

## SELF-REGULATORY ORGANIZATIONS AND THE CONSTITUTIONAL PRIVILEGE AGAINST SELF-INCRIMINATION

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How does a self-regulatory organization (SRO), on the one hand, steer clear of being deemed a government actor (and subjects of SRO investigations thereby having Fifth Amendment protections) while, on the other hand, coordinating with a governmental authority enough to avoid duplication or disruption? The current state of the law is that a respondent has a fairly heavy burden to show that an SRO was in fact acting as a state actor, so that constitutional protections would apply to SRO investigations or disciplinary proceedings. Nonetheless, with the expansion of the jurisdiction (and disciplinary authority) of SROs to include market participants generally (i.e., members of the public who use their markets) and not just exchange members, the likelihood that a court might find an SRO to be a state

actor may have increased. This is especially the case given the increase in coordinated actions by government regulators, the Department of Justice (DOJ) and the SROs over the same conduct.

In general, the U.S. Constitution only regulates government conduct, and not that of private actors, with certain exceptions.<sup>1</sup> Assertion of Constitutional privileges, such as the privilege against self-incrimination in the Fifth Amendment, can only be made against a private entity if the entity is properly considered a state actor. With respect to SROs, courts generally have not viewed them as governmental agencies or state actors and have not granted the targets of SRO investigations a right to assert their Fifth Amendment privilege.<sup>2</sup> The justification for this treatment is that SROs are private membership organizations that police their members' conduct, and not governmental entities policing the general public. Nonetheless, an SRO can be subject to the Fifth Amendment if it engages in state action by becoming significantly involved with a government investigation. Significant involvement that would constitute state action only occurs when the nexus between the government and the challenged action by a private party is so close "that the seemingly private behavior may be fairly treated as that of the State itself."<sup>3</sup>

In determining whether such a close nexus exists, factors considered by courts include whether (1) the challenged activ-



ity results from the State's exercise of coercive power; (2) the State provides significant encouragement, either overt or covert; or (3) a private actor operates as a willful participant in joint activity with the State or its agents.<sup>4</sup> Moreover, the Supreme Court found in the *Brentwood* case that a private entity in charge of regulating and supervising interscholastic athletics in Tennessee was a State actor based on the government's "entwinement" with its activities.<sup>5</sup> The Court did not precisely define what constitutes "entwinement," but simply emphasized the close relationship between the Tennessee Athletic Association and the government.<sup>6</sup> After *Brentwood*, some courts have focused on whether "the state has so far insinuated itself into a position of interdependence with the private entity that it must be recognized as a joint participant in the challenged activity,"<sup>7</sup> or whether "the particular actions challenged are inextricably intertwined with those of the government."<sup>8</sup>

Specifically in the context of SROs, a leading case relied upon when a denial of the Fifth Amendment privilege is claimed is *United States v. Solomon*.<sup>9</sup> The case involved testimony by an officer of an NYSE member firm in an NYSE investigation that was used to indict him. In the criminal case, the defendant argued that the NYSE had become an arm of the government, so that the Fifth Amendment should apply and his testimony in the NYSE investigation should be excluded. In evaluating the Fifth Amendment claim, the Court of Appeals for the Second Circuit noted that "[m]ost of the provisions of the Fifth Amendment, in which the self-incrimination clause is imbedded, are incapable of violation by anyone except government in the narrowest sense."<sup>10</sup> The court concluded that the actions of the NYSE were those of a private body and not

the government, noting that "[t]his is but one of many instances where the government relied on self-policing by private organizations to effectuate the purposes underlying federal regulating statutes."<sup>11</sup>

Similarly, it has been held that the National Futures Association (NFA), the SRO for the futures industry, is not subject to the Fifth Amendment's privilege against self-incrimination when it conducts investigations for violation of its own rules,<sup>12</sup> and that NASD, the predecessor to FINRA—the SRO for broker-dealers—is not a government functionary.<sup>13</sup> Moreover, the SEC has repeatedly held that FINRA Rule 8210's requirement that persons associated with FINRA member firms provide information in response to FINRA's requests does not impinge on the privilege against self-incrimination.<sup>14</sup>

However, the SEC has recognized that an SRO may be acting as an agent for the government in some circumstances. For example, in *In re Frank P. Quattrone*, the SEC reversed and remanded an NASD ban against Quattrone for refusing to testify on Fifth Amendment grounds, holding that Quattrone had the right to present evidence that NASD's role in a joint investigation with the NYSE and SEC rendered its request for testimony state action.<sup>15</sup> Evidence that suggested a joint investigation rendering NASD a state actor included, among other things, written statements from the NASD that its investigation was part of a joint investigation with the SEC and that any resolution of the matter would need to involve all three regulators (i.e., NYSE, the NASD, and SEC Enforcement). In addition, there was Congressional testimony by the then-Director of SEC Enforcement indicating that the investigations were conducted jointly.

