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Friend This: Why Those Damaged During the Facebook IPO Will Recover (Almost) Nothing from NASDAQ

Thomas L. Short

Washington and Lee University School of Law

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Friend This: Why Those Damaged During the Facebook IPO Will Recover (Almost) Nothing from NASDAQ

Thomas L. Short*

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I. Introduction

Facebook, Inc. (Facebook) “went public” on NASDAQ on May 18, 2012, raising \$16 billion—the third-largest initial public offering (IPO) in the history of the United States.¹ In the first 30 seconds of trading, 80 million shares changed hands.² By the end of the first day, 567 million shares had been traded.³ This was the highest volume of shares traded in an IPO, “smashing” General Motors Co.’s previous record of 450 million shares.⁴ The records do not stop there, however.

1. April Dembosky & Telis Demos, *Faltering Start for the New Facebook*, FT.COM (May 18, 2012, 11:23 PM), <http://www.ft.com/intl/cms/s/0/c7bfd916-a113-11e1-9fbd-00144feabdc0.html#axzz2Jqp27Nkz> (last visited Feb. 3, 2013) (noting that the Facebook IPO trailed VISA’s IPO in 2009 and General Motors’s IPO in 2010 in terms of funds raised) (on file with the Washington and Lee Law Review).

2. Julianne Pepitone, *Facebook Trading Sets Record IPO Volume*, CNN MONEY (May 18, 2012, 4:05 PM), <http://money.cnn.com/2012/05/18/technology/facebook-ipo-trading/index.htm> (last visited Feb. 3, 2013) (on file with the Washington and Lee Law Review).

3. *Id.*

4. *Id.*

The Facebook IPO also resulted in the largest number of lawsuits ever filed due to an IPO.⁵ As of September 2012, only four months after the IPO, twenty-nine securities class action lawsuits had been filed.⁶ By December 2012, seven months after the IPO, forty-one actions, and counting, were filed.⁷ As a result of “system difficulties” experienced by NASDAQ, major market makers and broker dealers lost approximately \$500 million in the IPO.⁸ Losses of this scale, and in this context, prompt a difficult question: What is the extent of NASDAQ’s liability for its system difficulties?⁹ The extent of NASDAQ’s liability is complicated.

Pursuant to the Securities Exchange Act of 1934 (Exchange Act),¹⁰ Congress established a regulatory system that relies upon self-regulatory organizations (SROs) to regulate and administer the day-to-day conduct of the national securities exchanges under the supervision of the Securities and Exchange Commission (SEC).¹¹ Since that time, many of the SROs have become private,

5. See David Benoit, *Another Facebook IPO Superlative: Most 2012 Lawsuits*, WALL ST. J. (Sept. 26, 2012, 1:37 PM), <http://blogs.wsj.com/deals/2012/09/26/another-facebook-ipo-superlative-most-2012-lawsuits/> (last visited Jan. 12, 2013) (“Facebook is getting sued. A lot.”) (on file with the Washington and Lee Law Review).

6. *Id.* (“In 2001, when the tech bubble was soaring and plenty of IPOs went sour, no IPO faced more than four separate lawsuits [according to Stanford University’s Securities Class Action Clearinghouse] . . .”).

7. *In re Facebook, Inc., IPO Sec. & Deriv. Litig.*, 288 F.R.D. 26, 31 (S.D.N.Y. 2012) (MDL No. 12-2389) [hereinafter SDNY Consolidation Order]. This is according to the U.S. District Court for the Southern District of New York (SDNY), which, per the U.S. Judicial Panel on Multidistrict Litigation, was assigned the actions stemming from the Facebook IPO. *Id.* at 29.

8. John McCrank, *UBS Says Nasdaq’s Facebook Compensation Plan Inadequate*, REUTERS (Aug. 23, 2012, 3:54 PM), <http://www.reuters.com/article/2012/08/23/us-nasdaq-facebook-compensation-idUSBRE87L0W620120823> (last visited Feb. 3, 2013) (on file with the Washington and Lee Law Review).

9. Legal actions for securities regulation violations have been filed against Facebook, Facebook’s officers, and the underwriters who participated in the IPO. These actions are outside the scope of this Note. For a broad overview of those actions, see SDNY Consolidation Order, *supra* note 7, at 31–34; Julianne Pepitone, *Facebook IPO: What the %\$#! Happened?*, CNN MONEY (May 23, 2012, 6:06 PM), <http://money.cnn.com/2012/05/23/technology/facebook-ipo-what-went-wrong/index.htm> (last visited Feb. 3, 2013) (providing a general overview of the claims sparked by the Facebook IPO) (on file with the Washington and Lee Law Review).

10. Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended in scattered sections of 15 U.S.C.).

11. See *Weissman v. Nat’l Ass’n of Sec. Dealers*, 500 F.3d 1293, 1296 (11th

for-profit corporations.¹² NASDAQ is an SRO, a national securities exchange, and a “quasi-private” regulatory entity that “operate[s] as an additional layer of investor protection” in the regulatory system.¹³ NASDAQ is also a private company with \$3.4 billion in gross revenues, net income of \$383 million, and over 173 million shares of common stock.¹⁴

In light of the governmental functions it provides, NASDAQ is protected by absolute immunity when it performs its quasi-governmental, “statutorily delegated adjudicatory, regulatory, and prosecutorial functions.”¹⁵ But NASDAQ is not entitled to absolute immunity when it acts pursuant to its “non-governmental” and “private business interests.”¹⁶ The question

Cir. 2007) (en banc) (noting that SROs “conduct the day-to-day regulation and administration of the United States stock markets, under the close supervision of the United States Securities and Exchange Commission”).

12. Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J.L. BUS. & FIN. 151, 159–70 (2008) (describing the history of NASDAQ and the NYSE and noting their present status as “public companies”).

13. STEPHEN J. CHOI & A.C. PRITCHARD, *SECURITIES REGULATION: CASES AND ANALYSIS* 16, 45 (3d ed. 2012).

14. The NASDAQ OMX Grp., Inc., Annual Report, 1, F-4 (Form 10-K) (2011) [hereinafter NASDAQ Annual Report].

15. *Weissman*, 500 F.3d at 1296 (citing *Barbara v. N.Y. Stock Exch.*, 99 F.3d 49, 58, 59 (2d Cir. 1996) (“[C]ourts have not hesitated to extend the doctrine of absolute immunity to private entities engaged in quasi-public adjudicatory and prosecutorial duties.”); *see also* *D’Alessio v. N.Y. Stock Exch., Inc.*, 258 F.3d 93, 105 (2d Cir. 2001) (“*Barbara* stood for the broader proposition that a[n] SRO, such as [NASDAQ], may be entitled to immunity from suit for conduct falling within the scope of the SRO’s regulatory and general oversight functions.”), *cert. denied*, 534 U.S. 1066 (2001); *Sparta Surgical Corp. v. Nat’l Ass’n of Sec. Dealers*, 159 F.3d 1209, 1215 (9th Cir. 1998) (noting that when NASD “acts in [its] capacity to suspend trading, NASD is performing a regulatory function cloaked in immunity”); *Zandford v. Nat’l Ass’n of Sec. Dealers*, No. 94-7058, 1996 U.S. App. LEXIS 41840, at *1 (D.C. Cir. Feb. 14, 1996) (per curiam) (noting that while SROs “are entitled to absolute immunity for actions that are prosecutorial or adjudicative in nature . . . absolute immunity does not extend to acts that are purely investigatory or administrative” (citations omitted)); *Austin Mun. Sec., Inc. v. Nat’l Ass’n of Sec. Dealers*, 757 F.2d 676, 692 (5th Cir. 1985) (concluding that an SRO “is entitled to absolute immunity for its role in disciplining its members and associates”).

16. *Weissman*, 500 F.3d at 1296 (noting that “efforts to increase trading volume and company profit, as well as the daily administration and management of other business affairs” are considered serving “private business interests” and are thus a “non-governmental function” not entitled to absolute immunity).

raised by the Facebook IPO is whether the \$500 million loss was a result of NASDAQ's "statutorily delegated adjudicatory, regulatory, and prosecutorial functions." NASDAQ unequivocally asserts that the actions it took during the IPO were undertaken pursuant to its regulatory function and are thus covered by absolute immunity.¹⁷ Additionally, NASDAQ has agreed to "pay [the SEC] \$10 million, the largest fine ever levied against an exchange, to settle accusations that it had violated numerous rules before and after the IPO" with its "poor systems and decision making."¹⁸

The problem with the Facebook IPO is that the law is ambiguous about drawing the line between actions taken pursuant to an SRO's regulatory function and its "non-governmental" and "private business interest[]." ¹⁹In the case of a quasi-private SRO, such as NASDAQ, the law is unclear about whether the SRO's actions are protected by absolute immunity. The two functions may even coincide in the same conduct, as they appear to here.

The ambiguity that underlies NASDAQ's liability is important and problematic. The capital markets and SROs such as NASDAQ are too important to the economic stability of the United States and the world for there to be such confusion over the extent of their liability.²⁰ NASDAQ OMX Group, the company

17. See Notice of Filing of Proposed Rule Change to Amend Rule 4626—Limitation of Liability, Exchange Act Release No. 34-67507, 77 Fed. Reg. 45,706, 45,714 (July 26, 2012) (SR-NASDAQ-2012-090) [hereinafter NASDAQ Proposal], <http://www.sec.gov/rules/sro/nasdaq/2012/34-67507.pdf> (noting that "exchanges are . . . immune from civil liability for claims for damages caused by actions taken in connection with the discharge of their regulatory duties). NASDAQ explicitly states that "[i]n an exercise of its *regulatory* authority, Nasdaq determined to proceed with the IPO . . . rather than postpone it." *Id.* at 45,707 (emphasis added).

18. Nathaniel Popper, *Nasdaq Is Fined \$10 Million over Mishandled Facebook Public Offering*, DEALBOOK (May 29, 2013, 2:09 PM), http://dealbook.nytimes.com/2013/05/29/nasdaq-to-pay-10-million-fine-over-facebook-i-p-o/?_r=0 (last visited Jan. 7, 2014) (on file with the Washington and Lee Law Review).

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

20. CHOI & PRITCHARD, *supra* note 13, at 16 (noting that NASDAQ has, on average, \$55.5 billion worth of shares trading daily on its exchange). Furthermore, the total market valuation of the companies listed on NASDAQ is \$3.9 trillion. *Id.*

behind the NASDAQ stock market, “owns and operates 24 markets, 3 clearing houses, and 5 central securities depositories, spanning six continents—making [it] the world’s largest exchange company.”²¹ It is “the largest single liquidity pool for US equities,” and it is “the power behind 1 in 10 of the world’s securities transactions.”²² Should an event suddenly impose massive liability upon NASDAQ, even without bankrupting the company completely, the knock-on effects would be felt worldwide.²³

The SEC is failing to “play[] an active role in overseeing . . . Nasdaq . . . to ensure that [it is] protecting investors.”²⁴ SEC Chairman Mary Jo White agrees, stating that “the current nature of exchange competition and the self-regulatory model should be fully evaluated in light of the evolving market structure and trading practices.”²⁵ SEC Chairman White goes on to say that “[t]he SEC should review whether the oversight of exchanges ‘continues to meet the needs of investors and public companies.’”²⁶ This Note calls for the SEC to address the ambiguity in the law with respect to whether SROs, such as NASDAQ, are acting pursuant to their regulatory function.²⁷

The Note is divided into three substantive Parts. Part II provides an analysis of the present state of the law regarding

21. *What is NASDAQ?*, NASDAQ OMX, (2014) <http://www.nasdaq.com/aboutus/whatisnasdaq/> (last visited Jan. 7, 2014) (on file with the Washington and Lee Law Review).

22. *Id.*

23. See NASDAQ Proposal, *supra* note 17, at 45,714 (“If exchanges could be called upon to bear all costs associated with system malfunctions and the varying reactions of market participants taken in their wake, the potential would exist for a single catastrophic event to bankrupt one or multiple exchanges, with attendant consequences for investor confidence and macroeconomic stability.”).

24. CHOI & PRITCHARD, *supra* note 13, at 16.

25. Andrew Ackerman, Scott Patterson & Jacob Bunge, *Policing of Exchanges Questioned*, WALL ST. J. (Oct. 2, 2013, 8:04 PM), <http://online.wsj.com/article/SB10001424052702304906704579111483532305624.html> (last visited Jan. 31, 2014) (on file with the Washington and Lee Law Review).

26. *Id.* (quoting SEC Chairman White).

27. See CHOI & PRITCHARD, *supra* note 13, at 46 (noting that the SEC is empowered to “approve, disapprove[,] or modify SRO rules as it ‘deems necessary or appropriate to insure the fair administration of the self-regulatory organization’ under § 19 of the Exchange Act”).

SRO absolute immunity. Part III describes the events of the Facebook IPO and illustrates how the law, as it stands, is inadequate to determine with any certainty whether NASDAQ's actions during the Facebook IPO were pursuant to its regulatory function and warranted absolute immunity, or whether its actions were pursuant to its nongovernmental private business interests and did not warrant absolute immunity. Part IV presents a new approach—first, NASDAQ, and other similarly situated SROs such as the NYSE, should adopt living wills specifying the national securities exchange's operating costs for a full year; second, those costs should be unconditionally protected by absolute immunity; and finally, only those actions of SROs undertaken pursuant to their prosecutorial and adjudicatory functions warrant absolute immunity.

II. SRO Liability Today

NASDAQ's potential liability for the Facebook IPO is far from settled. The extent, or very existence, of liability hinges upon the crucial determination of whether the actions taken by NASDAQ on May 18, 2012, were pursuant to NASDAQ's regulatory function or its nongovernmental private business interests. Essentially, the question is whether NASDAQ was acting as an SRO or as a private, for-profit corporation. Part II discusses (A) the general framework of the present regulatory system and NASDAQ's place within it and (B) the concept of absolute immunity, how it is determined, and what kinds of actions it protects. This Part also details instances in which absolute immunity has been afforded or withheld.

