ARTICLES
Advising Compliance in Financial Firms:
A New Mission for the Legal Academy.................................................................James A. Fanto

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Position of the Chief Compliance Officer......................................................Deborah A. DeMott

Self-Regulation of Insider-Trading
in Mutual Funds and Advisers........................................................................Tamar Frankel

Custodial Requirements for
Customer Funds...............................................................................................Jerry W. Markham

NOTES
The JOBS Act: Investor Protection,
Capital Formation, and Employment
in an Increasingly Political Economy..........................................................John P. Fargnoli

Blackout or Blackmail? How Garber v. MLB
Will Shed Light on Major League Baseball’s
Broadcasting Cartel.......................................................................................Nathan M. Hennagin

Mortgage Takings and Municipal Finance:
A Solution for Preserving Home Ownership..............................................Jourdain B. Poupore

#ihatemyboss: Rethinking the NLRB’s
Approach to Social Media Policies...............................................................Lauren R. Younkins
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# TABLE OF CONTENTS

## ARTICLES
- Advising Compliance in Financial Firms: A New Mission for the Legal Academy  
  *James A. Fanto*  
  *1*
- Punishing Bad Brokers: Self-Regulation and FINRA Sanctions  
  *Barbara Black*  
  *23*
- The Crucial but (Potentially) Precarious Position of the Chief Compliance Officer  
  *Deborah A. DeMott*  
  *56*
- Self-Regulation of Insider-Trading in Mutual Funds and Advisers  
  *Tamar Frankel*  
  *80*
- Custodial Requirements for Customer Funds  
  *Jerry W. Markham*  
  *92*

## NOTES
- The JOBS Act: Investor Protection, Capital Formation, and Employment in an Increasingly Political Economy  
  *John P. Fargnoli*  
  *134*
- Blackout or Blackmail? How *Garber v. MLB* Will Shed Light on Major League Baseball’s Broadcasting Cartel  
  *Nathan M. Hennagin*  
  *158*
- Mortgage Takings and Municipal Finance: A Solution for Preserving Home Ownership  
  *Jourdain B. Poupore*  
  *187*
- #ihatemyboss: Rethinking the NLRB’s Approach to Social Media Policies  
  *Lauren R. Younkins*  
  *222*
ARTICLES

ADVISING COMPLIANCE IN FINANCIAL FIRMS: A NEW MISSION FOR THE LEGAL ACADEMY

James A. Fanto*

This introduction to the symposium issue provides background on the subject of compliance in financial firms, whose task is to ensure that a broker-dealer and its employees comply with applicable laws and regulations. It explains the tasks of compliance in financial firms and discusses its origins, particularly in the statutory and regulatory obligation of supervision that is placed upon financial firms and their managers. It then looks at the reasons for the growth in importance of compliance in recent years, as well as the likely continued significance of this firm function. It particularly emphasizes how the recent financial reform legislation enhanced the role of compliance and diffused it into previously unregulated financial firms. It next offers several reasons why legal scholars have not devoted much attention to financial firm compliance and also discusses why compliance is attracting more scholarly attention, partly because law graduates are increasingly entering this field. It concludes by offering a few thoughts on how the legal academy can help compliance become more successful in its mission, with a reference to contributions of the professors made during the symposium and to useful work in managerial studies on how to build effective compliance programs.

INTRODUCTION ……………………………………………………………………….. 1
I. COMPLIANCE, ITS ORIGINS AND PRESENT STATE …………… 3
II. THE GROWING IMPORTANCE OF COMPLIANCE …………………… 13
III. COMPLIANCE AND THE LEGAL ACADEMY ………………….. 16
CONCLUSION ………………………………………………………………………... 21

INTRODUCTION

There were several motivations for our symposium on financial firm compliance, entitled “The Growth and Importance of Compliance in Financial Firms: Meaning and Implications.” First, since the role of compliance officers has become important and grown in prestige in
financial firms, it was interesting and useful to explore the reasons for this phenomenon in an academic setting. Second, the growth in importance of compliance has occurred without attracting much attention from legal scholars. Devoting a symposium to the subject helps partly to remedy this situation. Third, the symposium was also worthwhile to our students because they appear to be entering into this field in increasing numbers, for, in an otherwise gloomy job market, compliance represents a potential area of job growth. Fourth, alumni of our school have important positions in the compliance field and one of the purposes of our Center for the Study of Business Law & Regulation is to connect our students to alumni in business law practice. Accordingly, a symposium on compliance brought several of our alumni working in compliance to the school for this purpose.2

For the symposium we invited legal scholars who follow developments in finance closely and who are knowledgeable about broker-dealers and investment advisers. To a person, they recognized the importance of the topic and were happy to participate in the symposium. Moreover, as noted above, the symposium included practitioners in compliance. The design of the symposium was to have presentations by professors on compliance-related issues, with compliance practitioners commenting on their talks, often to inject a real-world perspective into the discussion. The Articles presented in this issue represent the fruit of that exchange but only imperfectly capture the lively debates that occurred during the symposium.3

In this Introduction to the symposium issue, I shall provide background on the subject of compliance. Part I will explain the nature of compliance in financial firms and discuss its origins, particularly in the statutory and regulatory obligation of supervision that is placed upon financial firms and their managers. Part II will look at the reasons for the growth in importance of compliance in recent years, as well as the likely continued significance of this firm function. It will particularly emphasize how the recent financial reform legislation enhanced the role of compliance. Part III will offer several reasons why legal scholars have not devoted much attention to financial firm compliance. This Part will also discuss why compliance is attracting more scholarly attention, partly because law graduates are increasingly entering this field. The Article concludes by offering a few thoughts on how the legal academy can help compliance become more successful in its mission, with a reference to contributions of the professors made during the symposium.

2. Commentators at the symposium included Ira Goldberg (class of ’96), a managing director of JP Morgan Securities; Jonathan Gottlieb (class of ’92), a managing director and senior counsel at RBS Securities; Jane A. Kanter (class of ’73), a partner at Dechert LLP; and Andrew S. Margolin (class of ’90), managing director and associate general counsel of Bank of America Merrill Lynch.

3. The symposium was a success even though it took place on a Friday when a blizzard rolled into the New York area!
I. COMPLIANCE, ITS ORIGINS AND PRESENT STATE

It is first useful to identify the compliance function in a firm. To put things simply, the basic job of compliance is to ensure that a broker-dealer and its employees comply with applicable laws and regulations. The relevant laws and regulations are mainly the federal securities laws and regulations of the U.S. Securities and Exchange Commission (the SEC), but they also include the rules and professional standards of self-regulatory organizations (SROs), as well as the diverse kinds of laws that apply to financial firms today (e.g., anti-money laundering rules). Compliance, which is composed of compliance officers, occupies a middle position between the business of the broker-dealer, on the one hand, and regulators and SRO officials, on the other. Compliance officers do not engage in the firm’s securities business, but are part of one of its oversight or control functions, like internal accounting, internal control, and legal. Indeed, in its early days compliance was a task of or a subdivision within the legal department. As a result of this oversight function, investment bankers, brokers, and other business employees of broker-dealers traditionally looked down upon and even resented compliance officers as being an unproductive part of, and even an impediment to, the investment banking

4. The discussion will focus on compliance only in broker-dealers, who are regulated under the Securities Exchange Act of 1934 (the Exchange Act), 15 U.S.C. §§ 78a–78pp (2012), since compliance is well developed in broker-dealers. A broker-dealer is a firm, registered as such under the Exchange Act, id. § 78o, that, as is typical, conducts both the functions of a “broker,” which acts as an agent for others in securities transactions, id. § 78c(a)(4), and a “dealer,” which generally is in the business of making markets in securities, id. § 78c(a)(5).


6. SROs are securities organizations where the members, rather than an outside body, primarily regulate themselves. See 1 NORMAN S. POSER & JAMES A. FANTO, BROKER-DEALER LAW AND REGULATION § 4-3 to 4-4 (4th ed. 2007 & Supp. 2013). The Securities Exchange Act of 1934 is based upon a self-regulatory model, where SROs do much of the regulation subject to the oversight of the SEC. See id. § 4-3. The Financial Industry Regulatory Authority (FINRA), which is a union of the former self-regulatory arms of the National Association of Securities Dealers (the NASD) and the New York Stock Exchange (the NYSE), is the main SRO for broker-dealers and is a registered securities association under section 15A of the Exchange Act, 15 U.S.C. § 78o-3. At the symposium, our opening speaker was Grace B. Vogel, FINRA’s Executive Vice President of Member Regulation.

7. See SIA, WHITE PAPER ON THE ROLE OF COMPLIANCE, supra note 5, at 5.

8. It is true that, in smaller firms, a broker, trader, or supervisor of the firm may also be a compliance officer because the firm is not large enough to have a separate compliance department or group. Or, in a small firm, the only compliance officer may be engaged in multiple control functions (e.g., be both the main privacy officer and chief anti-money laundering officer).

and securities business. A compliance officer helps ensure that the firm and its employees follow the laws and regulations, but he or she does not have the status and independence of a regulator or an SRO official, although he or she may have spent part of the career with the SEC or FINRA and this experience may have played a role in his or her obtaining the compliance officer position. Yet, as discussed below, regulators work closely with compliance officers and may consider them their eyes and ears in a firm.

To a great extent, compliance in broker-dealers grew out of broker-dealers’ supervisory obligations under the federal securities laws. To show this demands a brief review of several key statutory provisions for broker-dealers. Section 15(b)(4)(D) of the Exchange Act empowers the SEC to discipline a broker-dealer for, among other things, the willful violation of, or the inability to comply with, the federal securities laws or their regulations by the broker-dealer itself or by any person “associated with” the broker-dealer. If an employee of a broker-dealer willfully violated the securities laws or regulations, the broker-dealer would be subject to SEC discipline under this statutory provision, which could include suspension of its registration for up to twelve months or the “death sentence” of revocation of registration. This


11. See PROJECT ON GOV’T OVERSIGHT, DANGEROUS LIAISONS: REVOLVING DOOR AT SEC CREATES RISK OF REGULATORY CAPTURE 2 (2013), available at http://pogoarchives.org/ebooks/20130211-dangerous-liaisons-sec-revolving-door.pdf (“The movement of people to and from the financial industry is a key feature of the SEC, and it has the potential to influence the agency’s culture and values.”). The purpose of this report is to highlight the danger of regulatory capture, particularly as it affects decisions by regulators to pursue lawsuits against financial firms. However, it indicates the interest of financial firms in hiring former regulators in control functions. Many senior compliance officers have spent time with the SEC or FINRA. For example, Jonathan Gottlieb, who was one of the alumni compliance officers present at our symposium, formerly worked for the SEC’s Division of Enforcement.

12. See infra text accompanying note 44.

13. The focus here is only on the brokerage industry-specific origins of compliance within broker-dealers. See generally Miriam Baer, Governing Corporate Compliance, 50 B.C. L. REV. 949, 958–75 & nn.48–162 (2009) (discussing origins of corporate compliance and referencing the significant contributions to the scholarly literature about them). Professor Baer, who is a specialist on the interrelationship between compliance and enforcement, among other things, was a commentator at our symposium.

14. See 15 U.S.C. § 78o(b)(4)(D) (2012). “Associated person” is itself defined in section 3(a)(18) of the Exchange Act to include “any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer.” Id. § 78c(a)(18). This definition sweeps within it all those who engage in the securities business in a broker-dealer, as well as controlling persons, but an exception (not quoted above) excludes clerical and ministerial employees, among others. Id.

15. See generally Task Force on Broker-Dealer Supervision & Compliance of the Comm. on Fed. Regulation of Sec., Broker-Dealer Supervision of Registered Representatives and Branch
statutory provision thus gives a broker-dealer an incentive to supervise its employees to ensure that they comply with applicable laws and regulations so that it can, in fact, stay in business.

Section 15(b)(4)(D) was a rough and imperfect instrument for the SEC to ensure legal compliance by broker-dealers and their employees because it allows the SEC to discipline only the firm, not the violating employee, and it does not provide for discipline of firm supervisors.\textsuperscript{16} The Securities Acts Amendments of 1964 enhanced supervision, and gave a major impetus to compliance, by adding sections 15(b)(4)(E) and 15(b)(6).\textsuperscript{17} Under section 15(b)(4)(E), a broker-dealer is subject to sanctions if, among other things, it, or an associated person, willfully aided or abetted a federal securities law or rule violation or “failed reasonably to supervise, with a view to preventing” the violation, the person who committed the violation.\textsuperscript{18} This amendment made the broker-dealer explicitly liable for its own, and its associated persons, supervisory violations. Furthermore, section 15(b)(6) empowers the SEC to discipline an associated person who, among other things, willfully aids and abets a violation of the federal securities laws or who commits a supervisory violation.\textsuperscript{19} Under this provision the SEC can discipline branch managers and other supervisors in a broker-dealer for their failure to supervise employees under their authority. These explicit supervisory obligations on firms and firm supervisors created an enhanced need for a broker-dealer to have people (i.e., compliance officers) to tell the supervisors and the other employees what compliance with the laws and regulations entails so that the employees could conduct themselves in a lawful manner and the supervisors could properly conduct their supervision and avoid supervisory liability.

Even more importantly for the growth of compliance, section 15(b)(4)(E) provides both the firm—and, through section 15(b)(6), firm supervisors—with defenses to a supervisory violation charge. It states that “no person shall be deemed to have failed reasonably to supervise any other person” if, first, there were “established procedures, and a system for applying” them, “which would reasonably be expected to prevent and detect, insofar as practicable,” any securities law violations by the supervised person.\textsuperscript{20} It further stipulates that the supervisor has “reasonably” to discharge the duties under the procedures and system

\textit{Office Operations}, 44 BUS. LAW. 1361, 1363–64 (1989) (discussing the SEC’s early legal theories to enforce supervisory liability upon broker-dealers, which included the standard tort doctrine of respondeat superior).

\textsuperscript{16} See POSER & FANTO, supra note 6, § 9-5 to 9-6.
\textsuperscript{19} Id. § 78o(b)(6). This section imposes the supervisory obligation through a cross-reference to section 15(b)(4)(E).
“without reasonable cause to believe” that the supervised person was not complying with these procedures and system.21 This language means that the firm and its supervisors have a statutory defense if the firm has well-drafted supervisory procedures for ensuring that the firm and all its employees comply with securities laws and regulations, as well as a system, that is, the resources and responsible people, to implement these procedures. Moreover, the firm and its supervisors have to demonstrate that they actually fulfilled their responsibilities under these procedures and system (i.e., that the system was properly functioning and not just for show).

This availability of the statutory defense to a charge of failure to supervise led to the growth of compliance, since broker-dealers would have a real interest in having a firm function—compliance—that would be responsible for drafting the supervisory procedures and assisting the firm and its supervisors in the implementation of the supervisory system. Moreover, compliance officers would ensure that the last prong of the statutory defense—that the procedures and the system were being followed in practice—was satisfied. Firms would accomplish this by having compliance officers monitor employees for legal compliance and follow up on any problem or potential problem (known in the trade as a “red flag”22) that surfaced in a firm, which could suggest a legal violation and thus potentially a supervisory one. In sum, a firm and its supervisors can take advantage of the statutory defense by having a compliance department, or at least compliance officers, devoted to creating a well-functioning supervisory system for them to follow. The origin of compliance is, therefore, in the avoidance of supervisory liability.

SRO supervisory requirements similarly spurred the growth of compliance in firms, although by imposing a direct supervisory obligation on firms rather than indirectly through a defense to liability. The Exchange Act requires SROs to ensure that their members comply with federal securities laws and regulations, as well as with their own rules, and to have rules designed to “prevent fraudulent and manipulative acts and practices, [and] to promote just and equitable principles of trade.”23 FINRA’s requirements of supervision are extremely detailed. FINRA requires each of its members to have “a system to supervise the activities of each registered

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21. Id. § 78o(b)(4)(E)(ii).
22. A “red flag” is an unusual event or practice that could be a sign of a securities violation and, therefore, that must be monitored or investigated. See, e.g., Gutfreund, Exchange Act Release No. 31,554, 1992 WL 362753, at *12 (Dec. 3, 1992) [hereinafter Gutfreund] (red flags are “suggestions’ of irregularity”).
23. See 15 U.S.C. § 78o-3(b)(2), (6) (for securities associations); id. § 78b(b)(1), (5) (for exchanges). The SEC reviews the rules in connection with the registration of an association or an exchange, as well as ongoing proposed rule changes or ones initiated by the SEC. See id. § 78(a)–(c).
representative, registered principal, and other associated person that is reasonably designed to achieve compliance” with securities laws and regulations and FINRA rules. Among other things, the system requires a broker-dealer to have written procedures for the supervision of each of its securities businesses and associated persons (written supervisory procedures or WSPs), to designate supervisors for each regulated business, to have annual compliance reviews for each registered representative and principal, to have internal inspections of all offices, to have a principal review of the transactions and correspondence with the public of registered representatives relating to their securities business, and to investigate the character and qualifications of any associated person. Since SRO rules govern each securities business activity and dictate how it is to be conducted in accordance with the law, nearly every FINRA rule has supervisory and, therefore, compliance implications. FINRA rules grow or are modified each year as firms develop new businesses and products and as new legal obligations are imposed upon them. A broker-dealer must have a division or group of employees—in other words, compliance—who can keep track of all of the legal and regulatory duties of the firm and associated persons.