In *In re Ficken*,<sup>16</sup> the NASD barred Ficken from associating with any NASD member in any capacity based on his refusal to provide testimony, rejecting Ficken's assertion that NASD was a state actor because its staff had forwarded documents to the SEC and DOJ that were also investigating him. The SEC reversed and remanded, giving Ficken the opportunity to conduct discovery to prove his allegations of joint action between the NASD and SEC, since NASD had not provided such an opportunity. However, the SEC noted that "cooperation between the Commission and NASD will rarely render NASD a state actor, and the mere fact of such cooperation is generally insufficient, standing alone, to demonstrate state action."<sup>17</sup>

While the SEC remanded these cases to allow the respondents to develop the record on whether the SRO was a state actor, the SEC has stated that the burden of demonstrating joint activities to render an SRO a state actor is "high," and that burden "falls on the party asserting state action." In order to meet this burden, a respondent must demonstrate "a nexus between the state and the specific conduct of which the [respondent] complains."<sup>18</sup> The SEC concluded that the respondent in *In re Sassano* failed to demonstrate such a nexus, rejecting his assertions that the close chronology of discovery requests by the NYSE and SEC demonstrated such a nexus because there was no evidence that the SEC guided the NYSE's requests. The SEC found that the record merely showed that the investigations were conducted in parallel.<sup>19</sup> Sharing of information from the NYSE to the SEC in the form of written testimony of another witness similarly did not establish state action.<sup>20</sup>

These and other cases<sup>21</sup> show that there must

be more than just circumstantial evidence of coordination, such as close in time information requests, or sharing of information with the government, in order for an SRO to be considered a state actor. Evidence that may be considered sufficient would include written statements such as those cited in *Quattrone* suggesting a joint investigation. However, so long as neither the SRO nor the government make statements that their investigations are coordinated or otherwise demonstrate a nexus between their investigations, it is unlikely that a court would find the SRO to be a state actor subject to the Fifth Amendment. In light of the cases, it can be anticipated that SROs and the government will attempt to avoid or minimize making such statements, since obtaining testimony from individuals in SRO investigations is critical to their regulatory enforcement programs.

That said, a number of commenters have suggested that the status of SROs as state actors needs to be reexamined by the courts.<sup>22</sup> This seems particularly true in light of the expanded functions of SROs like FINRA and NFA, which perform a number of governmental functions delegated by the SEC and CFTC, respectively. While in the past justifications of denial of Fifth Amendment protections in the case of SROs often emphasized that SROs are self-regulatory and need to police their members, the authority of designated contract markets after the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act now extends far beyond policing their own members, but to members of the public who use their markets as well.<sup>23</sup> They thus may be deemed to be more like governmental entities in their regulatory functions rather than self-regulatory organizations. To be sure, procedural protections for respondents, such as

the right to counsel, are afforded under exchange rules and required by CFTC regulations,<sup>24</sup> but they do not allow for the privilege against self-incrimination. Notwithstanding their more “government-like” status, exchanges may contend that they have a right to effectively police their markets, and they should not in effect be penalized because the government has expanded their jurisdiction and made them appear more like governmental entities.

Even if despite these trends SROs may not be considered government actors, however, the increasing occurrence of contemporaneous investigations between SROs, regulators and the DOJ and the fact that SROs will share information they obtain with the government, seems to argue in favor of Fifth Amendment protections applying in SRO proceedings, especially if there is a likelihood that the person may be criminally prosecuted. Since SRO sanctions may include a permanent ban from the industry for failure to testify in addition to penalties, a respondent may feel compelled to testify because of the impact on his or her livelihood and not attempt to assert Fifth Amendment rights. In a few cases, the SEC and the courts have found that a permanent ban may be too severe a sanction for failure to testify,<sup>25</sup> but in general such permanent bars may be upheld. In practice, exchanges may decline to impose sanctions against a person who declines to testify if the exchange knows, for example, that a grand jury is investigating the same conduct, but they are not required to do so under the law.