A. SROs Within the Present Regulatory Scheme and NASDAQ's Place Within It

Pursuant to the Exchange Act, Congress established a regulatory system that relies upon SROs to "conduct the day-to-day regulation and administration of the United States stock markets, under the close supervision of the United States

Securities and Exchange Commission.”²⁸ The SEC, in 1997, authorized the National Association of Securities Dealers, Inc. (NASD), an SRO, to delegate its SRO functions to its subsidiary, NASDAQ, permitting NASDAQ to “operate and oversee” the NASDAQ stock market.²⁹ The NASD “authorized Nasdaq to develop, operate, and maintain the Nasdaq Stock Market, to formulate regulatory policies and listing criteria for the Nasdaq Stock Market, and to enforce those policies and rules, subject to the approval of the NASD and ultimately the SEC.”³⁰ Thereafter, NASDAQ served as an SRO pursuant to the Exchange Act.³¹ In addition to operating as an SRO, NASDAQ has, like many other SROs, become a for-profit corporation.³² In 2000, the NASD sold restricted shares of NASDAQ through a private placement offering.³³ Then, in 2002, NASDAQ’s shares began trading on the Over the Counter (OTC) Bulletin Board, and in 2005, via an offering of secondary shares, NASDAQ was listed on the NASDAQ Stock Market.³⁴ Now, NASDAQ is a private, for-profit company with \$3.4 billion in gross revenues, net income of \$383 million, and over 173 million shares of common stock.³⁵

28. *Weissman v. Nat’l Ass’n of Sec. Dealers*, 500 F.3d 1293, 1296 (11th Cir. 2007) (en banc).

29. *See id.* (citing Order Approving the Plan of Allocation and Delegation of Functions by NASD to Subsidiaries, SEC Release No. 34-39326, 62 Fed. Reg. 62,385 (Nov. 21, 1997) (approving the delegation of powers whereby “Nasdaq was given sole responsibility to operate and oversee the Nasdaq market”)); *DL Capital Grp., LLC v. Nasdaq Stock Mkt., Inc.*, 409 F.3d 93, 95 (2d Cir. 2005) (“The NASD has delegated some of its regulatory powers and responsibilities as an SRO to Nasdaq.”).

30. *DL Capital Grp.*, 409 F.3d at 95.

31. *See Weissman*, 500 F.3d at 1296 (“NASDAQ serves as an SRO within the meaning of the Securities Exchange Act . . . which vests it with a variety of adjudicatory, regulatory, and prosecutorial functions, including implementing and effectuating compliance with securities laws; promulgating and enforcing rules governing the conduct of its members; and de-listing stock offerings.”).

32. *When Did NASDAQ OMX First Go Public?*, NASDAQ OMX (2013), <http://ir.nasdaqomx.com/faq.cfm> (last visited Nov. 10, 2013) (on file with the Washington and Lee Law Review).

33. *Id.*

34. *Id.*

35. NASDAQ Annual Report, *supra* note 14, at 1, F-4.

NASDAQ operates as both an SRO and a private,³⁶ for-profit corporation.³⁷ As a “private corporation, NASDAQ may engage in a variety of non-governmental activities that serve its private business interests, such as its efforts to increase trading volume and company profit, as well as its daily administration and management of other business affairs.”³⁸ As an SRO, NASDAQ acts as a quasi-governmental authority that effectively “stands in the shoes of the SEC,” performing regulatory functions that the SEC would otherwise perform.³⁹ The resulting tension has been noticed by the SEC, which has stated that “[a]s competition among markets grows, the markets that SROs operate will continue to come under increased pressure to attract order flow. . . . [The resulting] business pressure can create a strong conflict between the SRO[s] regulatory and market operations functions.”⁴⁰ Crucially, it is along the distinction between these two functions that the question of NASDAQ’s liability hinges.

NASDAQ, even though it may act for the government in its capacity as an SRO, is not afforded sovereign immunity like a governmental agency.⁴¹ Instead, SROs are provided with “absolute immunity when performing governmental functions” but “cannot claim that immunity when they perform non-governmental functions” or act in their “own interest[s] as . . . private entit[ies].”⁴² Governmental functions include regulatory,

36. “Private” in this context reflects the fact that it is owned by private individuals and not the government. NASDAQ OMX Group is not a private company in the business sense given that it trades on the NASDAQ stock market and is therefore most appropriately considered a public company.

37. See *supra* notes 28–35 and accompanying text (describing the unique position of SROs such as NASDAQ that operate both as quasi-governmental SROs as well as nongovernmental private, for-profit corporations).

38. *Weissman v. Nat’l Ass’n of Sec. Dealers*, 500 F.3d 1293, 1296 (11th Cir. 2007) (en banc).

39. *DL Capital Grp., LLC v. Nasdaq Stock Mkt., Inc.*, 409 F.3d 93, 95 (2d Cir. 2005) (quoting *D’Alessio v. N.Y. Stock Exch., Inc.*, 258 F.3d 93, 105 (2d Cir. 2001)).

40. *Weissman*, 500 F.3d at 1296 n.4 (quoting Concept Release Concerning Self-Regulation, Exchange Act Release No. 34-50700, 69 Fed. Reg. 71,256, 71,261–62 (Dec. 8, 2004)).

41. See *id.* at 1296 (noting that SROs “lack the sovereign immunity that governmental agencies enjoy”).

42. *Id.* at 1296–97 (“SROs are protected by absolute immunity when they

adjudicatory, or prosecutorial activities that might ordinarily be performed by a governmental agency—only in the performance of those or similar activities do SROs have absolute immunity.⁴³ Conceptually, SROs are entitled to absolute immunity when “acting under the aegis of the Exchange Act’s delegated authority.”⁴⁴ It is an SRO’s “function as a quasi-governmental authority that entitles it to absolute immunity.”⁴⁵ Because an SRO’s absolute immunity is conditioned on the nature of the function being performed, the determination of what type of function the SRO is performing is critical in situations where the SRO is exposed to potential liability, such as the Facebook IPO.

B. Determining Absolute Immunity

In determining whether an action by an SRO warrants absolute immunity, a court considers the “objective nature and function of the activity for which the SRO seeks to claim immunity.”⁴⁶ The test does not hinge on an SRO’s subjective

perform their statutorily delegated adjudicatory, regulatory, and prosecutorial functions. . . . [A]bsolute immunity must be coterminous with an SRO[']s performance of a governmental function.” (citing *Barbara v. N.Y. Stock Exch.*, 99 F.3d 49, 58, 59 (2d Cir. 1996) (“[C]ourts have not hesitated to extend the doctrine of absolute immunity to private entities engaged in quasi-public adjudicatory and prosecutorial duties.”); *D’Alessio v. N.Y. Stock Exch., Inc.*, 258 F.3d 93, 105 (2d Cir. 2001), *cert. denied*, 534 U.S. 1066 (2001); *Sparta Surgical Corp. v. Nat’l Ass’n of Sec. Dealers*, 159 F.3d 1209, 1215 (9th Cir. 1998); *Zandford v. Nat’l Ass’n of Sec. Dealers*, No. 94-7058, 1996 U.S. App. LEXIS 41840, at *1–2 (D.C. Cir. Feb. 14, 1996) (per curiam); *Austin Mun. Sec., Inc. v. Nat’l Ass’n of Sec. Dealers*, 757 F.2d 676, 692 (5th Cir. 1985)).

43. See *supra* note 42 and accompanying text (detailing how SROs are entitled to absolute immunity when acting pursuant to their quasi-governmental functions but not when acting pursuant to their private, for-profit interests).

44. *Weissman v. Nat’l Ass’n of Sec. Dealers*, 500 F.3d 1293, 1296 (11th Cir. 2007) (en banc) (quoting *Sparta Surgical Corp. v. Nat’l Ass’n of Sec. Dealers*, 159 F.3d 1209, 1214 (9th Cir. 1998) (internal quotations omitted)).

45. *DL Capital Grp., LLC v. Nasdaq Stock Mkt., Inc.*, 409 F.3d 93, 93 (2d Cir. 2005).

46. *Weissman*, 500 F.3d at 1297; see also *Standard Inv. Chartered, Inc. v. Nat’l Ass’n of Sec. Dealers*, 637 F.3d 112, 116 (2d Cir. 2011) (per curiam), *cert. denied*, 132 S. Ct. 1093 (2012) (describing “a functional test to determine whether an SRO is entitled to immunity based upon the facts . . . which requires [the court] to look at ‘the nature of the function performed, not the identity of the actor who performed it’” (quoting *Forrester v. White*, 484 U.S. 219, 229

intent or motivation.⁴⁷ The propriety of actions or inactions is irrelevant.⁴⁸ The “central question [in] SRO-immunity cases is . . . whether the plaintiff’s allegations concern the exercise of powers within the bounds of the government functions delegated to it.”⁴⁹ The Eleventh Circuit, in *Weissman v. National Ass’n of Securities Dealers*,⁵⁰ rejected the proposition that an SRO is granted absolute immunity for “all activity that is merely ‘consistent with’” the SRO’s delegated powers.⁵¹ This position puts the Eleventh Circuit at odds with the Second Circuit, which does afford absolute immunity for actions that are “consistent with” an SRO’s delegated powers.⁵² The Second Circuit, in *Standard Investment Chartered v. National Ass’n of Securities Dealers*,⁵³ stated that while “[t]here is no question that an SRO and its officers are entitled to absolute immunity from private damages suits in connection with the discharge of their regulatory responsibilities . . . the doctrine ‘is of a rare and exceptional character,’” and “courts must examine the invocation of absolute immunity on a case by case basis.”⁵⁴ Lastly, when deciding whether to grant SROs like NASDAQ immunity for their actions, courts frequently turn to the statutorily delegated responsibilities

(1988))).

47. *Weissman*, 500 F.3d at 1297.

48. *Standard Inv. Chartered, Inc. v. Nat’l Ass’n of Sec. Dealers*, No. 07-CV-2014, 2010 WL 749844, at *1 (S.D.N.Y. Mar. 1, 2010) (citing *In re NYSE Specialists S.E.C. Litig.*, 503 F.3d 89, 98 (2d Cir. 2007)), *aff’d per curiam*, 500 F.3d 1293 (11th Cir. 2007) (en banc).

49. *In re NYSE Specialists Sec. Litig.*, 503 F.3d 89, 98 (2d Cir. 2007).

50. 500 F.3d 1293 (11th Cir. 2007) (en banc).

51. *Id.* at 1298. *But see NYSE Specialists*, 503 F.3d at 93, 99 (affording absolute immunity for “specific functions” that are “consistent with’ the exercise of power delegated to the SRO”); *DL Capital Grp., LLC v. Nasdaq Stock Mkt., Inc.*, 409 F.3d 93, 99–100 (2d Cir. 2005) (affording absolute immunity for actions “consistent with the quasi-governmental powers delegated to it by the NASD pursuant to the Exchange Act”).

52. *See supra* note 51 and accompanying text (detailing the Second Circuit’s position).

53. 637 F.3d 112 (2d Cir. 2011) (per curiam), *cert. denied*, 132 S. Ct. 1093 (2012).

54. *Id.* at 115–16 (citing *Barrett v. United States*, 798 F.2d 565, 571 (2d Cir. 1986)).

of such bodies.⁵⁵ The statutorily delegated responsibilities of NASDAQ require it

to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.⁵⁶

The following two sections provide examples of SROs being either afforded or denied absolute immunity for a variety of actions and upon a variety of claims.

1. Actions Afforded Absolute Immunity

Absolute immunity is most simply determined in cases involving an SRO acting pursuant to its prosecutorial or adjudicatory function. In *Austin Municipal Securities, Inc. v. National Ass'n of Securities Dealers*,⁵⁷ the Fifth Circuit ruled that an SRO, in that case NASD, was “entitled to absolute immunity for its role in disciplining its members and associates.”⁵⁸ The Second Circuit concurred in *Barbara v. New York Stock Exchange*,⁵⁹ in which the New York Stock Exchange (NYSE) brought disciplinary charges against an employee of a member of the NYSE.⁶⁰ In *Barbara*, the employee was permanently banned from the exchange, despite the fact that the charges were later reversed on procedural grounds.⁶¹ The Second Circuit had little

55. See *Weissman v. Nat'l Ass'n of Sec. Dealers*, 500 F.3d 1293, 1299 (11th Cir. 2007) (en banc) (citing 15 U.S.C. § 78o-3(b)(6) (2012) to determine “NASDAQ’s statutorily delegated responsibility”).

56. 15 U.S.C. § 78o-3(b)(6) (2012).

57. 757 F.2d 676 (5th Cir. 1985).

58. *Id.* at 692.

59. 99 F.3d 49 (2d Cir. 1996).

60. See *id.* at 59 (noting that the employee “alleged abuses in the conduct of the Exchange’s disciplinary proceedings”).

61. See *id.* at 52 (“Barbara alleged in his complaint that agents and officers of the Division had wrongfully barred him from the Exchange floor, thereby damaging Barbara’s reputation and causing him to lose employment opportunities with two Exchange members, and ultimately to leave the

trouble determining that the NYSE was absolutely immune from damages arising out of the allegedly abusive performance of its disciplinary function.⁶²

Later, the Second Circuit, in *D'Alessio v. New York Stock Exchange, Inc.*,⁶³ ruled that the NYSE was entitled to absolute immunity despite allegations that it had, in pursuit of its disciplinary function against a member's employee, incorrectly interpreted and applied the securities laws as well as improperly performed its interpretive, enforcement, and referral functions, specifically its "quasi-public adjudicatory" function.⁶⁴ The United States Attorney's Office and the SEC, with the assistance of the NYSE, suspended D'Alessio from the floor of the NYSE and investigated him for pursuing trading strategies that D'Alessio maintained were endorsed by the NYSE itself.⁶⁵ The court stated that the "alleged misconduct falls within the scope of [the] quasi-governmental powers delegated to the NYSE pursuant to the Exchange Act and, therefore, conclude[d] that absolute immunity precludes D'Alessio from recovering money damages in connection with his claims."⁶⁶ The NYSE *explicitly* argued that "it is absolutely immune from suit because the allegations in the complaint are predicated on the NYSE's *improper performance* of the regulatory functions delegated by the SEC to the NYSE pursuant to the Exchange Act."⁶⁷ The NYSE's argument prevailed at both the district court and the U.S. Court of Appeals for the

securities industry.").

62. *See id.* at 59 ("As a private corporation, the Exchange does not share in the SEC's sovereign immunity, but its special status and connection to the SEC influences our decision to recognize an absolute immunity from suits for money damages with respect to the Exchange's conduct of disciplinary proceedings.").

63. 258 F.3d 93 (2d Cir. 2001), *cert. denied*, 534 U.S. 1066 (2001).

64. *See id.* at 93 ("The NYSE's alleged improper interpretation of the type of conduct prohibited under [the securities laws] falls within the NYSE's 'quasi-public adjudicatory' duties.").

65. *Id.* at 97 ("D'Alessio contends that he relied on the NYSE's interpretation at the time he engaged in trading practices that were later determined to be illegal."). D'Alessio further contended that "the NYSE, in an effort to keep its activities secret and curry favor with law enforcement authorities, assisted the United States Attorney's Office and the SEC in their investigation and prosecution of D'Alessio by providing them with 'false, misleading and inaccurate information about . . . D'Alessio.'" *Id.* at 97-98.

66. *Id.* at 106.

67. *Id.* at 104 (emphasis added).

