SHARPER AND BRIGHTER: FOCUSING ON SANCTIONS AT THE NEW YORK STOCK EXCHANGE

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The New York Stock Exchange is the world's leading marketplace for the trading of securities. Nearly 400 of the largest securities firms in America are members of this enterprise. With total balance sheet assets of approximately $4.3 trillion, these firms service 88 million customer accounts, representing 81 percent of all customer accounts handled by broker-dealers in America.

For the staff of NYSE Regulation Inc., the regulators who operate most closely to this marketplace, the regulatory view of the securities markets is refracted through a particular, and possibly unique, lens. The Exchange, whose functions the Division of Enforcement protects, is a venerable institution within the securities markets. For the success of this marketplace, as with any marketplace, it is as important that rules be enforced so trades can be facilitated. The Exchange has a vitally important regulatory role.

Recently, the Exchange has taken two important steps to increase clarity and transparency in the sanctions area. The Division of Enforcement has issued two Information Memos entitled "Cooperation," and "Factors Considered in Determining Sanctions." In these two memoranda, NYSE Regulation

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has addressed the process by which regulation will function in the unique environment of exchange self-regulation – a process tied closely to the realities and requirements of securities markets.

I.
ENFORCEMENT AND SANCTIONS AT THE NEW YORK STOCK EXCHANGE

To the Division of Enforcement of NYSE Regulation Inc. falls the task of dealing with the spectrum of misconduct that can relate to a brokerage firm: violations that range from deliberate chicanery, fraud in all its aspects, to malfeasance and nonfeasance.[1] In 2005, the Exchange prosecuted 196 cases. In 2006, between January and mid-September, the Exchange prosecuted 157 cases. In 97 of these disciplinary actions it imposed suspensions or bars, including 36 permanent bars. In this same period, the Exchange imposed 70 fines, amounting to a total of $22,886,666.[2]

In the spring and summer of 2006, the Exchange took action against broker-dealers that put at risk the proxy voting rights of their customers. These firms had over-voted in proxy polls – that is, submitted more proxy votes to tabulators for more shares than they were entitled to vote on such issues. This over-voting created the serious risk that their customers who held shares in street name might not have their proxy votes duly counted, and violated these shareholders' right, even in routine corporate elections, to have their voting rights duly supervised by the firm at which they held their shares.[3]

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1. Through March 7, 2006, disciplinary action within the ambit of the market historically identified as the New York Stock Exchange was the responsibility of the New York Stock Exchange, Inc., with this entity's Division of Enforcement delegated responsibility for investigation and prosecution of misconduct. Since March 8, 2006, such self-regulatory obligations have been held by New York Stock Exchange LLC, which has delegated these regulatory duties to NYSE Regulation, Inc., to which the Division of Enforcement belongs. Hereinafter, regulatory action "by the Exchange," except as specifically noted, will refer to regulatory action effectuated by either of these entities during the relevant time-frame for which it held the regulatory duty.

2. This does not include the Exchange's participation in a matter that resulted in the payment of $270 million in disgorgement. Prudential Equity Group LLC, H.B.D. 06-156, at 14 (N.Y. Stock Exch. Aug. 18, 2006).

3. Deutsche Bank Sec. Inc., H.P.D. 05-45, at 9 (N.Y. Stock Exch. Feb. 2, 2006) (censure and fine of $1 million); Credit Suisse Sec. (USA) LLC,

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In 2004 and 2005, the Exchange disciplined two major broker-dealers that had ignored a fundamental tenet of the modern securities market, the rule that a prospectus must be delivered to the customer purchasing a security.[4]

In 2003 and 2004, in *The Research Analyst Cases*,[5] the Exchange disciplined eleven brokerage firms that had allowed their investment banking business to improperly influence recommendations by their research analysts. These decisions publicized the discrepancy between the positive research reports issued on many "dotcom" stocks and the negative opinions privately held on the same stocks by brokerage analysts (most memorably expressed in doubtful, even sarcastic e-mails).

Beginning in 2002, in *The E-Mail Cases*, the Exchange disciplined five prominent broker-dealers for their failure to retain copies of e-mail communications.[6] Because of these oversights, messages by firm employees had been overwritten, re-

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H.P.D. 06-54, at 8 (N.Y. Stock Exch. Apr. 18, 2006) (censure and fine of $250,000); UBS Sec. LLC, H.P.D. 06-55, at 8 (N.Y. Stock Exch. Apr. 18, 2006) (censure and fine of $600,000); Goldman Sachs Execution & Clearing, L.P., H.P.D. 06-61, at 10 (N.Y. Stock Exch. May 4, 2006) (censure and fine of $500,000).

4. Merrill Lynch, Pierce, Fenner & Smith Inc., H.P.D. 05-87, at 6 (N.Y. Stock Exch. July 21, 2005); Morgan Stanley DW Inc., H.P.D. 04-184, at 4-5 (N.Y. Stock Exch. Dec. 9, 2004).

5. Bear, Stearns & Co., H.P.D. 03-63, at 2 (N.Y. Stock Exch. Apr. 22, 2003); Credit Suisse First Boston LLC, H.P.D. 03-64, at 2 (N.Y. Stock Exch. Apr. 22, 2003); Goldman, Sachs & Co., H.P.D. 03-65, at 1-2 (N.Y. Stock Exch. Apr. 22, 2003); Lehman Bros. Inc., H.P.D. 03-66, at 2 (N.Y. Stock Exch. Apr. 22, 2003); Merrill Lynch, Pierce, Fenner & Smith Inc., H.P.D. 03-67, at 2 (N.Y. Stock Exch. Apr. 22, 2003); J.P. Morgan Sec. Inc., H.P.D 03-68, at 2 (N.Y. Stock Exch. Apr. 22, 2003); Morgan Stanley & Co., H.P.D. 03-69, at 2 (N.Y. Stock Exch. Apr. 22, 2003); UBS Warburg LLC, H.P.D 03-70, at 2 (N.Y. Stock Exch. Apr. 22, 2003); U.S. Bancorp Piper Jaffray Inc., H.P.D. 03-71, at 2 (N.Y. Stock Exch. Apr. 22, 2003); Citigroup Global Mkts. Inc., H.P.D. 03-72, at 2-3 (N.Y. Stock Exch. Apr. 22, 2003); Deutsche Bank Sec. Inc., H.P.D. 04-128, at 2 (N.Y. Stock Exch. Apr. 22, 2003); Thomas Weisel Partners LLC, H.P.D. 04-129, at 2 (N.Y. Stock Exch. Apr. 22, 2003).

6. Deutsche Bank Sec., Inc., H.P.D. 02-223, at 3 (N.Y. Stock Exch. Nov. 15, 2002); Goldman, Sachs & Co., H.P.D. 02-224, at 3 (N.Y. Stock Exch. Nov. 15, 2002); Morgan Stanley & Co., H.P.D. 02-225, at 3 (N.Y. Stock Exch. Nov. 15, 2002); Salomon Smith Barney Inc., H.P.D. 02-226, at 3 (N.Y. Stock Exch. Nov. 15, 2002); U.S. Bancorp Piper Jaffray Inc., H.P.D. 02-227, at 3 (N.Y. Stock Exch. Nov. 15, 2002). *See also* Wachovia Capital Mkts, LLC, H.B.D. 06-150, at 2 (N.Y. Stock Exch. Aug. 1, 2006); Wachovia Sec., LLC, H.B.D. 06-

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cycled, discarded – even erased when an employee left the firm. *The E-Mail* Cases highlighted the importance of e-mail records to investigations and litigation in the corporate realm, and the Exchange has continued to discipline firms for failing to make or retain such records, particularly when this hampers enforcement efforts.[7]

As the above examples illustrate, the perennial challenge facing Enforcement is to do everyday cases, never forgetting that these matters have real impact on the lives of the individual investor, while at the same time bringing complex, industry-wide cases, involving widespread harm to thousands of investors and damage to the marketplace. Wrongdoing in the retail area of the securities industry can do a peculiar degree of harm to the marketplace. When a broker enters unauthorized trades, or churns an account to make commissions, or steers a customer into making unsuitable investments – to say nothing of the cases where a broker attempts to embezzle customer funds – the costs to the customer can be immediate and substantial. The same enforcement process must address both the high-finance problems of Wall Street and white-collar misconduct that can take place in a brokerage office on any Main Street.

Dealing with such a broad range of misconduct means finding the appropriate response to the violation committed. Enforcement work is, by its nature, reactive. Ideally, however, the Exchange would like to prevent misconduct. This means that the Enforcement staff has had to think hard about the sanctions that the Exchange imposes and their effect on misconduct, both past and future.

