirement that the SRO enforce federal law means that this is not a situation that involves merely the resolution of private disputes.[181] The federal government has undertaken to police the Exchanges, by enacting the Exchange Act and by creating the Commission. Congress then required the Exchanges to enforce the Exchange

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[178] *See The Supreme Court, 1974 Term*, *supra* note 79, at 128.

[179] *Flagg Bros.*, 436 U.S. at 163.

[180] *Cf.* NCAA v. Tarkanian, 488 U.S. 179, 195-96 (1988) (holding no state action because state did not delegate any power to take specific action against private individuals).

[181] *See Flagg Bros.*, 436 U.S. at 157.

Act.[182] Both Congress and the Commission have recognized that this statutory scheme delegated governmental power to the SROs.[183] It is that delegation of governmental enforcement authority that, for limited purposes, turned the formerly private Exchanges into state actors.

One SRO, the NASD, has even argued that in certain instances it should be treated as if it were the government because of the law enforcement powers it exercises. *Ross v. Bolton*[184] concerned a civil action arising out of defendants' alleged wrongdoing in connection with certain over-the-counter trading. The NASD had conducted its own investigation of the relevant events during which it had obtained the testimony of several witnesses. Defendants subpoenaed the NASD (a non-party to the suit) seeking production of transcripts of the witnesses' statements. The NASD refused to comply with the subpoenas.

On the ensuing motion to compel, the NASD argued that it was quasi-governmental and was thus privileged from having to produce the documents. The NASD argued that it did not have to turn over its records "on the grounds that its law enforcement duties make it a quasi-governmental agency and that, as a result, its investigative files are entitled to the same privilege against discovery as that afforded to a governmental investigative body."[185] Although the court did not decide whether that characterization was correct,[186] it is significant that the NASD argued that when it is exercising its law enforcement functions, it is acting as a governmental body. This is exactly the type of activity the public function concept was designed to capture.

Application of the state actor doctrine in such circumstances also avoids the inconsistent results that can occur when federal law is enforced by the Commission with constitutional restrictions and protections, and enforced by an SRO "subject to com-

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[182] *See id.* at 164.

[183] Note, *Governmental Action and the National Association of Securities Dealers*, 47 FORDHAM L. REV. 585, 595 (1979).

[184] 106 F.R.D. 315 (S.D.N.Y. 1984).

[185] *Id.* at 315-16.

[186] The court held that NASD members are "contractually bound" to release any information requested by the NASD, thus no "chilling effect" would result by allowing discovery into NASD files. *Id.* at 316.

prehensive Commission oversight"[187] without any such restrictions or protections.

IV. EXISTING LOWER COURT DECISIONS

A perusal of the lower court cases discussing whether SROs are state actors indicates the following: (1) several federal court cases have held that SROs are state actors when they engage in enforcement proceedings;[188] (2) no federal court cases have held that any constitutional rights other than due process rights apply in connection with enforcement actions instituted by SROs; and (3) courts have not been careful to draw a distinction between an SRO acting in its general capacity and an SRO acting in its capacity as the enforcer of federal law pursuant to mandated responsibilities under the Exchange Act.

A. SROs As State Actors for Purposes of Due Process

In *Intercontinental Industries, Inc. v. American Stock Exchange*,[189] Intercontinental Industries, Inc. ("ICI") sued the American Stock Exchange ("AMEX") and the Commission seeking to set aside a Commission order allowing the AMEX to delist ICI stock. The AMEX applied the rules that allow it to delist securities if the AMEX determines that a listed corporation has disseminated inaccurate information concerning corporate developments. ICI claimed that when recommending to delist a stock, the AMEX is required to provide adequate proce-

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[187] Brief of the Securities and Exchange Commission, Respondent, at 4, Gabriel v. Securities and Exch. Comm'n, No. 94-4208 (2d Cir. filed March 27, 1995).

[188] *See* Intercontinental Indus., Inc. v. American Stock Exch., 452 F.2d 935, 941 (5th Cir. 1971) (stating that AMEX is a state actor); United States v. Sloan, 388 F. Supp. 1062, 1064 (S.D.N.Y. 1975) (noting that the proper remedy for dismissal by the NYSE for claiming a Fifth Amendment privilege is a suit for denial of due process) a prerequisite of which is a determination that the NYSE is a state actor; Villani v. New York Stock Exch., 348 F. Supp. 1185, 1188 n.1 (S.D.N.Y. 1972) (stating that NYSE is bound by due process requirements of Fifth Amendment), *aff'd sub nom* Sloan v. New York Stock Exch., 489 F.2d 1 (2nd Cir. 1973); Crimmins v. American Stock Exch., 346 F. Supp. 1256, 1259 (S.D.N.Y. 1972); Harwell v. Growth Programs, Inc., 315 F. Supp. 1184, 1188 (W.D. Tex. 1970) (stating that NASD is a state actor).