Second Circuit.⁶⁸ Therefore, the NYSE was afforded absolute immunity in *D'Alessio* irrespective of whether its actions were improper, undertaken in error, or provided the basis for D'Alessio's fault.⁶⁹

Generally, courts afford SROs absolute immunity for actions taken pursuant to their prosecutorial or adjudicatory functions with little difficulty.⁷⁰ The determination hinges, roughly, upon whether the conduct in question "share[d] . . . characteristics [with] the judicial process."⁷¹ In contrast, determining what actions undertaken by an SRO are undertaken pursuant to its regulatory function as opposed to its nongovernmental private business interests can be far more problematic.⁷²

In *Sparta Surgical Corp. v. National Ass'n of Securities Dealers*,⁷³ the Ninth Circuit determined that NASD was entitled to absolute immunity in the face of damage claims arising out of NASD's decision to suspend trading and temporarily delist a company.⁷⁴ The court determined that "NASD is charged with the duty and responsibility of monitoring its market carefully to protect the investing public [and] [w]hen it acts in this capacity to suspend trading, NASD is performing a regulatory function cloaked in immunity."⁷⁵ *Sparta* may be the most straightforward demonstration of the regulatory function.

68. *Id.*

69. *See supra* notes 67–68 and accompanying text (explaining how the NYSE was afforded absolute immunity irrespective of whether the actions taken by the NYSE were improper, in error, or caused harm to D'Alessio).

70. *See supra* notes 57–68 and accompanying text (providing examples of courts holding SROs absolutely immune for actions taken pursuant to their prosecutorial and adjudicatory functions).

71. *Barbara v. N.Y. Stock Exch., Inc.*, 99 F.3d 49, 59 (2d Cir. 1996) (citing *Austin Mun. Sec., Inc. v. Nat'l Ass'n of Sec. Dealers*, 757 F.2d 676, 688 (5th Cir. 1985) (citing *Butz v. Economou*, 438 U.S. 478, 510–13 (1978))).

72. *See infra* notes 73–164 and accompanying text (providing examples of courts finding SROs entitled to absolute immunity and denied absolute immunity for actions taken pursuant to their regulatory function).

73. 159 F.3d 1209 (9th Cir. 1998).

74. *See id.* at 1215 ("All of the damage Sparta claims flows from the trading suspension and temporary de-listing. Accordingly, defendants are immune from Sparta's claims.").

75. *Id.*

In *Standard Investment Chartered, Inc. v. National Ass'n of Securities Dealers*,⁷⁶ two SROs, the NASD and the regulatory arm of the NYSE, consolidated to form the Financial Industry Regulatory Authority, Inc. (FINRA).⁷⁷ FINRA was to be the sole regulator for the private members of both the NASD and the NYSE.⁷⁸ NASD, as a condition of the consolidation, was required to amend its bylaws to bring them in conformity with the NYSE's.⁷⁹ Plaintiff asserted that the NASD, in its proxy statement for a shareholder vote related to the bylaw amendment, "falsely asserted that \$35,000 was the maximum amount that NASD . . . was authorized by the Internal Revenue Service to pay members in connection with the merger."⁸⁰ In an effort to skirt NASD's absolute immunity, the plaintiff argued that the action challenged pertained to an "alleged misstatement . . . related to [NASD's] finances, not their regulatory functions."⁸¹ The Southern District of New York (S.D.N.Y.) explicitly stated that the "attempt to parse the proxy [statement] in order to separate 'financially-related' statements from 'regulatory-related' statements is artificial and unconvincing."⁸² The court determined that the focus on the financial component of the bylaws amendment missed the "entire purpose of the reorganization," which was regulatory, and thus afforded absolute immunity.⁸³ The district court found that "[i]t is patent that the consolidation that transferred NASD's and NYSE's regulatory powers to the resulting FINRA is, on its face, an exercise of the SROs' delegated regulatory functions and thus entitled to absolute immunity."⁸⁴

In a per curiam decision, the Second Circuit, in *Standard Investment Chartered, Inc. v. National Ass'n of Securities*

76. No. 07-CV-2014, 2010 WL 749844 (S.D.N.Y. Mar. 1, 2010), *aff'd per curiam*, 637 F.3d 112 (2d Cir. 2011).

77. *Id.* at *1.

78. *Id.*

79. *Standard Inv. Chartered, Inc. v. Nat'l Ass'n of Sec. Dealers*, 637 F.3d 112, 114–15 (2d Cir. 2011) (per curiam), *cert. denied*, 132 S. Ct. 1093 (2012).

80. *Standard*, 2010 WL 749844, at *1.

81. *Id.*

82. *Id.*

83. *Id.*

84. *Id.*

Dealers,⁸⁵ affirmed the district court's ruling that "the proxy solicitation, which was the only vehicle available to NASD for amending its bylaws, was plainly 'incident to the exercise of regulatory power' . . . and therefore an activity to which immunity attached."⁸⁶ The Second Circuit found significant (1) the fact that the NASD, as an SRO, cannot amend its rules without SEC approval and (2) the fact that the SEC retains discretion to amend the rules of any SRO, including the NASD.⁸⁷

In a precursor to the *Standard* decision, the Second Circuit, in *In re NYSE Specialists Securities Litigation*,⁸⁸ ruled on whether absolute immunity protected the NYSE from either intentionally, knowingly, or recklessly permitting the Specialist Firms that operate on the NYSE to engage in improper trading on their own behalf to the detriment of public investors.⁸⁹ The Specialist Firms play a pivotal role on the NYSE: each security listed for trading is assigned to a particular specialist firm and to "execute purchases and sales of a particular security, buyers or sellers must present their bids to buy and sell to the specific Specialist Firm assigned to that security."⁹⁰ Crucially, the Specialist Firm adjusts the price of the security to facilitate a liquid market in that security and correct imbalances in supply and demand.⁹¹ By virtue of the Specialist Firms' unique middleman posture, they are in a position to improperly profit at

85. 637 F.3d 112 (2d Cir. 2011) (per curiam), *cert. denied*, 132 S. Ct. 1093 (2012).

86. *Id.* at 116 (internal citations omitted).

87. *See id.* at 116–17 ("The statutory and regulatory framework highlights to us the extent to which an SRO's bylaws are intimately intertwined with the regulatory powers delegated to SROs by the SEC and underscore our conviction that immunity attaches to the proxy solicitation here.").

88. 503 F.3d 89 (2d Cir. 2007).

89. *See id.* at 99 (determining whether "the Specialist Firms actively took advantage of their unique position to self-deal and [whether] the NYSE neglected or abandoned its regulatory duties and oversight of the Specialist Firms by permitting and in some cases encouraging blatant self-dealing").

90. *Id.* at 92.

91. *See* CHOI & PRITCHARD, *supra* note 13, at 14 ("Adjusting prices to correct . . . imbalances of supply and demand is a critical task for the [S]pecialist [Firm]."). The Specialist Firm also plays a "central role in maintaining liquidity for that stock . . . [t]he specialist must sell when other investors are unwilling to sell and must buy when other investors are unwilling to buy." *Id.*

the expense of the NYSE's members.⁹² In the *NYSE Specialists* case, the plaintiffs alleged that the Specialist Firms did just that, in a variety of ways, with the possible intentional, knowing, or reckless permission of the NYSE.⁹³

The Second Circuit determined that the NYSE was entitled to absolute immunity in this instance because the claims related to the "proper functioning of the regulatory system[,] and it was "clear that the[] claims all involved the NYSE's action or inaction with respect to trading on the Exchange, which is indisputably within the NYSE's regulatory powers."⁹⁴ The court stated that SROs are entitled to absolute immunity when they are "acting within the scope of the powers granted to them."⁹⁵ The court also noted that "the immunity protects the power to regulate, not the mandate to perform regulatory functions in a certain manner."⁹⁶ With respect to the allegations that the NYSE "neglected or abandoned its regulatory duties and oversight," the court explicitly stated that if the conduct of the SRO was "within the ambit of the SRO's delegated power, immunity presumptively attaches, *even where the SRO wrongly exercises that power.*"⁹⁷ The Second Circuit was again stating that even where an SRO is in the wrong, or acting improperly, the SRO will be entitled to absolute immunity so as long as the "allegations of misconduct"

92. See *supra* note 91, *infra* note 93, and accompanying text (illustrating the position and manner in which Specialist Firms can, and did, profit at the expense of the NYSE's members).

93. See *NYSE Specialists*, 503 F.3d at 93 (noting that the Specialist Firms improperly engaged in interpositioning, trading ahead, freezing the book, and manipulating the tick). "[I]nterpositioning" means the Specialist Firms improperly positioned themselves between matching orders to make a profit for themselves. *Id.* "[T]rading ahead" means the Specialist Firms improperly undertook trades for their own accounts *before* undertaking trades for public investors that the Specialist Firm knew would impact the stock price and thus taking advantage of the Firm's future insight into price movements. *Id.* "[F]reezing the book" means improperly freezing the disseminated prices for a security to permit the Specialist Firms to engage in trading for their own account before undertaking trades for public investors. *Id.* "[M]anipulating the 'tick'" means improperly changing the price of the security to affect its principal trades. *Id.*

94. *Id.* at 99–100 (internal citations omitted).

95. *Id.* at 98.

96. *Id.*

97. *Id.* at 93, 99 (emphasis added).

pertain to a “specific function” that is “consistent with’ the exercise of power delegated to the SRO.”⁹⁸

In *DL Capital Group, LLC v. Nasdaq Stock Market, Inc.*,⁹⁹ the Second Circuit afforded NASDAQ absolute immunity for suspending trading, canceling trades previously made, and announcing those decisions.¹⁰⁰ Due to what NASDAQ believed was a system glitch, shares in Corinthian Colleges (COCO) dropped precipitously for no reason, falling from \$57.45 to \$38.45 in twelve minutes.¹⁰¹ NASDAQ, in response to the large decline in stock price, suspended trading in the shares for an hour.¹⁰² Forty-five minutes after resuming trading, NASDAQ announced that it was canceling all trades that took place in the twelve-minute stock price drop time period.¹⁰³ DL Capital went long in the twelve-minute window (betting the stock price would eventually rise, which it did), and then sold its shares *after* trading resumed, but *before* NASDAQ announced the cancelation of trades, making a profit.¹⁰⁴ DL Capital’s profit was converted into a loss when NASDAQ canceled the trades made during the twelve-minute window because it meant that DL Capital’s initial purchase of COCO was canceled but DL Capital’s sale was not.¹⁰⁵ This resulted in an “uncovered short sale”¹⁰⁶ whereby DL Capital had sold shares that it, after NASDAQ’s announcement and trade cancellation, did not own.¹⁰⁷ DL Capital therefore had to purchase the requisite shares in the market, securing them at a price

98. *Id.*

99. 409 F.3d 93 (2d Cir. 2005).

100. *Id.* at 96.

101. *Id.*

102. *Id.*

103. *Id.*

104. *Id.*

105. *Id.*

106. See *Uncovered Option*, (2013) INVESTOPEDIA.COM, <http://www.investopedia.com/terms/u/uncovered-option.asp#axzz2KXF427vY> (last visited Feb. 10, 2013) (describing an uncovered option, which is similar to an uncovered short sale, as a transaction whereby the seller sells a security without owning the underlying security, and thus must go out into the market to purchase the security at market prices in order to complete the transaction) (on file with the Washington and Lee Law Review).

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

higher than its sale price, leading to a loss.¹⁰⁸ DL Capital thus alleged that it was injured “by having to cover the forced short sale at a loss.”¹⁰⁹

The Second Circuit ruled that NASDAQ’s actions were afforded absolute immunity as NASDAQ was engaged in actions “consistent with the quasi-governmental powers delegated to it by the NASD pursuant to the Exchange Act.”¹¹⁰ In *DL Capital*, the plaintiff attempted to bifurcate NASDAQ’s actions attacking “not Nasdaq’s regulatory decisions to suspend trading, resume trading, or cancel trades, but . . . the manner in which Nasdaq publicly *announced* those decisions.”¹¹¹ The district court and the Second Circuit remained unconvinced, with the Second Circuit stating that “[a]s the district court aptly put it, ‘[a]nnouncing the suspension or cancellation of trades is as much a part of defendants’ regulatory duties as is the actual suspension or cancellation of trades.”¹¹²

The Second Circuit went on to state that “allegations of bad faith, malice and even fraud . . . cannot, except in the most unusual of circumstances, overcome *absolute* immunity.”¹¹³ It is clear that even the wrongful, improper, or errant performance of duties *incidental* to the performance of an SRO’s regulatory function will be protected by absolute immunity.¹¹⁴ This position establishes a high bar for plaintiffs to clear in suits brought against SROs in performance of their regulatory function.¹¹⁵

SROs have been granted absolute immunity in a variety of situations and circumstances. SROs have been granted absolute

108. *Id.*

109. *Id.*

110. *Id.* at 99–100.

111. *Id.* at 98.

112. *Id.* (second alteration in original).

113. *Id.*; *see also* *Dexter v. Depository Trust & Clearing Corp.*, 406 F. Supp. 2d 260, 263 (S.D.N.Y. 2005) (noting that the Second Circuit has extended absolute immunity to actions alleging fraud and bad faith by both individual investors and members of the SRO), *aff’d*, 219 F. App’x 91 (2d Cir. 2007).

114. *See supra* notes 112–13 and accompanying text (explaining how courts afford absolute immunity for actions *incidental* to the performance of an SRO’s regulatory function).

115. *See supra* note 113 and accompanying text (noting the Second Circuit’s position that even actions undertaken fraudulently, in bad faith, and with malice warrant absolute immunity).

immunity for (1) disciplining members and associates of the exchange;¹¹⁶ (2) disciplining employees of exchange members;¹¹⁷ (3) deciding to suspend trading and delist a company from the exchange;¹¹⁸ (4) deciding to ban a trader from the NYSE floor;¹¹⁹ (5) interpreting securities laws and regulations as applied to exchange members;¹²⁰ (6) referring exchange members to the SEC and other governmental agencies for civil and criminal enforcement under the securities laws;¹²¹ (7) suspending trading, canceling previous trades made, and announcing such decisions;¹²² and (8) “amend[ing] . . . [their] bylaws where . . . the amendments are inextricable from the SRO’s role as a regulator.”¹²³ In the above cases, the courts invariably concluded that, when objectively considering the nature and function of the action at issue, the action was undertaken pursuant to the quasi-

116. See *Austin Mun. Sec., Inc. v. Nat’l Ass’n of Sec. Dealers*, 757 F.2d 676, 692 (5th Cir. 1985) (“[T]he NASD is entitled to absolute immunity for its role in disciplining its members and associates.”).

