Law360: Stock Exchange Immunity Erodes As Biz Models Evolve

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Throughout the 20th century, the national securities exchanges were owned by their members and functioned strictly as self-regulatory organizations. Over the past decade, the exchanges have demutualized and are now publicly held, for-profit companies collectively generating billions of dollars in profits for their shareholders. Despite the fact that the exchanges are now profit-seeking commercial enterprises, they continue to argue that they are absolutely immune from suits arising from a wide range of competitive activity. Courts, however, are rejecting these arguments and are holding exchanges accountable where they are acting in their own interests, and not as delegates of theU.S. Securities and Exchange Commission.

Prior to demutualization, the exchanges successfully batted away lawsuits filed against them on the grounds that they were absolutely immune from such suits. In those cases, plaintiffs were typically challenging the exchanges' disciplinary adjudications, decisions to suspend trading or membership, or other conduct that clearly fell within their regulatory oversight role. Courts routinely held that such conduct is protected by absolute immunity. As one court has explained, "[t]he justification for this immunity is that Congress has enabled the SROs to perform 'a variety of regulatory functions that would, in other circumstances, be performed by a government,' and that the government would be immune when performing these functions."[1]

Prior to demutualization, courts did not usually undertake an in-depth analysis of the activity in question. Instead, in deciding that the exchanges were subject to immunity, courts generally focused on the fact that the exchanges were considered quasi-governmental entities that were delegated authority by the SEC under the Securities Exchange Act of 1934 or otherwise subject to the SEC rule-making process.

However, as the exchanges became commercial enterprises, the exchanges' competitive landscape, and their treatment by the courts, began to change. At the same time that the exchanges were demutualizing, the increase in multiple listing of securities, the development of electronic trading platforms, and the availability of nonexchange market venues forced exchanges to compete vigorously for order flow — not just with each other, but also with alternative trading systems. As one court recently pointed out, "[i]t cannot be disputed that exchanges are far more than backgrounds where trading takes place. They have evolved over time into entrepreneurial engines in their own right, sometimes competing with the members they seek to regulate. … In a post-2008 world, the notion that exchanges exist only to serve as neutral regulators would be considered extreme naiveté."[2]

As the exchanges have evolved, so has the case law on absolute immunity. Indeed, one court has questioned whether "SRO immunity would have put down such strong roots at a later point in American financial history."[3] As a consequence of the exchanges' new business model, the types of claims being brought against exchanges and SROs have changed. Although they still encounter actions relating to their disciplinary authority,[4] the exchanges are increasingly facing lawsuits arising from the manner in which they operate their markets and generate profits in an increasingly competitive landscape. Lawsuits have been filed against exchanges based upon a wide array of operational or commercial activities, including the sale of market data feeds and co-location services, the promotion of an initial public offering, the creation of an index fund, and the development and promotion of trading platforms and technology. The exchanges have attempted to characterize this operational and commercial activity as regulatory conduct on the grounds that these activities were subject to SEC rule-making and consistent with SEC regulations. However, courts are increasingly unwilling to conclude that the exchanges' conduct is related to their regulatory function and subject to absolute immunity.

The first major case in this evolution was the Eleventh Circuit's en banc opinion in Weissman v. Nasdaq.[5] In that case, the plaintiff alleged that the Nasdaq exchange had promoted the sale of WorldCom securities "in order to generate trading volume and income ...." The Eleventh Circuit concluded that Nasdaq's efforts to increase trading volume was a nongovernmental activity that served only the private business interests of the exchange.[6] The court concluded that immunity did not apply to Nasdaq's efforts to increase trading volume and profits.[7]

The Eleventh Circuit's decision was quickly followed by a district court decision in Opulent Fund LP v. Nasdaq Stock Market Inc.[8] In that case, the plaintiff alleged that Nasdaq negligently miscalculated the price of the Nasdaq-100, an index of 100 securities traded on Nasdaq. The court concluded that Nasdaq's creation and promotion of the Nasdaq-100 did not serve a regulatory function.[9] Rather, Nasdaq's actions "function to create a market and increase trading."[10] The court concluded that such actions are not entitled to immunity: The court distinguished actions such as suspending trading, banning traders or carrying out disciplinary actions, noting that those actions "all involve oversight of the market to protect investors."[11]