Recently the Enforcement staff undertook a review of all sanctions that the Exchange had imposed across the full panoply of violations. These cases ranged from one-customer cases involving sales-practice misconduct to industry-wide cases against large broker-dealers. This review was shaped by the recognition that the regulatory environment had changed dra-

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151, at 2 (N.Y. Stock Exch. Aug. 1, 2006); First Clearing, LLC, H.B.D. 06-152, at 2 (N.Y. Stock Exch. Aug. 1, 2006).

7. *See, e.g.*, Deutsche Bank Sec. Inc., H.P.D. 04-128, at 15-16 (N.Y. Stock Exch. Aug. 2, 2004); Advest, Inc., H.P.D. 04-179, at 2-3 (N.Y. Stock Exch. Nov. 23, 2004); H.D. Brous & Co., H.P.D. 04-188 (Dec. 15, 2004); J.P. Morgan Sec., Inc., H.P.D. 05-01, at 3-4 (N.Y. Stock Exch. Jan. 5, 2005).

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matically since 2000 and the awareness that the institutional structure of the marketplace had become and would remain a constant. The Enforcement staff compared the sanctions imposed by the Exchange to those of other regulators and examined the Exchange's sanctions in terms of their effectiveness, fairness and consistency. This penalty review has resulted in a sharper and brighter approach to sanctions.

In undertaking this assessment, Enforcement has been guided by the realization that *sanctions* does not mean simply *penalties*. Equally important has been the understanding that to think about sanctions is not merely to think about the last phase of an enforcement action. To consider sanctions means considering how the Exchange should rank offenses, and how the Exchange should determine which violations are more serious. To consider sanctions requires thinking about how the Exchange prioritizes its enforcement efforts. It extends to issues of proof and hearing procedure – consideration of how the Exchange resolves violations, whether by contested proceedings or through negotiated settlements. In the broader context, assessing sanctions means deciding whether a given violation should be analyzed as a single transaction involving individual wrongdoers or whether this misconduct represents a more systemic problem rooted in the corporate organization where those individuals are employed. Recognizing that the NYSE is working to regulate broadly across an industry, the Regulatory staff must consider when it makes sense to address a problem at one firm, and when to address a problem that may be common to many firms. Finally, to think about sanctions is also to think about transparency in the disciplinary process.

A "sharper" sanction is a sanction that has more of a sting to it. It means targeting sanctions more accurately and effectively, by dealing with the parties who are most fundamentally responsible for misconduct, even the senior management of a brokerage firm. To impose such sanctions means taking action that can and will change behavior by creating an incentive for firms to anticipate and avoid misconduct in the future. At the same time, to speak of a "brighter" approach reflects an understanding that the disciplinary process should be as transparent as possible. These related purposes are served by Enforcement's statements on cooperation and sanctions.

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II.
THE SANCTIONS CONTEXT: BARS, FINES, AND UNDERTAKINGS

The Exchange is authorized to employ a broad range of sanctions to pursue its regulatory goals. In the final analysis, any sanction that is appropriate to the conduct may be imposed. Generally, the Exchange has used two sanctions: bars and fines.

Under Exchange Rule 476(a)(11), the Exchange may impose "one or more of the following disciplinary sanctions":

- expulsion;
- suspension;
- limitation as to activities, functions, and operations, including the suspension or cancellation of a registration in or assignment of a stock;
- fines;
- censure;
- suspension or bar from being associated with any member organization;
- "or any other fitting sanction."[8]

That last phrase, "any other fitting sanction," as well as "the power to impose limitations," gives the Exchange ample latitude to take whatever action is needed to be effective.

For individual respondents, the Exchange has relied primarily upon bars from employment. This is partly out of a sense that removing a wrongdoer from the securities industry is a more meaningful sanction than a monetary fine. There is also a concern that to impose a fine might be misunderstood as allowing a respondent to buy his or her own way out of a sanction.[9] Thus, it is likely that the Exchange's default sanction will remain a bar.

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8. Even without the elastic clause that concludes this list of power, the power to impose "limitations" confers substantial flexibility in the determination of sanctions. *See* Valicenti Advisory Servs. v. SEC, 198 F.3d 62, 67 (2d Cir. 1999).

9. It has been suggested that the difference between a sanction and a price is that a sanction is "a detriment imposed for doing what is *forbidden*" while a price is a detriment that is accepted "in order to do what is *permitted*." Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523, 1524-25 (1984) (emphasis in original). To the extent that more categorical sanctions are available, it has been shrewdly suggested, "[f]ines condemn much more ambivalently . . . . [W]hen fines are used as a substitute for [stronger penalties], the message is likely to be that offenders' conduct is being priced

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Fines have been more generally employed against member firms. Fines can be readily assessed and efficiently collected. Monetary penalties are generally effective against such corporate entities.[10] In recent years, and particularly in securities enforcement proceedings and in federal criminal matters, fines imposed against corporate wrongdoers have been raised sharply, almost exponentially.[11] Here again, however, Enforcement has been working more frequently with other forms of sanctions – sanctions that, both in terms of their facts and in the language of the rule, may be more "fitting."

The Exchange has been making increased use of regulatory undertakings, particularly as a condition of settlement. An undertaking is an agreement that requires a member firm to make an assessment of its procedures and policies, and to make changes, where needed, to put itself into compliance with Exchange rules. Among the Exchange's recent prominent regulatory actions, undertakings were imposed in *The E-Mail Cases* and *Research Analyst Cases*, and have been employed in more recent cases on market timing and improper trading at the close of the market.[12]

In some regulatory cases, the undertaking may be more important than the fine. Frequently, the undertaking requires a corporate respondent to hire a consultant to prepare a report – to solve the problem and institute new procedures – and then to follow through to be sure that the procedures that

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rather than sanctioned." Dan M. Kahan, *What Do Alternative Sanctions Mean?*, 63 U. CHI. L. REV. 591, 621 (1996).

10. Professor Coffee has perceptively quipped that "[t]he literature on corporate sanctions sometimes seems to consist of little more than the repeated observation that the fines imposed on convicted corporations have historically been insignificant." John C. Coffee, *"No Soul to Damn: No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 388 (1981).

11. In the first decade of cases dealt with under the Federal Sentencing Guidelines relating to organizations, in approximately 1,500 cases where sentences were imposed, $2.3 billion in fines and nearly $279 million in restitution payments were imposed. Diana E. Murphy, *The Federal Sentencing Guidelines for Organizations: A Decade of Promoting Compliance and Ethics*, 87 IOWA L. REV. 697, 709 (2002).

12. Merrill Lynch, Pierce, Fenner & Smith Inc., H.P.D. 05-27, at 12-13 (Mar. 7, 2005); Lehman Bros. Inc., H.P.D. 05-108, at 7 (N.Y. Stock Exch. Sept. 29, 2005).

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have been put in place actually work. Dollar per dollar, this may be more costly than a fine.

More importantly, an undertaking may be more *effective* than a fine. An undertaking provides the opportunity for targeting sanctions to deal with specific problems at individual member firms. Where it is important to change Firm behavior, an undertaking offers a way to ensure that a Firm looks into the problems that caused a violation. With a fine, a Firm may be able to pay money and put to one side the underlying problem. However, when subject to a regulatory undertaking, a Firm is obligated to pay closer attention. An undertaking is likely to ensure that a firm has fewer violations in the future.

Recently, the Exchange resolved an enforcement matter with one of its specialists and his specialist firm.[13] In this matter, the undertaking that the specialist firm accepted was more important than the rest of the sanction. The violations involved trading that was not consistent with the obligation to maintain a fair and orderly market. This was the most recent of a series of violations by the Firm and its individual specialists. Such a record clearly indicated that the supervision systems in place at the firm were inadequate. The Exchange imposed a monetary fine on the Firm and on the individual specialist. The undertaking required that the Firm conduct a review of its policies for supervising its specialists and for controlling its trading on the Floor. This was an action that focused directly on the area where procedures and controls were lacking. In this context, such a detailed and case-specific sanction can be expected to have more impact than the fine. It represents a sanction calculated to change behavior and prevent future violations.

III.
SELF-REGULATION AND ITS OBLIGATIONS

As a self-regulatory organization, the Exchange has power delegated from the Securities and Exchange Commission, under the Securities Exchange Act of 1934, to enforce the federal securities laws. Under Section 6 of the Exchange Act, the

13. Genna, H.P.D. 05-54, at 4 (N.Y. Stock Exch. Apr. 21, 2005) ($50,000 fine against individual specialist); SIG Specialists, Inc., H.P.D. 05-55, at 4 (N.Y. Stock Exch. Apr. 21, 2005) ($100,000 fine and regulatory undertaking against specialist firm).