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24. “Principals” are associated persons “who are actively engaged in the management of the member’s investment banking or securities business, including supervision, solicitation, conduct of business or the training of persons associated with a member for any of these functions are designated as principals.” See NASD Rules, FINRA, http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=605&record_id=607 (last visited Nov. 17, 2013) [hereinafter NASD Rules] (NASD Rule 1021(b)). As a result of the consolidation of the NASD and the regulatory arm of the NYSE into FINRA, a new FINRA rulebook combining the rules of each of these SROs is being prepared and implemented. See FINRA, FINRA MANUAL: OFFICIAL PUBLICATION OF THE FINANCIAL INDUSTRY REGULATORY AUTHORITY (2011) [hereinafter FINRA MANUAL]. As a result, currently FINRA rules include some NASD rules, some NYSE rules (which apply only to broker-dealers formerly regulated by the NYSE), and the new FINRA rules (the latter apply to all broker-dealers). See id. at 21–111 (providing comprehensive conversion tables between the NASD, NYSE, and FINRA Rules). Associated persons who are not principals are generally “representatives,” a term defined to mean persons associated with a member, including assistant officers other than principals, who are engaged in the investment banking or securities business for the member including the functions of supervision, solicitation or conduct of business in securities or who are engaged in the training of persons associated with a member for any of these functions are designated as representatives.

NASD Rules, supra note 24 (NASD Rule 1031(b)).

25. See NASD Rules, supra note 24 (NASD Rule 3010(a)).

26. See id. (NASD Rule 3010(a)–(e)).


persons and who can help the firm’s employees satisfy their obligations, and the supervisors their supervisory duties, through guidance, monitoring, and follow-up.

Moreover, NASD Rule 3012 requires that a firm have one or more principals who set up supervisory controls to test its supervisory system on a yearly basis in order to assess its compliance effectiveness and to identify the need for additional WSPs. Under this rule, the responsible principal or principals establish the controls, conduct the testing, create additional WSPs to respond to weaknesses revealed by the testing, and report annually to a broker-dealer’s senior management about the results. The controls must cover (i) customer account activity conducted by branch office managers and other supervisors; (ii) customer account activity, such as the transmittal of funds or securities, address changes, and changes of investment objectives; and (iii) heightened supervision of certain “producing managers” who generate a significant portion of the revenue of a particular business unit. This kind of supervisory control system and related testing requires compliance specialists who understand supervisory and compliance systems and potential weaknesses in them and who follow industry developments with respect to their improvement. In addition, FINRA Rule 3130 (former NASD Rule 3013) requires a firm to appoint at least one chief compliance officer (CCO). Under this rule, a firm’s chief executive officer (CEO) must also certify annually that there are “in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with” SRO rules and federal securities laws and regulations, and FINRA Rule 3130 requires that the CEO has had “one or more meetings” with the CCO in the preceding twelve months to discuss the processes. This latter rule is both a regulatory acknowledgment of the importance of compliance and an effort to increase its importance and visibility in the management of broker-dealers. The CCO became the standard bearer of compliance in the managerial ranks of the firm.


30. See NASD Rules, supra note 24 (NASD Rule 3012(a)(1)).

31. See id. (NASD Rule 3012(a)(2)).

32. See FINRA MANUAL, supra note 24, at 5111 (FINRA Rule 3130(a)); NASD, Notice to Members No. 04-79, at 974 (Nov. 2004), available at http://www.finra.org/web/groups/industry/@ip/@reg/notice/documents/notices/p011955.pdf (“NASD Rule 3013 is intended to bolster attention to members’ compliance programs by requiring substantial and purposeful interaction between business and compliance officers throughout the firm.”).

33. See FINRA MANUAL, supra note 24, at 5111 (FINRA Rule 3130(b)). The rule also provides a “model” certification for the CEO. See id. at 5111–12 (FINRA Rule 3130(c)).
In their separate ways, therefore, the Exchange Act requirements and SRO rules helped transform compliance into a specialized function within broker-dealers. In the early days of compliance, firm supervisors, aided by in-house lawyers and outside counsel, ensured that their firm and employees complied with the securities laws and regulations, as well as SRO rules and standards.\(^{34}\) This model is still found in small broker-dealers, which operate with fewer resources than do large firms and where, for cost reasons, firm supervisors and other employees often wear multiple hats, including that of the CCO.\(^{35}\) However, compliance has become an increasingly specialized occupation in larger firms, as the SEC and the SROs pushed them to have a compliance function that reflects their size and activities.\(^{36}\) The increase in the number and complexity of financial activities of larger firms and the accompanying growth in laws and regulations relating to them mean that firm supervisors can no longer stay current with all of the legal, regulatory, and SRO responsibilities of their firm and associated persons.\(^{37}\) They thus have to create and then rely upon a specialized department within the firm, compliance, whose officers can devote most of their time and efforts to the compliance tasks.

As for the tasks of the typical compliance officer, first and foremost, he or she provides advice, on a daily basis, to brokers and their supervisors on the compliance requirements for business activities.\(^{38}\) A major, and indeed monumental, job of compliance officers is also to produce, and to keep current, the WSPs.\(^{39}\) To accomplish this task, compliance officers must work closely with business employees to understand a particular business activity, for the WSPs dictate how firm employees should conduct the firm so as to comply with laws and regulations and how the activity should be supervised and monitored. In many ways, then, the typical WSP is a step-by-step guide to the activity (e.g., how a broker should conduct a sale, how a firm can do advertising, and how must a trade be processed). Compliance officers must also refine existing WSPs in response to problems or gaps in them revealed by the firm’s experience, by the testing mandated by NASD

\(^{34}\) See generally SIA, White Paper on the Role of Compliance, supra note 5, at 1.

\(^{35}\) See id. at 2–3 (discussing different compliance needs and structure of small firms). Smaller firms may also “outsource” some of their compliance tasks. Id. at 2 n.10.


\(^{38}\) See SIA, White Paper on the Role of Compliance, supra note 5, at 3; see also Vass, supra note 9, at 56 (referring to compliance, not pejoratively, as a “dumping ground” for firm issues) (internal quotation marks omitted).

Rule 3012, or as a result of issues in them raised by FINRA or the SEC because of their inspection of a firm or because of the regulator’s concern over industry-wide matters. Since new laws and regulations appear constantly, the production and refinement of WSPs are never-ending tasks.

Compliance officers monitor the activities of brokers, often through the production and review of reports on transactions, to determine whether the procedures are in fact being followed. Today, compliance monitoring is aided by technology, which has greatly automated the reporting and review process. Compliance officers identify, and then follow up on, compliance problems or “red flags.” Compliance officers are responsible, through their surveillance, for finding out when the WSPs are not being followed, which may be due to anything from an innocent mistake, to purposeful, but not harmful, noncompliance, to outright fraud. Compliance officers also detect problems through the routine internal inspections of offices and branches that are part of the supervisory system. Moreover, they are usually the firm personnel who assist SROs, the SEC, and other regulators in regulatory examinations of their firms, and as a result they may detect problems, or at least regulatory concerns, through their interaction with the examiners.

Here, the work of compliance touches on the sensitive subject of enforcement of the securities and other laws and potential reporting of illegality to FINRA and the SEC. Although compliance officers may identify problems from their monitoring and inspections and assist in the conduct of investigations, the determination as to what to do about the violations generally belongs to firm supervisors.

It is worthwhile to raise here an important issue about the relationship between supervision and compliance that has not been definitively resolved. Supervision refers to the power of one person over another in a firm’s chain of command, which includes, as discussed above, the obligation to ensure

40. See id.

41. See id. at 4–5. This is often referred to as compliance’s “control,” as opposed to “advisory,” function. See SIFMA, THE EVOLVING ROLE OF COMPLIANCE, supra note 37, at 4. The most significant monitoring report is the “exception” report, which lists transactions that are outside certain parameters specified by the WSPs or that are otherwise flagged as suspicious, such as excessive trading or inappropriate concentration of certain products in customer accounts. See Vass, supra note 9, at 12 (discussing exception report).

42. For an excellent discussion of problems inherent in the use of technology in compliance, see Kenneth A. Bamberger, Technologies of Compliance: Risk and Regulation in a Digital Age, 88 TEX. L. REV. 669 (2010).

43. See NASD Rules, supra note 24 (NASD Rule 3010(c)); see also SIA, WHITE PAPER ON THE ROLE OF COMPLIANCE, supra note 5, at 5; SIFMA, THE EVOLVING ROLE OF COMPLIANCE, supra note 37, at 24–25.

44. See also SIA, WHITE PAPER ON THE ROLE OF COMPLIANCE, supra note 5, at 6; SIFMA, THE EVOLVING ROLE OF COMPLIANCE, supra note 37, at 26. A broker-dealer is subject to examination both by the SEC and FINRA, on a regular basis, as well as “for cause” (i.e., as a result of a complaint) or because of an overall investigation into brokerage practices. For a general discussion of this subject, see Poser & Fanto, supra note 6.

that the supervised employee complies with securities laws and regulations.46 It is often typified by the power of the supervisor to control the actions of, and ultimately to dismiss, an employee.47 Compliance in a broker-dealer is not, without more, part of the supervisory structure, and a compliance officer is not, again without more, a supervisor. Rather, as explained above, compliance makes effective supervision possible. Compliance officers are not themselves supervisors insofar as they do not tell employees what to do or make disciplinary decisions when a violation is found—those actions are for the supervisors, and investigations are generally for legal officers. However, the SEC has held that, once a compliance or legal officer has a sufficient position of influence within a firm, he or she may have the responsibility, with other supervisors, for taking appropriate action in response to misconduct.48 This action could include, in extreme circumstances such as when the main supervisors do not adequately respond to the misconduct, escalating the matter to the board of directors, resigning, or reporting the problem to regulatory authorities.49 Since there has been a notable recent instance where a compliance officer was alleged to be a supervisor,50 it has been recommended that compliance

46. See SIA, WHITE PAPER ON THE ROLE OF COMPLIANCE, supra note 5, at 10.
47. See Huff, Exchange Act Release No. 29,017, 1991 WL 296561, at *9 (Mar. 28, 1991). In a seminal SEC decision on this subject, Gutfreund, the SEC made the following observation in the context of discussing the supervisory responsibilities of legal and compliance officers, which offers a broader view than the control standard:

Employees of brokerage firms who have legal or compliance responsibilities do not become “supervisors” for purposes of Sections 15(b)(4)(E) and 15(b)(6) solely because they occupy those positions. Rather, determining if a particular person is a “supervisor” depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.

See Gutfreund, supra note 22, at *15 (emphasis added).
48. See Gutfreund, supra note 22, at *14.
49. See id. at *16. Arguably, the position taken by the SEC in the Urban case discussed below is broader than the two traditional theories of “control” and “affect,” since it finds supervisory liability when a person, such as a compliance officer, has “authority” in the firm, i.e., is listened to. See Urban, Initial Decision Release No. 402, 2010 WL 3500928, at *38 (Sept. 8, 2010) [hereinafter Urban].
50. Urban, supra note 49. Urban, who was a general counsel and also the CCO of a broker-dealer, attempted to take action against a rogue broker, who engaged in numerous legal violations, including unauthorized trading in client accounts and doing trades for a stock manipulator. Id. at *1, *13. Urban urged that the broker be dismissed, but he was overruled by the head of retail sales who agreed to supervise him personally. Id. at *21. The broker ultimately left the firm in the wake of numerous customer problems that resulted in a significant financial outlay by the broker-dealer. Id. at *25. Urban was charged with a supervisory violation. Id. at *38. The administrative law judge ruled that he was in fact a supervisor, but that he had fulfilled his supervisory responsibilities. Id. at *44–48. At the urging of the Enforcement Division, the SEC declined to affirm the judge’s ruling, stating, among other things, that it needed to consider whether it was enough for Urban to report problems to the supervisor of the broker or whether he should have escalated the matter to the firm’s chief executive officer and its board of directors. See Urban,
officers ensure that there is clear reporting structure in their firm, which shows that they are outside the supervisory structure.\textsuperscript{51}

Furthermore, compliance officers serve as educators within the broker-dealer. Brokers have a continuing education obligation,\textsuperscript{52} and every broker must certify annually that he or she is in compliance with applicable laws and regulations.\textsuperscript{53} Compliance officers are generally responsible for obtaining this certification (or for monitoring the technology permitting it), and they must provide, or arrange for the provision of, the necessary continuing education.\textsuperscript{54} They are also involved in workforce training when new products or a new business line are being introduced, which requires education for brokers about how to sell the products or do the new business in compliance with the law.\textsuperscript{55} Compliance officers also conduct training in professional and ethical standards as well as produce and administer a code of ethical conduct for the firm.\textsuperscript{56} In this role, they may be asked to provide advice on ethical issues, as well as on matters that fall within the grey areas of the law.

The position of compliance officer in a broker-dealer is indeed diverse, often entailing such varied roles as advisor to employees involved in the securities business, transcriber of WSPs, monitor and investigator of problems, and ethical counselor. It is no wonder that this position has assumed a growing importance in firms, a subject to which I shall now turn.

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\textsuperscript{51} See SIFMA, THE EVOLVING ROLE OF COMPLIANCE, supra note 37, at 17.

\textsuperscript{52} For a discussion of the continuing education obligations of broker-dealers and their registered representatives, see Poser & Fanto, supra note 6, § 6-56.10 to 6-56.12. These requirements are set out in FINRA Rule 1250. Generally, a broker has an obligation to fulfill a continuing education requirement every three years. See FINRA MANUAL, supra note 24, at 3115–20.

\textsuperscript{53} See NASD Rules, supra note 24 (NASD Rule 3010(a)(7)).

\textsuperscript{54} See SIA, WHITE PAPER ON THE ROLE OF COMPLIANCE, supra note 5, at 4.

\textsuperscript{55} See id. at 7.

\textsuperscript{56} See id.; SIFMA, THE EVOLVING ROLE OF COMPLIANCE, supra note 37, at 27–28. In addition, compliance officers have many specialized functions too numerous to discuss here: for example, they oversee the screening process and background checks for employees, as well as their licensing and qualifications; they establish and oversee anti-money laundering and Foreign Corrupt Practices Act programs; they establish control programs for the safeguarding of customer nonpublic personal information; and they oversee procedures designed to prevent insider trading and other conflicts of interest. See generally id. at 24–26.
II. THE GROWING IMPORTANCE OF COMPLIANCE

Compliance officers are thus in every broker-dealer, which now number approximately 4200 firms.\textsuperscript{57} Since under FINRA rules every firm must have a CCO,\textsuperscript{58} the number of brokerage employees engaged primarily in compliance is, at a minimum, equal to the number of firms. Larger firms are likely to have more compliance officers because their businesses are diverse and complex and thus demand a more developed compliance function.\textsuperscript{59} Many of those who have the position of compliance officer or CCO in smaller firms have other jobs and do not devote themselves fulltime to compliance.\textsuperscript{60} Compliance officers work in all kinds of organizational structures, depending upon the size and businesses of a firm.\textsuperscript{61} In large broker-dealers, they would generally be in a separate department or division under the CCO and thus in a separate reporting line from brokers. Although there is not extensive information available about compliance compensation,\textsuperscript{62} the data shows that it is less than compensation for bankers and brokers because it is not based directly on business results.\textsuperscript{63} However, the gap between compliance and business personnel has diminished as compensation for compliance officers has increased in recent years.\textsuperscript{64}

57. According to FINRA statistics, which are the most recent as of October 2013, there are 4195 member firms, with 162,808 branch offices and 634,955 registered representatives. See FINRA Statistics, FINRA, http://www.finra.org/Newsroom/Statistics/ (last updated July 12, 2013). The firms fall into four rough categories: (i) approximately 200 large firms, which historically were members of the New York Stock Exchange, which have most of the customer assets and most of the industry’s revenue and which are often in large financial groups; (ii) mid-sized, full-line firms, which are generally regional; (iii) discount brokerage firms; and (iv) smaller firms, sometimes operating with only few brokers. See SIFMA, FACT BOOK 2009, at 43 (2009) (discussing the kinds of broker-dealers).

58. See supra note 32 and accompanying text.


61. See generally SIFMA, THE EVOLVING ROLE OF COMPLIANCE, supra note 37, at 17–18 (discussing the various compliance structures used).


64. Id. (discussing the narrowing gap between compensation of business employees and those in control functions). Compliance officer compensation has recently stabilized. See Nat’l.
Compliance gained in importance as a result of the financial crisis. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), with its accompanying SEC regulations, has resulted in more work for compliance because compliance officers have to translate the new laws and regulations into WSPs with accompanying monitoring, reporting, and inspections.\(^{65}\) In addition, after the crisis, regulators and SROs have increased their oversight of financial firms and their enforcement of the laws, rules, and standards, which increases the work of compliance officers. Both the SEC and FINRA revamped their examinations of broker-dealers with, among other things, the involvement of more specialist examiners, the sharing of information among divisions (including the enforcement division), and more examinations targeting firms with the highest risks.\(^{66}\) The SEC beefed up its enforcement function by forming prosecutorial groups focusing on particular kinds of financial institutions and specific abuses.\(^{67}\) This examination and enforcement activity demands the attention of the compliance officer, who generally is the point person for the firm in regulatory examinations and who assists the firm’s legal officers in responding to enforcement inquiries.