That courts are drawing a distinction between regulatory oversight and operational activity became even clearer in In re Facebook Inc. IPO Securities and Derivative Litigation.[12] There, different classes of investors brought both federal securities fraud and negligence claims against Nasdaq in connection with Facebook's initial public offering. The "negligence plaintiffs" accused Nasdaq of negligence in the design, testing and touting of its IPO-related technology and trading platform and in Nasdaq's decision not to halt trading during the IPO or cancel trades impacted by system issues.[13] The "securities plaintiffs" accused Nasdaq of failing to update pre-class period statements touting its technology and trading platform and making announcements regarding its decision to proceed with trading without disclosing the system issues it was encountering.

The court concluded that Nasdaq's decision not to halt trading, and its related public announcement, was protected by SRO immunity because the capacity to suspend trading is "a quintessentially regulatory function."[14] The court reached the opposite conclusion, however, with respect to the design, testing and touting of Nasdaq's technology. The court reasoned that "[t]he SEC has never engaged in the business aspects of facilitating and promoting IPOs or creating technology to increase trading, nor has Congress authorized it to do so."[15] To the contrary, "NASDAQ represents no one but itself when it entices investors to trade on its exchange."[16] Similarly, the court concluded that Nasdaq's failure to correct the statements regarding the reliability and capability of its trading platform is not regulatory conduct protected by immunity.[17]

Following Facebook, the exchanges faced a series of actions accusing them of favoring one class of investors over another. In In re Barclays Liquidity Cross and High Frequency Trading Litigation,[18] the plaintiffs accused multiple exchanges of giving an unfair advantage to high-frequency trading firms by offering certain products and services — proprietary data feeds, co-location services and complex order types — that gave those firms an unfair advantage over ordinary investors who could not afford to purchase the products or services. In Rabin v. Nasdaq OMX PHLX LLC,[19] the plaintiffs accused the exchange of implementing fee caps that allegedly favored large market makers over retail investors. In both cases, the district court held that the exchanges' conduct was regulatory and therefore immune.[20] These cases, however, had very different outcomes on appeal.

The Third Circuit issued a short, unpublished and nonprecedential opinion, declining to reach the issue of immunity, but affirming the district court's decision in Rabin on the grounds that the plaintiffs had failed to plead the elements of securities fraud.[21]

The Second Circuit, on the other hand, reversed the Barclays court, issuing an opinion (now restyled as City of Providence v. BATS Global Markets Inc.) with a lengthy analysis of the exchanges' alleged conduct and the application of SRO immunity. Largely adopting an amicus brief submitted by the SEC, the Second Circuit concluded that the exchanges were not immune from securities fraud claims arising from the exchanges' sale or offering of proprietary data feeds, co-location services and complex order types to high-frequency trading firms.[22]

The Second Circuit acknowledged that the SEC had approved rules pertaining to each of these products and services. Yet, even though the SEC actively regulated the conduct in question, the Second Circuit concluded that "the plaintiffs' claims do not involve any exchange conduct that we could properly characterize as regulatory."[23] The court reasoned that, "[w]hen an exchange engages in conduct to operate its own market that is distinct from its oversight role, it is acting as a regulated entity — not a regulator. Although the latter warrants immunity, the former does not."[24]

In its City of Providence decision, the Second Circuit made clear that, in deciding the immunity issue, courts are no longer focusing on whether the exchanges' conduct is subject to SEC approval or rule-making. Instead, courts are drawing a line between regulatory oversight activity (which is immune) and operational or competitive activity (which is not immune). But the Second Circuit and its sister courts are not alone in expressing concern over the exchanges' assertion of the immunity defense in the context of commercial activity.