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Exchange has the statutory obligation to implement and enforce rules that are designed "to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade. . . and, in general, to protect investors and the public interest."[14]

The regulatory requirements imposed by the Exchange Act are substantial. Nonetheless, long before the Exchange Act became effective, the Exchange held the power to discipline its members. This power was conferred as long ago as March 8, 1817, in the first Constitution adopted by the Exchange.[15] Thus, for almost 200 years, the Exchange has been

14. Securities Exchange Act of 1934 § 6(B)(5), 15 U.S.C. § 78f(b)(5) (2000). Since 1975, the Exchange has been defined as a self-regulatory organization ("SRO"). Securities Exchange Act of 1924 § 3(a)(26), 15 U.S.C. 78c(a)(26) (2000). As of March 8, 2006, in connection with the merger of the New York Stock Exchange, Inc. and Archipelago, Inc., the overall corporate structure of the resulting businesses reflected the following structure. A single publicly-held holding company, NYSE Group, Inc. (organized as a for-profit corporation under Delaware law) holds, as a wholly-owned subsidiary, New York Stock Exchange LLC (organized as a limited liability company under New York law). NYSE Group is also the parent company of a second national securities exchange, the Pacific Exchange (held through Archipelago). New York Stock Exchange LLC is the entity registered as a national securities exchange under Section 6 of the Exchange Act, with responsibility for the Exchange's work as an SRO. The Rules of the New York Stock Exchange, Inc., providing for self-regulation under Section 6 of the Exchange Act, became the Rules of the New York Stock Exchange LLC. The New York Stock Exchange LLC is in turn the parent of two entities organized as not-for-profit organizations under New York law, NYSE Market, Inc. and NYSE Regulation, Inc. To NYSE Regulation, Inc. have been delegated the regulatory functions of New York Stock Exchange LLC. The delegation of regulatory functions to NYSE Regulation, Inc. is subject to certain provisions designed to ensure the ability of the New York Stock Exchange LLC to comply with its obligations as a self-regulatory organization and to maintain the ability of the Securities and Exchange Commission to ensure effective oversight of those obligations. *See generally* New York Stock Exchange, Inc., Order Granting Approval of Proposed Rule Change, Exchange Act Release No. 53,382, 71 Fed. Reg. 11,251 (Feb. 27, 2006).

15. The Constitution of 1817 provided for fining members for various infractions and declared that any member who did not comply with Exchange rules could be expelled with a two thirds vote of the membership. NEW YORK STOCK EXCHANGE BOARD CONST. arts. 4, 10, 14, 15 (1817). An additional article, adopted a week later, provided that any member convicted of making a fictitious sale would be expelled. NEW YORK STOCK EXCHANGE BOARD CONST. art. 18 (1817). A history of the early years of New York securities market, and the regulatory efforts which can be identified even in this early era, is found in WALTER WERNER & STEVEN T. SMITH, WALL

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responsible for "maintaining high standards of commercial honor and integrity among its members, promoting and inculcating just and equitable principles of trade."[16]

The rights and duties defined by participation in the Exchange community have long provided the context in which the Exchange has functioned – first as a voluntary, unincorporated association, and subsequently as a not-for-profit enterprise.[17] The responsibilities of participation have meshed seamlessly with the oversight exercised by the Exchange's central structure. Those who participate in the Exchange community thereby take up the responsibilities of participating in the self-regulatory process. Employees of member firms share in the obligations of belonging to the Exchange community. An individual who seeks employment as a stockbroker with a member firm of the Exchange (a "registered person" in the language of the Exchange Act) signs a registration application. The last paragraph of this form provides that the applicant submits to Exchange jurisdiction and agrees to comply with the Exchange Rules.

In keeping with these principles, the courts have consistently upheld disciplinary action by the Exchange or other regulatory institutions in the securities or commodities areas. In these decisions, whether they date from 2004 or from 1904, a common thread is that an exchange has authority to impose

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STREET (1991). *See also* ROBERT SOBEL, THE BIG BOARD: A HISTORY OF THE NEW YORK STOCK MARKET (1965).

16. *See, e.g.*, NEW YORK STOCK EXCHANGE, INC. CONST. art. I, § 2(a) (2005). That membership in the securities community is bound up with the obligation to pursue "just and equitable principles of trade," one of the principles mandated in the Exchange Act, was first set forth by the Exchange Constitution of 1902.

17. Under the Exchange's present structure, the concept of membership continues to play a defining role in measuring the obligation of participation in the Exchange. There continue to be "members" and "member organizations" of the New York Stock Exchange. Such members and member organizations are comprised of (1) organizations that obtain Trading Licenses in accordance with the rules of New York Stock Exchange LLC (including the rules of eligibility applying to those who wish to be a member or member organization) and (2) broker-dealers that agree to submit to the jurisdiction and rules of New York Stock Exchange LLC, without obtaining a Trading License and without having rights to directly access the trading facilities of NYSE Market. New York Stock Exchange, Inc., Order Granting Approval of Proposed Rule Change, Exchange Act Release No. 53,382, 71 Fed. Reg. 11,251, 11,255 (Feb. 27, 2006).

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discipline because the respondent, the individual whose misconduct is in question, chose to join the exchange community and assume the responsibilities of participation.[18]

Following the passage of the Exchange Act, the Exchange became a participant in the federal regulatory framework for securities. The 1975 amendments to the Exchange Act enhanced and "federalized" its role. Although the Exchange plays a crucial role in the overall regulation of the securities markets under the oversight of the Securities and Exchange Commission, the Exchange retains its own identity, authority, and separate legal character. It is not a "state actor" or government entity.[19] As the federal courts and the SEC have repeatedly affirmed, "no self-regulatory organization, including the NYSE, is an agency of the United States government."[20]

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18. Decades before the federal government essayed regulation of the securities industry, the Exchange had put into place a regulatory framework whose essential features remain familiar today. In the seminal case of *Cohen v. Thomas* the court affirmed both the Exchange's regulatory purpose and its members' assent to its regulatory oversight:

The Exchange is a voluntary association of individuals, who have agreed to be bound, as to their several interests, rights, privileges, and duties, by the provisions of a constitution and of by-laws . . . . They have invested the Governing Committee with the powers of government and the Committee's decision, after the trial of a member for an offense under its laws, is final.

Cohen v. Thomas, 103 N.E. 708, 709 (N.Y. 1913). Courts have consistently reaffirmed that the Exchange has the authority to rule on action involving its members or those who are employed by its member firms, based on their voluntary submission to its discipline. Recently, in *D'Alessio v. SEC*, the Court of Appeals for the Second Circuit reiterated the point: D'Alessio, by becoming an Exchange member, "voluntarily submitted himself to the discipline of what is largely a self-regulating association."

D'Alessio v. SEC, 380 F.3d 112, 123 (2d Cir. 2004) (quoting Markowski v. SEC, 34 F.3d 99, 105 (2d Cir. 1994)); *See also* Gold v. SEC, 48 F.3d 987, 993 (7th Cir. 1995); Valentino, Exchange Act Release No. 49,255, 2004 SEC LEXIS 330, at *13-*14 (Feb. 13, 2004) (when employee "registered with NASD, she agreed that she understood and consented to abide by its rules.").

19. The leading decision on this point remains United States v. Solomon, 509 F.2d 863, 869 (2d Cir. 1975). *See also In re* Colin, Hochstin Co., 41 B.R. 322, 324 (Bankr. S.D.N.Y. 1984) (NYSE not "government instrumentality" under Bankruptcy Code); D.L. Cromwell Invs., Inc. v. NASD Regulation, Inc., 279 F.3d 155, 162 (2d Cir. 2001) (citations omitted).

20. Kobey, Exchange Act Release No. 31,630, 53 SEC Docket 151, 153 n.4 (Dec. 22, 1992), (citing Cotzin, 45 S.E.C. 575, 578 (1974)). In a very recent ruling, Quattrone, Exchange Act Release No. 53,547, 2006 SEC LEXIS 703, at *22 (March 24, 2006), the SEC took care to reiterate this point. The Com-

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Belonging to a self-regulating organization places certain affirmative obligations upon those who take part. Any person who has joined the Exchange community is under positive duties to obey the Exchange Rules, report misconduct, and cooperate in Exchange proceedings.