Congress in Dodd-Frank and the SEC in its regulations also use the existing model of broker-dealer compliance for previously unregulated financial participants. For instance, a significant part of the legislation involved the regulation of the swap markets and their major participants.\(^{68}\)

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\(^{66}\) The requirement to enhance examinations was primarily motivated by the SEC’s failure to detect the Bernard Madoff scandal, which was revealed when his Ponzi scheme collapsed during the crisis. See Poser & Fant, supra note 6, § 7-60 to 7-64. The SEC’s enhancement of examinations was mandated by Congress in Dodd-Frank section 929U, which, among other things, added a new section 4E of the Exchange Act. See Dodd-Frank Act sec. 4E, § 929U, 124 Stat. at 1867–68 (codified as amended at 15 U.S.C. § 78d-5 (2012)). This provision required specialized examiners for the SEC’s Division of Trading and Markets, which oversees broker-dealers. Id. On the SEC’s risk-based examination system, see SEC, FISCAL YEAR 2012 AGENCY FINANCIAL REPORT 3 (2012) [hereinafter SEC FISCAL YEAR 2012 REPORT], available at http://www.sec.gov/about/secpar/secafr2012.pdf. On FINRA’s enhancement to its own examinations in reaction to the scandal, see FINRA SPECIAL REVIEW COMMITTEE, REPORT OF THE 2009 SPECIAL REVIEW COMMITTEE ON FINRA’S EXAMINATION PROGRAM IN LIGHT OF THE STANFORD AND MADOFF SCHEMES 6–8 (2009), available at http://www.finra.org/web/groups/corporate/@corp/documents/corporate/p120078.pdf.


\(^{68}\) See Dodd-Frank Act tit. 7, §§ 721–74, 124 Stat. 1658–1802. Swap regulation was divided between the Commodity Futures Trading Commission and the SEC, depending upon the nature of the underlying asset that was the subject of the swap.
Swap dealers are now regulated in a manner that, understandably enough, parallels, and is modeled on, that of broker-dealers. As a result, a swap dealer must have a supervisory structure and record-keeping, which naturally demand a compliance function. Dodd-Frank has thus ushered in a whole new era for compliance, albeit particularly in financial firms like investment advisers and swap dealers.

That compliance officers now have a significant place in broker-dealers means that ultimately the regulatory burden emanating from the crisis will fall on them. As a result of the financial crisis, as discussed above, legislators, regulators, and FINRA officials have shown a renewed zeal for law creation and enforcement, but their efforts will eventually wane. Legislators become distracted with other, more pressing concerns. The SEC has limited resources in this time of scarcity, and its budget is neither growing nor likely to grow significantly in the future. FINRA has improved its oversight over broker-dealers. Yet while the SRO is closer to these firms, its examiners and enforcement staff are not in them on a day-to-day basis.

Compliance officers, by contrast, are in the firms, and, as discussed above, they are specifically charged with legal, professional, and ethical compliance. Most importantly, they actually see what is occurring in the firms. They are thus well situated to alert supervisors and senior executives to growing problems, such as the securitization of subprime loans, which may infiltrate the financial industry and gradually grow into a dreaded and resented financial crisis. Being involved with compliance and assisting in the supervision of every broker and securities activity in a broker-dealer, a compliance officer is well positioned to identify such problems perhaps before they are transformed into larger, potentially systemic issues. Furthermore, given the sheer number of new laws and regulations imposed upon broker-dealers as a result of the most recent financial crisis, the brokerage industry could not survive without compliance officers. The compliance officer today in a broker-dealer does not generally have to worry about remaining employed, but he or she is likely to be overwhelmed with work. A question posed by the symposium is whether the legal academy can help him or her with the burden.

69. See Poser & Fant0, supra note 6, § 5-40 to 5-44.1.
70. Indeed, new section 15F(k) of the Exchange Act dealing with security-based swap dealer regulation mandates that such a dealer have a CCO to implement compliance in the dealer. See 15 U.S.C. § 78o-10(k).
71. See supra notes 66–67.
73. See SEC FISCAL YEAR 2012 REPORT, supra note 66, at 48.
74. See supra text accompanying notes 38–56.
75. See SIFMA, THE EVOLVING ROLE OF COMPLIANCE, supra note 37, at 18–19.
III. COMPLIANCE AND THE LEGAL ACADEMY

There has been little work on financial compliance in the legal academy. It is not that scholars have ignored compliance entirely. Indeed, there have been scholarly articles written on compliance in public corporations, including studies with the approach of New Governance—an academic movement encouraging regulators and the regulated to produce more effective regulation by cooperating in rule-making. Many New Governance insights can be brought to the financial area and could be applied to the role of compliance in the development of cooperative regulation. In addition, there has been considerable academic work about how the emphasis on enforcement and prosecution adversely affects regulation, including the regulation of financial institutions. This is relevant to financial firm compliance insofar as compliance officers can be enlisted in the SEC’s and FINRA’s enforcement efforts, as well as prosecution by the U.S. Department of Justice. Despite these fruitful areas of scholarly activity with their occasional references to financial compliance, there has been little sustained attention to this subject.

Given the nature of the legal academy and its relationship to legal practice, this lack of attention is not surprising. Compliance is part of the day-to-day operations of broker-dealers and is a technical feature of broker-dealer practice. Law professors who specialize in securities law spend most of their time on issues related to capital raising and public company disclosure and considerably less time on market structure and particularly on market intermediaries. Their orientation may reflect the traditional desired destination of the students of elite schools, the large corporate law firms that focus primarily upon financing and transactions, not on the

77. See generally Miriam Baer, Organizational Liability and the Tension Between Corporate and Criminal Law, 19 I.L. & POL’Y 1 (2010) (arguing that the emphasis on prosecutorial discretion as a means of rehabilitating corporate wrongdoers creates the potential for waste and abuse and detracts from the need for corporate and securities laws that decrease the underlying risks of criminal misconduct); John Hasnas, Managing the Risks of Legal Compliance: Conflicting Demands of Law and Ethics, 39 LOY. U. CHI. L.J. 507, 517 (2008) (“[T]he use of extrinsic punishment and rewards by the command-and-control approach undermines the intrinsic motivation necessary to the self-regulatory approach.”).
78. See SIFMA, THE EVOLVING ROLE OF COMPLIANCE, supra note 37, at 35 (discussing regulators’ “deputizing” compliance officers as their agents).
79. This is exemplified by the coverage in securities law textbooks. For example, one prominent book spends about 450 pages on capital raising and about 140 pages on securities markets and broker-dealers. See JOHN C. COFFEE, JR. & HILLARY A. SALE, SECURITIES REGULATION (12th ed. 2012).
operations of intermediaries like broker-dealers or securities exchanges.\(^{81}\) Moreover, even scholars who occasionally study intermediaries are likely to be interested in legal issues like fiduciary duties that are more academic and jurisprudential, rather than in the day-to-day operations of compliance departments.\(^{82}\) The relative lack of attention in the legal academy to compliance may also reflect that compliance as a field was not traditionally the exclusive domain of lawyers, but included operations and back office personnel.\(^{83}\) Finally, my personal impression is that few legal academics today come to law teaching from as specialized a practice background as financial firm compliance. They are thus not likely to have the experience to write about it.

Things may now be changing. There is an employment reason for this transformation because there is a perception, whether it is right or wrong, that financial firm compliance offers job opportunities for students in this difficult employment environment. This may be true since, given the sheer number of regulations that compliance must handle, it is useful for compliance officers to have legal training. Indeed, law schools are now entering into the process of training students for compliance positions\(^{84}\) and providing externships with financial regulators or within compliance departments of financial firms.\(^{85}\) Moreover, since law schools are feeling the pressure to prepare their students for the practicing world that awaits them, they might provide a transition course in compliance for students entering the field.\(^{86}\) Thus, this perceived need to teach about compliance may spur more scholarly focus on the subject, and it was precisely to stimulate this scholarly work that the symposium was organized.

This new academic focus on compliance may be beneficial. As has been explained above, compliance officers occupy a difficult, but important, position in financial firms, translating the laws and regulations into actual firm practice and serving as an intermediary between the regulators and the regulated.\(^{87}\) It would be valuable if academics could reflect upon this role


\(^{82}\) See, e.g., Arthur Laby, *Selling Advice and Creating Expectations: Why Brokers Should Be Fiduciaries*, 87 WASH. L. REV. 707 (2012). Professor Laby, a former SEC staff member, is one of the few professors who understands compliance, but even his work centers more on properly legal topics like fiduciary duty.

\(^{83}\) But see Vass, *supra* note 9, at 55 (“In the earlier years, persons who served as internal general counsels were often also designated as Compliance officers.”).


\(^{85}\) Our own law school has for a long time offered externships with FINRA, the SEC, and financial firms.

\(^{86}\) The author offers such a course at Brooklyn Law School together with compliance officers and other specialists in the compliance field. It is entitled “An Introduction to Compliance and Risk Management in Financial Institutions.”

\(^{87}\) See *supra* Part II.
with all the imagination (and without the concern about not offending their clients) that they typically bring to the task. This attention could of course have unpredictable results because it is certainly possible that they would criticize compliance and even argue that it be reduced in firms. To give an example, Professor Birdthistle, who was a participant in our symposium, has co-written an article with Professor Todd Henderson of the University of Chicago. In this paper, among other things, they criticize the compliance industry as part of their overall criticism of FINRA’s transformation from an SRO into a quasi-governmental regulator. Their implication is that compliance officers and compliance consultants, often drawn from regulators and FINRA, do not want to challenge the current regulatory status quo of FINRA’s dominance since they profit from it, even if this situation is not the best for the financial industry and investors.

Alternatively, law professors could look critically at the current functioning of compliance, identify issues or problems in it, and suggest how compliance officers could address these issues and improve their performance. Legal academics are particularly useful in this regard, again because they are not beholden to specific clients and because they take a broad view of the subject matter, which might enable them to see trends and issues not clear to those “in the trenches.” This kind of scholarly work was evident at the symposium. Professor Barbara Black, a noted securities scholar who has longstanding experience with FINRA’s disciplinary proceedings through her participation on its National Adjudicatory Council, reflected upon the compliance-specific implications of FINRA sanctions, which are expressly remedial rather than punitive. Professor Jerry Markham raised an issue that has been the subject of considerable concern in the compliance industry throughout financial services: the safe custody of customer assets.

As he identified, the issue has surfaced in failures or scandals in different kinds of financial firms, such as broker-dealers, investment advisers, and commodities firms, where the firms inappropriately used or

88. See William A. Birdthistle & M. Todd Henderson, Becoming a Fifth Branch, 99 CORNELL L. REV. 1 (2013). Professor Birdthistle, who was sick on the day of the symposium, spoke by videoconference.
89. See id. at 44–49.
90. See id. at 48.
92. This is because, perhaps starting with the Bernard Madoff case, there have been repeated cases of financial firms either stealing customer assets or using them improperly. The most recent case was MF Global, where customer assets were used essentially to prop up the firm, which was failing because of its bets on European government securities. See Report of Investigation of Louis J. Freeh, Chapter 11 Trustee of MF Global Holdings, Ltd. et al., In re MF Global Holdings Ltd., No. 11-15059 (MG) (Bankr. S.D.N.Y. Apr. 4, 2013), available at http://www.mfglobalcaseinfo.com/pdflib/1279_15059.pdf (discussing the scandal).
simply misappropriated customer assets. Professor Markham provided an overview of this problem and the regulatory responses to it, which could help in the reform process as regulators decide upon the most effective approach to safeguarding customer assets. Professor Deborah DeMott examined the position of the CCO and its importance in enhancing the firm’s reputation.

Legal scholars could also aid compliance because they often bring insights from other academic disciplines into their legal analysis. One of the most prominent academics who has often drawn insights from psychology and organizational studies is Professor Donald Langevoort, who at our symposium offered comments on other professors’ papers. He intriguingly raised the point that compliance’s task of helping to ensure that financial firm employees comply with the law is all the more challenging because of the very nature of the business employees. He meant here physical nature, citing intriguing work on the neurological basis of financial risk-taking. In a similarly broad vein, Professor Tamar Frankel (albeit through a proxy, since she could not attend the symposium because of the weather) explored the beneficial effect of codes of conduct in changing the culture of regulated investment funds with respect to deterring insider trading. From her typically broad perspective, which incorporates learning from ethical studies, she offered thoughts on why the codes work in this situation, which could serve as a model for other financial firms wishing to have effective codes.

I offered my own psychologically based reflections on compliance at the symposium. To take one case discussed above, compliance officers spend a lot of time drafting and revising WSPs and then monitoring the brokers’ compliance with them. Despite these detailed directions and monitoring, it is not possible for compliance officers to cover every topic and to oversee all activity in brokerage operations. Indeed, this kind of extensive direction and oversight might even have a negative effect in a field like brokerage, many of whose activities are not routine, and which benefits from the discretion and independence given to its employees.

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93. See Jerry W. Markham, Custodial Requirements for Customer Funds, 8 BROOK. J. CORP. FIN. & COM. L. 92 (2013).
96. See Tamar Frankel, Self-Regulation of Insider-Trading in Mutual Funds and Advisers, 8 BROOK. J. CORP. FIN. & COM. L. 80 (2013).
97. See id. at 90.
98. See supra text accompanying notes 41–45.
the WSPs produce too much routine behavior and the monitoring is too heavy-handed, brokers and bankers may see the compliance procedures as external to their business and ultimately as a hindrance, to be complied with only formally or even “gamed.” Compliance officers will likely succeed in catching most of the egregious violations through this kind of monitoring, but there are likely to be others that slip by them. More significantly, there may be problems that do not rise yet to the level of violations but that could do so in time or that pose professional or ethical issues, which may have an eventual, calamitous effect upon the firm if brokers continue to engage in them.

While compliance officers must continue to produce the WSPs (if only to let brokers know about their legal obligations) and to monitor for compliance, their ultimate goal has to be self- or internal compliance by a broker—the compliance officer would be left essentially to be an advisor on difficult issues. In other words, the ideal purpose of a compliance officer would be to have brokers internalize legal and regulatory policies and ethical standards so that these policies and standards come to the foreground in their decision-making and displace others, such as self-interest, which could lead to legal and ethical violations. This purpose falls squarely within the educational and cultural role of compliance. Yet in order to promote this internal compliance, compliance officers would have to understand how decision-making in fact occurs in people, particularly when they have competing goals and work in cohesive groups and organizations, and what techniques might be used to encourage brokers to focus on legal and ethical standards in decision-making. This understanding

100. See Tammy L. MacLean & Michael Behnam, The Dangers of Decoupling: The Relationship Between Compliance Programs, Legitimacy Perceptions, and Institutionalized Misconduct, 53 ACAD. MGMT. J. 1499 (2010) (discussing how compliance programs can become divorced from the business activity of the firm, resulting in more misconduct). In other words, the employees would find a way to “disengage” the legal and ethical values from their everyday practice. See generally Albert Bandura et al., Mechanisms of Moral Disengagement in the Exercise of Moral Agency, 71 J. PERSONALITY & SOC. PSYCHOL. 364 (1996) (discussing the classic processes of moral disengagement: justifying detrimental action by (i) classifying it as moral, (ii) diffusing the responsibility for it, (iii) disregarding or distorting its consequences, and (iv) blaming the victims for one’s actions).

101. What I term “external” monitoring is always necessary for compliance, since it is a major way in which social values are enforced. See Bandura et al., supra note 100, at 372. Thus, I am not suggesting that we eliminate the detailed compliance procedures and the external monitoring.


103. Another way of saying this is to ensure that the policies and standards do not “fade.” See generally MAX H. BAZERMAN & ANN E. TENBRUNSEL, BLIND SPOTS: WHY WE FAIL TO DO WHAT’S RIGHT AND WHAT TO DO ABOUT IT 69 (2011) (discussing “ethical” fading, where ethical dimensions of a decision “fade” at the time of decision-making).
is likely to come from the disciplines of psychology, social psychology, organizational studies, and, to a lesser extent, from economics.104

For a long time, management scholars have provided these kinds of insights and guidance to managers and executives, who of course are concerned with having legally and ethically compliant organizations and employees.105 It seems to me that legal scholars who follow developments, or who are even trained, in the above fields could do the same for compliance officers, particularly, as noted above, since an increasing number of compliance officers have legal training and are open to discussions with law professors. This work should be attractive to securities law scholars, for they are concerned with legal policies that improve the functioning of markets and market intermediaries. Certainly, investors will actively participate in securities markets if they perceive, partly as a result of a more robust compliance, that the broker is acting on their behalf in accordance with securities law policies and SRO professional standards, and not just thinking of investors as a personal profit center.

CONCLUSION

The symposium at Brooklyn Law School, as well as the contributions in this issue, recognizes the growth and importance of compliance in financial firms. Its growth was initially spurred by the statutory and regulatory requirements of broker-dealers to have supervisory systems to address the potential supervisory liability of the firm and its managers for legal and ethical violations by its employees. As the legal, regulatory, and ethical obligations on firms and their employees have grown over the past forty years, compliance has evolved from a minor task performed by a supervisor with the assistance of outside counsel, or by back office personnel, to a developed control function in the firm. Now compliance officers, who are required in every firm, often preside over a large department and have a seat

104. I give this qualification to economics because its model of human decision-making appears not to reflect how people actually make decisions in real circumstances. For a summary of advances of economics in this regards, see Nicholas C. Barberis, Thirty Years of Prospect Theory in Economics: A Review and Assessment, 27 J. ECON. PERSP. 173 (2013). On the utility of the economic rational actor framework in some circumstances, see Colin F. Camerer & Ernst Fehr, When Does “Economic Man” Dominate Social Behavior?, 311 SCIENCE 47 (2006).