117. See *Barbara v. N.Y. Stock Exch.*, 99 F.3d 49, 59 (2d Cir. 1996) (recognizing “an absolute immunity from suits for money damages with respect to the Exchange’s conduct of disciplinary proceedings” against an employee of an exchange member).

118. See *Sparta Surgical Corp. v. Nat’l Ass’n of Sec. Dealers*, 159 F.3d 1209, 1215 (9th Cir. 1998) (“NASD is charged with the duty and responsibility of monitoring its market carefully to protect the investing public. When it acts in this capacity to suspend trading, [or delist a company from exchange] NASD is performing a regulatory function cloaked in immunity.”).

119. See *D’Alessio v. N.Y. Stock Exch., Inc.*, 258 F.3d 93, 104–06 (2d Cir. 2001) (noting that “[b]ecause these actions ‘share the characteristics of the judicial process’ the NYSE is entitled to immunity from suit for claims based on these actions” (quoting *Barbara*, 99 F.3d at 59)).

120. See *id.* (noting that SROs stand in the shoes of the SEC when “interpreting the securities laws for its members and in monitoring compliance with those laws,” and thus the SROs should be afforded the same immunity as the SEC when performing those functions delegated to it by the SEC).

121. See *id.* (noting that an SRO is entitled to immunity when it acts pursuant to its “quasi-prosecutorial” function).

122. See *DL Capital Grp., LLC v. Nasdaq Stock Mkt., Inc.*, 409 F.3d 93, 97–100 (2d Cir. 2005) (quoting, in support, the district court, which stated that “[a]nouncing the suspension or cancellation of trades is as much a part of defendants’ regulatory duties as is the actual suspension or cancellation of trades” (quoting *DL Capital Grp., LLC v. Nasdaq Stock Mkt., Inc.*, No. 03-CV-9730, 2004 WL 993109, at *6 (S.D.N.Y. May 5, 2004))).

123. *Standard Inv. Chartered, Inc. v. Nat’l Ass’n of Sec. Dealers*, 637 F.3d 112, 116 (2d Cir. 2011) (per curiam), *cert. denied*, 132 S. Ct. 1093 (2012).

governmental prosecutorial, regulatory, or adjudicatory function of the SRO, and thus warranting absolute immunity.¹²⁴

The courts are highly deferential in affording SROs absolute immunity for their actions.¹²⁵ *Austin, Barbara, D'Alessio, Sparta Surgical, Standard Investment Chartered, NYSE Specialists, DL Capital*, and *Dexter v. Depository Trust & Clearing Corp.*¹²⁶ all contain instances of courts affording absolute immunity to SROs for actions taken pursuant to their prosecutorial, regulatory, or adjudicatory functions in addition to, in some cases, actions *incidental* to such functions.¹²⁷ SROs were afforded absolute immunity when they performed their quasi-governmental functions abusively,¹²⁸ improperly and in error (and irrespective of the harm caused to others who may have detrimentally relied upon the SROs error),¹²⁹ wrongfully,¹³⁰ in bad faith, with malice, and even fraudulently.¹³¹ As noted by the court in *Dexter*, “absolute immunity must be absolute” and even conduct “incorrect and[/or] unlawful . . . is nevertheless protected” irrespective of how “badly motivated, inept, or even unlawful” the SRO’s conduct might have been.¹³² Given the diverse nature of

124. See *supra* notes 116–23 and accompanying text (detailing various situations in which SROs have been afforded absolute immunity).

125. See *supra* Part II.B.1 (detailing various situations in which SROs have been afforded absolute immunity upon a variety of claims).

126. 406 F. Supp. 2d 260 (S.D.N.Y. 2005), *aff'd*, 219 F. App'x 91 (2d Cir. 2007).

127. See *supra* Part II.B.1 (detailing various situations in which SROs have been afforded absolute immunity upon a variety of claims).

128. See *Barbara v. N.Y. Stock Exch., Inc.*, 99 F.3d 49, 59 (2d Cir. 1996) (affording absolute immunity to an SRO for actions take pursuant to its governmental function even when performed abusively).

129. See *D'Alessio v. N.Y. Stock Exch., Inc.*, 258 F.3d 93, 104 (2d Cir. 2001) (affording absolute immunity to an SRO for actions taken pursuant to its governmental function when performed improperly, even when the SRO allegedly caused harm to others who relied upon the SRO's improper actions), *cert. denied*, 534 U.S. 1066 (2001).

130. See *In re NYSE Specialists Sec. Litig.*, 503 F.3d 89, 99 (2d Cir. 2007) (affording absolute immunity to an SRO for actions take pursuant to its governmental function even when wrongfully exercising its power).

131. See *DL Capital Grp., LLC v. Nasdaq Stock Mkt., Inc.*, 409 F.3d 93, 98 (2d Cir. 2005) (noting that absolute immunity for an SRO cannot be overcome by bad faith, malice, or even fraud).

132. *Dexter v. Depository Trust & Clearing Corp.*, 406 F. Supp. 2d 260, 263, 264 (S.D.N.Y. 2005), *aff'd*, 219 F. App'x 91 (2d Cir. 2007).

actions afforded absolute immunity and the strength of the absolute immunity itself, it seems difficult to imagine instances in which courts would not grant SROs absolute immunity, yet immunity has been denied in certain circumstances.

2. Actions Denied Absolute Immunity

In *Weissman v. National Ass'n of Securities Dealers*, the Eleventh Circuit denied absolute immunity to NASDAQ.¹³³ In *Weissman*, NASDAQ asserted absolute immunity for any liability arising from the active promotion of NASDAQ, and several companies listed on it, including WorldCom.¹³⁴ The advertisements, which were detrimentally relied upon by an investor, specifically referenced NASDAQ's belief in the need for the companies listed on NASDAQ to "provide accurate financial reporting in accordance with Generally Accepted Accounting [sic] Principals ('GAAP') and for the companies to be "supported by a Knowledgeable Audit Committee."¹³⁵ The advertisement also provided a list of companies that supposedly endorsed this opinion, including WorldCom.¹³⁶ It was alleged that at the time of the advertisements, NASDAQ was aware that WorldCom was not in compliance with NASDAQ's audit committee requirements.¹³⁷ WorldCom collapsed within months after the advertisements were promulgated in a massive "accounting scandal that created billions in illusory earnings," almost completely wiping out the plaintiff's investment.¹³⁸

133. *Weissman v. Nat'l Ass'n of Sec. Dealers*, 500 F.3d 1293, 1299 (11th Cir. 2007) (en banc) (affirming the district court's denial of absolute immunity as NASDAQ's activity did not serve an adjudicatory, regulatory, or prosecutorial function).

134. *See id.* at 1298–99 (noting that pursuant to "NASDAQ's view, even advertisements that promote the sale of a particular stock and serve no regulatory function whatsoever would be shielded by absolute immunity, because advertisements are 'consistent with' NASDAQ's role as an SRO").

135. *Id.* at 1299.

136. *Id.*

137. *Weissman v. Nat'l Ass'n of Sec. Dealers*, No. 05–61107, 2004 WL 3395190, at *2 (S.D. Fla. June 18, 2004), *aff'd in part & rev'd in part*, 468 F.3d 1306 (11th Cir. 2006), *rev'd en banc*, 500 F.3d 1293 (11th Cir. 2007).

138. Simon Romero & Riva D. Atlas, *Worldcom's Collapse: The Overview; WorldCom Files for Bankruptcy; Largest U.S. Case*, N.Y. TIMES (July 22, 2002),

The Eleventh Circuit, reversing itself en banc, stated that absolute immunity is “appropriate only when an SRO is performing regulatory, adjudicatory, or prosecutorial functions that would otherwise be performed by a government agency” and that “absolute immunity must be coterminous with an SRO’s performance of a governmental function.”¹³⁹ In this instance, the court determined that the advertisements were private business activity, and “[w]hen conducting private business, [SROs] remain subject to liability.”¹⁴⁰ Therefore, in this instance, NASDAQ was not afforded absolute immunity.¹⁴¹ The court specifically stated that “NASDAQ represents no one but itself when it entices investors to trade on its exchange and, specifically, when it suggests that particular companies are sound investments.”¹⁴² The court was clear that activities undertaken “in the service of NASDAQ’s own business, not the government’s” do not warrant absolute immunity.¹⁴³

It may appear that NASDAQ’s actions were unquestionably undertaken pursuant to its nongovernmental private business interests. As the Eleventh Circuit itself stated, SRO’s are not entitled to absolute immunity for “such distinctly nongovernmental conduct” as advertising.¹⁴⁴ The result in *Weissman*, however, followed a tortuous journey through the lower courts wherein the Eleventh Circuit reversed itself.¹⁴⁵ In the district court, NASDAQ’s motion to dismiss pursuant to absolute immunity was denied.¹⁴⁶ NASDAQ appealed to a panel

<http://www.nytimes.com/2002/07/22/us/worldcom-s-collapse-the-overview-world-com-files-for-bankruptcy-largest-us-case.html?src=pm> (last visited Jan. 8, 2014) (on file with the Washington and Lee Law Review); see also *Weissman*, 2004 WL 3395190, at *1 (describing the fall of WorldCom as a “well publicized accounting fraud and collapse”).

139. *Weissman v. Nat’l Ass’n of Sec. Dealers*, 500 F.3d 1293, 1297 (11th Cir. 2007) (en banc).

140. *Id.* at 1299 (quoting *Sparta Surgical Corp. v. Nat’l Ass’n of Sec. Dealers*, 159 F.3d 1209, 1214 (9th Cir. 1998)).

141. See *id.* at 1299 (concluding that NASDAQ’s actions were not protected by absolute immunity in this case).

142. *Id.*

143. *Id.*

144. *Id.*

145. *Id.* at 1295.

146. See *id.* (“The district court denied the motion in all respects.”).

of the Eleventh Circuit that reversed the denial of absolute immunity in part and affirmed it in part.¹⁴⁷ Finally, the Eleventh Circuit, en banc, “affirm[ed] the district court’s determination that NASDAQ does not enjoy immunity for the conduct alleged,” overruling the previous Eleventh Circuit panel decision.¹⁴⁸

Weissman demonstrates how, even in what appears to be a clear-cut case of an SRO performing functions that were undertaken pursuant to its nongovernmental private business interests, the courts struggle with separating those private actions from actions undertaken pursuant to an SRO’s regulatory function.¹⁴⁹ *Weissman* also demonstrates how hesitant the courts are to find an SRO exposed to any sort of liability.¹⁵⁰ *Every single one* of the cases cited by *Weissman* that addresses SRO liability in the financial sphere found the SRO entitled to absolute immunity.¹⁵¹ This illustrates the protection afforded to SROs such as NASDAQ in the financial context.

Weissman is the only circuit level opinion in which an SRO in the financial sphere is denied absolute immunity. Widening the search parameters to federal district courts reveals only one case, not including the *Weissman* district court opinion, in which an SRO in the financial sphere was denied absolute immunity.¹⁵² In

147. *See id.* (noting that the Eleventh Circuit panel “reversed the district court’s denial of absolute immunity with regard to . . . portions of Weissman’s complaint . . . but affirmed the denial of absolute immunity with regard to the remainder of Weissman’s complaint”).

148. *Id.*

149. *See supra* notes 144–48 and accompanying text (describing the procedural history of *Weissman*, wherein the Eleventh Circuit reversed itself).

150. *See supra* notes 144–48 and accompanying text (noting how a final result was reached only after the Eleventh Circuit reversed itself).

151. *Weissman v. Nat’l Ass’n of Sec. Dealers*, 500 F.3d 1293 *passim* (11th Cir. 2007) (en banc). In one instance, *Zandford v. National Ass’n of Securities Dealers*, the D.C. Circuit remanded the absolute immunity question to its district court. *Zandford v. Nat’l Ass’n of Sec. Dealers*, No. 94-7058, 1996 U.S. App. LEXIS 41840, at *2 (D.C. Cir. Feb. 14, 1996) (per curiam) (remanding “to the district court for reconsideration of whether, and to what extent, the alleged misconduct . . . may be shielded by absolute immunity”). The district court determined that the SRO’s actions were protected by absolute immunity and, even if they were not, the plaintiff’s claims were time barred; the circuit court affirmed. *Zandford v. Nat’l Ass’n of Sec. Dealers*, 30 F. Supp. 2d 1, 18, 24 (D.D.C. 1998), *aff’d*, 221 F.3d 197 (D.C. Cir. 2000).

152. *See Opulent Fund, L.P. v. Nasdaq Stock Mkt., Inc.*, No. C-07-03683, 2007 WL 3010573, at *5 (N.D. Cal. Oct. 12, 2007) (denying NASDAQ absolute

Opulent Fund v. Nasdaq Stock Market, Inc.,¹⁵³ the Northern District of California denied NASDAQ absolute immunity.¹⁵⁴

In *Opulent*, the plaintiffs were private investment partnerships trading in stock options on the Nasdaq-100.¹⁵⁵ On the day in question, plaintiffs alleged that NASDAQ miscalculated the value of the Nasdaq-100.¹⁵⁶ Plaintiffs determined this based upon their own calculation of the value of the Nasdaq-100 using the NOOP of the underlying stocks.¹⁵⁷ This miscalculation had a significant impact on the plaintiffs' portfolio of options, causing the plaintiffs to suffer a far greater loss on their contracts than if the value of the index had been correctly calculated.¹⁵⁸

The *Opulent* court agreed with the plaintiffs that "pricing an index is not a 'regulatory function' and therefore not cloaked in absolute immunity."¹⁵⁹ The court felt that NASDAQ established this index to profit from the selling of market price data and that in doing so, NASDAQ "represent[ed] no one but itself."¹⁶⁰ The court stated that "Nasdaq's duty to accurately calculate and disseminate an index price does not function to protect investors; instead, Nasdaq's actions function to create a market and

immunity).

153. No. C-07-03683, 2007 WL 3010573 (N.D. Cal. Oct. 12, 2007).

154. See *id.* at *5 ("Nasdaq's market facilitating actions at issue in this case were non-regulatory, and hence there is no absolute immunity.").

155. *Id.* at *1

The Nasdaq-100 is an index of the one-hundred largest non-financial securities traded on the Nasdaq Exchange. The index is weighted by the market value of each of the 100 component securities, whose values depend on their NASDAQ Official Opening Price ("NOOP"). The SEC has reviewed and approved the structure of the Nasdaq-100 index The SEC also approved Nasdaq's calculation and publication of NOOP prices. Nasdaq encourages investors to use the Nasdaq-100 index to create derivatives, and the accurate and timely reporting of the index's value is critical to the existence of the market for Nasdaq-100 derivatives.

(internal citations omitted).

156. *Id.*

157. *Id.*

158. *Id.*

159. *Id.* at *5.