IV.
DISCIPLINARY SANCTIONS AND THE REGULATORY PROCESS

The sanctions that the Exchange imposes are also shaped by the unique nature of the disciplinary process as a self-regulating organization. The proceedings before the Exchange's Hearing Board are not meant to be "formalistic tribunals." Exchange self-regulation is meant to operate better by being closer to the facts of the marketplace. In providing for disciplinary action by self-regulating organizations, the SEC believes, Congress "clearly" did not intend

> "to create formalistic tribunals akin to the courts or even to this Commission. Self-regulation or cooperative regulation necessarily calls for informality. In such a program businessmen bring their knowledge of trade practices to bear on a case. They make their decisions 'in the light of their experience as technicians in the securities markets rather than as lay jurors or legalistic judges.'"[21]

One of the outcomes of this approach is that the sanction imposed in any Exchange proceeding is a determination grounded in a case-by-case response to the facts of an individual respondent's violations.[22] The SEC has frequently stated

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mission ruled that the National Association of Securities Dealers should not have used summary procedures to deny a non-cooperating respondent the opportunity to prove, via a hearing, that NASD action and SEC action were so closely coordinated as to make the NASD, for this purpose, a state actor. Carefully circumscribing any substantive reading of this decision, the SEC specifically cautioned that "Applicable law indicates that cooperation between the Commission and NASD will rarely render NASD a state actor, and the mere fact of such collaboration is generally insufficient, standing alone, to demonstrate state action." *Id.*

21. Cotzin, Exchange Act Release No. 10,850, 4 SEC Docket 420, 422 (June 12, 1974) (citing Nat'l Ass'n of Sec. Dealers, 17 S.E.C. 459, 468 (1944).

22. Likewise, decisions by federal courts establish that sanctions applied by the Exchange and confirmed by the SEC can only be overturned if they are "unwarranted in law . . . or without justification in fact." *Markowski*, 34

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that the "proper" sanction in any case "depends on the unique facts and circumstances of each case, and it cannot be determined by comparison with other cases."[23] This offers a reminder that securities regulation is a subset of administrative law, and that administrative tribunals are directed and empowered primarily to resolve factual issues rather than make legal decisions.[24]

At the same time, the SEC has sometimes noted, approvingly, that a sanction in a particular case was consistent with results reached in other cases.[25] Similarly, within the perimeter of Exchange regulatory action, in Hearing Board rulings and appeals that have been decided by the Exchange Board,

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F.3d at 105 (citing Butz v. Glover Livestock Comm'n Co., 411 U.S. 182, 185-86 (1973)). *See also D'Alessio*, 380 F.3d at 123; McCarthy v. SEC, 406 F.3d 179, 188 (2d Cir. 2005).

23. *See* Davrey Financial Services, Inc., Exchange Act Release No. 51,780, 2005 SEC LEXIS 1288, at *12-*13 (June 2, 2005); Kwiatkowski, Exchange Act Release No. 48,707, 2003 SEC LEXIS 2568, at *26-*27 (Oct. 28, 2003). A primary authority for the Commission's stand on this matter is *Butz*, 411 U.S. at 187-88 (reiterating case-focused approach of administrative proceedings). The specific statutory standard by which Exchange regulatory action is judged focuses closely on factual matters. Under Section 19(e) of the Exchange Act, disciplinary action by the Exchange will be upheld by the SEC if the Commission finds that (a) the respondent engaged in the acts in which the NYSE found him to have engaged; (b) that the respondent's acts violated the statutory provisions which the Exchange polices (the Exchange Act, the federal securities regulation under the Exchange Act, or the Rules of the Exchange); and (c) that the Exchange applied these provisions consistent with the purposes of the Exchange Act. The SEC must also determine that the Exchange's sanction is not anti-competitive, excessive, or oppressive. Securities Exchange Act of 1924 § 19(e)(2), 15 U.S.C. § 78s(e)(2) (2000).

24. Not infrequently, in appeals to the SEC, respondents have argued that the sanctions imposed on them by self-regulatory organizations are excessive or oppressive. The great majority of these claims are found to lack merit – particularly where the disciplinary decision by the self-regulatory organization develops thoroughly the facts that support the sanction. *See, e.g.*, SIG Specialists, Inc., Exchange Act Release No. 51,867, 2005 SEC LEXIS 1428, at *31 (June 17, 2005) (sanction upheld where specialist's failure to uphold fair and orderly market violated central responsibility of specialist function and impaired essential price-determination function of market); Lu, Exchange Act Release No. 51,047, 84 SEC Docket 2444, 2450 (Jan. 14, 2005) (sanction upheld as consistent with NASD guidelines, and where discussion identified specific factors aggravating offense).

25. *See, e.g.*, Wong, Exchange Act Release No. 45,426, 76 SEC Docket 2157, 2161-62 (Feb. 8, 2002) (upholding regulatory action by American Stock Exchange).

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"consistency with Exchange precedents" is one of the touchstones of a sanction's validity.[26]

On first consideration, these concepts may seem somewhat contradictory. In fact, these concepts are like differing harmonics of the same regulatory chord. A sanction should be consistent with precedent. However, *consistent with* does not mean *identical to.* Ultimately, the regulatory staff should analyze the facts of a case closely, and the sanction applied should relate appropriately to those facts. Where cases involve similar issues, the sanction in one case merits consideration in another matter, but resolving any case involves its particular facts and circumstances, in addition to analyzing precedent. Simply because a sanction was applied in one case, it should not be applied automatically in another case featuring a similar kind of violation.

The Exchange's enforcement proceedings are not criminal prosecutions and the Exchange does not impose criminal penalties. Their enforcement actions are intended to be remedial, not punitive.[27] The Second Circuit Court of Appeals, which handles much of the litigation in the securities markets, recently issued a terse rejoinder when it observed that the pur-

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26. *See, e.g.*, Deutsche Bank Sec. Inc., H.P.D. 05-45, at 1, (N.Y. Stock Exch. Feb. 2, 2006) (affirming facts found and imposing sanction set forth in settlement agreement on grounds that it was "reasonable and appropriate under the facts and circumstances of [the] case, is consistent with relevant precedent and is the product of voluntary and good faith negotiations by the parties."). Such decisions continue a steady series of precedents begun with Guice, H.P.D. 79-1, at 1 (N.Y. Stock Exch. Jan. 12, 1979), *rev'd*, N.Y. Stock Exch. Bd. of Dirs. (Apr. 5, 1979).

27. Disciplinary action by self-regulatory organizations has been found by the SEC to be generally civil and remedial, and not punitive. *See* Pac. On-Line Trading & Sec. Inc., Exchange Act Release No. 48,473, 81 SEC Docket 80, 84 n.21 (Sept. 10, 2003) (the "NASD's disciplinary proceedings are not criminal matters"); Wolny, Exchange Act Release No. 40,013, 67 SEC Docket 353, 357 (May 20, 1998) (self-regulatory organizations' procedures on statutory disqualification are civil in nature). Similarly, SEC proceedings and sanctions have been deemed civil and remedial and upheld against claims that they are punitive. *See, e.g.*, SEC v. Palmisano, 135 F.3d 860, 866 (2d Cir. 1998); Lincoln, Exchange Act Release No. 39,629, 66 SEC Docket 972, 975 (Feb. 9, 1998). Under a standard approved by the Supreme Court in Hudson v. United States, 522 U.S. 93, 100 (1997), and applied in *Palmisano* and *Lincoln*, an administrative sanction denominated as civil will only be invalidated where "the clearest proof" demonstrates that it is so punitive as to become a criminal sanction.

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pose of regulation is to protect investors, rather than to punish brokers.[28]

These types of concerns affect the disciplinary process at the Exchange, and even to shape the language in which Enforcement works. The Exchange does not frame its regulatory proceedings in terms of punishment. Exchange decisions and disciplinary actions are couched in terms of deterrence and remediation. Consistent with its role as a remedial organ, the Exchange's most important mandate is to provide investor protection – protection of the individual investor and more broadly of the market.[29]

One of the goals of investor protection is to deter misconduct. To this end, a central concern is to ensure Exchange sanctions have an adequate deterrent effect. During Enforcement's penalty review, when sanctions imposed by the Exchange were examined, concerns where raised that sometimes the sanctions imposed lacked the necessary deterrent effect. Certain respondents were repeatedly involved in the examination findings of the Division of Member Firm Regulation or investigations by the Division of Enforcement, leading to the obvious conclusion that previously imposed sanctions were insufficient to deter future misconduct. This is true for individuals and member firms.

Effective sanctions impose a penalty that individuals and brokerage firms will work hard to avoid. A sanction must be sufficiently sharp that it cannot be dismissed as simply another cost of doing business. Where misconduct has been serious, an appropriate sanction will probably have to be severe. A

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28. McCarthy v. SEC, 406 F.3d 179, 188 (2d Cir. 2005). Moreover, sanctions should not be applied in an unduly harsh or discriminatory manner. To prevail on a claim of improper selective prosecution claim, a respondent must establish that he was singled out for enforcement action while others similarly situated were not, and that his prosecution was motivated by arbitrary or unjust considerations such as his race, religion, or the desire to prevent his exercise of a constitutionally protected right. Such claims are not infrequently made but have not generally prevailed. Lu, Exchange Act Release No. 51,047, 84 SEC Docket 2444, 2448-49 (Jan. 14, 2005).