105. Many of the scholarly articles providing this guidance appear in, among other places, the Academy of Management publications. I have mentioned several of these works in the course of the last paragraphs. For other useful works, see Brian C. Gunia et al., Contemplation and Conversation: Subtle Influences on Moral Decision Making, 55 ACAD. MGMT. J. 13, 17, 22 (2012) (finding that conversation that raises ethical matters or figures, as opposed to conversation focusing on self-interest, leads to more ethical decisions); David M. Mayer et al., Who Displays Ethical Leadership, and Why Does It Matter? An Examination of Antecedents and Consequences of Ethical Leadership, 55 ACAD. MGMT. J. 151, 153–54 (2012) (discussing the importance of ethical leadership in organizations); Long Wang & J. Keith Murnighan, On Greed, 5 ACAD. MGMT. ANNALS 279, 301 (2011) (discussing how “calculative” self-interested mindset is triggered).
at the table of top management. With the growth of compliance has come its development as a career path, which is attractive in a tight job market. For this and for other reasons, compliance is now noticed by law schools.

I have argued in this introductory Article that the new attention to compliance could be fruitful both to legal scholars and to compliance officers. The latter occupy a key place on the front lines of financial firms between regulators and employees conducting the securities business. They are expected to help firm employees comply with legal and ethical obligations in jobs that demand considerable freedom and discretion. If compliance officers are to be successful in this goal, they need to do more than simply translate the laws and rules for employees and monitor compliance with them. They have to promote compliant conduct within the employees themselves, which is a complex advisory and educational task. The interaction between compliance officers and legal scholars, who follow developments in disciplines like social psychology and organizational research that study how to promote compliant and ethical conduct, could contribute to the future growth and success of compliance itself. Let us hope that our symposium will be one of many steps in this fruitful collaboration.
PUNISHING BAD BROKERS:
SELF-REGULATION AND FINRA SANCTIONS

Barbara Black*

INTRODUCTION

Regulation of the broker-dealer industry by a self-regulatory organization (SRO)\(^1\) is an integral part of the federal regulatory scheme under the Securities Exchange Act of 1934 (the Exchange Act). As a result, the Financial Industry Regulatory Authority (FINRA), the sole SRO for U.S. broker-dealers,\(^2\) plays an important role in protecting investors, especially retail investors, and bolstering investor confidence in the securities industry and capital markets.\(^3\) Suppose a retail investor believes that the sales representative of the brokerage firm with whom she has an account\(^4\) (colloquially, her “broker”) has abused her trust and caused her financial loss. The investor likely wants to recover her losses and to see the broker punished. FINRA, and not the U.S. Securities and Exchange Commission (the SEC), is the regulator that primarily addresses her concerns, the first through its arbitration forum\(^5\) and the second through its disciplinary proceedings. FINRA is the “cop on the beat.” In 2012 FINRA brought approximately 1500 disciplinary actions against broker-dealer firms and associated persons, imposed fines of more than $68 million, and

\* Charles Hartsock Professor of Law and Director, Corporate Law Center, University of Cincinnati College of Law. This paper was written for Brooklyn Law School’s February 8, 2013, symposium on the Growth and Importance of Compliance in Financial Firms: Meaning and Implications. My thanks to Professor James Fanto for inviting me to participate. Bryan Wisecup and Christopher Jones, Corporate Law Fellows and UC Law ’14, provided valuable research assistance.


3. “Our chief role is to protect investors by maintaining the fairness of the U.S. capital markets.” About FINRA: Leadership, supra note 2.


ordered restitution of $34 million to injured investors. It expelled thirty firms, barred 294 individuals, and suspended another 549 individuals. Most of FINRA’s disciplinary proceedings are mundane and do not grab headlines. Consisting of a single broker accused of simple fraud, the proceedings are frequently uncontested, or if contested, the broker appears pro se. Thus, FINRA’s enforcement efforts do not garner the headlines that the SEC receives, and there has been little scholarly interest in FINRA disciplinary proceedings.

My interest in securities self-regulation and, in particular, FINRA sanctions stems from my service as a member of FINRA’s National Adjudicatory Council (the NAC) from 2009–2011. The NAC is the appellate body that reviews initial decisions in FINRA disciplinary and membership proceedings. Its fourteen members, consisting of seven industry representatives and seven public representatives, engage in extended discussions about the facts and circumstances of the cases that come before it, and the discussions frequently boil down to whether the misconduct was “egregious,” warranting stiffer sanctions, or something less serious, sometimes expressed as “serious but not egregious.” FINRA adjudicators have broad discretion in determining sanctions; there is no definition of this key concept “egregious.” Although many NAC members

8. See Yin Wilczek, FINRA Enforcement Numbers on Track to Match 2012 Record, Chief Enforcer Says, BLOOMBERG L., http://about.bloomberglaw.com/law-reports/fina-enforcement-numbers-on-track-to-match-2012-record-chief-enforcer-says/ (last visited Nov. 17, 2013) (reporting that FINRA Chief of Enforcement says the home office continues to see a significant number of “single broker cases” involving “ petty dishonesty”).
9. It is reported that FINRA CEO Richard Ketchum now seeks greater visibility for FINRA and is “tracking bigger game.” See Ben Protess, Regulator Plans to Expand Its Focus, N.Y. TIMES DEALBOOK (Jan. 8, 2013, 12:54 PM), http://dealbook.nytimes.com/2013/01/08/regulator-plans-to-expand-its-focus/.
13. Id. (answer to question 17) (In determining if a violation is egregious, the adjudicators “assess the individual facts and circumstances of the case” and “also consider all relevant aggravating and mitigating factors.”).
Punishing Bad Brokers

are attorneys,\textsuperscript{14} the discussions do not generally involve legal precedent. The habits of a law professor die hard, however, and my experience has caused me to think more about the nature of industry self-regulation and, in particular, the fundamental principles underlying sanctions imposed by an industry regulator. This Article, the product of that exercise, describes, in Part I, the evolution of securities self-regulation since the 1938 Maloney Act and, in Part II, the theory and practice of FINRA sanctions.

I. THE EVOLUTION OF SECURITIES SELF-REGULATION

A. CONTRASTING VIEWS ON SECURITIES SELF-REGULATION

Although regulation of the broker-dealer industry by an SRO has long been part of the federal regulatory system, the model of self-regulation has not migrated to other participants and products regulated under the federal securities laws. In recent years Congress has considered authorizing SROs for mutual funds\textsuperscript{15} and investment advisers;\textsuperscript{16} in both instances, however, the proposals did not move forward. While there can be many reasons why new SROs did not come into existence,\textsuperscript{17} the lack of enthusiasm for them may suggest doubts about the self-regulatory model. Both Congress and the SEC have viewed it with suspicion and refer to “the natural lack of enthusiasm for regulation on the part of the group to be regulated”\textsuperscript{18} as a serious flaw in the self-regulatory model. According to the SEC, “[i]nherent in self-regulation is the conflict of interest that exists when an organization

\textsuperscript{14} Of the 2013 NAC members, all of the seven public members are lawyers (five of them law professors), and three of the industry members (Mahon, Ostergaard, and Senatore) are lawyers. See National Adjudicatory Council, FINRA, http://www.finra.org/Industry/Enforcement/Adjudication/NAC/naccommittee/ (last updated Jan. 17, 2013).


\textsuperscript{17} See Mark Schaeff Jr., At Crucial Hearing, Deck Will Be Stacked Against SRO Opponents, INVESTMENT NEWS, http://www.investmentnews.com/article/20120605/BLOG07/120609962 (last visited Nov. 17, 2013). Both the mutual fund and investment advisory industries opposed regulation by an SRO, at least in part because of additional costs associated with another regulator. Id. In addition, FINRA initially sought to become the SRO for investment advisers, which the advisory industry fought because it views the regulatory model for investment advisers as fundamentally different from the broker-dealer model. Id.

\textsuperscript{18} SECURITIES INDUSTRY STUDY, S. REP. NO. 93-13, at 145 (1973) [hereinafter SECURITIES INDUSTRY STUDY].
both serves the commercial interests of and regulates its members or users.”

In addition to a tendency to protect the economic interests of its members, there are persistent concerns about uneven and discriminatory enforcement, particularly by larger, more established firms against smaller, newer entrants.

There is, however, an alternative, positive view of the self-regulatory model that has plausibility. Indeed, no one may be more motivated to discipline brokers and to remove bad brokers from the industry than the industry itself. Good firms spend considerable resources on training their salespersons and other employees and on maintaining compliance programs to prevent violations; bad firms, in contrast, scrimp on these costs. The actions of bad actors, nevertheless, will cost the entire industry in terms of loss of investor confidence and increased government surveillance.

In addition, self-regulation may be more effective than government regulation because of industry experience and expertise, the ability to perform detailed oversight functions, and greater acceptance of regulation by the industry rather than by the government. It is frequently asserted that industry regulators can enforce ethical standards that are loftier than mere legal compliance, although, as I discuss later on, this assertion, if ever true, is questionable today. Finally, as a practical matter, the size of the brokerage industry means that the SEC could not be the primary enforcer without a significant infusion of resources, and the federal government prefers that


20. See infra notes 94–103 and accompanying text (discussing the NASD’s 1996 scandal involving collusion among market makers); see also SEC Concept Release, supra note 19, § IV.A.I, at *7 (discussing concerns about undue influence of large member firms).

21. See Paul S. Grant, The National Association of Securities Dealers: Its Origin and Operation, 1942 WIS. L. REV. 597, 608 (describing disciplinary proceedings and stating that “the experience and judgment of men in the business are the best qualifications for fair, even strict determination of findings and penalties” and “[t]he members passing on complaints are determined that the industry will raise its standards”); see also Onnig H. Dombalagian, Self and Self-Regulation: Resolving The SRO Identity Crisis, 1 BROOK. J. CORP. FIN. & COM. L. 317, 321–22 (2007) (describing reciprocal regulation to signal higher standards of care adhered to by SRO members).


24. SEC SPECIAL STUDY, supra note 23, at 722.

25. For example, it is unlikely that the NASD could enforce a view of manipulation that was contrary to the SEC’s. See infra notes 104–107 and accompanying text (discussing NASD v. SEC, 431 F.3d 803 (D.C. Cir. 2005)). In Dep’t of Mkt. Regulation v. Leighton, Complaint No. CLG050021, 2010 WL 781457, at *2 (FINRA NAC Mar. 3, 2010), the NAC reversed the findings of the Extended Hearing Panel’s majority based on a “tenuous” industry standard that limited the profits an institutional sales trader could make on trades.
the industry pay these regulatory costs. For this reason alone, whatever the assessment of its strengths and weaknesses, self-regulation of the broker-dealer industry is here to stay.

B. THE CURRENT STATUTORY FRAMEWORK

Section 15A of the Exchange Act, which provides for the registration with the SEC of national securities associations, has been amended frequently since its initial enactment in 1938 in the Maloney Act. We first set forth the current statutory framework and then discuss the legislative history of the Maloney Act and subsequent significant developments.

Section 15A provides that an association of brokers and dealers may be registered as a “national securities association” (NSA) if it applies for registration with the SEC and meets the statutory requirements as well as others prescribed by the SEC. In order for an association of brokers and dealers to be registered as an NSA, the SEC must make a number of determinations, including that the association is “able to carry out the purposes of [the Exchange Act]” and “to enforce compliance by its members and persons associated with its members, with the provisions” of the Exchange Act and its rules and the rules of the association. The association must adopt rules designed for a variety of enumerated purposes, including “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.” The association’s rules must provide for appropriate discipline of its members and associated persons for violations of the Exchange Act and its rules and the association’s rules. The statute authorizes a broad range of sanctions, including “expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction.”

The statute requires that the association’s rules set forth “a fair procedure” for the discipline of its members and associated persons.


29. Id. § 78o-3(b)(2).

30. Id. § 78o-3(b)(6).

31. Id. § 78o-3(b)(7).

32. Id.

33. Id. § 78o-3(b)(8).
addition, the statute specifies certain procedures to assure notice and an
opportunity to be heard, as well as the creation of a reviewable record. In
any disciplinary proceeding, the association must “bring specific charges,
notify such member or person of, and give him an opportunity to defend
against, such charges, and keep a record.”34 A determination to impose a
disciplinary sanction must be accompanied by a statement setting forth (A)
the act or practice that the member or associated person was found to have
engaged or found to have omitted; (B) the specific provision of the
Exchange Act, its rules, or the SRO rules which the act, practice, or
omission violated; and (C) the sanction imposed and the reason for it.35

FINRA disciplinary proceedings are heard before a panel chaired by a
professional hearing officer and two industry representatives.36 Any party
may seek to appeal a hearing panel’s decision to the NAC, and the NAC
may decide on its own to hear an appeal.37 The NAC’s decision is FINRA’s
final action on the matter unless FINRA’s Board of Governors decides to
review it.38

All disciplinary proceedings are subject to de novo review by the SEC,
on the agency’s own motion or upon application by any “aggrieved”
person.39 So that the SEC is kept apprised of SRO disciplinary proceedings,
the SRO is required to provide the agency notice of any final disciplinary
sanction containing such information as the agency requires by rule.40 To
uphold any sanction imposed by the SRO, the SEC must make findings that
the member or associated person

has engaged in such acts or practices, or has omitted such acts, as the self-
regulatory organization has found him to have engaged in or omitted, that
such acts or practices, or omissions to act, are in violation of such
provisions of this chapter, the rules or regulations thereunder, [or] the
rules of the self-regulatory organization, . . . and that such provisions are,
and were applied in a manner, consistent with the purposes of this
chapter.41

If, however, the SEC does not make the requisite findings of a
violation, then it must set aside the sanction and, “if appropriate,” remand to

34. Id. § 78o-3(h)(1).
35. Id.
36. Adjudication, FINRA, http://www.finra.org/Industry/Enforcement/Adjudication/ (last
visited Nov. 17, 2013). FINRA Code of Procedure Rules 9231 and 9232 set forth the criteria for
/display_viewall.html?rbid=2403&element_id=3895&record_id=11675 (last visited Nov. 17,
2013).
37. Adjudication, supra note 36.
38. Id.
40. Id. § 78s(d)(1). The notice requirement is set forth in SEC Rule 19d-1. Notices by Self-
the SRO for further proceedings. Moreover, after the SEC makes the requisite findings of a violation, if it finds, “having due regard for the public interest and the protection of investors,” that the sanction imposed by the SRO “imposes any burden on competition not necessary or appropriate in furtherance of the purposes of this chapter or is excessive or oppressive,” then it may “cancel, reduce, or require the remission of such sanction.”

Although the statute is phrased in terms of agency discretion, according to the D.C. Circuit, the SEC must, when reviewing a FINRA disciplinary action, consider whether the sanction is “excessive or oppressive” and must carefully consider any aggravating or mitigating factors relevant to the determination of an appropriate sanction.

Finally, the Exchange Act provides for judicial review of an SEC final order by a “person aggrieved” by the order. The standard of review is the “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law” standard set forth in the Administrative Procedure Act.

C. EVOLVING VIEWS ON SECURITIES SELF-REGULATION

Since its inception in 1939, FINRA (including its predecessor, the NASD) has evolved from a membership association primarily responsible for enforcing industry norms to a regulator that enforces federal securities laws as an adjunct of the SEC. This section summarizes the milestones in that development.

1. The Maloney Act

The original concept of securities self-regulation was that of membership associations having contractual powers to enforce sound business practices and ethical standards that were considered beyond the scope of government regulation. As described by William Douglas:

Self-regulation . . . can be pervasive and subtle in its conditioning influence over business practices and business morality. By and large, government can operate satisfactorily only by proscription. That leaves untouched large areas of conduct and activity; some of it susceptible of

42. Id. § 78s(e)(1)(B).
43. Id. § 78s(e)(2). The SEC also has discretion to remand to the SRO for further proceedings.
44. Saad v. SEC, 718 F.3d 904, 909, 913 (D.C. Cir. 2013).
47. See generally Karmel, supra note 10 (describing how at least some of the “self” has been taken out of FINRA).
48. SELIGMAN, supra note 23, at 186.
government regulation but in fact too minute for satisfactory control; some of it lying beyond the periphery of the law in the realm of ethics and morality. Into these larger areas self-government and self-government alone, can effectively reach.50

The Exchange Act, as enacted in 1934, designated national securities exchanges, principally the New York Stock Exchange (NYSE), as SROs with the responsibility to regulate member broker-dealers but did not provide for self-regulation of broker-dealers operating in the over-the-counter (OTC) markets. Congress addressed this lacuna in 1938. The Maloney Act amended the Exchange Act to set up “a system for cooperative regulation of the over-the-counter markets, through the activities of voluntary associations of investment bankers, dealers and brokers doing business in these markets, under appropriate governmental supervision.”51 The legislative history identified three aspects to regulation of the OTC markets:

First, to protect the investor and the honest dealer alike from dishonest and unfair practices by the submarginal element in the industry; second, to cope with those methods of doing business which, while technically outside the area of definite illegality, are nevertheless unfair both to customer and decent competitor, and are seriously damaging to the mechanism of the free and open market; and, third, to afford to the investor an economic service the efficiency of which will be commensurate with its economic importance, so that the machinery of the Nation’s markets will operate to avoid the misdirection of the Nation’s savings, which contributes powerfully toward economic depressions and breeds distrust of our financial processes.52

Congress identified two regulatory alternatives. Rejecting the first, a “pronounced expansion of the [SEC],” with a large increase in expenditure of public funds, accompanied by “a minute, detailed, and rigid regulation of business conduct by law,”53 Congress opted for “cooperative regulation,”54 as described by Senator Maloney:

The Federal Government, through the Securities and Exchange Commission, says to the investment bankers of the country, “You may create your own association or associations. You may provide your own rules and your own regulations. We want you to run your own business. We want a representation, however. We want a right of review and supervision.” So, while some of us would like to call what is provided for

50. SECURITIES INDUSTRY STUDY, supra note 18, at 149.
52. H.R. REP NO. 75-2307, at 4.
53. Id.
54. Id.
self-regulations, it is in effect a cooperative regulation . . . . It is purely voluntary.\textsuperscript{55}

Similarly, the purpose of the legislation was “to enable the people of this business to guide and direct the affairs of their own industry under government supervision.”\textsuperscript{56} The legislation presupposed that “regulation can best be achieved by the efforts of honest brokers and dealers themselves . . . .”\textsuperscript{57} The SEC is “injected into the association or associations to prevent the growth of monopoly and to protect the rights of minorities, and the little dealer as well as the small buyers.”\textsuperscript{58}

Consistent with the concept that the membership associations would enforce their own rules, Exchange Act section 15A, as originally enacted, did not explicitly give NSAs the authority to bring disciplinary proceedings for violations of federal securities laws and regulations.\textsuperscript{59} It was not until the 1975 amendments to the Exchange Act that NSAs had express authority to enforce the Exchange Act and its rules, although prior thereto, the NASD had enforced at least some federal securities provisions through its general requirement of “high standards of commercial honor and just and equitable principles.”\textsuperscript{60}

The NASD was established in 1939 and was—and continues to be through its successor, FINRA—the sole NSA for broker-dealers.\textsuperscript{61}

\section*{2. The SEC’s Special Study of Securities Markets}

In 1961 Congress appropriated funds for the SEC to undertake “a broad study of the adequacy of investor protection in the securities markets,”\textsuperscript{62} including an examination of the OTC market. Joel Seligman, the foremost historian of the SEC, described the \textit{Special Study of Securities Markets} (the \textit{Special Study}), conducted by a quasi-independent group within the SEC, as “the single most influential document published in the history of the SEC.”\textsuperscript{63} A principal component of the \textit{Special Study} is “a factual documentation of the limits of self-regulation in the securities industry,”\textsuperscript{64} including the performance of the securities exchanges and the NASD as well as the SEC’s oversight of them.