160. *Id.* (citing *Weissman v. Nat'l Ass'n of Sec. Dealers*, 500 F.3d 1293, 1299 (11th Cir. 2007) (en banc)).

increase trading.”¹⁶¹ Importantly, the court stated that “SEC approval of a rule imposing a duty on an SRO is not the *sine qua non* of SRO immunity; engaging in regulatory conduct is.”¹⁶² Furthermore, the court noted that the fact that “the SEC approved the pricing formula against which Nasdaq’s conduct will be judged does not automatically convert Nasdaq’s conduct into an immunized ‘regulatory function.’”¹⁶³ Ultimately, the court ruled that NASDAQ’s “market facilitating actions at issue in this case were non-regulatory” and therefore, NASDAQ was not entitled to absolute immunity.¹⁶⁴

The *Opulent* court affirmatively stated that even if the SEC has approved the specific methods employed by the SRO, or if the SEC has approved the imposition of duties upon the SRO, that does not mean that the SRO’s actions employing those methods or performing those duties are regulatory functions warranting absolute immunity.¹⁶⁵ This is significant because during the Facebook IPO, like in *Opulent*, a system approved by the SEC and employed by NASDAQ—the Nasdaq Cross—failed, causing harm to others.¹⁶⁶ Likewise, the SEC approved NASD’s delegation of authority to NASDAQ, to “operate and oversee” the NASDAQ stock market in 1997.¹⁶⁷

161. *Id.*

162. *Id.*

163. *Id.*

164. *Id.*

165. See *supra* notes 162–64 and accompanying text (detailing how, per *Opulent*, the approval of the SEC does not unequivocally convert approved actions into regulatory conduct).

166. See *infra* notes 219–22 and accompanying text (noting that the NASDAQ Cross was approved by the SEC); *infra* Part III.A (detailing the events of the Facebook IPO).

167. See Order Approving the Plan of Allocation and Delegation of Functions by NASD to Subsidiaries, Exchange Act Release No. 34-39326, 62 Fed. Reg. 62,385, 62,391 (Nov. 21, 1997) [hereinafter NASD Delegation Order] (approving the delegation of authority from the NASD to NASDAQ to “operate and oversee” the NASDAQ stock market).

3. Absolute Immunity and SROs—The Tests Employed

Aside from *Weissman*, *Opulent*, and the occasional lower state court,¹⁶⁸ the courts have found SROs entitled to absolute immunity.¹⁶⁹ The lack of cases in which courts have denied SROs absolute immunity is a testament to the breadth of protection afforded to SROs by their absolute immunity.¹⁷⁰ As *Weissman* and *Opulent* make clear, however, SROs will not always be afforded absolute immunity.¹⁷¹

As was demonstrated above in *Standard Investment Chartered*, *NYSE Specialists*, *DL Capital*, *Dexter*, *Weissman*, and *Opulent*, the courts resort to vague language when determining whether an SRO was acting pursuant to its regulatory function or a nongovernmental private business interest.¹⁷² Courts will inquire as to whether the SRO was acting “coterminous with [the] . . . performance of a governmental function”;¹⁷³ acting “incident to the exercise of regulatory power”;¹⁷⁴ “acting within the scope of the powers granted to them”;¹⁷⁵ acting “consistent with the quasi-governmental powers delegated to [the SRO]”;¹⁷⁶

168. See *Platinum Partners Value Arbitrage Fund, Ltd. P’ship v. Chi. Bd. Options Exch.*, 976 N.E.2d 415, 426 (Ill. App. Ct. 2012), *appeal denied*, 981 N.E.2d 1003 (Ill. 2012) (denying SRO defendants absolute immunity).

169. See *supra* Part II.B.1–2 (providing examples of SROs being afforded and denied absolute immunity for a variety of actions and upon a variety of claims).

170. See *supra* Part II.B.2 (providing examples of SROs being denied absolute immunity).

171. See *supra* notes 133–64 and accompanying text (detailing the court’s refusal to find the actions of the SROs in *Weissman* and *Opulent* entitled to absolute immunity).

172. See *supra* Part II.B.1–2 (providing examples of SROs being afforded and denied absolute immunity for a variety of actions and upon a variety of claims).

173. *Weissman v. Nat’l Ass’n of Sec. Dealers*, 500 F.3d 1293, 1297 (11th Cir. 2007) (en banc).

174. *Standard Inv. Chartered, Inc. v. Nat’l Ass’n of Sec. Dealers*, 637 F.3d 112, 116 (2d Cir. 2011) (per curiam), *cert. denied*, 132 S. Ct. 1093 (2012) (citing *In re NYSE Specialists Sec. Litig.*, 503 F.3d 89, 98 (2d Cir. 2007)).

175. *In re NYSE Specialists Sec. Litig.*, 503 F.3d 89, 98 (2d Cir. 2007).

176. *DL Capital Grp., LLC v. Nasdaq Stock Mkt., Inc.*, 409 F.3d 93, 99–100 (2d Cir. 2005). *But see Weissman*, 500 F.3d 1298 (rejecting the proposition that an SRO is granted absolute immunity for “all activity that is merely ‘consistent with’ the SROs delegated powers”).

acting in such a way that “the conduct “ar[ose] out of the discharge of [the SRO’s] duties under the Exchange Act”;¹⁷⁷ and whether or not the SRO was acting in such a way that it “represent[ed] no one but itself.”¹⁷⁸ The various, equally vague standards suggest that a coherent method for determining whether an SRO’s actions were undertaken pursuant to its regulatory function or pursuant to its nongovernmental private business interests would prove beneficial.¹⁷⁹ The approach detailed in Part IV intends to clarify this ambiguity.¹⁸⁰

III. NASDAQ’s Conditional Absolute Immunity in Light of the Facebook IPO

As Part II has demonstrated, courts have little difficulty identifying when SROs are acting pursuant to their prosecutorial and adjudicatory functions.¹⁸¹ Courts, however, struggle to determine when SROs are acting pursuant to their regulatory function as opposed to their private, for-profit business interests.¹⁸²

The Facebook IPO illustrates the complexity of applying these vague standards to complicated actual events to ascertain whether the SRO in question, NASDAQ, was acting pursuant to its regulatory function or was acting pursuant to its

177. *Dexter v. Depository Trust & Clearing Corp.*, 406 F. Supp. 2d 260, 263 (S.D.N.Y. 2005) (citing *D’Alessio v. N.Y. Stock Exch., Inc.*, 258 F.3d 93, 104 (2d Cir. 2001), *aff’d*, 219 F. App’x 91 (2d Cir. 2007), *cert. denied*, 534 U.S. 1066 (2001)).

178. *Opulent Fund, L.P. v. Nasdaq Stock Mkt., Inc.*, No. C-07-03683, 2007 WL 3010573, at *5 (N.D. Cal. Oct. 12, 2007) (quoting *Weissman v. Nat’l Ass’n of Sec. Dealers*, 500 F.3d 1293, 1299 (11th Cir. 2007) (en banc)).

179. *See supra* Part II.B.1–2 (providing examples of SROs being afforded and denied absolute immunity for a variety of actions and upon a variety of claims).

180. *See infra* Part IV.A (detailing the new approach).

181. *See supra* notes 57–71 and accompanying text (providing examples of SROs afforded absolute immunity for actions taken pursuant to their prosecutorial and adjudicatory functions).

182. *See supra* notes 172–78 and accompanying text (providing examples of the vague language courts resort to when determining whether an SRO was acting pursuant to its regulatory function or a nongovernmental private business interest).

nongovernmental private business interests. Part III, in subpart A, provides a very brief narrative of the Facebook IPO.¹⁸³ Subpart B applies the present law of SRO absolute immunity to NASDAQ's conduct during the Facebook IPO in an attempt to determine if NASDAQ is entitled to absolute immunity.

A. *The Events of the Facebook IPO*

NASDAQ establishes the opening price of an IPO through a process known as the “Nasdaq Cross” (Cross).¹⁸⁴ The Cross process begins at 7:00 A.M. on the day of the IPO, and from then on, NASDAQ accepts orders for shares in the IPO.¹⁸⁵ Those orders can be entered or canceled freely, although no information on the orders is publically disseminated until the “Display-Only Period,” and no orders are actually completed until the Cross itself executes.¹⁸⁶ The Display-Only Period begins fifteen minutes prior to the scheduled release time of the IPO, which in the case of Facebook was 11:00 A.M.¹⁸⁷ During the Display-Only Period, NASDAQ disseminates information about the auction price and the auction volume on NASDAQ's public data feeds at five-second intervals.¹⁸⁸ During this period, members of NASDAQ may continue to enter and cancel orders in the IPO.¹⁸⁹ “Over the course of the Display-only period, market participants develop an understanding of the state of supply and demand, changes in the indicative price typically become smaller, and the indicative volume typically increases.”¹⁹⁰ After the Display-Only Period has

183. For a detailed description of NASDAQ's IPO process and the specific issues NASDAQ faced during the Facebook IPO see NASDAQ Proposal, *supra* note 17. This level of detail is beyond the scope of this Note.

184. NASDAQ Proposal, *supra* note 17, at 45,708–09.

185. *Id.* at 45,708.

186. *Id.*

187. *Id.* at 45,708–09.

188. *Id.* at 45,708.

189. *Id.*

190. *Id.* NASDAQ can extend the Display-Only Period up to six times, each for five-minute increments. *Id.* NASDAQ would do so if it “detect[ed] an order imbalance in the security,” which would be determined if the current reference price disseminated by NASDAQ differed by more than 5% or \$0.50 in the fifteen seconds before the Cross executed or “all buy or sell market orders w[ould] not be executed in the [C]ross.” *NASDAQ Stock Market Rules, Rule 4120 (c)(7)(C).*

come to an end, the “IPO [C]ross executes, the Nasdaq official opening price is disseminated, a bulk trade” is executed, and messages confirming individual executions for Cross-executed shares are sent to market participants.¹⁹¹ The Cross calculates the execution price by “determining the price that will maximize the number of shares executed and, in the case of multiple prices providing the same maximum number of shares executed, selecting the price nearest to the offering price.”¹⁹²

On the day of the Facebook IPO, the Cross failed to execute correctly, falling into a continuous loop of calculations and recalculations. At 11:05:10 A.M., NASDAQ attempted to “conclude the quoting period, execute the Cross and print the opening trade,” a procedure that, when initiated, results in the Cross application running its final calculation to match buy and sell orders and then formulating the opening trade.¹⁹³ The system is designed to capture changes to the existing orders even while the system is calculating the Cross up until one second before the Cross is completed, incorporating the changes made while the calculation for the Cross is being processed.¹⁹⁴ In the Facebook IPO, however, the system got stuck in a continuous loop: “after the initial calculation of the Cross was completed, but before the opening trade was printed, additional order modifications were

Limit Up-Limit Down Plan and Trading Halts, NASDAQ OMX (June 13, 2006), <http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp%5F1%5F1%5F4%5F1&manual=%2Fnasdaq%2Fmain%2Fnasdaq%2Dequityrules%2F> (last visited Jan. 8, 2014) [hereinafter NASDAQ Stock Market Rules] (on file with the Washington and Lee Law Review).

191. NASDAQ Proposal, *supra* note 17, at 45,708.

192. *Id.*

193. *Id.*

194. *Id.*; See Notice of Filing of Proposed Rule Change and Amendment Nos. 1 and 2 Thereto to Establish the Nasdaq Halt Cross, Exchange Act Release No. 34-53488, 71 Fed. Reg. 14,272, 14,274 (Mar. 21, 2006) (SR-NASD-2006-015) [hereinafter Proposal for NASDAQ Cross] (describing the NASDAQ Cross as capable of processing further changes to the existing orders while the system is processing within one second of the final calculation should the changes exceed a predetermined threshold or variance). *But see* Letter from Daniel Keegan, Managing Dir., Citigroup Inc., to Elizabeth M. Murphy, Sec’y, U.S. Sec. & Exch. Comm’n (Aug. 22, 2012) [hereinafter Citi Comment Letter] (stating that the NASDAQ Cross system, which “continued to accept cancels and modifications to orders up to one second before the opening [C]ross,” contained a “known design flaw that resulted in a similar technology issue dating back to Fall 2011”), <http://graphics8.nytimes.com/packages/pdf/business/CitiCommentLetter.pdf>.

received by the system As designed, the system re-calculated the Cross to factor in the new state of the book.”¹⁹⁵ As the Cross was recalculating, new changes were again received by the system, and, after the recalculation was completed but before the opening trade was printed, the system again recalculated the Cross to incorporate the received changes.¹⁹⁶ Thus, the system fell into a continuous loop of recalculations.¹⁹⁷

NASDAQ, after a “system modification,” was able to break the continuous cycle and complete the Cross at 11:30:09 A.M., twenty-five minutes late.¹⁹⁸ But, “only orders received prior to 11:11:00 a.m. participated in the 11:30:09 a.m. Cross.”¹⁹⁹ Thus, any orders “entered between 11:11:00 a.m. and 11:30:09 a.m.” were neither calculated in the 11:30:09 a.m. Cross nor executed by NASDAQ.²⁰⁰ Robert Greifeld, NASDAQ OMX Group’s Chief Executive Officer, stated that “[a]s many as 30 million shares worth of trading were affected by the glitch.”²⁰¹

As a result of its “system modification,” NASDAQ was not disseminating transaction confirmation messages (order confirmations).²⁰² NASDAQ did not transmit transaction confirmation messages until 1:50 P.M., over two hours after the market for Facebook had opened.²⁰³ NASDAQ believed that, “[i]n spite of the absence of confirmation messages[,]” market participants would have been largely unaffected by the absence.²⁰⁴ Citi, on the other hand, believed that the lack of

195. NASDAQ Proposal, *supra* note 17, at 45,709.

196. *Id.*

197. *Id.*

198. *Id.*

199. *Id.*

200. *Id.*

201. See Jenny Strasburg, Jacob Bunge & Gina Chon, *Nadaq’s Facebook Problem*, WALL ST. J. (May 21, 2012, 8:02 AM), <http://online.wsj.com/article/SB10001424052702303610504577416530447015656.html> (last visited Jan. 12, 2013) (noting how the CEO of NASDAQ described the IPO as not NASDAQ’s “finest hour”) (on file with the Washington and Lee Law Review).

202. NASDAQ Proposal, *supra* note 17, at 45,709.

203. *Id.*; see also Citi Comment Letter, *supra* note 194, at 7 (“In the period between 11:30 a.m. and 1:50 p.m. . . . system issues prevented Nasdaq from disseminating Cross transaction reports.” (citation omitted)).