29. As the Supreme Court has written, "[T]he primary objective of the federal securities laws [is the] protection of the investing public and the national economy through the promotion of 'a high standard of business ethics . . . in every facet of the securities industry.'" Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 315 (1985) (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186-87 (1963)).

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sanction should be a memorable event; it cannot be punitive but must necessarily involve some hardship. This calls for care in calibrating the length of an individual's suspension or the amount of fine appropriate for a firm. For a respondent who has left the industry, a suspension of any length may have no meaning at all. For a stockbroker who is still working in the industry, a suspension of less than a month may be more of a vacation than a sanction. Particularly where sales practice misconduct has been serious, a suspension measured in months or years may be necessary. In some cases, a more tailored sanction may be more appropriate – but in any case, the facts of the individual case provide the standard by which the sanction must be measured.

There have been some cases in which a combination of plenary and specific bars may create the desired effect. For example, a respondent who had engaged in excessive options trading might be sanctioned with a plenary bar of three months and barred for a year from entering options trades.[30] The Exchange may also use more often the requirement that a respondent re-take and pass a licensing examination as a tool for re-education.

The combination of a suspension and monetary penalty may be the most fair and effective sanction available. However, where the Exchange imposes a fine, it is necessary that the Exchange have the will and the means to collect it, if a respondent fails to make a voluntary payment. At the same time, the Exchange must have a way to calibrate the fine so that it is appropriate to an individual respondent's means. By incorporating a waiver of indemnity into the settlement document, the Exchange can ensure that the respondent, and not

30. In Fall 2006, NYSE Enforcement took action against improper stock-lending transactions. In a trio of cases – *CIBC World Markets Corp.*, *Nandra Group Inc.*, and *Jonathan F. Gutman* – the Exchange fined the firms and barred two parties from future securities lending. CIBC World Markets Corp., H.B.D. 06-140, at 6 (N.Y. Stock Exch. Oct. 5, 2006) (censure and $200,000 fine); Nandra Group, Inc., H.B.D. 06-164, at 7-8 (N.Y. Stock Exch. Oct. 5, 2006) (censure, $75,000 fine, permanent bar from stock lending, and regulatory undertaking); Gutman, H.B.D. 06-165, at 7 (N.Y. Stock Exch. Aug. 24, 2006) (censure, three-month plenary suspension and successive one-year supervisory suspension, with permanent bar from stock lending, and regulatory undertaking).

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the member firm that employs him or her, is actually paying for the fine.

It is equally true that a sanction should be a memorably negative experience for a brokerage firm. It must provide an unmistakable alert. In imposing a sanction, the Exchange ought to get the attention of the Firm. The sanction must signal that misconduct carries consequences – that misconduct is not so minor a matter as to be excused by the simple writing of a check. A significant sanction will motivates firms to make lasting changes and put in place the sort of institutional safeguards that will keep the misconduct from happening again.

"Alternative" sanctions may also be employed with regard to member firms. For firms that do most of their business on the Trading Floor, a particularly meaningful sanction may the reallocation of a stock away from that firm. This has been done in the past, particularly where a Floor Firm's misconduct had involved trading violations in a specific stock.[31] Recently, the threat of reallocating stocks in which a Firm acted as a specialist was part of the sanction imposed to ensure that the Firm met its obligation to deliver e-mail records in an investment.[32] In certain cases, it may also be appropriate to bar a Firm from opening a new branch office or entering a certain line of business until specified conditions are met. The curtailing of a Firm's business activity is an action peculiarly well

31. *See, e.g.*, Gavin Benton & Co., H.P.D. 95-29, at 18 (N.Y. Stock Exch. Mar. 6, 1995); Fried, H.P.D. 78-82, at 7 (N.Y. Stock Exch. Nov. 1, 1978); Albert Fried & Co., H.P.D. 78-83, at 7 (N.Y. Stock Exch. Nov. 1, 1978); Michael, Bregman & Co., H.P.D. 77-16, at 5 (N.Y. Stock Exch. Apr. 26, 1977).

32. LaBranche & Co., H.P.D. 03-164, at 5 (N.Y. Stock Exch. Sept. 4, 2003), *aff'd*, N.Y. Stock Exch. Bd. of Dirs. (Apr. 1, 2004) (where specialist firm did not supply e-mail communications requested by NYSE Enforcement, should non-cooperation continue for two months following date of Hearing Panel Decision finding this to be a violation, firm's most active security would be reallocated, and should non-compliance continue, an additional security would be reallocated for each month of non-compliance). The SEC wields similar powers to impose "alternative" sanctions, through the use of temporary restraining orders, receiverships, and asset freezes. Barry W. Rashkover, *Reforming Corporations Through Prosecution: Perspectives from an SEC Enforcement Lawyer*, 89 CORNELL L. REV. 535, 537-38, 545 (2004).

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calculated to prevent further violations and draw attention to an area where supervision has been lacking.[33]

When the Exchange undertakes an investigation of an issue or practice that appears to be spread across the industry as a whole, the determination of an appropriate fine in these matters may not be strictly controlled by Exchange precedent. Particularly if there has been a total breakdown or lack of control in some area and multiple firms have engaged in similar violations there may be little advantage in seeking guidance from sanctions in old or tangentially relevant cases. To put it plainly, where the level of misconduct is unprecedented, Enforcement must look to factors beyond the existing precedents. In such matters, the Exchange may set a sanction measured by the actual value of the customer harm caused by the misconduct (to the extent this is readily quantifiable) and require firms to make customers whole by setting up a restitution fund. Alternatively, the Exchange may look at the actual profit earned as a result of the misconduct and require firms to disgorge such improper gains.

Monetary sanctions need not be fines in the most limited sense. Fines can also take the form of payments to be used for the improvement of the industry.[34] This includes purposes such as contributions to investor education funds, or the Independent Research fund established in *The Research Analyst Cases* by pooling contributions from the respondent firms. The Exchange has also used monies from fines to fund its regulatory program. This represents a more targeted way of assessing costs. Under this approach, those who violate the Exchange Rules and securities laws bear a larger portion of the costs of regulating the marketplace.

V.
THE COOPERATION AND SANCTIONS MEMOS

Recently, the Division of Enforcement issued two Information Memos designed to publicize the regulatory approach

33. As for example in the *Nandra* and *Gutman* cases, *supra* note 30, involving permanent bars from stock lending business.

34. Similarly, under Sec. 308 of the Sarbanes-Oxley Act of 2002, penalties imposed by federal regulators no longer always go to the Treasury; such penalties may be added to funds disgorged by corporate wrongdoers, for the additional benefit of those injured by the misconduct. *See* Sarbanes-Oxley Act of 2002 § 308(a), 15 U.S.C.A. 7246(a) (2006).

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on two critical areas of the disciplinary process. The first of these is Exchange Information Memo 05-65, on "Cooperation" ("the Cooperation Memo"), released September 14, 2005.

A. *Cooperation with the Exchange: Information Memo 05-65*

At the Exchange, cooperation is taken very seriously. All persons and firms within the Exchange community, as spelled out in Exchange Rule 476(a), have the obligation to cooperate with investigations conducted by the Exchange. This is where the fact of the duty of Exchange participants to cooperate in the self-regulatory process assumes a particular importance.

In October 2001, the SEC published its widely-noted Commission Statement on the Relationship of Cooperation to Agency Enforcement Decision, a document that has customarily been referred to as the Seaboard Decision.[35] In this report, which explained why the SEC had not taken disciplinary action against a corporation that had employed certain individuals who had engaged in violations of the securities laws, the SEC addressed what it saw as cooperation.[36] Stephen M. Cutler, the former head of enforcement at the Securities and Exchange Commission, has also highlighted the SEC's focus on cooperation, when discussing factors considered by the

35. Commission Statement on the Relationship of Cooperation to Agency Enforcement Decision, Exchange Act Release No. 44,969, 2001 SEC LEXIS 2210 (Oct. 23, 2001). *See also* Rashkover, *supra* note 32, *passim.*

36. These factors included the following: whether the firm's highest authority responded to reports of misconduct by making full, immediate disclosure to the government and market; whether the firm took put in place revised, augmented procedures to prevent recurrence of misconduct; the nature of the misconduct, on a spectrum of scienter ranging from inadvertence and "honest mistake" to willful misconduct and "unadorned venality"; how the misconduct arose; where in the organization the misconduct occurred, what attitude management took toward it, and whether it was systemic or isolated; how long the misconduct lasted and what enduring effect it had; the extent of the misconduct upon investors; how the misconduct was detected; what response the company took, what procedures it employed in responding, and how rapidly an effective response was implemented; how seriously the firm committed itself to investigating fully; whether the firm made available to regulators the results of its investigations and documented its findings; what assurances were there that the misconduct will not recur; and whether the firm's corporate culture or legal identity had changed. *See* Commission Statement on the Relationship of Cooperation to Agency Enforcement Decision, Exchange Act Release No. 44,969, 2001 SEC LEXIS 2210, at *5-*9 (Oct. 23, 2001).