The \textit{Special Study} described the evolution of the NASD from “a somewhat unique experiment in supervised self-regulation” to “an

\begin{itemize}
\item \textsuperscript{55} 83 CONG. REC. 4451 (1938) (statement of Sen. Francis Maloney).
\item \textsuperscript{56} Senator Francis Maloney, Radio Address on Over-the-Counter Securities Markets (Feb. 25, 1938), in 83 CONG. REC. app. at 789 (1938).
\item \textsuperscript{57} Id. at 790.
\item \textsuperscript{58} Id.
\item \textsuperscript{59} See SEC SPECIAL STUDY, supra note 23, at 646.
\item \textsuperscript{60} Id. at 646 n.420.
\item \textsuperscript{61} See supra note 2 and accompanying text.
\item \textsuperscript{62} SEC SPECIAL STUDY, supra note 23, pt. 1, at iii (Letter of Transmittal).
\item \textsuperscript{63} SELIGMAN, supra note 23, at 299.
\item \textsuperscript{64} Id.
\end{itemize}
established part of the regulatory scheme exerting a substantial influence on numerous phases of the securities industry.”

In its judgment, the NASD was at a crossroads because “its capacity to do its job is overtaxed.”

“The NASD’s job of self-regulation is an enormous one in every dimension, but from the beginning it has sought to adhere to a concept of self-regulation with a maximum emphasis on ‘self’—members in the securities business regulating themselves—and with minimal reliance on full-time paid staff.”

With respect to the NASD’s disciplinary proceedings, the Special Study reported that the NASD “placed great emphasis on informality and simplicity in all phases of the disciplinary process”—what was important to the membership was that decisions were “made by businessmen based upon their knowledge of the procedures of their business.”

The Special Study concluded that the principal problem with disciplinary proceedings was lack of efficiency and speed in handling cases; it also found troubling disparities in the penalties for certain kinds of misconduct that suggested discrimination against smaller firms.

To address the NASD’s deficiencies, the Special Study called for the creation of a larger professional staff with greater responsibilities, centralization of enforcement authority, and permanent hearing officers for disciplinary hearings. In addition, the Special Study observed that the NASD’s “purpose of promoting voluntary compliance with ethical standards beyond the reach of formal regulation has limited its resort to codification or other ‘legalistic’ techniques that might ease its burden of day-to-day regulation.”

In short, in the view of the Special Study, the NASD should become more bureaucratic, with a professional staff and a rulebook. These recommendations signaled a significant change in the

65. SEC SPECIAL STUDY, supra note 23, at 673.
66. Id. at 674.
67. Id.
68. Id.; see Howard C. Westwood & Edward G. Howard, Self-Government in the Securities Business, 17 L. & CONTEMP. PROBS. 518, 533 (1952) (describing how, when the NASD applied to register with the SEC, it originally contemplated that it would not need a paid staff, but the SEC objected and also thought the proposed schedule of membership fees was too low).
69. SEC SPECIAL STUDY, supra note 23, at 664.
70. Id. at 665 (quoting letter from the NASD’s executive director); Grant, supra note 21, at 608 (describing disciplinary proceedings and stating that “the experience and judgment of men in the business are the best qualifications for fair, even strict determination of findings and penalties” and “[t]he members passing on complaints are determined that the industry will raise its standards”).
71. SEC SPECIAL STUDY, supra note 23, at 681.
72. Id. at 666 (describing the relative leniency in free-riding cases in contrast to net capital violations; the former is not found primarily in marginal firms).
73. Id. at 676. “[T]he NASD’s paid staff should be increased in size, stature, and responsibility . . . .” Id. at 680.
74. Id.
75. Id. at 679.
concept of securities self-regulation that was implemented in subsequent amendments to the Exchange Act.

3. 1964 Amendments to the Exchange Act

In 1964 Congress amended section 15A of the Exchange Act to require, for the first time, that NSAs have standards of financial responsibility for member firms and standards of training, experience, and other qualifications for associated persons. The amendment also permitted the NASD to bring disciplinary proceedings against associated persons without proceeding against their firms. According to the Senate report accompanying the legislation, the amendments “contemplate[d] an even greater degree of reliance upon self-regulation, although under somewhat more intensive [SEC] supervision.”

In addition, the Senate report essentially repudiated the Maloney Act’s concept of a voluntary membership association enforcing through contract its business and ethical standards on its members and instead emphasized that the association was a regulator acting pursuant to delegated authority: “Registered securities associations are not private clubs. They are organized under statutory authority to perform, under governmental oversight, regulatory functions in the over-the-counter securities market.”

This emphasis on delegated government power becomes the dominant theme in subsequent congressional consideration of the concept of securities self-regulation, although lip service is still paid to the Maloney Act’s concept of self-regulation.

4. The Securities Industry Study of 1973

In 1970, when Congress enacted the Securities Investor Protection Act to address the crisis caused by the failures of a number of large NYSE firms and to deal with the threat of loss of investor confidence, a number of Senators expressed concern that the securities industry was in need of fundamental reform. As a result, in 1971 the Senate authorized a thorough study of the securities industry and the securities markets, conducted by the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs, which was completed in 1973. The Securities Industry Study made a number of conclusions and recommendations, many of them concerning industry self-regulation, including that “[t]he division of

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78. Id.
79. SECURITIES INDUSTRY STUDY, supra note 18, at 1.
80. Id. at 3.
responsibility between the SEC and the self-regulatory organizations requires redefinition to establish clearer lines of responsibility for decisionmaking. 81 The Securities Industry Study emphasized that

there is a common and serious misunderstanding of the nature and limits of the concept of self-regulation . . . . [S]elf-regulation is thought to mean that the securities industry regulates itself and therefore is not regulated by the government. Such a conception of self-regulation is seriously misleading in failing to acknowledge the essential and continuing role of the federal government. 82

The Securities Industry Study expressed a great deal of skepticism about securities self-regulation and described the

inherent limitations in allowing an industry to regulate itself . . . : the natural lack of enthusiasm for regulation on the part of the group to be regulated, the temptation to use a façade of industry regulation as a shield to ward off more meaningful regulation, the tendency for businessmen to use collective action to advance their interests through the imposition of purely anti-competitive restraints as opposed to those justified by regulatory needs, and a resistance to changes in the regulatory pattern because of vested economic interests in its preservation. 83

Despite this lack of enthusiasm for securities self-regulation, the Securities Industry Study acknowledged practical realities: that “the Congress was well aware of the serious practical problems confronting the government if it were to assume the entire regulatory burden.” 84 Accordingly, Congress established a regulatory model that balanced the “limitations and dangers” 85 of self-regulation against “the sheer ineffectiveness of attempting to assure [regulation] directly through the Government on a wide scale.” 86

In addition, the Securities Industry Study did acknowledge that securities self-regulation had significant advantages apart from its practical necessity, which included bringing industry members’ expertise to bear on the regulatory issues and involving industry members in the regulatory process. 87 Indeed, what it identified as the most important advantage harkened back to the Maloney Act’s original concept: “its potential for

81. Id. Seligman notes that Congress was frustrated with the SEC’s passivity in supervising the SROs and that “[b]etween 1971 and 1975, the SEC’s supervision of stock market regulation was the subject of almost incessant congressional hearings and reports.” SELIGMAN, supra note 23, at 443.

82. SEcurities Industry Study, supra note 18, at 137.
83. Id. at 145 (footnote omitted).
84. Id. at 146.
85. Id.
86. Id. (quotation marks in original).
87. Id. at 149.
establishing and enforcing what Mr. Justice Douglas referred to as “ethical standards beyond those any law can establish.”

5. 1975 Amendments to the Exchange Act

Somewhat surprisingly, the NASD did not have express statutory authority to enforce the Exchange Act and its rules until the 1975 amendments to the Exchange Act. The 1975 amendments also strengthened SEC oversight in several key respects, including procedures applicable to SEC review of SRO proposed rule changes and SRO disciplinary actions. In addition, Congress reinforced the notion that SROs are not “private clubs” by requiring that their governing bodies have at least one public member, i.e., not from the industry.

Once again, the legislative history emphasized that “self-regulatory organizations exercise authority subject to SEC oversight. They have no authority to regulate independently of the SEC’s control.”

6. The NASD’s 1996 Scandal Involving Collusion Among Market Makers

In the 1990s, both the U.S. Department of Justice’s Antitrust Division and the SEC investigated allegations of abusive practices by Nasdaq market makers to suppress competition and mislead customers. In 1996 the SEC and the NASD entered a settlement after the agency instituted public proceedings against the NASD. The SEC, in addition to making findings of misconduct in the Nasdaq market by Nasdaq market makers, found that the NASD inadequately enforced its rules applicable to market makers and processed certain membership applications in a manner inconsistent with its rules, both of which were attributable to the undue influence of market makers in the NASD regulatory processes. The SEC also found that the

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88. Id. (footnote omitted).
90. Id. sec. 16, § 19(b)–(c), 89 Stat. at 147–50.
91. Id. sec. 16, § 19(d)–(e), 89 Stat. at 150–51.
92. Id. sec. 12(2), § 15A(b)(4), 89 Stat. at 127.
95. The SEC can impose sanctions on an SRO if it finds, on the record and after notice and opportunity for a hearing, that the SRO has violated or is unable to comply with any provision of the Securities Exchange Act and its rules, or the SRO’s own rules. 15 U.S.C. § 78s(h)(1) (2012).
96. NASD, Exchange Act Release No. 37,538, 1996 WL 447193 (Aug. 8, 1996) [hereinafter NASD Release]. For background on the Nasdaq trading practices at issue, see SELIGMAN, supra note 23, at 698–702. Arthur Levitt, the SEC Chairman at the time, acknowledged that the SEC itself “failed to see that the NASD had gradually been taken over by a cabal of dealers who used the NASD’s disciplinary process to punish certain players, such as daytraders, while failing to prosecute serious infractions by market-makers.” Id. at 699 (quoting ARTHUR LEVITT, TAKE ON
influence exerted by the market makers resulted in the NASD staff’s targeting less-favored constituencies in examinations and disciplinary actions. 97 The NASD did not admit or deny the findings.

In response to the scandal, prior to the SEC settlement, the NASD had already accepted the recommendation of its Select Committee headed by former Senator Warren Rudman to review Nasdaq structure and governance98 and determined to separate the NASD’s market and regulatory functions.99 The SEC censured the NASD and required it to consent to a number of reforms, including reforms designed to reduce the influence of members over regulatory and disciplinary matters. Thus, the settlement required “at least 50% independent public and non-industry membership on its Board of Governors” and on the boards of all subsidiaries and affiliates that have self-regulatory functions, and on the major NASD committees, including the predecessor to the NAC, the National Business Conduct Committee.100 The participation of industry members in disciplinary proceedings was also reduced. The NASD was required to institute the use of professional hearing officers—“who shall be attorneys with appropriate experience and training”—to preside over disciplinary proceedings.101 In addition, the NASD was required “to provide for the autonomy and independence of the regulatory staff” so that the staff would have sole discretion as to what matters to investigate and prosecute, subject only to supervision of the Board of Governors, and would be “generally insulated from the commercial interests of its members and the Nasdaq market.”102

As a result of this demonstration of the fatal flaw of securities self-regulation—the undue influence exerted by powerful members—the NASD’s transformation into a professional regulator largely independent of its membership, as recommended by the 1963 Special Study, was substantially accomplished. Today, after the 2007 consolidation, FINRA describes itself as the “leading non-governmental regulator for all securities firms doing business with the U.S. public.”103

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97. Specifically, NASD staff targeted day trading firms that used Nasdaq’s Small Order Execution System. See SEC, REPORT PURSUANT TO SECTION 21(A), supra note 94, at 40–44.
99. Id. at 8; see also SELIGMAN, supra note 23, at 701–02.
100. NASD Release, supra note 96, § IV.B.1, at *3.
101. Id. § IV.B.3.
102. Id. § IV.B.4, at *4.
103. About FINRA: Leadership, supra note 2 (emphasis added).
7. The Current View of Securities Self-Regulation

As this brief history demonstrates, the concept of FINRA has evolved from a voluntary membership organization enforcing through contract its business practices and ethical standards to a regulator that is independent from its membership, whose authority to enforce federal securities laws derives from Congress and is subject to SEC oversight. Two appellate opinions underscore this transformation.

In *NASD v. SEC*, the NASD sought judicial review of an SEC order that set aside the NAC’s findings of market manipulation in violation of Exchange Act section 10(b) and Rule 10b-5 and the sanctions imposed for that violation, which were expulsion of the member firm and an industry bar of its owner. The SEC concluded that the evidence did not establish that the respondents committed market manipulation. In ruling that the NASD did not have standing to appeal the SEC order, the D.C. Circuit described it as a “quasi-governmental agency, with express statutory authority to adjudicate actions against members who are accused of illegal securities practices and to sanction members found to have violated the Exchange Act or [SEC] regulations issued pursuant thereto.” The NASD’s subordinate status was clear. Under the statutory scheme providing for securities self-regulation, “[t]he NASD’s authority to discipline its members for violations of federal securities law is entirely derivative. The authority it exercises ultimately belongs to the SEC, and the legal views of the self-regulatory organization must yield to the Commission’s view of the law.”

The court held that the NASD, as a first-level adjudicator, was not a “person aggrieved” that can appeal an SEC decision under Exchange Act section 25(a). It rejected summarily the NASD’s argument that it was “an aggrieved person” based on its staff’s frustration in its mission because it would be unable to bring disciplinary proceedings except in the narrow circumstances covered by the SEC decision. Simply put, the NASD

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104. *NASD v. SEC*, 431 F.3d 803, 804–05 (D.C. Cir. 2005). As the court noted throughout the opinion, this was the first case in nearly seventy years in which the NASD sought judicial review of an SEC order when the NASD was acting as an adjudicator. *Id.* at 811.

105. The NAC stated that the question presented by the appeal was “whether a market marker that trades a small volume of stock can violate the antifraud provisions of SEC and NASD rules when the evidence demonstrates that the firm took actions that were designed to artificially increase the price of the stock” and answered the question in the affirmative. *Mkt. Regul. v. Elgindy*, Complaint No. CMS000015, 2003 WL 21203080, at *1 (NASD NAC May 7, 2003). The SEC, however, concluded that the record did not support a finding that the respondents’ actions were part of a manipulative scheme. *Elgindy*, Exchange Act Release No. 49,389, 2004 WL 865791, at *4–5 (Mar. 10, 2004).

106. *NASD*, 431 F.3d at 804.

107. *Id.* at 806.

108. *Id.* at 805.