204. See NASDAQ Proposal, *supra* note 17, at 45,709 (“[M]arket participants . . . would reasonably have had certain *expectations* for the execution or non-execution of their orders.” (emphasis added)).

transaction confirmation messages meant that “legions of investors were unable to make rational trading decisions because they had no idea whether they owned Facebook stock or not.”²⁰⁵ UBS concurred, stating that of its losses “in excess of \$350 million, the vast majority . . . resulted directly from Nasdaq’s unprecedented failure to deliver execution reports for tens of thousands of trades executed in the opening [C]ross [of] the Facebook IPO.”²⁰⁶ Citi believed that the lack of transaction confirmation messages resulted in “investors submitting multiple redundant orders based on the belief that the orders were not going through. . . . In other cases, investors submitted cancellations [for their purchase orders] before receiving order confirmations, but were stuck with the stock.”²⁰⁷ Other individuals were affected by the lack of transaction confirmation messages, and they were left wondering whether they owned any Facebook shares at all: “People didn’t know where their orders stood, and it became a big guessing game.”²⁰⁸ It was even reported that some brokerages, four days after the IPO, “weren’t sure if some of their orders had closed, or at what price.”²⁰⁹

205. Citi Comment Letter, *supra* note 194, at 7.

206. Letter from Mark Shelton, Gen. Counsel UBS Americas, UBS AG, to Elizabeth M. Murphy, Sec’y, U.S. Sec. & Exch. Comm’n, at 2 (Aug. 22, 2012) [hereinafter UBS Comment Letter] (on file with the Washington and Lee Law Review).

207. Citi Comment Letter, *supra* note 194, at 7.

208. Hibah Yousuf, *Facebook Trader: Nasdaq “Blew it,”* CNN MONEY (May 21, 2012, 3:24 PM), <http://money.cnn.com/2012/05/21/markets/facebook-nasdaq/index.htm?iid=EL> (last visited Jan. 21, 2013) (on file with the Washington and Lee Law Review); *see also* Strasburg, Bunge & Chon, *supra* note 201 (“Brokers and traders who placed orders [between 11:11:00 a.m. and 11:30:09 a.m.] didn’t know the status of those transactions until 1:50 p.m.”). Some brokers, traders, and investors “said they had put in orders to sell shares early in the day, but those orders didn’t go through. By the time they discovered that in the afternoon, the share price had fallen, so they were able to sell only at the lower price.” *Id.* Others “said that because they didn’t have confirmations of their earlier buy orders from Nasdaq, they weren’t able to sell those shares until after 1:50 p.m.” after the share price had fallen. *Id.* Still others stated that “orders . . . didn’t go through, or were filled at an inferior price later in the day . . . [or] went through [but] weren’t confirmed until hours later.” Pepitone, *supra* note 9. “That left investors unsure about how many shares they bought or sold, and at what price.” *Id.*

209. Pepitone, *supra* note 9.

B. The Present Law Applied to NASDAQ's Conduct During the Facebook IPO

To be afforded absolute immunity, NASDAQ must demonstrate that the actions it took during the Facebook IPO were within its quasi-governmental prosecutorial, regulatory, or adjudicatory functions.²¹⁰ Because the actions NASDAQ took to effectuate the Facebook IPO do not “share . . . characteristics [with] the judicial process,” NASDAQ did not act pursuant to its adjudicatory or prosecutorial functions.²¹¹ Therefore, the inquiry pertains solely to whether NASDAQ acted pursuant to its regulatory function. Even if effectuating IPOs is within NASDAQ's regulatory function, NASDAQ's actions during the Facebook IPO should be analyzed to determine if they are entitled to absolute immunity.²¹²

1. The Argument for Absolute Immunity

To prevail on a claim of absolute immunity, NASDAQ must demonstrate that (1) IPOs are an exercise of its quasi-governmental regulatory function and (2) that NASDAQ's actions during the Facebook IPO, however characterized, warrant absolute immunity.²¹³

a. IPOs Constitute a Regulatory Function

NASDAQ could argue that IPOs are undertaken pursuant to its regulatory function given the extensive regulatory authority delegated to NASDAQ by the NASD (approved by the SEC), the

210. See *supra* Part II.B.1 (providing examples of SROs afforded absolute immunity for actions taken pursuant to their prosecutorial, adjudicatory, and regulatory functions).

211. *Barbara v. N.Y. Stock Exch., Inc.*, 99 F.3d 49, 59 (2d Cir. 1996) (citing *Austin Mun. Sec., Inc. v. Nat'l Ass'n of Sec. Dealers*, 757 F.2d 676, 688 (5th Cir. 1985) (citing *Butz v. Economou*, 438 U.S. 478, 510–13 (1978))).

212. See *supra* Part II.B.1–2 (providing examples of SROs being afforded and denied absolute immunity for a variety of actions and upon a variety of claims).

213. See *supra* Part II.B.1 (providing examples of SROs being afforded absolute immunity for a variety of actions and upon a variety of claims).

SEC's explicit approval of the NASDAQ Cross (the system NASDAQ uses to effectuate IPOs), and the breadth of regulatory authority provided by Congress to NASDAQ as a national securities exchange.²¹⁴ The strength of each argument is analyzed in turn.

In 1997 NASDAQ was given "sole responsibility to operate and oversee the Nasdaq market."²¹⁵ NASDAQ was authorized to "develop, operate, and maintain the Nasdaq Stock Market, to formulate regulatory policies and listing criteria for the Nasdaq Stock Market, and to enforce those policies and rules."²¹⁶

The breadth of authority delegated to NASDAQ to oversee the NASDAQ stock market, and the fact that NASDAQ had "sole responsibility" to do so, provides support for the assertion that part of the regulatory function conferred to NASDAQ was the effectuation of IPOs.²¹⁷ After all, the only way to grow or even maintain a stock market is to add companies to it via IPOs.²¹⁸

Furthermore, the SEC explicitly approved the implementation of the NASDAQ Cross—the system employed by NASDAQ to effectuate IPOs.²¹⁹ The proposal pertaining to the implementation of the NASDAQ Cross described the various ways in which the Cross would impact the effectuation of IPOs.²²⁰ The Commission's approval of the very system employed by NASDAQ to effectuate IPOs generally, and the Facebook IPO specifically, provides evidence that the Commission approved of NASDAQ's role in developing and building the NASDAQ stock

214. *Infra* notes 215–27 and accompanying text.

215. NASD Delegation Order, *supra* note 167.

216. DL Capital Grp., LLC v. Nasdaq Stock Mkt., Inc., 409 F.3d 93, 95 (2d Cir. 2005) (emphasis added).

217. NASD Delegation Order, *supra* note 167.

218. See NASDAQ Stock Market Rules, *supra* note 190, at Rule 3351(i) ("Trading Practice") ("No member or person associated with a member shall execute or cause to be executed, directly or indirectly, on Nasdaq a transaction in a security subject to an initial public offering until such security has first opened for trading on the national securities exchange . . .").

219. See Order Approving Proposed Rule Change to Establish the Nasdaq Halt Cross, Exchange Act Release No. 34-53687, 71 Fed. Reg. 24,878 (Apr. 27, 2006) (SR-NASD-2006-015) [hereinafter NASDAQ Cross Approval] (approving the implementation of the NASDAQ Cross).

220. See Proposal for NASDAQ Cross, *supra* note 194, *passim*.

market through IPOs.²²¹ It is clear that the SEC was not only aware of, but approved of, NASDAQ effectuating IPOs on the NASDAQ stock market.²²²

Finally, NASDAQ, as a national securities exchange, is required to “promote just and equitable principles of trade,” “facilitat[e] transactions in securities,” “remove impediments to and perfect the mechanism of a free and open market and a national market system,” and “protect investors and the public interest.”²²³

Arguably, IPOs accomplish all four objectives. IPOs promote just and equitable principles of trade and facilitate transactions in securities generally, as well as those within a particular company, because what other process “remove[s] impediments to and perfect[s] the mechanism of a free and open market” like a company “going public”—allowing the average investor to freely “trade” and take a stake in a, previously unavailable, company?²²⁴ IPOs also trigger mandatory disclosure obligations for companies listed on national securities exchanges.²²⁵ This “protect[s] investors and the public interest,” because more information about a company is now available to the market.²²⁶ The Second Circuit, in reference to the NYSE, an SRO comparable to NASDAQ, stated that all “action or inaction with respect to trading on the Exchange . . . is indisputably within the [SRO’s] regulatory powers.”²²⁷

221. See NASDAQ Cross Approval, *supra* note 219, at 24,878–79 (approving the implementation of the NASDAQ Cross). In adopting the Cross, the SEC stated that it was “consistent with the requirements of the [Securities Exchange] Act and the rules and regulations thereunder applicable to a national securities association.” *Id.*

222. See Proposal for NASDAQ Cross, *supra* note 194, *passim* (referencing the various ways in which the Cross would affect IPOs); NASDAQ Cross Approval, *supra* note 219, at 24,878–79 (approving the NASDAQ Cross).

223. 15 U.S.C. § 78f(b)(5) (2012).

224. *Id.*; see CHOI & PRITCHARD, *supra* note 13, at 392 (noting how IPOs have “downside[s] for the company’s pre-existing owners[:] bringing in more equity owners dilutes the potential upside return”).

225. See CHOI & PRITCHARD, *supra* note 13, at 169 (noting how “Congress adopted mandatory disclosure for companies with securities listed on a national securities exchange as part of the Exchange Act of 1934”).

226. 15 U.S.C. § 78f(b)(5).

227. *In re NYSE Specialists Sec. Litig.*, 503 F.3d 89, 99–100 (2d Cir. 2007).

Therefore, NASDAQ can argue that IPOs constitute a regulatory function of NASDAQ and NASDAQ, when effectuating IPOs, may warrant absolute immunity.²²⁸

b. NASDAQ's Actions in Effectuating the Facebook IPO Warrant Absolute Immunity

NASDAQ's actions during the Facebook IPO, however characterized, will not forfeit NASDAQ's absolute immunity: "absolute immunity must be absolute."²²⁹

Absolute immunity protects SROs even when they perform their quasi-governmental functions abusively,²³⁰ improperly and in error (irrespective of the harm caused to others who may have detrimentally relied upon the SRO's error),²³¹ wrongfully,²³² in bad faith, with malice, and even fraudulently.²³³ As noted in *Dexter*, conduct "incorrect and[or] unlawful . . . is nevertheless protected" by absolute immunity irrespective of how "badly motivated, inept, or even unlawful" the SRO's conduct might have been.²³⁴ Absolute immunity even covers actions taken incidental to the performance of an SRO's regulatory function if performed wrongfully, improperly, or errantly.²³⁵

228. *Supra* notes 215–27 and accompanying text.

229. *Dexter v. Depository Trust & Clearing Corp.*, 406 F. Supp. 2d 260, 263 (S.D.N.Y. 2005), *aff'd*, 219 F. App'x 91 (2d Cir. 2007).

230. *See Barbara v. N.Y. Stock Exch., Inc.*, 99 F.3d 49, 59 (2d Cir. 1996) (affording absolute immunity to an SRO for actions take pursuant to their governmental function even when performed abusively).

231. *See D'Alessio v. N.Y. Stock Exch., Inc.*, 258 F.3d 93, 104 (2d Cir. 2001) (affording absolute immunity to an SRO for actions take pursuant to its governmental function even when performed improperly and, even when the SRO, allegedly, caused harm to others who relied upon the SROs improper actions), *cert. denied*, 534 U.S. 1066 (2001).

232. *See In re NYSE Specialists Sec. Litig.*, 503 F.3d 89, 99 (2d Cir. 2007) (affording absolute immunity to an SRO for actions take pursuant to its governmental function even when wrongly exercising its power).

233. *See DL Capital Grp., LLC v. Nasdaq Stock Mkt., Inc.*, 409 F.3d 93, 98 (2d Cir. 2005) (noting that absolute immunity for an SRO cannot be overcome by bad faith, malice, or even fraud).

234. *Dexter*, 406 F. Supp. 2d at 264.

235. *See DL Capital Grp.*, 409 F.3d at 98 (affording absolute immunity for actions incidental to the performance of an SRO's regulatory function even when performed wrongfully, improperly, or errantly).

NASDAQ's actions during the Facebook IPO could arguably be characterized as wrongful, improper, incorrect, badly motivated, or inept.²³⁶ But even if NASDAQ's actions, undertaken pursuant to its regulatory function,²³⁷ were so characterized, NASDAQ would still be afforded absolute immunity.²³⁸ NASDAQ's actions probably could not, even arguably, be characterized as abusive, undertaken in bad faith, with malice, fraudulently, or unlawfully.²³⁹ And if NASDAQ's actions were so characterized, NASDAQ would *still* be afforded absolute immunity.²⁴⁰ Given the extent to which courts have afforded SROs absolute immunity, despite the manner in which the SROs have performed their quasi-governmental functions, it is clear that NASDAQ's actions, which could be characterized in a number of ways, would warrant absolute immunity.²⁴¹

Therefore, NASDAQ could argue that an IPO, in general, is an exercise of its quasi-governmental regulatory function warranting absolute immunity.²⁴² NASDAQ should then be able to assert confidently that the actions taken, or not taken, by it during the Facebook IPO, however characterized, would warrant absolute immunity.²⁴³

236. See *supra* Part III.A (detailing the events of the Facebook IPO).

237. See *supra* Part III.B.1.a (arguing that the effectuation of IPOs is pursuant to NASDAQ's regulatory function).

238. See *supra* Part II.B.1 (demonstrating that absolute immunity cannot be successfully defeated on the basis of activity characterized as wrongful, improper, incorrect, badly motivated, or inept).

239. See *supra* Part III.A (detailing the events of the Facebook IPO).

240. See *supra* Part II.B.1 (demonstrating that absolute immunity cannot be successfully defeated on the basis of activity characterized as abusive, undertaken in bad faith, undertaken with malice, fraudulent, or unlawful).

241. See *supra* Part II.B.1 (demonstrating that absolute immunity cannot be successfully defeated on the basis of activity characterized as wrongful, improper, incorrect, badly motivated, inept, abusive, undertaken in bad faith, undertaken with malice, fraudulent, or unlawful).

242. See *supra* Part III.B.1.a (demonstrating that the effectuation of IPOs is pursuant to NASDAQ's regulatory function and therefore warrants absolute immunity).

243. See *supra* Part II.B.1 (demonstrating that absolute immunity cannot be successfully defeated on the basis of activity characterized as wrongful, improper, incorrect, badly motivated, inept, abusive, undertaken in bad faith, undertaken with malice, fraudulent, or unlawful).