In a related area not involving an SRO but a private entity, Gavin Black, a former Deutsche Bank trader, recently was convicted in October 2018 by a federal jury of wire fraud and conspir-

acy in connection with his alleged role in the manipulation of Libor rates.<sup>26</sup> Absent from the government’s case were statements Black had made to attorneys engaged by Deutsche Bank to conduct an internal investigation that the government ultimately elected not to have admitted in evidence.<sup>27</sup> At issue was the principle of the Supreme Court’s decision in *Garrity v. New Jersey*,<sup>28</sup> which protects a public employee from being coerced by the threat of termination of employment to make incriminating statements during an investigation by his employer (the government).

While *Garrity* involved a government employer, the principle has been extended to coercion by private employers, when the coercion is “significantly encouraged” by the government. In *United States v. Stein*,<sup>29</sup> the court suppressed statements that KPMG employees made to DOJ on the basis that the government was responsible for the pressure KPMG had put on its employees to talk with prosecutors (or be fired) such that their statements to DOJ could be considered compelled for purposes of the Fifth Amendment.

In the Black case, Black, then a Deutsche Bank employee, was interviewed by the bank’s attorneys who were conducting an internal investigation. Bank policy required employees to either cooperate with the internal investigation or find new employment, and Black believed he would be terminated if he did not agree to be interviewed. The interview was subsequently disclosed to the government in cooperation with its contemporaneous criminal investigation. Black moved to exclude the interview statements, maintaining that Deutsche Bank’s compulsion of his statements should be attributed to the government because the bank regularly received direc-

tion from DOJ in connection with interviewing bank employees, shared reports about what occurred during the interviews and received guidance from DOJ on how to conduct the interviews. Black also cited DOJ policy, which he argued pressured Deutsche Bank to conduct and disclose employee interviews to DOJ in order to obtain cooperation credit and that, because of this pressure, the government was responsible for compelling his statements. The court, while evidently somewhat persuaded by Black's arguments,<sup>30</sup> did not rule on the admissibility of Black's statements because the government ultimately decided not to submit them in evidence. Although the question of whether statements made to a nongovernmental investigator can be considered compelled for purposes of the Fifth Amendment was not decided,<sup>31</sup> the case suggests that there may be avenues for defendants to pursue in that context, which presumably could be extended to the case of an SRO investigation as well.

Thus, while it is unlikely under the current state of the law that an SRO will be found to be a state actor, in light of changes to the nature of SROs in recent years to be more government like as opposed to being purely self-regulatory bodies, the increasing occurrence of parallel investigations between SROs and the government, and the sanctions imposed by SROs for failure to cooperate including permanent bars, it is possible that a defendant may successfully persuade a court to reconsider whether an SRO is a state actor in a particular case and assert the Fifth Amendment privilege.

#### ENDNOTES:

<sup>1</sup>A handful of provisions in the Constitution, such as the 13<sup>th</sup> Amendment, apply to private

entities.

<sup>2</sup>See, e.g., *Jones v. S.E.C.*, 115 F.3d 1173, 1182-83, Fed. Sec. L. Rep. (CCH) P 99481 (4th Cir. 1997); *U.S. v. Solomon*, 509 F.2d 863, Fed. Sec. L. Rep. (CCH) P 94948 (2d Cir. 1975). See generally R. Karmel, Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?, 14 Stan. J. L. Bus. & Fin. 151 (2008-2009).

<sup>3</sup>*Brentwood Academy v. Tennessee Secondary School Athletic Ass'n*, 531 U.S. 288, 295, 121 S. Ct. 924, 148 L. Ed. 2d 807, 151 Ed. Law Rep. 18 (2001).

<sup>4</sup>Id. at 296.

<sup>5</sup>Id. at 298 (stating that “[t]he nominally private character of the Association is overborne by the pervasive entwinement of public institutions and public officials in its composition and workings, and there is no substantial reason to claim unfairness in applying constitutional standards to it.”).

<sup>6</sup>For example, the Court cited that 84% of the association's members were public schools, there was evidence that the state had traditionally delegated regulation of interscholastic athletics to the association; most of the association's funding was derived from member public schools; most of its meets were held on government property; and the government appointed non-voting members of the association's committees. Id.

<sup>7</sup>*Kirtley v. Rainey*, 326 F.3d 1088, 1039 (9th Cir. 2003). See generally R. Karmel, *supra* note 2 at 158 (2008-2009).

<sup>8</sup>*Mathis v. Pacific Gas and Elec. Co.*, 75 F.3d 498, 503, 11 I.E.R. Cas. (BNA) 564 (9th Cir. 1996).

<sup>9</sup>*U.S. v. Solomon*, 509 F.2d 863, Fed. Sec. L. Rep. (CCH) P 94948 (2d Cir. 1975).

<sup>10</sup>Id. at 867.

<sup>11</sup>Id. at 869.