[189] 452 F.2d 935 (5th Cir. 1971).

dural protections pursuant to the Fifth Amendment to the Constitution. To resolve this issue, the court first needed to determine whether the Exchange was a state actor.

The *Intercontinental* court applied the standard enunciated in *Burton v. Wilmington Parking Authority*[190] to determine that the AMEX was a state actor.[191] *Burton* had held that private actions may be deemed governmental action when the government "so far insinuated itself into a position of interdependence with [a private entity] that it must be recognized as a joint participant in the challenged activity."[192] The state actor test employed by *Burton* is fact intensive. The court in *Intercontinental* considered not only the extensive regulation of Exchanges, but also the fact that Exchanges are required to register with the Commission, submit rules for approval by the Commission, and enforce federal securities laws — all under a potential penalty of suspension of registration if such responsibilities are not completed by the Exchange.

The *Intercontinental* court concluded that "the intimate involvement of the [AMEX] with the Securities and Exchange Commission brings it within the purview of the Fifth Amendment controls over governmental due process."[193] The court further held that the AMEX had satisfied applicable constitutional due process concerns.[194]

Several cases have followed the conclusion reached in *Intercontinental*.[195] None of these cases, including *Intercontinental*, identified the distinction between disciplinary proceedings involving enforcement of SROs' rules as opposed to disciplinary proceedings involving enforcement of the Exchange Act. *Crimmins v. American Stock Exchange* directly followed the holding of *Intercontinental*.[196] In *Crimmins*, a broker-dealer charged with churning customers' accounts sought an injunction to prevent the AMEX from holding a disciplinary hearing with-

[190] 365 U.S. 715 (1961).
[191] *Intercontinental*, 452 F.2d at 941.
[192] *Burton*, 365 U.S. at 725.
[193] *Intercontinental*, 452 F.2d at 941.
[194] *Id.* at 943.
[195] *See supra* note 186.
[196] 346 F. Supp. 1256, 1259 (S.D.N.Y. 1972).

out allowing him to be represented by counsel.[197] The Court stated:

> "[T]he day is long gone when a national stock exchange can 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 powers conferred upon it by the [Exchange] Act, it is engaged in governmental action, federal in character, and the [Exchange] Act imposed upon it the requirement that it comply with fundamental standards of fair play."[198]

Although the court held that the Fifth Amendment applied because of the "governmental impairment of a private interest,"[199] the failure to provide counsel in *Crimmins* was deemed not to be violative of due process.[200]

Villani v. New York Stock Exchange also followed *Intercontinental* and held that the New York Stock Exchange (the "NYSE") was a state actor when it conducted disciplinary hearings pursuant to the Exchange Act.[201] In *Villani*, two partners in a member firm of the NYSE sought an injunction against the NYSE: (1) to allow them to have representation by counsel in disciplinary hearings; (2) to provide them with access to certain documents; and (3) to prevent the NYSE from bringing disciplinary charges simultaneously with a civil action being brought against their firm.[202] The Court stated that "[i]t is now beyond dispute that the Fifth Amendment due process requirements as to federal action apply to disciplinary hearings conducted by the Exchange. Such hearings are conducted under the self-regulatory power conferred upon it by a federal agency, the Securities and Exchange Commission."[203] The

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[197] *Id.* at 1258.

[198] *Id.* at 1259 (citing Silver v. New York Stock Exch., 373 U.S. 341 (1963)).

[199] *Id.* (citing Cafeteria & Restaurant Workers Union, Local 473 v. McElroy, 367 U.S. 886 (1961)).

[200] *Id.*

[201] 348 F. Supp. 1185, 1188 n.1 (S.D.N.Y. 1972), *aff'd sub. nom.* Sloan v. New York Stock Exch., 489 F.2d 1 (2d Cir. 1973).

[202] *Id.* at 1188.

[203] *Id.* at 1188 n.1. For authority that SROs are bound by the due process protections of the Fifth Amendment, both *Crimmins* and *Villani* rely on Silver v. New York Stock Exch., 373 U.S. 341, 364 (1963). Although that case held that the NYSE was obligated to provide certain procedural protections, the

Intercontinental line of cases address but do not directly analyze the fact that the due process requirements discussed therein are specifically afforded pursuant to the Exchange Act. More specifically, each of the decisions following *Intercontinental* could be justified based upon Section 6(b)(7) of the Exchange Act[204] which requires that the rules of an Exchange must, in general, provide fair procedures with respect to discipline of members. Section 6, as discussed herein, provides that in disciplinary proceedings the Exchange must provide at least the basics of due process including bringing specific charges, providing defendants the opportunity to defend against the charges, maintaining a record of the proceedings and supporting the sanctions by indicating the acts or practices in which the member or associated person engaged. These cases do not address the more complicated issues of whether other constitutional protections are implicated, including the privilege against