Indeed, it appears that the exchanges' persistent assertion of the immunity defense for nonregulatory conduct, and the courts' consistent rejection of the exchanges' immunity defense, have finally caught the attention of the SEC itself. In a recent interview, Commissioner Robert Jackson noted that it is likely that the SEC will, in the near future, revisit the question of exchange immunity in order to ensure that the regulatory regime reflects the new reality that the exchanges are now for-profit enterprises.[25] "Exchanges cannot have it both ways," said Jackson, "they cannot keep profits for the private shareholders and then expect to be able to hurt people and not be held accountable. It is one or the other — either they are the government, or they are a private profit-making institution."[26] Jackson acknowledged that it is "time to take a hard look at exchanges."[27]

There does not appear to be any slackening in the number of actions being brought against exchanges, as reflected by the recent flurry of 26 class action complaints filed against theChicago Board Options Exchange, or Cboe, and its affiliates relating to the VIX volatility index derivatives.[28] Accordingly, one can expect that the distinction between immunized regulatory oversight and unprotected operational and commercial activity will continue to be further defined by the courts, and will remain high on the SEC's regulatory agenda.

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[1] In re Facebook Inc. IPO Sec. & Deriv. Litig ., 986 F. Supp. 2d 426, 449 (S.D.N.Y. 2013) (quoting Sparta Surgical Corp. v Nat'l Ass'n of Sec. Dealers, Inc., 159 F.3d 1209, 1213-15 (9th Cir. 1998)).

[2] Rabin v. Nasdaq OMX PHLX LLC , 182 F. Supp. 3d 220, 238 (E.D. Pa. 2016).

[3] Id.

[4] See, e.g., In re NYSE Specialists Sec. Lit., 503 F.3d 89 (2d Cir. 2007) (plaintiffs complained that exchanges failed to appropriately monitor and discipline member firms); O'Callaghan v. New York Stock Exchange, No. 11 Civ. 6331 (NRB), 2012 WL 3955968 (S.D.N.Y. Aug. 15, 2012) (plaintiff sued exchange and certain of its employees for a variety of claims purportedly arising out of disciplinary action against him); Shimoda-Atlantic Inc. v.Financial Industry Regulatory Authority Inc., No. 08-CV-5222, 2008 WL 2003160 (W.D. Ark. 2008) (plaintiff sued FINRA for allowing undercover

agents to obtain “bogus” registrations as representatives of “fictional” broker-dealers).

[5] 500 F.3d 1293 (11th Cir. 2007) (en banc).

[6] Id. at 1296; see also id at 1299 (“NASDAQ represents no one but itself when it entices investors to trade on its exchange.”).

[7] Id. at 1297.

[8] No. C-07-03683, 2007 U.S. Dist. LEXIS 79260 (N.D. Cal. Oct. 12, 2007).

[9] Id. at *14-15.

[10] Id. at *14.

[11] Id.

[12] 986 F. Supp. 2d 428 (S.D.N.Y. 2013).

[13] Id. at 450, 454, 457.

[14] Id. at 454.

[15] Id. at 452.

[16] Id.

[17] Id. at 456-57.

[18] 126 F. Supp. 3d 342 (S.D.N.Y. 2015).

[19] 182 F. Supp. 3d 220 (E.D. Pa. 2016).

[20] Id. at 239.

[21] Rabin v. Nasdaq OMX PHLX LLC , No. 16-2511, *9 (3d Cir. Oct. 3, 2017) (“We need not decide whether Exchange Defendants are immune or whether any claims are time-barred because Rabin’s pleading is incurably deficient.”).

[22] City of Providence, Rhode Island v. BATS Global Markets Inc., 878 F.3d 36 (2d Cir. 2017).

[23] Id. at 47.

[24] Id. at 48.

[25] Markets Media, “SRO Governance On The Block,” (Aug. 6, 2018).

[26] Id.

[27] Id.

[28] See, e.g., https://www.law360.com/article/1059634/cboe-accused-of-manipulating-vix-futures-in-antitrust-suit.