<sup>12</sup>*Weinberg v. Commodity Futures Trading Com'n*, 699 F. Supp. 808, 814 (C.D. Cal. 1988), judgment aff'd, 884 F.2d 1396 (9th Cir. 1989).

<sup>13</sup>*D.L. Cromwell Investments, Inc. v. NASD*

*Regulation, Inc.*, 279 F.3d 155, 162 (2d Cir. 2002).

<sup>14</sup>See, e.g., *In the Matter of the Application of FRANK W. LEONESIO For Review of Disciplinary Action Taken by the NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.*, Release No. 3423524, 36 S.E.C. Docket 328, 1986 WL 625415 (1986).

<sup>15</sup>Exchange Act Release No. 53,547, 2006 SEC LEXIS 703 (Mar. 24, 2006).

<sup>16</sup>*In re Ficken*, Exchange Act Release No. 34-54,699, 2006 SEC LEXIS 2547 (Nov. 3, 2006).

<sup>17</sup>*Id.* at 11. See also *In re Warren E. Turk*, Exchange Act Release No. 55,942 (June 22, 2007)(a similar opportunity to prove state action in an NYSE proceeding where a specialist was barred for asserting the Fifth Amendment privilege).

<sup>18</sup>*In re Sassano*, Exchange Act Release No. 58,623 (Sept. 24, 2008).

<sup>19</sup>See also *D.L. Cromwell Investments, Inc. v. NASD Regulation, Inc.*, 279 F.3d 155, 162 (2d Cir. 2002)(declining to find that an NASD request for information constituted state action based on “the chronology of certain events” in simultaneous government and NASD investigations).

<sup>20</sup>See also *Scher v. National Ass’n of Securities Dealers, Inc.*, 386 F. Supp. 2d 402, 408 (S.D.N.Y. 2005)(finding, where an NASD investigator shared information with the district attorney’s office with which he once worked approximately one year after plaintiffs testimony, that “such collaboration,” which ultimately led to the plaintiffs criminal prosecution, does not in itself demonstrate that a “close nexus” existed between the challenged conduct of the NASD and a state actor).

<sup>21</sup>See, e.g., *In re Romano*, Exchange Act Release No. 76,011 (Sept. 24, 2015)(stating that it is well established that close timing of FINRA and government investigations by themselves do not establish state action).

<sup>22</sup>See, e.g., R. Karmel, *supra* note 2 and Note, *Is FINRA a State Actor? A Question that Exposes*

the Flaws of the State Action Doctrine and Suggests a Way to Redeem It, 67 Vand. L. Rev. 1173 (2014).

<sup>23</sup>See 17 CFR 38.151(a)(requiring that prior to granting any member or market participant access to its markets, a designated contract market must require that the member or market participant consent to its jurisdiction).

<sup>24</sup> See 17 CFR Part 38, Subpart N.

<sup>25</sup>See, e.g., *PAZ Securities, Inc. v. S.E.C.*, 494 F.3d 1059, 1062-63, Fed. Sec. L. Rep. (CCH) P 94437 (D.C. Cir. 2007) (remanding a case where the NASD had permanently barred an associated person for failing to respond to requests for information, where the SEC had affirmed the bar without addressing potentially mitigating factors, concluding that such a bar is the industry equivalent of capital punishment, and holding that the SEC was required to explain why such a severe sanction was remedial rather than punitive in light of mitigating evidence).

<sup>26</sup>*United States v. Black*, No. 1:16-CR-00370 (S.D.N.Y. Oct. 17, 2018).

<sup>27</sup>See J. Shur and E. Nitz, *Prosecutors Avoid Fifth Amendment Showdown in Libor Case*, Law 360 (Oct. 26, 2018).

<sup>28</sup>*Garrity v. State of N.J.*, 385 U.S. 493, 87 S. Ct. 616, 17 L. Ed. 2d 562 (1967).

<sup>29</sup>*U.S. v. Stein*, 440 F. Supp. 2d 315, 98 A.F.T.R.2d 2006-5581 (S.D. N.Y. 2006).

<sup>30</sup>See Shur and Nitz, *supra* n.27.

<sup>31</sup>Black filed motions to vacate his conviction and dismiss the indictment on the basis of prosecutorial misconduct and alleged violations of his constitutional rights, including the Fifth Amendment privilege, that are currently before the court as of this writing. In response, the government argued that Black did not show that his statements were coerced and, even if they were, the error was harmless because the government did not offer his statements at trial. See *United States’ Response to Defendant Gavin Black’s Motion for Kastigar Relief*, filed Feb. 4, 2019.