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Crimmins and *Villani* courts' reliance on it extends the narrow holding in *Silver*. In *Silver*, the plaintiff, a non-member of the NYSE, sued the NYSE for forcing member firms to disconnect direct-wire telephone connections with the plaintiff without giving the plaintiff the opportunity to present evidence as to why such service should be maintained. *Silver*, 373 U.S. at 361. The Court determined that, at a minimum, the NYSE was obligated to provide the plaintiff with notice and an opportunity to be heard, *i.e.*, basic due process protections. *Id.* at 361. The Court did not reach this decision by deciding that the NYSE was a state actor subject to the Fifth or Fourteenth Amendments, but instead by applying the Sherman Act. *Id.* The Court stated that although antitrust laws do not impose a requirement of due process, by denying the plaintiff procedural protections, the NYSE was exceeding its authority under the Exchange Act and therefore could not rely on that Act for an exemption from the Sherman Act. *Id.* at 364-365.

In *Villani*, the district court interpreted the holding in *Silver* to mean that the Exchange Act requires the NYSE to comply with the due process requirements of the Fifth Amendment. *Villani*, 348 F. Supp. at 1188 n.1. Although this interpretation extends the actual holding in *Silver*, the *Silver* court recognized that the lack of checks on the power of the NYSE created the potential for abuse. *Silver*, 373 U.S. at 357. In *Villani*, the court was troubled by the lack of counsel in disciplinary proceedings. However, the NYSE avoided a ruling against it by adopting an amendment to the exchanges constitution allowing representation by counsel, thus rendering the plaintiff's complaint moot. *Villani*, 348 F. Supp. at 1189. Although disposing of the plaintiff's claim in that suit, the problem remains the same. Because the federal government has delegated the enforcement of securities laws to SROs without those entities being bound by the same limitations as the government itself, the potential for abuse persists.

[204] 15 U.S.C. § 78f(b)(7) (1994).

self-incrimination, double jeopardy protections and similar concerns including Fourth Amendment protections with respect to searches and seizures.

In contrast to the holdings in the *Intercontinental* line of cases, several courts have held that SROs are not state actors even when they are enforcing federal law in disciplinary proceedings.[205] In *United States v. Solomon*, Judge Friendly writing for the Second Circuit rejected *Intercontinental* and held that an interrogation by the NYSE did not trigger the Fifth Amendment privilege against self-incrimination.[206] In *Solomon*, the NYSE called Alan Solomon, an officer of a member firm, before a disciplinary body of the NYSE and questioned him about financial irregularities allegedly committed in violation of both federal laws and NYSE rules. Pursuant to NYSE rules, Solomon's failure to respond to such an inquiry could result in suspension or expulsion.[207] Solomon asserted that he was coerced into testimony by the threat of immediate loss of his livelihood if he failed to cooperate. The court did not consider this risk to Solomon's livelihood as coercive and therefore did not find the NYSE rules with respect to such interrogation to violate the Fifth Amendment privilege against self-incrimination for two reasons. First, as the punishment of suspension or expulsion by the NYSE for failing to respond to its inquiry is not mandatory, the court found that Solomon was not coerced into giving testimony.[208] Second, as the NYSE was itself not a state actor, constitutional protections did not become relevant.[209]

Apart from its decision with respect to the status of the NYSE as a state actor, the *Solomon* court's conclusion that

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[205] United States v. Solomon, 509 F.2d 863 (2d Cir. 1975); First Heritage Corp. v. National Ass'n of Secs. Dealers, Inc., 785 F. Supp. 1250 (E.D. Mich. 1992) (holding that member of NASD not entitled to due process protections in arbitration); United States v. Bloom, 450 F. Supp. 323 (E.D. Pa. 1978) (holding that broker was not entitled to protections of the Fourth Amendment when his papers were seized by his employer and turned over to the Commission); People v. Barysh, 408 N.Y.S.2d 190 (Sup. Ct. 1978).

[206] 509 F.2d at 871 (stating that the suggestion by the court in *Intercontinental* that stock exchanges are subject to due process requirements was "dictum").

[207] *Id.* at 865.

[208] *Id.* at 867 (distinguishing Garrity v. New Jersey, 385 U.S. 493 (1967)).

[209] *Id.* at 869.

Solomon was not coerced into giving testimony as a result of his concern with respect to suspension or expulsion ignores the reality of NYSE procedures. An associated person or a member firm is generally subject to regulatory authority of the SROs that regulate the member firm,[210] which, in Solomon's case, was the NYSE. An associated person of a member firm who is threatened with loss of livelihood and reputational damage for failure to submit to an inquiry is subject to very real compulsion to testify or face sanctions which could jeopardize or eliminate such person's position in the securities industry. At the very least, further analysis of the practices of the NYSE with respect to expulsion or suspension should have been undertaken by the *Solomon* court.