2. *The Argument Against Absolute Immunity*

NASDAQ will be denied absolute immunity if the effectuation of IPOs is found to constitute a private, for-profit business activity.²⁴⁴ The SEC itself acknowledges that “[a]s competition among markets grows, the markets that SROs operate will continue to come under increased pressure to attract order flow. . . . [The resulting] *business pressure* can create a strong conflict between the SRO[s] regulatory and market operations functions.”²⁴⁵

a. IPOs Constitute a Private, For-Profit Business Activity

It could be argued that the effectuation of IPOs constitutes a private, for-profit business activity of NASDAQ given the positive effect IPOs have on NASDAQ’s bottom line and its “trading and brand value.”²⁴⁶

NASDAQ aggressively solicited Facebook to have Facebook IPO on the NASDAQ stock market as opposed to the NYSE.²⁴⁷ To do so made business and financial sense: At stake was NASDAQ’s

244. *Weissman v. Nat’l Ass’n of Sec. Dealers*, 500 F.3d 1293, 1299 (11th Cir. 2007) (en banc) (“When conducting private business, [SROs] remain subject to liability.” (quoting *Sparta Surgical Corp. v. Nat’l Ass’n of Sec. Dealers*, 159 F.3d 1209, 1214 (9th Cir. 1998))). Activities undertaken “in the service of NASDAQ’s own business, not the government’s,” do not warrant absolute immunity. *Id.*

245. *Id.* at 1296 n.4 (quoting Concept Release Concerning Self-Regulation, SEC Release No. 34-50700, 69 Fed. Reg. 71,256, 71,261–62 (Dec. 8, 2004)) (emphasis added).

246. See Whitney Kisling, *NYSE, Nasdaq Vie for Facebook IPO*, BLOOMBERG (Feb. 1, 2012, 6:41 PM), <http://www.bloomberg.com/news/2012-02-01/facebook-yet-to-friend-exchanges-as-nyse-nasdaq-vie-to-list-initial-offer.html> (last visited Feb. 22, 2013) (describing the benefits securing the Facebook IPO would provide to NASDAQ) (on file with the Washington and Lee Law Review).

247. See Kayla Tausche, *Nasdaq 100 Changes Listing Rules to Woo Facebook IPO*, CNBC.COM (Apr. 16, 2012, 1:59 PM), http://www.cnbc.com/id/47063617/Nasdaq_100_Changes_Listing_Rules_to_Woo_Facebook_IPO (last visited Feb. 22, 2013) (describing how the NASDAQ stock market changed its rules to allow a company to be listed on the Nasdaq-100 index in a quicker amount of time after its IPO, which “w[as] a key component in Facebook’s choosing to go public on Nasdaq instead of the New York Stock Exchange”) (on file with the Washington and Lee Law Review); Kisling, *supra* note 246 (noting that the NYSE and NASDAQ were competing to have Facebook IPO on their respective exchanges).

reputation as the go-to exchange for technology companies, a \$35,000 to \$99,500 listing fee for the IPO itself, as well as the infinitely more valuable “trading and brand value” that comes from landing a big company like Facebook on one’s exchange.²⁴⁸ Additionally, revenues from IPOs accounted for 22% of NASDAQ’s revenue in the third quarter of 2011.²⁴⁹ After news broke that the Facebook IPO would take place on the NASDAQ stock market, NASDAQ’s stock price rose and the NYSE’s fell—evidence of the market’s position that securing the Facebook IPO made NASDAQ a more valuable *business*.²⁵⁰

The *Weissman* court specifically provided that “efforts to increase trading volume and company profit” constituted “non-governmental activities that serve [the SRO’s] private business interests.”²⁵¹ The court also made it clear that activities undertaken “in the service of NASDAQ’s own business, not the government’s” do not warrant absolute immunity.²⁵²

A federal district court has stated that the fact that the SEC approved the “pricing formula,” upon which NASDAQ’s “conduct will be judged[,] does not automatically convert Nasdaq’s conduct into an immunized ‘regulatory function.’”²⁵³ Thus, the SEC’s approval of NASDAQ’s authority to “operate and oversee the Nasdaq market” and the SEC’s approval of the NASDAQ Cross—with knowledge that the Cross was to be used by NASDAQ to effectuate IPOs—does not mean that such actions constitute NASDAQ’s regulatory function.²⁵⁴

248. Kisling, *supra* note 246.

249. *Id.*

250. See Evelyn Rusli, *Facebook Is Said to Pick Nasdaq for I.P.O.*, N.Y. TIMES (Apr. 5, 2012, 1:50 PM), <http://dealbook.nytimes.com/2012/04/05/facebook-picks-nasdaq-for-i-p-o/> (last visited Feb. 22, 2013) (“For Nasdaq, Facebook is not just any listing.”) (on file with the Washington and Lee Law Review).

251. *Weissman v. Nat’l Ass’n of Sec. Dealers*, 500 F.3d 1293, 1296 (11th Cir. 2007) (en banc).

252. *Id.* at 1299.

253. *Opulent Fund, L.P. v. Nasdaq Stock Mkt., Inc.*, No. C-07-03683, 2007 WL 3010573, at *5 (N.D. Cal. Oct. 12, 2007).

254. NASD Delegation Order, *supra* note 167; see also NASDAQ Cross Approval, *supra* note 219 (approving the implementation of the NASDAQ Cross); *supra* notes 219–22 and accompanying text (describing the SEC’s approval of the NASDAQ Cross).

One could argue that NASDAQ, when effectuating IPOs, acts only for itself in the service of its own private, for-profit business and is therefore not entitled to absolute immunity. This makes some sense considering the overwhelming benefit that NASDAQ, as a private, for-profit corporation derives from IPOs generally, and the Facebook IPO specifically.²⁵⁵ The fact that the SEC approved the authority of NASDAQ to undertake IPOs, and even approved of the specific method used by NASDAQ to effectuate them, does not necessarily mean that such activities constitute a regulatory function.²⁵⁶

3. Why a Court Should Find that NASDAQ Is Entitled to Absolute Immunity for Its Actions During the Facebook IPO

A court will most likely find that IPOs fall within NASDAQ's regulatory function.²⁵⁷ Additionally, no matter how NASDAQ's actions during the Facebook IPO are reasonably characterized, the absolute immunity shield should cover NASDAQ's conduct during the IPO.²⁵⁸ The cases brought against NASDAQ for its conduct during the Facebook IPO have been consolidated in the U.S. District Court for the Southern District of New York.²⁵⁹

a. IPOs Will Be Considered a Regulatory Function

A court in the Second Circuit will most likely find that IPOs constitute a regulatory function performed by NASDAQ for four

255. See *supra* notes 247–50 and accompanying text (detailing the benefits afforded to NASDAQ from the performance of IPOs).

256. *Supra* notes 253–54 and accompanying text.

257. See *infra* Part III.B.3.a (determining that IPOs should be considered a regulatory function).

258. See *supra* Part II.B.1 (providing examples of SROs afforded absolute immunity for a variety of actions and upon a variety of claims).

259. See SDNY Consolidation Order, *supra* note 7, at 43 (“[A]ll the NASDAQ Actions are henceforth consolidated.”). Extensive searches did not reveal a single instance of an SRO, in the financial sphere, being denied absolute immunity in either the Second Circuit or S.D.N.Y. While this in no way ends the determination, in a case such as this, with facts that weigh in favor of NASDAQ being afforded absolute immunity, the S.D.N.Y. is unlikely to deny NASDAQ absolute immunity given the Second Circuit precedent.

reasons: (1) the broad delegation of authority provided to NASDAQ to “operate and oversee” the NASDAQ Stock Market, a delegation of authority approved of by the SEC;²⁶⁰ (2) the SEC’s approval of the very method used by NASDAQ to effectuate IPOs, a function explicitly discussed in the proposal calling for the approval of the method by the SEC;²⁶¹ (3) the fact that NASDAQ’s statutory responsibilities are broad enough to encompass the oversight of IPOs;²⁶² and (4) the Second Circuit’s precedent regarding SRO immunity.²⁶³

The NASD delegated authority to NASDAQ to “operate and oversee” the NASDAQ stock market.²⁶⁴ The SEC approved this delegation of authority.²⁶⁵ The Second Circuit, in *DL Capital*, explicitly detailed NASDAQ’s authority to “develop, operate, and maintain the Nasdaq Stock Market.”²⁶⁶ An SRO develops a stock market by adding to it, and an SRO maintains a stock market, in part, the same way, as companies delist over time forcing the SRO to add more companies to maintain the market’s present position. Therefore, the Second Circuit’s endorsement of NASDAQ’s regulatory authority to develop and maintain the NASDAQ stock market is an endorsement of the position that IPOs constitute a regulatory function of NASDAQ.²⁶⁷ There is no other way in which “develop” and “maintain” would make sense in this context.²⁶⁸

NASDAQ effectuates IPOs via the NASDAQ Cross.²⁶⁹ NASDAQ’s proposal to the SEC requesting SEC approval of the NASDAQ Cross contained numerous references to how NASDAQ

260. NASD Delegation Order, *supra* note 167.

261. See Proposal for NASDAQ Cross, *supra* note 194, *passim* (referencing the various ways in which it would affect IPOs).

262. 15 U.S.C. § 78f(b)(5) (2012).

263. See *In re NYSE Specialists Sec. Litig.*, 503 F.3d 89, 99–100 (2d Cir. 2007) (stating that “action or inaction with respect to trading on the Exchange . . . is indisputably within the [SRO’s] regulatory powers”).

264. NASD Delegation Order, *supra* note 167.

265. *Id.*

266. *DL Capital Grp., LLC v. Nasdaq Stock Mkt., Inc.*, 409 F.3d 93, 95 (2d Cir. 2005) (emphasis added).

267. *Id.*

268. *Id.*

269. See *supra* notes 184–92 and accompanying text (providing an explanation of the NASDAQ Cross).

would use the Cross to effectuate IPOs, among other functions.²⁷⁰ The SEC approved NASDAQ's proposal.²⁷¹

The statutory responsibilities by which NASDAQ, as a national securities exchange, must abide pursuant to 15 U.S.C. § 78f(b)(5)²⁷² are broad enough to encompass the oversight of IPOs—particularly the provisions that require NASDAQ to “facilitat[e] transactions in securities,” “remove impediments to and perfect the mechanism of a free and open market,” and “protect investors and the public interest.”²⁷³ Arguably, IPOs accomplish all three objectives: IPOs facilitate transactions in securities and remove impediments to free and open markets by creating an opportunity for investors to own equity in companies previously unavailable for investment.²⁷⁴ IPOs also trigger mandatory disclosure obligations for companies listed on national securities exchanges, which “protect[s] investors and the public interest,” by making available a wide variety of information not previously accessible on a newly listed company.²⁷⁵

Finally, the Second Circuit has stated that “action or inaction with respect to trading on the Exchange . . . is indisputably within the NYSE's regulatory powers”—a position that, given the equivalent position that NASDAQ holds to the NYSE, affords NASDAQ regulatory power over IPOs.²⁷⁶ This is because IPOs unequivocally relate to “action or inaction with respect to trading” on the NASDAQ stock market.²⁷⁷

A court, particularly one in the Second Circuit, would most likely determine that NASDAQ, in the performance of an IPO, is acting pursuant to its quasi-governmental regulatory function

270. See Proposal for NASDAQ Cross, *supra* note 194, *passim* (referencing the various ways in which it would affect IPOs).

271. See NASDAQ Cross Approval, *supra* note 219 (approving the NASDAQ Cross).

272. 15 U.S.C. § 78f(b)(5) (2012).

273. *Id.*

274. See CHOI & PRITCHARD, *supra* note 13, at 392 (noting how IPOs have “downside[s] for the company's pre-existing owners[:] bringing in more equity owners dilutes the potential upside return”).

275. See *id.* at 169 (noting that “Congress adopted mandatory disclosure for companies with securities listed on a national securities exchange as part of the Exchange Act of 1934”).

276. *In re NYSE Specialists Sec. Litig.*, 503 F.3d 89, 99–100 (2d Cir. 2007).

277. *Id.*

and is therefore entitled to absolute immunity.²⁷⁸ A court would also most likely find that NASDAQ's conduct during the Facebook IPO, however feasibly characterized, would be protected by its absolute immunity.²⁷⁹

IV. Regulatory Functions and Absolute Immunity: A New Approach

Courts have trouble determining whether actions undertaken by quasi-private SROs, such as NASDAQ, were undertaken pursuant to their regulatory function or their "non-governmental" "private business interests."²⁸⁰ Occasionally, as may be the case with IPOs, actions undertaken by quasi-private SROs such as NASDAQ appear to constitute both regulatory action and private, for-profit business activity, rendering such a distinction impossible.²⁸¹ Courts have devised a number of vague tests to determine whether challenged actions were undertaken pursuant to an SRO's regulatory function or its nongovernmental private business interest.²⁸² Rather than detail a new test which, given the complexity of the problem could be equally vague and problematic, a legislative solution is required.²⁸³ The SEC should

278. See *supra* Part III.B.3.a (determining that IPOs are within NASDAQ's regulatory function).

279. See *Dexter v. Depository Trust & Clearing Corp.*, 406 F. Supp. 2d 260, 263 (S.D.N.Y. 2005) ("[A]bsolute immunity must be absolute."), *aff'd*, 219 F. App'x 91 (2d Cir. 2007); *supra* Part II.B.1 (demonstrating that absolute immunity cannot be successfully defeated on the basis of activity characterized as wrongful, improper, incorrect, badly motivated, inept, abusive, undertaken in bad faith, undertaken with malice, fraudulent, or unlawful).

280. See *supra* Part II.B.1–2 (providing examples of SROs afforded and denied absolute immunity for a variety of actions and upon a variety of claims).

281. See *supra* Part III.B.1–2 (detailing arguments that effectuating IPOs constitutes a regulatory function and a private, for-profit business activity).

282. See *supra* Part II.B.3 (providing examples of the vague tests employed by the courts).

283. Earlier drafts of this Note provided the following new test: First, courts should presume that actions undertaken by SROs warrant absolute immunity. Second, should questions arise as to whether an SRO's actions were undertaken pursuant to its regulatory function or pursuant to its private, for-profit business interests, this presumption may be rebutted after consideration of the following factors: (1) the extent to which the SRO's actions are analogous—substantively and in all material respects—to actions taken by other nongovernmental private corporations and (2) the substantial likelihood that the SRO would undertake

apply a version of the Federal Deposit Insurance Corporation's (FDIC) living will approach to NASDAQ and equivalent SROs, and it should remove the SRO's absolute immunity for actions taken pursuant to its regulatory function.²⁸⁴ Part IV, in subpart A, introduces the new approach. Subpart B applies the new approach to NASDAQ's conduct during the Facebook IPO. Subpart C provides counterarguments to the new approach.