109. *Id.* at 809–10.
appears before this court as a disgruntled first-level tribunal, complaining
because it has been reversed by a higher tribunal.”110

The question left unaddressed by NASD v. SEC was whether FINRA
could adopt and enforce its own definition of market manipulation apart
from the Exchange Act as a violation of its requirement that members
observe “high standards of commercial honor and just and equitable
principles of trade.”111 Fiero v. FINRA,112 discussed next, suggests that
courts would not be receptive to efforts to impose significant sanctions for
violations that were based solely on ethical standards that go beyond the

Fiero even more clearly demonstrates that courts view FINRA’s powers
as exclusively derived from the Exchange Act.113 In 2002 the NAC
affirmed a hearing panel’s findings that Fiero Brothers, Inc., a member
firm, and John Fiero, its president (collectively, the Fieros) engaged in
market manipulation and its sanctions of expulsion/bar from the industry
and a $1 million fine imposed jointly and severally on the Fieros.114 The
Fieros did not appeal the NAC’s decision to the SEC.115 After the Fieros
refused to pay the fine, FINRA commenced an action in New York state
court.116 The trial court awarded judgment in its favor, upholding its
authority to bring the action under contract law, because the Fieros had
agreed to comply with the SRO’s rules, including imposition of fines and
sanctions, when the firm became a NASD member and Fiero became an
associated person of the firm.117 The court further noted that “‘New York
state courts have long recognized the right of a private membership
organization to impose fines on its members, when authorized to do so by
statute, charter or by-laws.’”118 New York’s highest court, however,
subsequently reversed on the ground that the federal courts possessed
exclusive jurisdiction because the FINRA complaint was an action to

110. Id. at 809.
112. Fiero v. FINRA, 660 F.3d 569 (2d Cir. 2011).
113. See id. at 576.
114. The hearing panel also found, and the NAC affirmed, a finding that the Fieros violated a
NASD Rule. The NAC imposed the $1 million fine for the market manipulation claim. Dep’t of
Enforcement v. Fiero, Complaint No. CAF980002, 2002 WL 31476976, at *33 n.60 (NASD NAC
Oct. 28, 2002).
115. If the Fieros had appealed and the SEC had affirmed the NAC fine, the SEC would have
had the authority to bring a proceeding to collect the fine under Exchange Act § 21(e). Fiero, 660
F.3d at 574–75; but see id. at 575 n.7 (expressly noting that the issue of SEC authority was not
before the court).
118. Fiero, 660 F.3d at 572 (citing NASD v. Fiero, No. 102755/04, slip op. at 2 (N.Y. Sup. Ct.
Sept. 12, 2005), rev’d on other grounds, 882 N.E.2d 879 (N.Y. 2008)).
enforce a liability or duty created under the Exchange Act.\textsuperscript{119} The Fieros then brought an action in federal district court, seeking a declaratory judgment that FINRA had no authority to collect fines through judicial proceedings; FINRA filed a counterclaim, again seeking to enforce the fine under contract theory.\textsuperscript{120} Reversing the district court’s judgment in favor of FINRA, the court of appeals held that the Exchange Act did not confer on FINRA authority to bring judicial actions to enforce collection of its fines.\textsuperscript{121}

The court of appeals’ analysis was based on the premise that “where FINRA enforces statutory or administrative rules, or enforces its own rules promulgated pursuant to statutory or administrative authority, it is exercising the powers granted to it under the Exchange Act.”\textsuperscript{122} The court of appeals relied principally on the statutory language: while Exchange Act section 15A(b) confers on SROs the power and obligation to discipline members and impose sanctions, including fines, the Exchange Act did not expressly confer on SROs the power to bring judicial actions to collect fines.\textsuperscript{123} The court contrasted this with statutory provisions conferring express power on the SEC to seek judicial enforcement of monetary penalties and concluded on this basis that the omission of comparable power to SROs was intentional.\textsuperscript{124} The court also found that FINRA’s breach of contract theory undermined Exchange Act section 27, which confers on federal courts exclusive jurisdiction to enforce the Exchange Act, explaining that “FINRA contract enforcement actions may bristle with Exchange Act legal issues because the most serious fines levied by FINRA will be for member violations of the Act.”\textsuperscript{125} Assuming that the court was correct in its assertion that FINRA’s largest fines are imposed for Exchange Act violations, it did not explain how an action brought to collect a fine would require courts to interpret the Exchange Act.\textsuperscript{126}

The court acknowledged that its interpretation left a “seemingly inexplicable nature of a gap in the FINRA enforcement scheme: fines may be levied but not collected.”\textsuperscript{127} The court, however, did not find this troublesome because FINRA had another “draconian sanction not involving court action:”\textsuperscript{128} it could expel the member from the industry for non-

\textsuperscript{119} Fiero, 882 N.E.2d at 882.
\textsuperscript{120} Fiero v. FINRA, 606 F. Supp. 2d 500, 502 (S.D.N.Y. 2009).
\textsuperscript{121} Fiero, 882 N.E.2d at 882.
\textsuperscript{122} Fiero, 660 F.3d at 575–76 (emphasis added).
\textsuperscript{123} Id. at 574.
\textsuperscript{124} Id. at 575.
\textsuperscript{125} Id. at 576.
\textsuperscript{126} Cf. Fiero v. FINRA, 606 F. Supp. 2d 500, 517–18 (S.D.N.Y. 2009) (rejecting this argument because FINRA is not suing for violations of securities laws or introducing disciplinary proceedings as evidence of the Fieros’ securities violations).
\textsuperscript{127} Fiero, 660 F.3d at 576.
\textsuperscript{128} Id.
payment or, in this case, refuse to permit the Fieros to re-enter the industry until they paid the fine. ¹²⁹ In addition, in a non sequitur, the court observed that a violator of the Exchange Act would likely face a “panoply of private and SEC remedies.”¹³⁰

Both opinions view the Exchange Act as the exclusive source of authority for FINRA; the organization has no independent power or authority. In addition, both opinions adhere to a literal, non-expansive interpretation of the association’s statutory authority. Neither opinion offers FINRA any encouragement to explore new regulatory approaches or to be innovative in its approach to regulation; both opinions emphasize that FINRA was asserting a power that it had not previously attempted to exercise.

The current view of securities self-regulation may be a significant cabining of FINRA’s ability to enforce ethical standards beyond the antifraud provisions of the Exchange Act for the protection of retail investors. Yet, because of the seriousness of the sanctions, broker-dealers and associated persons need fair notice of what kinds of conduct constitute violations; the law cannot be “soft” or vague. Moreover, the 1996 market-maker scandal demonstrated that the historic concern for undue industry influence was not misplaced and that Congress was correct in identifying the need for more independence from the industry and greater SEC oversight.

II. FINRA SANCTIONS

As previously described, the Exchange Act requires FINRA to adopt rules to regulate the conduct of its members¹³¹ and to provide for appropriate discipline of firms and associated persons for violations of the Exchange Act and its rules, as well as the SRO’s rules.¹³² The statute authorizes a broad range of sanctions and confers broad discretion on FINRA to determine the appropriate sanction, subject to the SEC’s power to reduce a sanction if it imposes an undue burden on competition or is “excessive or oppressive.”¹³³ Part II fleshes out the bare statutory framework and explores the theory and practice of FINRA sanctions.

A. REMEDIAL VERSUS PUNITIVE SANCTIONS

Recall that this Article started with the premise that it is likely, and indeed understandable, that members of the investing public who have been harmed by broker-dealer misconduct want to see that bad brokers are

¹²⁹. *Id.*
¹³⁰. *Id.*
¹³². *Id.* § 78o-3(b)(7).
¹³³. *See supra* notes 43–44 and accompanying text.
punished for their wrongdoing. Public approval for regulators may decrease if they are seen as “soft” on violators; Robert Khuzami, the former SEC Director of the Enforcement Division, frequently reminded people that the SEC was not a federal prosecutor. The investing public may be especially skeptical about industry regulators and suspect them of being soft on offenders. Moreover, regulators (like the rest of us) probably find it satisfying to punish; industry regulators may feel a strong sense of disapproval toward conduct that reflects badly on the industry as a whole. Nevertheless, regulators may not impose sanctions as retribution, because the wrongdoers deserve it, however satisfying that may be to both the regulators and the investing public.

Why is it impermissible for FINRA to punish bad brokers for their conduct? First, FINRA is a private actor, not an arm of the federal government. Courts, however, have long recognized that Congress can confer on private bodies the power to impose sanctions, including the revocation of licenses. The right of disciplined firms and associated persons to seek de novo SEC review of FINRA’s findings and sanctions, and the statutory requirement that the agency make its own findings, provide an additional layer of protection for the individual or firm found to have committed a violation. In their review of disciplinary orders, the federal courts of appeals do not distinguish between SEC orders that affirm FINRA disciplinary sanctions and SEC orders that affirm sanctions imposed through the SEC’s administrative hearing system; both are


137. Minzner, supra note 136, at 904–13 (explaining why there are significant reasons to be concerned about agencies as retributive entities).

138. See Bd. of Trade v. Wallace, 67 F.2d 402, 407 (7th Cir. 1933); see also Markowski v. SEC, 34 F.3d 99, 105 (2d Cir. 1994) (rejecting challenges to disciplinary sanctions, noting that the individual voluntarily submitted himself to the discipline of a self-regulating association whose power to enforce its standards of conduct “makes its imprimatur meaningful and commercially valuable to its membership”). In addition, the laws of many states recognize that private-membership associations may impose sanctions on members when authorized by statute or governance documents. E.g., NASD v. Fiero, No. 102755/04, slip op. at 2 (N.Y. Sup. Ct. Sept. 12, 2005), rev’d on other grounds, 882 N.E.2d 879 (N.Y. 2008).

139. See Cody v. SEC, 693 F.3d 251, 257 (1st Cir. 2012) (stating that court reviews SEC order rather than FINRA’s decision); Heath v. SEC, 586 F.3d 122, 142–43 (2d Cir. 2009) (stating that any procedural errors committed by the hearing officer are cured by the SEC’s thorough de novo review of the record).
considered SEC orders. Accordingly, parties rarely raise the objection that FINRA is not a government body, and if the objection is raised, courts quickly dispense with it.

The Exchange Act requires that the SRO provide a “fair procedure” for its disciplinary proceedings, which specifically includes providing specific charges and an opportunity to be heard. Fairness requires that the firm or individual has notice that the charged conduct was illegal and that the SRO bring the charges without undue delay. The protections accorded those charged with misconduct, however, do not raise to the level of constitutional protections required when the government seeks to impose criminal sanctions on those charged with misconduct: need for proof beyond a reasonable doubt, trial by jury, privilege against self-incrimination (for individuals), protection from double jeopardy, and right to legal representation. Courts have dispensed with these constitutional protections so long as the sanction is remedial and not penal, or punishment, for past offenses. The Supreme Court defers to legislative intent, so that conferring a regulatory authority with the power to impose sanctions denominated as “civil” is prima facie evidence of congressional intent to provide for a non-criminal sanction. The Court, however, recognizes that even if Congress intended civil sanctions, a statutory scheme can be so punitive either in purpose or effect as to “transform[m]...

140. 15 U.S.C. § 78o-3(h)(8) (2012). Courts have held that the FINRA procedures mandated by the Exchange Act require the substance of procedural due process, Cody, 693 F.3d at 357, and are fair, see Bussacca v. SEC, 449 Fed. App’x 886, 891 (11th Cir. 2011), and that procedural errors committed by the hearing officer can be cured by the SEC’s thorough de novo review of the record. Heath, 586 F.3d at 142–43.
142. Even a minimal sanction can be excessive if the individual could not fairly understand that the conduct was illegal. Upton v. SEC, 75 F.3d 92, 98 (2d Cir. 1996).
143. SRO disciplinary proceedings are not subject to any statute of limitations; “a successful laches defense requires a lack of due diligence by the [SRO], and prejudice to the [respondent].” Gluckman, Exchange Act Release No. 41,628, 1999 WL 507864, at *6–7 (July 20, 1999). The SEC dismissed, for the first time, an SRO disciplinary proceeding on fairness grounds because of the age of the case, without a showing of prejudice, in Hayden, Exchange Act Release No. 42,772, 2000 WL 571683, at *2 (May 11, 2000), because an SRO has a “statutory obligation to ensure the fairness and integrity of its disciplinary proceedings.” In Dep’t of Enforcement v. Morgan Stanley DW Inc., Discip. Proceeding No. CAF000045, 2002 NASD Discip. LEXIS 11 (NASD NAC July 29, 2002), the NAC interpreted Hayden as setting forth a fairness test based on equitable principles and requiring consideration of the facts and circumstances of the particular case.
144. See, e.g., Steadman v. SEC, 450 U.S. 91, 96–103 (1991) (holding that because the Congress set forth a preponderance of evidence standard for disciplinary proceedings under the Investment Company Act of 1940 and the Investment Advisers Act of 1940, policy arguments for a higher standard were inapposite).
145. Wright v. SEC, 112 F.2d 89, 94 (2d Cir. 1940).
146. Hudson v. United States, 522 U.S. 93, 99–103 (1997) (holding that the statutory scheme under which Office of Comptroller of Currency imposed penalties and debarment on bank officers demonstrated congressional intent that such penalties be deemed civil, so that the double jeopardy clause did not protect against criminal prosecution).
what was clearly intended as a civil remedy into a criminal penalty.

The Court has identified relevant factors in distinguishing between punitive and remedial sanctions:

(1) whether the sanction involves an affirmative disability or restraint; (2) whether it has historically been regarded as a punishment; (3) whether it comes into play only on a finding of scienter; (4) whether its operation will promote the traditional aims of punishment-retribution and deterrence; (5) whether the behavior to which it applies is already a crime; (6) whether an alternative purpose to which it may rationally be connected is assignable for it; and (7) whether it appears excessive in relation to the alternative purpose assigned.

Legislative intent is entitled to judicial deference; “only the clearest proof” will suffice to override legislative intent and transform what has been denominated a civil remedy into a criminal penalty.

The Exchange Act provides for a regulatory system of civil sanctions, and FINRA consistently describes its sanctions as remedial. Therefore, FINRA sanctions are presumed to be civil remedies, yet a too-severe sanction may be deemed punitive. The question remains: what is the distinction between kicking someone out of the industry as punishment and kicking someone out as a remedial sanction? A sanction imposed for the purpose of punishing someone for past conduct, as retribution for a wrong or just deserts, is unquestionably punitive in nature. Sanctions imposed to compensate the government for a loss (restitution), or disgorgement of ill-gotten gains, by contrast, are unquestionably remedial. Deterrence as a rationale is less clear. Traditionally, sanctions imposed as deterrence were generally viewed as punitive. The modern view, however, is to

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147. Id. at 99 (quoting Rex Trailer Co. v. United States, 350 U.S. 148, 154 (1956)).
148. Hudson, 522 U.S. at 100 (quoting Kennedy v. Mendoza-Martinez, 372 U.S. 144, 168–69 (1963)) (internal quotation marks omitted). In Mendoza-Martinez, the Court found that a statute taking away U.S. citizenship for evading military service was punitive based on congressional descriptions of the purpose of the statute. 372 U.S. at 186.
149. Hudson, 522 U.S. at 100 (quoting United States v. Ward, 448 U.S. 242, 249 (1980)).
150. See infra notes 178–181.
151. Mendoza-Martinez, 372 U.S. 144. In ruling that a state statute requiring registration of convicted sex offenders was non-punitive and therefore did not violate the ex post facto clause, the Supreme Court acknowledged that public shaming as the motive for sanctions may raise constitutional problems. Smith v. Doe, 538 U.S. 84, 102 (2003).
153. Sweeney, Exchange Act Release No. 29,884, 1991 WL 716756, at *5 (Oct. 30, 1991) (stating that, generally, disgorgement should be ordered in all cases in which the SRO can identify direct financial gain obtained as a result of wrongful activity, in order to remedy past wrongs and deter future misconduct). Disgorgement amounts must be approximately equal to the unjust enrichment or else they are unreasonable and excessive. Hateley v. SEC, 8 F.3d 653, 656 (9th Cir. 1993).
154. Bajakajian, 524 U.S. at 329. In Johnson v. SEC, 87 F.3d 484, 488 (D.C. Cir. 1996), the court held that a “penalty,” as the term is used in the statute of limitations for government
distinguish between general and specific deterrence. Specific deterrence is recognized as remedial, serving to protect the public by removing the person from the industry.\textsuperscript{155} General deterrence is also recognized as an appropriate factor to take into consideration, at least where the offense was egregious.\textsuperscript{156} General deterrence, however, is not appropriate without specific deterrence; it is not permissible to make an example of someone who does not otherwise warrant specific deterrence.\textsuperscript{157} Accordingly, a bar, expulsion, or long-term suspension is considered remedial so long as there are reasons as to why the sanction serves to protect the trading public from future harm.\textsuperscript{158}

In reviewing SEC orders imposing sanctions,\textsuperscript{159} courts recognize that they should not ordinarily substitute their judgment for the agency’s as to measures necessary to protect the public interest because “the relation of remedy to policy is peculiarly a matter for administrative competence.”\textsuperscript{160} Nevertheless, courts do more than rubber-stamp the SEC order, and, at least in instances of a bar or long-term suspension, courts will consider whether the sanction is appropriately remedial and not punitive.\textsuperscript{161} \textit{Steadman v. SEC,\textsuperscript{162} v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979) (requiring SEC to articulate compelling reasons for permanent expulsion, e.g., that violation is so egregious that it mandates permanent expulsion as a deterrent to others); Busacca v. SEC, 449 Fed. App’x 886, 893 (11th Cir. 2011) (rejecting argument that SEC’s acknowledged aim of encouraging other supervisors to respond to operational problems was impermissibly punitive).}

\textsuperscript{155} McCurdy v. SEC, 396 F.3d 1258, 1264–65 (D.C. Cir. 2005) (rejecting argument that a one-year suspension against a certified public accountant was punitive because it was based on his past reckless conduct, finding it “difficult to imagine how any suspension, remedial or not, could be based on anything but past actions,” and making it clear that the purpose of the suspension was to protect the public); Wright v. SEC, 112 F.2d 89, 94 (2d Cir. 1940) (rejecting argument that proof beyond a reasonable doubt was required to expel member). A six-month disciplinary suspension “would less resemble punishment if the SEC had focused on [the individual’s] current competence or the degree of risk she posed to the public.”\textsuperscript{163} Johnson, 87 F.3d at 489.