The existing lower court case law with respect to SROs as state actors when enforcing federal law is deficient in that the analysis fails to focus on the specific role of the SROs in enforcing federal law as opposed to their general historic self-regulatory role in enforcing their own rules against their members. Moreover, the cases fail to engage in substantial development of a factual record with respect to the interaction of the Commission and the SROs in regard to enforcement proceedings, and the coercive power exercised by the Commission pursuant to Sections 19(h) and 21(e) and (f) of the Exchange Act. The cases analyze only the state action issue as it relates to SROs enforcing their membership rules. This was clearly the case in *Solomon* where Judge Friendly concluded, "we thus prefer to place [the] decision on the basic ground that interrogation by the [NYSE] in carrying out its own legitimate investigatory purposes does not trigger the privilege against self-incrimination."[211] This conclusion was drawn even though "Solomon's conduct violated both a rule of [the] NYSE . . . and

[210] This pervasive influence over members and non-members alike led to the *Silver* court's conclusion that unfettered authority by SROs undermined the rights of individuals. Silver v. New York Stock Exch., 373 U.S. 341, 359 (1963) (stating that "[e]nforcement of exchange rules, particularly those of the [NYSE] with its immense economic power, may well, in given cases, result in competitive injury to an issuer, a non-member brokerdealer, or another. . . . Such unjustified self-regulatory activity can only diminish public respect for and confidence in the integrity and efficacy of the exchange mechanism.").

[211] *Solomon*, 509 F.2d at 867.

federal law."[212] Judge Friendly's analysis with respect to enforcement of federal law was supported by his conclusion that the "NYSE's inquiry into [Defendant] was in pursuance of its own interests and obligations, not as an agent of the SEC."[213]

This conclusion is without foundation. Stated simply, the NYSE had not of its own volition undertaken to enforce federal law. Instead, it has been required to do so as a prerequisite to its continued existence and under threat of sanction from the Commission. The NYSE's enforcement of its own rules may be an historic function which is, to some extent, merely administration of its own internal affairs.[214] However, its enforcement of federal law is required under the Exchange Act, and this compulsion mandates that such enforcement be subject to constitutional protections.

Solomon, like the remaining lower court decisions discussed, fails to segregate out from the many SRO functions the enforcement of federal law. It is this failure to precisely analyze these separate functions that has led to inadequate analysis of this issue.

V. CONCLUSION

Exchanges were in existence long before the passage of the Exchange Act. Prior to 1934, they retained the exclusive right and obligation to enforce their rules against members and their associated persons. SROs have thus had a long history of private enforcement of securities regulation. This aspect of securities regulation was not federalized by passage of the Exchange Act. SROs retain the right subject to the rule-making process and the oversight role assigned to the Commission to enforce internal rules even if they are more onerous than the Exchange Act and its regulations. As a function of political compromise, SROs were also delegated a companion function of enforcing federal law. The obligation to enforce federal law was a requisite to an SRO's continued existence and could be enforced judicially by the Commission. In this limited role, the SRO is a

[212] *Id.* at 869.

[213] *Id.*

[214] Section 6 of the Exchange Act, 15 U.S.C. § 78(f) (1994), does require exchanges to enforce their own rules.

federal actor deputized to carry out an essential enforcement role.

This conclusion is not revolutionary. It results from a reasonable application of mainstream state action jurisprudence. Proper application of state action jurisprudence will also not lead to revolutionary results. Two specific concerns with respect to the application of the state action doctrine to SROs have been raised. First, the concern that such conclusion will lead to a substantial federalization of various similar enforcement activity in other industries.[215] This is simply not the case. The delegation of federal law enforcement authority pursuant to federal law, together with the authority to impose sanctions including monetary penalties and suspensions, is unique to the securities and commodities industries.[216]

More importantly, to the extent that such delegation exists in other industries, the state action doctrine should be applied consistently. Clothing SROs with state actor status will not lead to any absurd or unintended results. Nor will it clothe SROs with any federal authority to act in any governmental capacity, inasmuch as state action status is only applicable in the context of enforcing federal law. In this context, governmental status acts only as a limitation upon the enforcement activities which the SRO may undertake.

It is more than sixty years since the SROs were legislatively deputized to enforce the federal securities laws. State action jurisprudence, even in its most restrictive interpretations, requires that constitutional protections apply in federally related SRO actions in the same manner as they apply when such actions are pursued by the Commission. A level playing field for defendants in this limited dual-enforcement system is constitutionally mandated.

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[215] *See Solomon*, 509 F.2d at 870.

[216] *See* SEC REPORT, *supra* note 17.