A. The New Approach

The SEC should require SROs, like NASDAQ and the NYSE, that both perform a regulatory function and possess nongovernmental private business interests to detail a living will providing their "contingency plans for resolution [of the SRO's activities] in the event of the [SRO's] failure."²⁸⁵ In cases like the Facebook IPO, the living will could be activated in the event of substantial, SRO-threatening, litigation. The SEC should require that every year, NASDAQ and the NYSE detail the approximate cost of running their national securities exchange for the next year—the national securities exchange operating cost. The SEC should further require that in the event of litigation against the SRO, the SRO's national securities exchange operating cost is absolutely immune from liability under all circumstances. This would ensure that, irrespective of the outcome of any litigation, no matter how big, the national securities exchange would continue operating uninterrupted for at least a year.²⁸⁶ This would reduce the likelihood that a national securities exchange's

the same action with prior knowledge that, in so doing, the SRO would not be covered by absolute immunity.

284. *FDIC Board Approves Final Rule Requiring Resolution Plans for Insured Depository Institutions Over \$50 Billion*, FED. DEPOSIT INS. CORP. (Jan. 17, 2012), <http://www.fdic.gov/news/news/press/2012/pr12003.html> (last visited Jan. 31, 2014) (announcing the FDIC's approval of "a final rule requiring an insured depository institution with \$50 billion or more in total assets to submit to the FDIC periodic contingency plans for resolution in the event of the institution's failure") (on file with the Washington and Lee Law Review).

285. *Id.*

286. *See id.* (noting that "resolution plans for large and complex [SROs] are essential for their orderly and least-costly resolution" and will permit the SRO and SEC, in this case, to "resolve the institutions in a manner that limits any disruption from their insolvency" or litigation).

operations would be impacted by litigation, which could have a “catastrophic . . . [effect on] investor confidence and macroeconomic stability,” especially if such an exchange went bankrupt.²⁸⁷ This would also serve to remove the damage that the threat of large litigation could impose upon an SRO or national securities exchange.

The SEC should also eliminate the SRO’s absolute immunity for actions taken pursuant to its regulatory function. While regulatory function immunity would no longer exist, SROs would still be afforded absolute immunity for actions undertaken pursuant to their adjudicatory and prosecutorial functions.²⁸⁸ This makes sense given that such a determination hinges upon whether the conduct in question “share[d] . . . characteristics [with] the judicial process,” a fairly straightforward analysis.²⁸⁹

B. The New Approach as Applied to the Facebook IPO

The new approach would permit parties damaged in the Facebook IPO to bring suit directly against NASDAQ without having to first demonstrate that NASDAQ’s actions were undertaken pursuant to its nongovernmental private business interests. While not an issue in this case, under the new approach, the parties would first have to demonstrate that NASDAQ’s actions were not undertaken pursuant to its prosecutorial or adjudicatory function, an easy bar to clear in most instances.²⁹⁰

This does not mean that NASDAQ is automatically liable for the \$500 million in damages alleged to have been lost as a result of the “system difficulties” experienced by NASDAQ during the

287. NASDAQ Proposal, *supra* note 17, at 45,714.

288. See *supra* notes 57–71 and accompanying text (providing examples of SROs afforded absolute immunity for actions taken pursuant to their prosecutorial and adjudicatory functions).

289. *Barbara v. N.Y. Stock Exch., Inc.*, 99 F.3d 49, 59 (2d Cir. 1996) (citing *Austin Mun. Sec., Inc. v. Nat’l Ass’n of Sec. Dealers*, 757 F.2d 676, 688 (5th Cir. 1985) (citing *Butz v. Economou*, 438 U.S. 478, 510–13 (1978))).

290. See *supra* notes 57–71 and accompanying text (providing examples of SROs afforded absolute immunity for actions taken pursuant to their prosecutorial and adjudicatory functions).

IPO.²⁹¹ The parties must first prevail on their federal securities claims that NASDAQ “made material misrepresentations and omissions concerning the capability of its technology and trading platform” and their state law negligence claims that NASDAQ, “in breach of duties owed to investors, negligently failed to promptly and accurately process investors’ trades.”²⁹²

While NASDAQ would not be protected by absolute immunity under the new approach, the plaintiffs’ claims must be litigated in full, and NASDAQ would be afforded all of the advantages of a defendant in the legal process.²⁹³ This would, arguably, permit a much more efficient resolution of the claims given that the substance of the claims could be litigated immediately, rather than only after the question of whether NASDAQ’s actions were undertaken pursuant to its regulatory function is litigated and resolved: a murky undertaking at best.²⁹⁴

C. Counterarguments to the New Approach

The new approach attempts to address the conflict inherent to SROs such as NASDAQ and the NYSE that balance their private, for-profit interests with their quasi-governmental, regulatory functions.²⁹⁵ The new approach is not without its own problems, however. Primarily, the new approach is vulnerable to the claim that removing an SRO’s absolute immunity for actions

291. McCrank, *supra* note 8. UBS alone lost over \$350 million while Knight Capital Group, Inc. (Knight) lost roughly \$35.4 million. UBS Comment Letter, *supra* note 206, at 2; Press Release, Knight Capital Grp., Inc., Knight Capital Group Announces Consolidated Earnings of \$0.04 Per Diluted Share For the Second Quarter 2012 (July 18, 2012) [hereinafter Knight Press Release], <http://www.knight.com/investorRelations/pressReleases2.asp?compid=105070&releaseID=1715693>.

292. SDNY Consolidation Order, *supra* note 7.

293. *Supra* Part IV.A.

294. See *supra* Part II.B.3 (providing examples of the vague tests employed by the courts to determine if an SRO is acting pursuant to its regulatory function or nongovernmental private business interests).

295. See *Weissman v. Nat’l Ass’n of Sec. Dealers*, 500 F.3d 1293, 1296–97 (11th Cir. 2007) (en banc) (noting that SROs “enjoy absolute immunity when performing governmental functions,” but SROs “cannot claim that immunity when they perform non-governmental functions” or act in their “own interest as a private entity”).

taken pursuant to its regulatory function will unleash a torrent of legal claims against the SRO. The result of such a move could be threefold: the cost of operating an exchange and participating in one could rise; the incentive to own and operate a national securities exchange could fall; and national securities exchanges could, under extreme circumstances, go bankrupt.

NASDAQ has stated that should it be forced to “bear all costs associated with system malfunctions and the varying reactions of market participants in their wake[,] . . . the cost of providing exchange services would have to rise dramatically for all investors to cover this material and new risk.”²⁹⁶ Such a result would be unfortunate, but market forces—particularly competition between the various national securities exchanges—could function to minimize this risk.²⁹⁷ It is even possible that members would be inclined to pay larger costs knowing that should issues arise in the future, they would have an opportunity to bring suit and receive compensation for any losses they sustain.

A reduction in the incentive to own and operate a national securities exchange poses a much larger problem. As NASDAQ has stated “[h]undreds of billions of dollars of securities transactions are matched through the systems of Nasdaq and other exchanges every day.”²⁹⁸ Given the incredibly large volume of transactions that SROs such as NASDAQ handle on a daily basis, the potential for liability is incredibly large and likely. Electronic trading today is so fast that massive liability can be generated in a matter of hours or even seconds, as Knight Capital Group’s \$461 million in losses and near bankruptcy for the improper installation of new software suggests.²⁹⁹ Even if the

296. NASDAQ Proposal, *supra* note 17, at 45,714.

297. See Tausche, *supra* note 247 (describing how NASDAQ implemented a rule change to make the Nasdaq stock market a more attractive venue for Facebook’s IPO relative to the NYSE); Kisling, *supra* note 246 (noting that the NYSE and NASDAQ were competing to have Facebook IPO on their respective exchanges).

298. NASDAQ Proposal, *supra* note 17, at 45,714.

299. See John McCrank, *Knight Capital Posts \$389.9 Million Loss on Trading Glitch*, REUTERS (Oct. 17, 2012, 7:18 AM), <http://www.reuters.com/article/2012/10/17/us-knightcapital-results-idUSBRE89G0HI20121017> (last visited Feb. 14, 2014) (“The net results included \$461.1 million in losses associated with the glitch on August 1, when Knight, one of the biggest

majority of the claims brought after the implementation of this Note's new approach were ultimately found to be meritless, NASDAQ would expend a vast amount of its resources proving that that is the case. This complaint is valid and potentially lethal to the approach proposed here.

While no perfect solution could be devised initially, the SEC and the SRO could monitor the claims as they come in and devise additional rules tailored to blocking the promulgation of meritless claims. In effect, this approach would statutorily provide for absolute immunity in specific instances or scenarios. This could be done in a fashion similar to NASDAQ's existing Stock Market Rules³⁰⁰ (the Rules), perhaps with detailed comments and examples to illustrate the Rules' application. NASDAQ's Stock Market Rules provide that, except as stated in Rule 4626(b), "Nasdaq and its affiliates shall not be liable for any losses, damages, or other claims arising out of the Nasdaq Market Center or its use."³⁰¹ Rule 4626(b) provides, in part, "Nasdaq . . . may compensate users of the Nasdaq Market Center for losses directly resulting from the systems' actual failure to correctly process an order, Quote/Order, message, or other data, provided the Nasdaq Market Center has acknowledged receipt of the order, Quote/Order, message, or data."³⁰²

Finally, while the national securities exchange would continue to function if the SRO that "operates and oversees" the exchange was bankrupted by the imposition of liability, given the explicit protection afforded to the national securities exchange's operating cost, the event could still result in severe damage to investor confidence and could undermine "macroeconomic

executors of stock trades in the United States, went live with new software that had been improperly installed.") (on file with the Washington and Lee Law Review).

300. NASDAQ Stock Market Rules, *supra* note 190, Rule 0115 (Applicability) ("These rules apply to all members and persons associated with a member."). The rules define a "member" or "Nasdaq Member" as "any registered broker or dealer that has been admitted to membership in Nasdaq." *Id.* at Rule 0120(i).

301. *See id.* at Rule 4626(b) (detailing that in some instances, liability is predicated upon "Nasdaq determin[ing] *in its sole discretion* that [a] systems malfunction or error was caused exclusively by Nasdaq" (emphasis added)).

302. *Id.* (emphasis added).

stability.”³⁰³ It is even possible that a year might not be enough time to figure out what action to take with respect to the national securities exchange. This is also a valid concern. The continued operation of the national securities exchange for at least a year, however, would most likely provide the required buffer to devise a workable solution for the future.

The new approach is not without fault. It can be fairly criticized as potentially rendering SROs such as NASDAQ vulnerable to a torrent of legal claims, many without merit. Removing the initial regulatory function hurdle should allow NASDAQ to more efficiently address such claims, however, enabling it to focus on the underlying claim or claims at issue. This approach also aligns the incentives of NASDAQ and its members appropriately: NASDAQ has a vested interest in acting as diligently as it can to avoid liability to its members in the future, an interest that correspondingly benefits NASDAQ’s members.

V. Conclusion

NASDAQ has two hats. Wearing its regulator hat, NASDAQ, acting pursuant to its quasi-governmental prosecutorial, adjudicatory, and regulatory functions, provides vital day-to-day regulation and administration of a national securities exchange. When wearing this hat, NASDAQ is absolutely immune from common law liability.³⁰⁴ NASDAQ may be liable for limited damages pursuant to its own Stock Market Rules, however.³⁰⁵ Wearing its corporate hat, NASDAQ, acting pursuant to its nongovernmental private business interests, is beholden to its 173 million shareholders.³⁰⁶ When wearing this hat, NASDAQ is fully liable for its actions.³⁰⁷

303. NASD Delegation Order, *supra* note 167; NASDAQ Proposal, *supra* note 17, at 45714.

304. *See supra* Part II.B.1 (providing examples of SROs being afforded absolute immunity for a variety of actions and upon a variety of claims).

305. *See supra* notes 300–02 and accompanying text (providing a brief description of NASDAQ’s Stock Market Rules, particularly Rule 4626 (Limitation of Liability)).

306. NASDAQ Annual Report, *supra* note 14, at 1, F-4.

307. *See supra* Part II.B.2 (providing examples of SROs being denied

The crux of NASDAQ's liability, therefore, depends upon which hat NASDAQ is wearing for a given action. This determination is relatively straightforward when NASDAQ is performing either its prosecutorial or adjudicatory function.³⁰⁸ Distinguishing between NASDAQ's nongovernmental private business interests and its regulatory function is incredibly problematic. Although a variety of vague tests exist to differentiate between the two functions, none are convincing in application, predictable for the parties involved, or an efficient use of scarce judicial resources.³⁰⁹ This problem is especially acute given the rapid pace of electronic trading, and the increasingly global and the increasingly significant position national securities exchanges, such as NASDAQ's, occupy.³¹⁰

The Facebook IPO is illustrative of this problem: due to NASDAQ's "system difficulties," roughly \$500 million in damages was incurred by major market makers and broker dealers in a matter of hours.³¹¹ Should NASDAQ face any liability for these "system difficulties"?

Given the vital role that SROs such as NASDAQ play in both the United States and global economy, the law cannot afford to be vague about whether NASDAQ's actions constitute a regulatory function and thus warrant absolute immunity, or constitute a private, for-profit business activity and are therefore exposed to liability. Which hat NASDAQ is wearing matters, and it matters a lot. Therefore, the SEC should not settle for the currently ambiguous state of the law with respect to determining when an SRO, such as NASDAQ, is acting pursuant to its regulatory

absolute immunity for a variety of actions and upon a variety of claims).

308. See *supra* notes 57–71 and accompanying text (providing examples of SROs afforded absolute immunity for actions taken pursuant to their prosecutorial and adjudicatory functions).

309. See *supra* Part II.B.3 (providing examples of the vague tests employed by the courts to determine if an SRO is acting pursuant to its regulatory function or nongovernmental private business interests).

310. See *What is NASDAQ?*, NASDAQ OMX (2013), <http://www.nasdaq.com/aboutus/whatisnasdaq/> (last visited Feb. 24, 2013) (stating that NASDAQ OMX Group is "the largest single liquidity pool for US equities and the power behind 1 in 10 of the *world's* securities transactions" (emphasis added)) (on file with the Washington and Lee Law Review).

311. See McCrank, *supra* note 8 ("Major market makers and broker dealers . . . lost upward of \$500 million in the IPO.").

function or its nongovernmental private business interests. The SEC should adopt the new approach presented here and remove the SRO's absolute immunity for actions taken pursuant to its regulatory function. The SEC should also require SROs such as NASDAQ and the NYSE to adopt a living will specifying the national securities exchange operating costs for the following year. That pool of money should be, unconditionally, entitled to absolute immunity. This method ensures the continuity of the national securities exchanges despite any liability imposed; preserves judicial resources by allowing the parties to litigate the heart of their claims against SROs initially; and aligns the SRO's incentives with their members—both of whom benefit from a diligent and risk-averse national securities exchange.