\textsuperscript{156} Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979) (requiring SEC to articulate compelling reasons for permanent expulsion, e.g., that violation is so egregious that it mandates permanent expulsion as a deterrent to others); Busacca v. SEC, 449 Fed. App’x 886, 893 (11th Cir. 2011) (rejecting argument that SEC’s acknowledged aim of encouraging other supervisors to respond to operational problems was impermissibly punitive).

\textsuperscript{157} PAZ Sec., Inc. v. SEC, 494 F.3d 1059, 1066 (D.C. Cir. 2007) (quoting and agreeing with Second Circuit’s statement on general deterrence); McCarthy v. SEC, 406 F.3d 179, 189 (2d Cir. 2005) (stating that general deterrence is not sufficient justification for expulsion or suspension, although it may be considered as part of the overall remedial inquiry); Beck v. SEC, 430 F.2d 673, 674–75 (6th Cir. 1970) (holding that four-month suspension was punitive where it did not appear that the broker would be inclined to commit any further misconduct).

\textsuperscript{158} Ricupero v. SEC, 436 Fed. App’x 31, 33 (2d Cir. 2011) (quoting McCarthy, 406 F.3d at 188) (In reviewing an SEC order sustaining SRO sanctions, the foremost consideration is whether it “protects the trading public from further harm.”).

\textsuperscript{159} Courts do not draw a distinction between SEC orders that originated within the SEC (through an ALJ) or originated with an SRO, since an agency’s review of an SRO order is de novo and it must make the requisite findings. See supra notes 39–41.

\textsuperscript{160} O’Leary v. SEC, 424 F.2d 908, 911 (D.C. Cir. 1970). The courts acknowledge that there is considerable discretion in determining the appropriate sanction, recognizing only that “[p]erhaps gross disparities in sanctions for similar behavior would at least suggest underlying bias.” D’Alessio v. SEC, 380 F.3d 112, 125 (2d Cir. 2004) (emphasis added).

\textsuperscript{161} E.g., Steadman v. SEC, 603 F.2d 1126, 1141 (5th Cir. 1979).
SEC, a frequently cited case, lists factors that essentially amount to a prediction about whether the person is likely to engage in misconduct in the future:


Another frequently cited opinion, McCarthy v. SEC, identified as relevant factors: “[t]he 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.” Other courts state more generally that sanctions are punitive if they are too severe or draconian. What the courts require is that the SEC considered the facts and circumstances of the particular case, made the requisite findings of a violation, and articulated reasons why the sanction is appropriate for the particular violation. Courts have criticized boilerplate findings of wrongdoing and do not find it sufficient if the agency merely stated, in effect, that the conduct was illegal or that the individual in question was a bad person. Courts have vacated SEC orders for failing to address mitigating factors advanced by the individual to reduce the sanction. Courts are especially concerned where the SEC has upheld a permanent bar, since it amounts to termination of a professional career.

Courts often identify lack of remorse by the violator and substantial losses to investors, particularly unsophisticated customers, as important factors in upholding bars. Instances where a bar was upheld because of findings of egregious conduct include:

162. Id. at 1140.
163. Id. (noting that these are the factors deemed relevant to the issuance of an injunction).
164. McCarthy v. SEC, 406 F.3d 179, 190 (2d Cir. 2005).
165. Id.
166. E.g., D’Alessio v. SEC, 380 F.3d 112, 124 (2d Cir. 2004).
167. McCarthy, 406 F.3d at 189 (finding it suggestive that the SEC did not devote individual attention to the unique facts and circumstances of the case).
168. Id. at 188; Blinder, Robinson & Co. v. SEC, 837 F.2d 1099, 1113 (D.C. Cir. 1988).
170. Id. at 906 (quoting PAZ Sec., Inc. v. SEC, 494 F.3d 1059, 1065 (D.C. Cir. 2007)) (describing a lifetime bar as “the securities industry equivalent of capital punishment”); see also Blinder, 837 F.2d at 1113 (“Faced with a task of such gravity, the Commission must craft with care.”). Courts have rejected, however, arguments that the SEC can impose a permanent bar only if it makes findings explaining why a lesser sanction is not sufficient. Paz Sec., Inc. v. SEC, 566 F.3d 1172, 1176 (D.C. Cir. 2009); Rizek v. SEC, 215 F.3d 157, 161 (1st Cir. 2000).
171. Failure to express remorse may be more common in cases where the brokers are not represented by counsel, as is frequently the case in disciplinary proceedings.
Broker showed no remorse, customers were unsophisticated, and losses were substantial; \(^{172}\)

Broker did not acknowledge wrong, blamed others (including customer), and engaged in ongoing deception; \(^{173}\) and

Broker engaged in a pattern of wrongdoing and harm to retail customers. \(^{174}\)

In contrast, examples of impermissible, “draconian” penalties include:

- An uncertain regulatory environment; \(^{175}\)
- Non-frivolous claim of “systemic pattern of disparate treatment” against newer, smaller firms that resulted in “predictably, disproportionately harsh sanctions;” \(^{176}\) and
- Individual has been engaged in the industry without further trouble since the misconduct. \(^{177}\)

**B. THE PRACTICE OF FINRA’S SANCTIONS**

In the preceding section, we looked at the theory and law of FINRA’s sanctions as developed in the case law. In this section, we look at the practice of FINRA’s sanctions.

First and foremost, FINRA articulates as a fundamental principle that its sanctions are remedial. \(^{178}\) Thus, for example, statements by FINRA CEO Richard G. Ketchum consistently emphasize that a strong enforcement program is for the protection of investors and do not speak in terms of punishing violators. \(^{179}\) Similarly, a former NYSE regulator (prior to the

\(^{172}\) Rizek v. SEC, 215 F.3d at 159–60 (churning in accounts of five customers).

\(^{173}\) Otto v. SEC, 253 F.3d 960, 962 (7th Cir. 2001) (misuse of a customer’s funds for his personal use).


\(^{175}\) Blinder v. SEC, 837 F.2d at 1112 (anti-fraud and antimanipulation violations in underwriting penny stock offerings); Arthur Lipper Corp. v. SEC, 547 F.2d 171, 175 (2d Cir. 1976) (payment of give-ups); see also Upton v. SEC, 75 F.3d 92, 98 (2d Cir. 1996) (vacating an SEC order because of insufficient notice that the SEC considered the firm’s practice a violation of its customer protection rule).

\(^{176}\) Blinder, 837 F.2d at 1112.

\(^{177}\) McCarthy v. SEC, 406 F.3d 179, 189 (2d Cir. 2005) (floor trading violations); Beck v. SEC, 430 F.2d 673, 674 (6th Cir. 1970) (misrepresentations to customers in connection with sales of a security).


\(^{179}\) See, e.g., News Release, FINRA, 2012: FINRA Year in Review (Jan. 8, 2013), available at http://www.finra.org/Newsroom/NewsReleases/2013/P197624 (“Protecting investors and helping to ensure the integrity of the nation’s financial markets is at the heart of what we do every day.”); see also Letter from Richard G. Ketchum, Chairman & CEO, FINRA, in FINRA, FINRA 2010 YEAR IN REVIEW AND ANNUAL FINANCIAL REPORT 2–3 (2011), available at
consolidation) stated that “[t]he Exchange does not frame its regulatory proceedings in terms of punishment.” 180 FINRA’s Sanction Guidelines (the Guidelines) also emphasize the remedial purpose of sanctions, as is discussed shortly. 181

Second, it is important to keep in mind that very few of FINRA’s sanctions are imposed after a disciplinary hearing; consequently, the number of sanctions that are reviewed even by the NAC is small. This is true even with respect to the most severe sanctions. A review of the monthly FINRA disciplinary actions for 2008 showed a total of 274 disciplinary actions imposing bars, of which over two-thirds were settled. 182 Another twenty-five percent were default decisions. 183 Only in sixteen reported disciplinary actions imposing a bar was a hearing conducted in which respondents contested the charges, and in many of them respondents appeared pro se. 184 There were another thirteen reported actions imposing a two-year suspension, only two of which involved hearings where respondents contested the charges. 185 Of the eighteen reported decisions, the highest ultimate adjudicator in each instance was as follows: one was a

181. See infra notes 198–205 and accompanying text; see also FINRA, SANCTION GUIDELINES, supra note 178, at 4.
183. See id.
184. See id.
185. Four were concluded by Letters of Acceptance, Waiver, or Consent; seven were concluded by Offers of Settlement.
judicial decision,186 seven were SEC decisions,187 four were NAC decisions,188 and six were hearing panel decisions.189

Failure to contest the charges or to retain legal representation is not surprising since a firm is likely to terminate the employment of an associated person who is charged with a serious violation, and that individual is not likely to have a bright future in the industry unless he is a very successful salesperson. A recent empirical study, however, shows that respondents who proceed to a hearing frequently persuade the hearing panel to impose lower sanctions than the staff offered in settlement.190


190. Brian L. Rubin & Jae C. Yoon, Stepping into the Ring Against the SEC and FINRA: Sometimes It Pays to Duke It Out Against the Regulators, 40 SEC. REG. L.J. 485 (2012). During the time period, when FINRA staff sought an industry bar, “75% of [respondents] convinced a Hearing Panel to impose a lesser sanction.” Id. at 489. FINRA respondents with a lawyer also fared significantly better than pro se respondents; during the time period, pro se respondents were uniformly unsuccessful. Id. at 494 n.16.
Because few disciplinary sanctions are imposed after a formal hearing and fewer still are subject to any level of appeal, there is only a small body of NAC decisions analyzing the factors to take into account in determining appropriate sanctions, hence the importance of FINRA’s Sanction Guidelines, which the NAC developed for use by hearing panels and the NAC to determine appropriate sanctions and to promote consistency and uniformity. Consistent with the “facts and circumstances” approach generally followed, the Guidelines do not prescribe fixed sanctions for particular violations, but instead are intended “to provide direction for Adjudicators in imposing sanctions consistently and fairly,” and adjudicators have discretion to impose sanctions that fall outside the recommended ranges. The Guidelines set forth aggravating and mitigating factors for adjudicators to take into account and permit adjudicators to consider other aggravating and mitigating factors as well. The value of the Guidelines is that they focus the attention of the adjudicators on relevant considerations, and to the extent the factors focus on remediation, the Guidelines may act as a curb on the natural tendency to punish wrongdoers. Courts have cited with approval the SEC’s references to the Guidelines in its consideration of appropriate sanctions. Indeed, the D.C. Circuit recently vacated an SEC order affirming a NASD permanent

191. FINRA, SANCTION GUIDELINES, supra note 178, at 1. NASD first published the Sanction Guidelines in 1993, and they are regularly revised. March 2006 Revisions, supra note 12 (answer to question 1). The NAC “possesses ultimate authority with respect to the Sanction Guidelines.” Id.

192. FINRA, SANCTION GUIDELINES, supra note 178, at 1, 3, 4. FINRA, however, has established a bar as the standard sanction for three violations: failure to respond to a FINRA inquiry or investigation, conversion of a customer’s funds or securities, and cheating on qualifications examinations. See infra notes 206, 208 and accompanying text.

193. FINRA, SANCTION GUIDELINES, supra note 178, at 1. By contrast, the Exchange Act authorizes the SEC to impose a civil penalty if the agency finds that it is in the public interest and that the person has committed a willful offense or failed reasonably to supervise another person. 15 U.S.C. § 78u-2(b) (2012). The statute then sets forth a three-tier structure for determining monetary penalties in SEC administrative proceedings and federal district court proceedings brought by the SEC. Id. § 78u(d)(3). The third tier provides for the maximum amount of penalties and thus identifies the most serious types of offenses. To impose third-tier penalties, the adjudicator must find that the violation involved at least reckless disregard of a regulatory requirement and resulted in substantial losses, or created a significant risk of substantial losses, to other persons or resulted in substantial pecuniary gain to the violator. Id. §§ 78u(d)(3)(B)(iii), 78u-2(b)(3). If adopted by FINRA, these factors could provide more concrete guidance as to what constitutes “egregious” conduct. The statute also sets forth a non-exclusive list of factors the SEC may consider in deciding whether a penalty is in the public interest: whether the violation involved fraud, deceit, manipulation, or deliberate or reckless disregard of regulatory requirements; the harm to other persons resulting from the violation; the extent to which any person was unjustly enriched, taking into account any restitution made to the injured persons; whether the person is a recidivist; and the need to deter such person and other persons. Id. § 78u-2(c).

194. FINRA, SANCTION GUIDELINES, supra note 178, at 1.

195. Id.

bar because it failed to address all of the mitigating factors raised by the associated person, including, in particular, a factor expressly identified in the Guidelines as mitigating.\(^{197}\)

The Guidelines contain general principles that should be considered in all cases as well as specific considerations for common violations (the General Principles). Beginning with the First Principle, the Sanction Guidelines convey a message that FINRA sanctions are “remedial”:

**Disciplinary sanctions are remedial in nature and should be designed to deter future misconduct and to improve overall business standards in the securities industry.** The overall purposes of FINRA’s disciplinary process and FINRA’s responsibility in imposing sanctions are to remediate misconduct by preventing the recurrence of misconduct, improving overall standards in the industry, and protecting the investing public. Toward this end, Adjudicators should design sanctions that are significant enough to prevent and discourage future misconduct by a respondent, to deter others from engaging in similar misconduct, and to modify and improve business practices.\(^{198}\)

Similarly, other statements in the General Principles set forth purposes that courts have recognized as appropriately remedial.\(^{199}\) Thus, adjudicators are encouraged to design sanctions to prevent the recurrence of misconduct.\(^{200}\) In order to remediate misconduct, adjudicators should order restitution and/or rescission\(^{201}\) and should take into account a respondent’s ill-gotten gain in determining fines.\(^{202}\) Requiring a violator to requalify in any or all capacities is an appropriate sanction when adjudicators have found that his actions demonstrated a lack of knowledge or familiarity with the rules of the securities industry.\(^{203}\)

The literature on sanctions recognizes that regulators may appropriately impose sanctions to induce compliance with the rules and to deter misconduct by raising the cost of violation above the cost of compliance.\(^{204}\)

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197. Saad v. SEC, 718 F.3d 904, 913 (D.C. Cir. 2013); see also PAZ Sec., Inc. v. SEC, 494 F.3d 1059, 1065 (D.C. Cir. 2007) (stating that the SEC must carefully consider potentially mitigating factors, especially when the associated person faces a lifetime bar).

198. FINRA, SANCTION GUIDELINES, supra note 178, at 2 (General Principle 1).

199. Id. at 4.

200. Id. at 3 (General Principle 3). Examples include requiring a consultant to design or implement compliance procedures and requiring a firm to implement heightened supervision of certain individuals or departments. Id.

201. Id. at 4 (General Principle 5). Adjudicators may order restitution when an identifiable person “has suffered a quantifiable loss proximately caused by respondent’s misconduct.” Id. Without causation, however, a restitution sanction is arbitrary and non-remedial. See Siegel v. SEC, 592 F.3d 147, 161–62 (D.C. Cir. 2010).

202. FINRA, SANCTION GUIDELINES, supra note 178, at 5 (General Principle 6).

203. Id. at 5 (General Principle 7).

204. The classic economic analysis of this is Gary S. Becker, Crime and Punishment: An Economic Approach, 76 J. POL. ECON. 169 (1968). For a recent discussion of its application to securities offenses, see Samuel W. Buell, Liability and Admissions of Wrongdoing in Public
Under this approach, an important factor for the regulator to take into account in determining sanctions is the difficulty in detecting violations.205 This factor, however, is not mentioned as a consideration in the Sanction Guidelines and is not discussed in the opinions, perhaps because FINRA does not want to suggest that some violations are difficult to detect.

FINRA explains that, in determining if a violation is egregious, adjudicators “assess the individual facts and circumstances of the case” and “also consider all relevant aggravating and mitigating factors.”206 FINRA does not attempt to define “egregious,” but the dictionary definition of “[e]xtremely or remarkably bad” provides a working definition consistent with the Sanction Guidelines.207 Thus, the Sanction Guidelines identify factors that can lead to a finding of egregious conduct: repeated instances of wrongful conduct;208 the violator’s motives, e.g., bad faith209 and intentional misconduct;210 significant injury to customers211 and activity involving numerous customers;212 and failures to meet compliance requirements for extended periods of time.213 The Sanction Guidelines frequently refer to factors that go to mens rea, scienter, and prior disciplinary history.214 Thus, the General Principles state that “sanctions should be more severe for recidivists.”215 Similarly, the Guidelines identify a number of factors that may be mitigating or aggravating, as the case may be,216 many of which also go to mens rea, including repentance (especially prior to detection),217 lack of remorse and concealment,218 and intent/culpability.219 Although the emphasis on mens rea suggests an intention to punish, these factors can also be described as remedial since they address the need to protect the general enforcement of Law, 81 U. CIN. L. REV. (forthcoming 2013), available at http://ssrn.com/abstract=2230396 (describing the deterrent effect of sanctions).

205. See Minzner, supra note 136, at 877–78 (citing the literature).
206. March 2006 Revisions, supra note 12 (answer to question 17). The website explains that adjudicators have “wide discretion” in determining sanctions. Id. (answer to question 7).
208. FINRA, SANCTION GUIDELINES, supra note 178, at 98 n.2 (categories of egregious unauthorized trading); id. at 13 (outside activities including selling away); id. at 39 (failure to register).
209. Id. at 98 n.2 (egregious unauthorized trading).
210. Id. at 41 (failure to comply with continuing education requirements).
211. Id. at 13 (outside activities including selling away).
212. Id. at 82 (failure to comply with risk disclosure requirements for day trading accounts).
213. Id. at 64 (failure to comply with TRACE reporting requirements).
214. See id. at 4–6.
215. Id. at 2.
216. Id. at 6–7.
217. Id. at 2–4.
218. See id. at 6.
219. See id. at 4, 7.
investing public from an individual who has shown himself to be a “bad apple.”