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Commission in determining the appropriate level of sanctions. This list of factors emphasized the extent of cooperation by a violator, "which will often prove decisive in our analysis."[37]Given the SEC's statements in this area – and in light of the heightened obligation that members of the Exchange have to cooperate with investigations conducted by the Exchange – Enforcement felt that it was important to address cooperation separately, and has done so in this Information Memo.[38]

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37. Stephen M. Cutler, Remarks at the 24th Annual Ray Garret Jr. Corporate & Securities Law Institute (Apr. 29, 2004), *available at* http://www.sec.gov/news/speech/spch042904smc.htm. Also cited as factors considered by the Commission were the following: an offender's prior record of discipline (with recidivism aggravating an offense and supporting higher sanctions); professional expertise (with sophistication or professional training requiring a higher sanction for an offense whose nature was clear); receipt of profit from the wrongdoing; the seniority of an employee; and the duration of an offense.

38. The National Association of Securities Dealers in 1998 approved a two-tiered system of "general principles" and 19 "principal considerations" to be used in setting sanctions in the NASD's regulatory sphere. In January 2003, in the document known as the Thompson Memorandum, the United States Department of Justice set forth a series of considerations for federal prosecutors to take into account when deciding whether to charge business organizations with misconduct, a fairly comprehensive list of sanctions standards, fairly applicable to individual as well as corporate defendants. Memorandum from Larry D. Thompson, Deputy U.S. Attorney General to Heads of Dep't. Components & U.S. Attorneys, Principles of Federal Prosecution of Business Organizations (Jan. 20, 2003), *available at* http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm. More recently, the North American Securities Administrators Association (NASAA) has prescribed a similar series of criteria. *See* NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION PRINCIPAL CONSIDERATIONS FOR REGULATORY ACTION (2005), *available at* http://www.nasaa.org/Industry___Regulatory _Resources/Broker_Dealers/3762.cfm. The SEC returned to the area in January 2006, with a release accompanying two settlements. *See* SEC Sues McAfee, Inc. for Accounting Fraud, Litigation Release No. 19,520, 2006 SEC LEXIS 2 (Jan. 4, 2006); Press Release, SEC, Statement of the Securities and Exchange Commission Concerning Financial Penalties, SEC Press Release 2006-04 (Jan. 4, 2006), http://www.sec.gov/news/ press/2006-4.htm. In *McCarthy v. SEC*, the Second Circuit approved consideration of several specific factors to be considered in assessing the validity of a sanction. On remand, the court held the SEC should weigh such factors as the following: The seriousness of the offense, the corresponding harm to the trading public, the potential gain to the broker for disobeying the rules, the potential for repetition in light of the current regulatory and enforcement regime, and the deterrent value to the offending broker and others are all relevant factors to be considered in decid-

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The Cooperation Memo, thus, discusses what is "Required Cooperation," and then examines what might be considered "Extraordinary Cooperation."

B. *The Duty to Cooperate*

The duty to cooperate is one of the most important duties that a person assumes when joining the Exchange community. The duty is unqualified, and exists independently of state or federal law. The Exchange lacks subpoena power, and has to rely upon cooperation from firms and individuals to supply the information and records that it needs to police the marketplace. In a consistent series of decisions, the Exchange has driven home this point. It has repeatedly emphasized that a respondent has the obligation to cooperate in the process of industry self-regulation:

> Effective self-regulation depends upon the Exchange's ability to conduct thorough and complete investigations of alleged wrongdoing by those subject to its jurisdiction. Those having possible knowledge of such wrongdoings may not frustrate an investigation by failing to cooperate; and the Exchange's rules plainly provide for discipline for non-cooperation.[39]

Very significantly, the duty to cooperate is not limited by any right against self-incrimination. An individual who does not testify in an Enforcement proceeding can be barred from employment in the Exchange community. This is irrespective of whether the respondent wants to avoid testifying on the grounds that his or her testimony might be used against him in a court of law. This is one of the Exchange's oldest requirements, as a regulator – going back a century – and one of the best-established. It is well settled, on the authority of the seminal case of *United States v. Solomon*,[40] that the Fifth Amendment privilege against self-incrimination is not available and may not be asserted in connection with investigations conducted by the Exchange.[41]

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ing whether the sanction is appropriately remedial and not excessive or punitive. McCarthy v. SEC, 406 F.3d 179, 190 (2d Cir. 2005).

39. *See* Goldsmith, H.P.D. 96-60, at 2-3 (N.Y. Stock Exch. July 26, 1996).

40. United States v. Solomon, 509 F.2d 863 (2d Cir. 1975).

41. In *Solomon*, the question was persuasively and decisively addressed. Because of the Exchange's continuing duty to perform "the traditional pro-

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When an investigation is underway, the respondent must give full and timely responses to all Exchange requests, and not use delay as a litigation tactic. A respondent cannot put conditions on his or her cooperation. In *Richard Neuberger*, the seminal Exchange ruling on this matter, the Hearing Panel wrote:

> [T]he method, order, direction and scope of an investigation [by the Exchange] are not matters within the control of a respondent. . . . *They are matters that must remain within the discretion of the Exchange in meeting its self-regulatory obligations.*[42]

In this context, the Cooperation Memo keys closely into the case-law that addresses failure to cooperate.

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cess of self-regulation," the Court of Appeals for the Second Circuit found (in an opinion by Judge Friendly), "interrogation by the New York Stock Exchange in carrying out its own legitimate investigative purposes does not trigger the privilege against self-incrimination." *Id.* at 867, 869. The doctrine established by *Solomon* has been consistently followed. *See, e.g.*, Scher v. Nat'l Assoc. of Sec. Dealers, 386 F. Supp. 2d 402 (S.D.N.Y. July 4, 2005); D.L. Cromwell Invs. Inc. v. NASD Regulation, 279 F.3d 155 (2d Cir. 2002), *cert. denied*, 537 U.S. 1028 (2002). Among the numerous Exchange precedents following this holding are the recent representative decisions in William Edward Glass, H.P.D. 04-176, at 2 (N.Y. Stock Exch. Nov. 17, 2004) and Jamie Allen Zimmerman, H.P.D. 03-185, at 2 (N.Y. Stock Exch. Oct. 2, 2003). In *Quattrone*, Exchange Act Release No. 53,547, 2006 SEC LEXIS 703, at *17-*19 (Mar. 24, 2006), the SEC held that, where a respondent alleges specific facts supporting a claim that a self-regulatory organization has participated in a joint investigation with government authorities, the self-regulatory organization should not dismiss such claims in a summary proceeding. Rather, such issues of state action warrant consideration in the self-regulatory organization's hearing process. Because the NASD had used summary procedures to find Quattrone guilty of failure to cooperate, rather than hearing his claims of "joint investigation" and "state action," the SEC set aside the discipline that the NASD had imposed. The *Quattrone* ruling clearly indicates that, where a claim of "joint action" by an SRO and the government is fact-based, specific, and colorable, the respondent is entitled to have that claim heard. However, under *Quattrone*, a respondent's bare claim of Fifth Amendment privilege or "joint investigation" will not foreclose discipline should he or she fail to cooperate with the self-regulatory organization's investigation. Most significantly, the *Quattrone* ruling does not challenge the general principle that regulatory action by the NYSE or any other self-regulatory organization is not "state action." Nor does *Quattrone* hold that a self-regulatory organization in its independent disciplinary proceedings, must recognize the Fifth Amendment privilege against self-incrimination.

42. Richard Neuberger, H.P.D. 80-39, at 4 (N.Y. Stock Exch. July 11, 1980), *aff'd*, N.Y. Stock Exch. Bd. of Dirs. (Jan. 7. 1981) (emphasis added).

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1. *"Required Cooperation" of Firms and Individuals As An Obligation of Exchange Participation*

It is against this background that the Cooperation Memo frames its discussion of "Required Cooperation." Required cooperation, in a nutshell, means providing information, documents and testimony as required by the Exchange's Constitution and Rules, promptly and in a straightforward manner. When a firm notifies the Exchange of possible misconduct, it must supply a full and candid report – not be unduly brief, or mischaracterize the misconduct.

The Cooperation Memo also speaks to the degree of self-reporting and disclosure that member firms are required to supply. Under the Exchange Rules, whenever a brokerage firm employee is terminated for cause, or where there is a settlement with a customer for more than a specified amount, or where the Firm has discovered a violation of Exchange Rules or federal securities laws, the brokerage firm must make a filing reporting this.[43]

As the Cooperation Memo emphasizes, it is essential that a member firm make reports that are timely, accurate and full because these reports provide the information upon which Enforcement relies in determining which cases to screen out and which should be the subject of further investigation.

> In terms of disclosure requirements. . . disclosure of reportable matters must be full, accurate, comprehensible, and timely. Reports of misconduct that are late (*i.e.*, submitted more than 30 days after a reportable event), unduly short, vague, or misleading, or that mischaracterize a matter – for example, by reporting that firm discipline was imposed for a violation of Firm policies, when this discipline in fact related to misconduct that contravened Exchange Rules or the federal securities laws – interfere with the Exchange's ability to efficiently make informed decisions as to whether review of a reported matter is appropriate.

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43. *See, e.g.*, NYSE, Inc., Rules of Board, Rule 345.17, at 351 (2006) ("prompt" filing of required disclosure means within 30 days); NYSE, Inc., Info. Memorandum 06-11 (Mar. 16, 2006) provides further guidance on when filings should be appropriately made.

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Beyond supplying information to Enforcement, there are vital goals that are also served by full and timely reporting. The information that the Firm discloses through these filings becomes part of the stockbroker's employment history. If another firm is to know the background of a broker whom it is considering hiring – or, more immediately, if an investor is to know the person with whom he or she is dealing – it is essential that this record be up-to-date.

To ensure that its reporting system is accurate, a brokerage firm needs to have in place a supervisory infrastructure. Firm managers need to know that violations will be reported up the chain of command in a timely manner, and that misconduct cannot be hidden. In gathering and describing individual acts of misconduct, a firm puts together the mass of information necessary to understand how well it has perceived and managed the risk it faces. It may be able to see where its procedures are not working. It may also see what new kinds of misconduct are emerging. The fuller the disclosure, the brighter the regulatory picture. The process of reporting misconduct flows seamlessly into the larger process of risk assessment.

The disclosure of required information is a critical variable in the deterrence equation. It allows a regulatory system to avoid a pitfall in the system of deterrence, what has been called "the deterrence trap."

> [A]n actor who contemplates committing a crime will be deterred only if the "expected punishment cost" of a proscribed action exceeds the expected gain. This concept of the expected punishment cost involves more than simply the amount of the penalty. Rather, the expected penalty must be discounted by the likelihood of apprehension and [punishment] in order to yield the expected punishment cost.[44]

To the extent that a wrongdoer can expect that a violation can be concealed, or will otherwise go unnoticed, penalties must be logically be raised to compensate. However, where violations are difficult to detect, a penalty rigorously calculated to deter wrongdoing – ironically – may be raised too high. An

44. Coffee, *supra* note 10, at 389.

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in terrorem sanction, elevated in the expectation that it will deter wrongdoers by hanging ominously over their heads, may be so harsh that it will seldom be imposed in fact. This reduces the sanction's deterrent effect: rather than a likely consequence, the sanction becomes a theoretical speculation. However, where a regime for reporting violations is functioning, this reduces the possibility that misconduct will go unaddressed – both reduces the tendency to discount a sanction, and makes it possible for a lower, more realistic sanction to be applied in everyday regulation.

The duties of regulatory reporting and effective supervision also have an interface with the obligations of corporate management. Directors and executives who have demonstrably taken the pains to install an effective compliance program – who have assured that information on misconduct is promptly reported to compliance and management, and cannot be concealed by individual employees or areas of their firm – may have earned a defense, should claims resulting from such misconduct be raised, to charges of deficient supervision or personal misfeasance.[45]

2. *"Extraordinary Cooperation" in Exchange Proceedings*

After defining what an Exchange member must provide and what the Exchange may expect in terms of required cooperation, the Cooperation Memo discusses "Extraordinary Cooperation." This is cooperation and assistance that is so remarkable that it may serve, in the exceptional case, as a mitigating factor.

Extraordinary cooperation means an effort that is substantially above and beyond the cooperation that is required by virtue of holding membership in the Exchange. In evaluating requests for "credit for cooperation," Enforcement examines several factors, including whether a Firm's reporting was fully forthcoming and completely candid.

> Before suggesting that its cooperation has been exceptional, a firm's reporting must be more than adequate; it should be detailed, complete, and can-

45. *See, e.g., In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 969-70 (Del. Ch. 1996); Dellastatious v. Williams, 242 F.3d 191, 195-96 (4th Cir. 2001).

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> did. . . . A firm seeking credit for exceptional cooperation must supply to the Exchange the full and unvarnished record concerning the misconduct at issue, including its causes and consequences, and not a self-serving and distilled version of events.

Even better situated are firms that follow early disclosure with a thorough internal review and then share the facts discovered with the Exchange.

This raises the issue of waiver of attorney-client privilege. The Exchange respects privacy and Exchange Rule 476(h) specifically accords any participant in an Exchange matter the right to be represented by counsel.

The Cooperation Memo recognizes that attorney-client privilege is an important factor in the regulatory process. Nonetheless, the waiver of attorney-client privilege must be recognized as a significant step that can expedite an investigation and demonstrate extraordinary cooperation. The essence of cooperation is sharing facts.[46] Extraordinary cooperation

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46. The Cooperation Memo carefully observes: "The essence of cooperation is that facts relevant to an investigation must be made available to Exchange investigators, and as long as those facts are candidly and completely presented, there will be no adverse effect arising from the non-waiver of a privilege." At the same time, "[b]ecause facts themselves are generally not protected and cannot be hidden behind a shroud of privilege, to cooperate fully, yet maintain the privilege, firms and counsel must find ways to convey relevant facts without compromising the privilege sought to be maintained." *Id.* at 4 n.8. On June 26, 2006, in what is becoming known as "the KPMG case," *United States v. Stein*, a federal court in the Southern District of New York ruled that federal prosecutors had acted wrongfully, and unconstitutionally, in pressuring a corporate defendant to cut off payment of legal expenses for individual employees who had been indicted. United States v. Stein, 435 F. Supp. 2d 330 (S.D.N.Y. 2006). Significantly, this rejects a principal factor set forth in the Thompson Memorandum, *supra* note 38, which discusses factors to be considered by federal prosecutors with regard to charges and sanctions. The *Stein* case involved improper tax shelters set up by KPMG LLP, the accounting firm, and individual employees of the firm. *Stein*, 435 F. Supp. 2d at 336. The firm avoided criminal prosecution (although it agreed to pay a substantial monetary penalty). This result was reached, the court held, after prosecutors wrongfully pressured the firm to cut off the payment of legal expenses for 16 individual employees. Under the Thompson Memorandum and prior federal policy, a target firm's decision to advance legal fees to employees, except where required by law, may be viewed as the protection of culpable individuals and might contribute to a decision to indict the corporation. THOMPSON MEMORANDUM, *supra* note 38. The court presented a record in which prosecutors sought to pressure the

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includes aiding the Exchange, in terms of helping the Exchange obtain evidence that the Exchange could not on its own have obtained – for example, by helping produce witnesses or evidence outside the jurisdictional reach of the Exchange. It may also involve partnering with the Exchange to ferret out industry-wide wrongdoing and providing substantial assistance.

If the Firm can show that it has made such an extraordinary effort, credit will be forthcoming. Charges may be reduced, or sanctions may be lessened. There may be no need for an undertaking (particularly if the firm's remedial actions have already put its house in order). The Exchange may publicly acknowledge the Firm's cooperation – a meaningful step in today's environment where investors are focused on good corporate citizenship. Indeed, in the exceptional case, ex-

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firm to cut off legal support to the individual defendants, via threats to consider the payment of such fees as a factor supporting indictment. The firm ultimately complied. The firm not only cut off legal fees for employees who were indicted, but also appears to have conditioned the payment of legal fees upon full cooperation with prosecutors. The court also faulted the government for using such leverage, when possible, to attempt to conduct its prosecution without the involvement of defense attorneys. The court concluded that the government had violated the Fifth and Sixth Amendments by cutting off, through coercion, the payment of legal fees for individuals who had been indicted. The court considered that a criminal defendant's right to fairness in the criminal process ranked as a fundamental liberty interest and was entitled to protection as a matter of substantive due process against government efforts to coerce a third party to withhold funds lawfully available to the defendant. Given the importance of this interest, strict scrutiny was applied to the prosecutors' action. Under this standard, the policy of considering favorably a firm's decision to cut off legal support to an individual defendant was not sufficiently narrowly tailored to obtain a compelling objective, and the policy mandated by the Thompson Memorandum could not withstand strict scrutiny. *Stein*, 435 F. Supp. 2d at 353-82.

In December 2006, the Department of Justice revised its guidelines in this area. Principles of Federal Prosecution of Business Organizations: Memorandum to Heads of Department Components and United States Attorneys from Paul J. McNulty, Deputy Attorney General (December 12, 2006), *available at* http://www.usdoj.dag/speech/2006/mcnulty_memo.pdf. This document, known as the McNulty Memorandum, as well as addressing the circumstances in which corporations should be charged with criminal offenses, created new approval standards for prosecutors seeking waiver of attorney-client or work product privileges, and directed that prosecutors considering whether to criminally charge a corporation may not consider (except in exceptional cases) the corporation's advancement of attorney fees to an employee.

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traordinary cooperation may mean that no enforcement action will be brought.

Significantly, there is a theme that steadily works its way through the Cooperation Memo's listing of factors. That is the importance of effective supervision and active compliance work, by a member firm. "The presence of a strong culture of compliance" at a respondent firm, the Cooperation Memo notes, "may appropriately influence [Enforcement's] discipline-related decisions with respect to member firms."[47] In recognizing the value of a "culture of compliance," Enforcement recognizes that this reflects that a firm has accepted due responsibility – that it has internalized the values that self-regulation requires and that the regulatory system defends. For the Exchange, there may be less need to sanction past misconduct and deter future misconduct, in the case where a member firm can demonstrate that it has institutionalized a system designed to detect and prevent wrongdoing, to such an extent that misconduct would be out of character.[48]

When a firm displays extraordinary cooperation, this allows an investigation to be completed in a timely and comprehensive manner. It allows customers to be made whole sooner. It allows Enforcement to deploy its resources as efficiently as possible to the other matters that require them. So valuable are these factors to the task of Exchange self-regula-

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47. COOPERATION MEMO, *supra* note 46. This will "usually" be reflected in "a sparse disciplinary history, thorough self-policing, informative and complete self-reporting, prompt customer remediation, and consistent cooperation with the Exchange and other regulatory bodies." *Id.* at 4-5

48. "Rehabilitation and incapacitation," it has well been said, "cannot be divorced from deterrence: policy revision, disciplinary control, and changes in [standard operating procedures] are important rehabilitative and incapacitative effects which deterrent threats against corporations are intended to catalyze." Brent Fisse, *Reconstructing Corporate Criminal Law: Deterrence, Retribution, Fault, and Sanctions*, 56 S. CALIF. L. REV. 1141, 1165-66 (1983). The fear of legal penalties is not the only mechanism that works to prevent misconduct. Individuals may comply with rules and norms because they have internalized and made the moral commitment to follow such practices, and because they wish to avoid the disapproval (should they violate those rules) from peers who have made and maintained this similar commitment. Harold G. Grasmick & Donald E. Green, *Legal Punishment, Social Disapproval, and Internalization as Inhibitors of Illegal Behavior*, 71 J. CRIM. L. & CRIMINOLOGY 325 (1980). The coercion of the disciplinary process is thus reinforced and complemented by the presence of a corporate culture that values compliance.

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tion – and so essential are these qualities to this same demanding task – that the Cooperation Memo extends recognition to them. Where a firm has aligned itself with the Exchange in the demanding task of making markets safer, its contribution warrants such recognition.

3. *Sanctions Considered by Enforcement: Information Memorandum 05-77*

In Information Memorandum 05-77, released October 7, 2005, (the "Sanctions Memo"), the Division of Enforcement discusses factors that may be considered by the Division of Enforcement in determining sanctions. They represent recognized criteria – drawn from the published disciplinary decisions of the NYSE, as well as from action taken by other regulators - that help Enforcement staff evaluate the seriousness and the scope of a respondent's misconduct.

This Sanctions Memo was issued to discuss the factors upon which sanctions may be based and to clarify that regulatory action and disciplinary sanction are not bound with mathematical exactitude by precedent. Precedent may be of limited value because every case must be evaluated on its particular facts. As Enforcement has found, where sanctions imposed in the past have been less than effective – where a respondent may commit new violations, regarding sanctions as a cost of doing business – a blinkered reliance on precedent would only serve to perpetuate ineffective sanctions.

If a defendant has acted with scienter, that guilty intent may indicate that his or her misconduct is worse than that of another whose misconduct was not so clearly intended.[49] There are other ways, as the Sanctions Memo recognizes, that misconduct can be measured. Misconduct may be measured by the number of customers, or the duration of the time in which wrong-doing was active, or by any other criterion that may define its extent. The sophistication of a customer who is

49. Intent to cause a violation may be considered intent to gain an unfair advantage. Where misconduct goes unpunished, norms are undercut, and those brokers and firms who follow the rules are wrongly put at a disadvantage. As has been noted, "The unfair advantage is not abstract, overindulgent . . . self-preference, but down-to-earth exploitative gain." Fisse, *supra* note 48, at 1171. Regulatory action by the Exchange can redress this unfairness and maintain the balance of active competition within the securities industry.

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harmed may matter. So may the dollars and cents harm done to a specific customer – or the harm that is caused when damage is done not to a specific individual, but to a broader set of investors, or the market.[50] Obviously it will be important to take into account a respondent's prior record – or whether the respondent profited or intended to profit from the misconduct. Enforcement will also consider, where appropriate, the size or financial resources of an entity or the net worth of an individual.

In assessing sanctions, Enforcement looks at voluntary restitution and corrective measures. This is reflected in Enforcement's consideration of whether training and education addressing the misconduct is provided. Similarly, it may be taken into account when Enforcement considers the issue of whether a supervisor or a manager disregarded red flags of misconduct by an employee, and thereby chose to ignore the possibility of preventing misconduct. Moreover, the Sanctions Memo spells out, specifically, that the Exchange will consider how well supervision and compliance systems have been planned, funded, and tested.

> *Effectiveness of Operational, Supervisory, and Compliance Controls*. The effectiveness of a member firm respondent's operational, supervisory, and compliance policies and procedures will be considered, where appropriate, including whether adequate resources have been devoted and whether the respondent has engaged in a periodic review of its internal controls. The respondent's identification of and response to operational and supervisory risks and/or failures would be included as part of this consideration.

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50. In cases where brokerage firms had failed to comply with the basic requirement of delivering prospectuses to customers, this broad, market-wide failure supported stiff regulatory action without a showing of harm to specific customers. Merrill Lynch, Pierce, Fenner & Smith Inc., H.P.D. 05-87, at 17 (N.Y. Stock Exch. July 21, 2005) ($10 million fine); Morgan Stanley DW Inc., H.P.D. 04-184, at 14 (N.Y. Stock Exch. Dec. 9, 2004) ($13 million fine). Similarly, in *Deutsche Bank Sec. Inc.*, imposing the sanction consented to, a firm's long-standing over-voting of corporate proxies for shares that it held in street name was sanctioned with a fine of $1 million, although there was no finding that these omissions had cost individual shareholders a proxy vote. Deutsche Bank Sec. Inc., H.P.D. 05-45, at 9 (N.Y. Stock Exch. Feb. 2, 2006), *rev'd*, N.Y. Stock Exch. Bd. of Dirs. (Feb. 15, 2006).

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It must be reiterated that such factors are not sentencing guidelines – that they do not represent a grid of number of months or number of dollars. These factors provide a window into Enforcement's deliberative process when determining an appropriate sanction. The true significance of factors is in how they are applied.

At the Exchange, Enforcement takes very seriously the decision to authorize an enforcement proceeding. When any investigation is completed, there is a robust process, in which Enforcement staff, management, and officers discuss what violations to charge and what sanctions to bring. Those discussions go beyond Enforcement, to include an even broader group of regulators drawn from other areas of NYSE Regulation, Inc. Input is obtained from senior staff of the Division of Member Firm Regulation or the Division of Market Surveillance and every action is authorized by the Chief Regulatory Officer.

VI.
CONCLUSION

Within the Exchange community, the process of industry self-regulation and the operation of a membership organization offer a unique study in the interplay of what – to play on words – may be called market forces. Discipline by the Exchange helps maintain the balance of active competition. Disclosure and compliance are the other side of deterrence; the more information that is discovered and disclosed, the less intense the regulatory action that need be taken. Sanctions imposed for past misconduct work to prevent future violations; to reprove misconduct raises the cost to its perpetrators, and reinforces the securities industry's stand against such aberrant action. In meeting its obligation to provide effective discipline, the Exchange works toward its goal of promoting just and equitable principles of trade.

Enforcement has been transparent about the factors that it considers in deliberating and setting the appropriate sanctions. Enforcement and the Exchange trust that the result of these labors will be a stronger, safer marketplace for all investors.

Enforcement's sanction review has resulted in a sharper focus on the purpose of sanctions in this membership context

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– to change behavior, to prevent future misconduct that harms investors and that diminishes the integrity of the marketplace. In the process, Enforcement has reiterated that sanctions at the Exchange must be sharp enough to achieve this purpose, targeted at the responsible party, fair and consistent. The process has been made brighter by Enforcement's communicating forthrightly with the Exchange community as to what expectations apply to their duties to self-report and cooperation and the credit they can expect from extraordinary cooperation.

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