By contrast, the Exchange Act provides somewhat more guidance for the imposition of civil penalties in SEC actions. The statute authorizes the SEC to impose a civil penalty if the agency finds that it is in the public interest and that the person has committed a willful offense or failed reasonably to supervise another person. The statute then sets forth a three-tier structure for determining monetary penalties in SEC administrative proceedings and in federal district court proceedings brought by the SEC. The third tier provides for the maximum amount of penalties and thus identifies the most serious types of offenses. To impose third-tier penalties, the adjudicator must find that the violation involved at least reckless disregard of a regulatory requirement and resulted in substantial losses, or created a significant risk of substantial losses, to other persons or resulted in substantial pecuniary gain to the violator. If adopted by FINRA, these factors could provide more concrete guidance as to what constitutes “egregious” conduct. The statute also sets forth a non-exclusive list of factors the SEC may consider in deciding whether a penalty is in the public interest: whether the violation involved fraud, deceit, manipulation, or deliberate or reckless disregard of regulatory requirements; the harm to other persons resulting from the violation; the extent to which any person was unjustly enriched, taking into account any restitution made to the injured persons; whether the person is a recidivist; and the need to deter such person and other persons. These factors are similar to those identified in the Sanction Guidelines.

Two other factors set forth in the Sanction Guidelines are also worthy of mention. Firm size and the ability to pay are considerations that do not seem relevant in assessing whether sanctions are appropriately remedial. Congress, however, identified the violator’s ability to pay a civil penalty as an important consideration when in 1990 it authorized, for the first time, the SEC to impose monetary penalties, and the Small Business Regulatory Enforcement Fairness Act of 1996 requires federal agencies to establish a policy to provide for the reduction or waiver of civil penalties for small entities. In 1996, the SEC vacated a NASD restitution order because its refusal to consider evidence of financial inability to pay was unduly

221. Id.
222. Id. § 78u(d)(3).
223. Id. §§ 78u(d)(3)(B)(iii), 78u-2(b)(3).
224. Id. § 78u-2(c).
harsh. As a result of these directives from Congress and the SEC, the Guidelines instruct adjudicators to consider firm size to ensure that the sanctions are “not punitive but are sufficiently remedial to achieve deterrence.” The Guidelines also explicitly state that the SEC requires adjudicators to consider ability to pay in connection with the imposition, reduction, or waiver of a fine or restitution when the respondent raises the issue. The Guidelines, while stating generally that adjudicators should consider firm size, also draw a distinction between sanctions imposed for violations based on negligent conduct and those based on fraudulent, willful, or reckless conduct. In the latter instances, adjudicators are permitted not to take into account firm size.

A second important factor that does relate to a remedial purpose is compliance. The Guidelines emphasize the importance of compliance. Thus, adjudicators may appropriately consider:

- “Whether, at the time of the violation, the . . . firm had developed reasonable supervisory, operational and/or technical procedures or controls that were properly implemented,”
- “Whether, at the time of the violation, the firm had developed adequate training and educational initiatives,”
- “Whether the respondent demonstrated reasonable reliance on competent legal or accounting advice;” and
- Whether the firm can demonstrate that the conduct was “not otherwise reflective of the firm’s historical compliance record.”

Because regulatory standards require compliance systems for investor protection and because compliance systems are expensive, these factors identify important remedial purposes.

Finally, despite FINRA’s emphasis on the facts and circumstances of the inquiry, there are three violations where a bar is standard. These are:

- Individuals who fail to respond in any manner to FINRA inquiry or investigation. Because FINRA does not have subpoena power, this is a violation of the fundamental nature of self-regulation; lack

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228. FINRA, SANCTION GUIDELINES, supra note 178, at 2. General Principle 8 requires adjudicators to consider ability to pay when raised by a respondent. Id. at 5.
229. Id. at 5.
230. Id. at 2 n.2.
231. Id. at 6.
232. Id.
233. Id.
234. Id. at 7.
235. See id. at 33. Where mitigation exists, suspension in any or all capacities for up to two years is suggested.
of harm to customers or benefit to the violator does not mitigate this violation.\textsuperscript{236}

- Conversion of a customer’s funds or securities, regardless of amount converted.\textsuperscript{237} More than any other violation, this offense damages the public’s confidence in the broker-dealer relationship.
- Cheating on qualifications exams.\textsuperscript{238} An individual who gained entry through cheating should not be allowed to continue in the industry.

As described earlier, a review of the FINRA 2008 Monthly and Quarterly Disciplinary Actions found eighteen decisions where a bar or a two-year suspension was imposed.\textsuperscript{239} Many of the violations that resulted in a bar were those for which a bar is standard. Thus, five of eighteen decisions imposed a bar on an individual for failure to respond to a FINRA inquiry or investigation;\textsuperscript{240} another three imposed a bar for conversion of customers’ funds.\textsuperscript{241} Bars or a two-year suspension were also imposed for other forms of simple fraud or obvious wrongdoing, such as failure to disclose one’s criminal record on the Form U-4,\textsuperscript{242} forgery,\textsuperscript{243} misuse of customer’s funds,\textsuperscript{244} excessive trading in a customer’s account,\textsuperscript{245} trading ahead of a customer,\textsuperscript{246} or interpositioning.\textsuperscript{247} Many decisions note as aggravating factors the willful or intentional nature of the conduct,\textsuperscript{248} the failure to acknowledge responsibility for wrongdoing,\textsuperscript{249} substantial harm to customers,\textsuperscript{250} and taking advantage of vulnerable customers.\textsuperscript{251} Youth and inexperience were not accepted as mitigating factors.\textsuperscript{252} Dishonest conduct

\begin{itemize}
\item \textsuperscript{236} Id. at 2 n.2.
\item \textsuperscript{237} Id. at 36.
\item \textsuperscript{238} Id. at 40.
\item \textsuperscript{239} See supra notes 187–189 and accompanying text.
\item \textsuperscript{240} Ortiz Release, supra note 187; Fawcett Release, supra note 187; Hodge Discip. Proceeding, supra note 189; Varone Discip. Proceeding, supra note 189; Hansen Discip. Proceeding, supra note 189. In one administrative proceeding, a NASD member firm and its CEO received two-year suspensions for failure to respond in a timely fashion. CMG Release, supra note 187.
\item \textsuperscript{241} Paratore Complaint, supra note 188; Selewach Discip. Proceeding, supra note 189; Mattes Discip. Proceeding, supra note 189.
\item \textsuperscript{242} Craig Release, supra note 187.
\item \textsuperscript{243} Ortiz Release, supra note 187.
\item \textsuperscript{244} Varone Discip. Proceeding, supra note 189.
\item \textsuperscript{245} Zaragoza Complaint, supra note 188.
\item \textsuperscript{246} Nicolas Complaint, supra note 188.
\item \textsuperscript{247} Gonchar v. SEC, 409 Fed. App’x 396, 399 (2d Cir. 2010).
\item \textsuperscript{248} Ortiz Release, supra note 187; Audiffern Release, supra note 187.
\item \textsuperscript{249} Ortiz Release, supra note 187, at *8; Audiffern Release, supra note 187, at *14. In one decision two brokers received two-year suspensions because they accepted responsibility, while another was barred for failure to do so. Behany Discip. Proceeding, supra note 189.
\item \textsuperscript{250} Nicolas Complaint, supra note 188.
\item \textsuperscript{251} Zaragoza Complaint, supra note 188; Mattes Discip. Proceeding, supra note 189.
\item \textsuperscript{252} Epstein Release, supra note 187, at *21.
was not excused because it was done for the purpose of benefitting the customer.\textsuperscript{253}

**CONCLUSION**

Part I documents the transformation of the securities SRO from a membership organization with contractual powers to require its members to adhere to aspirational standards to a professional regulator that derives its powers from the Exchange Act. Part II explores the tenuous distinction between remedial and punitive sanctions and describes FINRA’s current system for disciplining its members and associated persons. This is a system that, to date, has operated largely under the radar without much academic scrutiny.

\textsuperscript{253} Behany Discip. Proceeding, *supra* note 189 (improperly obtaining CDSC waivers for customers; two brokers who accepted responsibility received two-year suspensions).
THE CRUCIAL BUT (POTENTIALLY) PRECARIOUS POSITION OF THE CHIEF COMPLIANCE OFFICER

Deborah A. DeMott

INTRODUCTION

Although the importance of internal systems geared to ensure a firm’s compliance with applicable law and regulation is widely acknowledged, as is the visibility of major compliance failures in scandal-ridden financial-services firms, the roles and status of compliance personnel are relatively unexamined by scholars. Focusing specifically on the position of Chief Compliance Officer (CCO), this Article explores the functions performed by a CCO as well as circumstances that may strengthen or limit a CCO’s effectiveness, including the implications of legal doctrine and regulation. The Article argues that a CCO’s position is distinct, drawing comparisons with the position of a firm’s general counsel or Chief Legal Officer (CLO) to illustrate. Additionally, situated within a firm, a CCO is responsible for compliance systems that the firm itself designs and implements. To be sure, internal compliance systems and personnel may be characterized as supplements to or substitutes for external regulation, whether imposed ex ante to deter problematic conduct or ex post through the imposition of legal and regulatory penalties for misconduct. Lines of demarcation between mechanisms of external regulation and internal compliance systems are not identically drawn within the financial services industry as a whole; Morgan Stanley’s transformation in 2008 to a bank holding company from a firm regulated as a securities broker-dealer led, inter alia, to the physical presence of full-time regulatory personnel within the firm.1 Nonetheless, in general, a CCO’s position differs from those occupied by external gatekeepers such as external auditors or rating agencies; a compliance officer’s approval is not requisite to open a point of entry so that a firm may engage in transactions or other activity. Likewise, a CCO’s position differs in fundamental ways from those of compliance monitors who are imposed on a firm following major lapses in compliance

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1. See Aaron Lucchetti & Julie Steinberg, Life on Wall Street Grows Less Risky, WALL ST. J., Sept. 10, 2013, at A1, A14 (noting that “about 50 full-time government regulators are now stationed at Morgan Stanley”). Additionally, the firm has “doubled the head count” for risk management and shifted its balance of revenue sources away from investment banking and trading toward wealth and asset management. Some highly paid employees departed. Id.
and charged with acting as agents on behalf of governmental authorities. Like a CCO and other internal compliance personnel, a compliance monitor is tasked to engage with and address compliance issues. However, a compliance monitor appointed at the behest of governmental authorities functions as their agent; a compliance monitor works inside the monitored firm to assist its personnel and only once externally detected misconduct triggers the appointment as an alternative to or deferral of criminal indictment.

More generally, assessing the strengths and weaknesses of compliance functions and personnel requires a shift in scholarly focus to look deeper within private-sector firms and away from a single-eyed focus on firms’ boards of directors and Chief Executive Officers (CEOs). Compliance personnel and processes might be characterized as internal governance mechanisms through which a firm may establish and enhance its reputation for integrity—at a minimum, for legality—in its operations. The law and regulation may enhance a firm’s incentives to invest in its reputation by strengthening its compliance functions and the role of compliance personnel, most fundamentally by mandating that regulated firms adopt and implement policies and procedures reasonably designed to prevent violations and designating a CCO with responsibility for their administration. However, effective compliance may also be undercut by unforeseen consequences of legal doctrine and regulation, in particular consequences that undermine internal compliance personnel and systems, as well as by the underdeveloped professional status of compliance functions. Better results across the board require more recognition of the practical significance of internal compliance and how to strengthen it.

2. Compliance monitors appointed pursuant to deferred prosecution agreements or non-prosecution agreements are beyond the scope of this Article. It suffices for present purposes to note that evident compliance failures precede their appointment and that the choice of monitor is not that of the monitored firm. For a recent example of a post-compliance-failure appointment of a monitor, see infra text accompanying notes 10–11. On compliance monitors generally, see Veronica Root, The Monitor-Client Relationship, 100 VA. L. REV. (forthcoming 2014), available at http://ssrn.com/abstract=2309498.

3. For a wide-reaching statement of the importance of scholarly engagement with internal governance mechanisms that lower governmental monitoring costs and operate largely below the level of a corporation’s board, see Omari Scott Simmons, The Corporate Immune System: Governance from the Inside Out, 2013 U. ILL. L. REV. 1131.

4. For registered investment advisers, see 17 C.F.R. § 275.206(4)-3(a), (c) (2013). The U.S. Securities and Exchange Commission (the SEC) adopted this rule in 2003. One consequence of the registration of many hedge funds mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was that theretofore unregistered funds, once registered, became subject to inspection by the SEC and to the compliance requirements imposed by Rule 206(4)-3. Id. § 275.206(4)-3. For broker-dealers, see Self-Regulatory Organizations, Exchange Act Release No. 50,347, 83 SEC Docket 2219 (Sept. 10, 2004) (approving proposed rule change by National Association of Securities Dealers (NASD) to require appointment of a CCO who must certify annually that the firm has in place a process to establish, maintain, and test policies and procedures reasonably designed to achieve compliance with applicable NASD rules and federal securities law). The NASD has been succeeded by FINRA.
The Article opens in Part I with an introduction to the now-commonplace observation that internal compliance failures have dogged many financial-services firms in recent years. Part I uses as illustrations two recent incidents that, albeit extreme, are suggestive of internal firm structures and other circumstances that may undermine the effectiveness of internal compliance personnel and systems and may destroy both a firm’s reputation and potentially its ability to continue in operation. Part II focuses more narrowly on the CCO’s position, contrasting it with roles occupied by other professional and executive agents and personnel whose work is relevant to legal and regulatory compliance, in particular a firm’s general counsel or CLO. Part II also sketches the centrality of the CCO’s functions to a firm’s reputation and explores relationships between reputation and regulation. Part III examines a series of recent cases to illustrate that legal doctrine and regulation may sometimes undermine the effectiveness of compliance systems and personnel, as opposed to enhancing a firm’s incentives to strengthen internal compliance systems and the positions of those who staff them. The Article concludes by returning to the theme of relationships between a firm’s reputation and the quality of its internal compliance personnel and systems.

I. NARRATIVES OF FAILED COMPLIANCE

A. NOW-HISTORICAL EPISODES WITH LARGER IMPLICATIONS

By definition, narratives of scandal are not celebrations of success achieved by compliance systems and personnel. Thus, it would be mistaken to base one’s overall assessment of compliance within financial-services firms solely on incidents that follow or are associated with major compliance failures. However, it would also be mistaken to ignore the significance of scandalous episodes that were necessarily preceded by compliance failures. This is because their magnitude or outrageous character may suggest that systemic reforms are warranted. Additionally, even singular or exceptional episodes may illustrate factors that explain less spectacular incidents. For example, among now-historic scandals preceded by compliance failures, Bernard Madoff’s long-running Ponzi scheme carried out in the guise of investment management was understood by many observers as evidence of flaws in the SEC’s inspection regime for investment advisers and in the self-regulatory regime applicable

5. On scandals more generally, see Deborah A. DeMott, The Stages of Scandal and the Roles of General Counsel, 2012 WISC. L. REV. 463, 464 (defining a scandal as an organizational crisis that “embroil[s] identifiable actors who are (or should be) held responsible for the consequences of their actions,” and noting that “[t]he underlying conduct that makes an incident a scandal often violates the law”).
to broker-dealers, as well as in the firm’s own compliance efforts. Similarly, MF Global’s use of client funds in an ill-fated attempt to rescue investment bets gone wrong may indicate that regulatory rules applicable to intermediaries’ custody and use of clients’ assets are suboptimal.

**B. RECENT EPISODES ILLUSTRATING MAJOR COMPLIANCE FAILURES**

1. HSBC Bank: Organizational Inhibitions to Effective Compliance

Two recent episodes furnish good illustrations of how compliance personnel and systems may be compromised. The first demonstrates the potential impact of structures allocating authority within a firm or a group of affiliated firms, plus inadequate staffing and other resources, as well as inhibitions on the intra-firm flow of compliance-relevant information. In early July 2013, the federal government filed an information charging HSBC Bank USA, N.A. with several criminal offenses, including willfully failing to maintain an effective anti-money laundering (AML) program. Separately, its affiliate HSBC Holdings plc was charged with willfully facilitating financial transactions on behalf of sanctioned entities in violation of the International Emergency Economic Powers Act and the Trading with the Enemy Act. Simultaneously, the government filed a deferred prosecution agreement (DPA) with a five-year term, plus an agreement in which both entities consented to the appointment of a corporate compliance monitor. As detailed in the court’s order approving

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7. See Ben Protess & Azam Ahmed, MF Global’s Shortfall No Surprise, Some Say, N.Y. TIMES, Mar. 28, 2012, at B1; Aaron Lucchetti, Customer Divide at MF Global, WALL ST. J., May 7, 2012, at C2. Of at least anecdotal interest is the fact that MF Global’s senior vice-president for legal matters and head of compliance previously served as the head of compliance at Refco, a broker that failed due to massive accounting fraud. See DeMott, supra note 5, at 474 n.45.


10. Id. at *1.
At the same time, one of its largest Mexican customers had its own significant AML lapses, which enabled Mexican and Colombian drug traffickers to launder hundreds of millions of dollars in drug proceeds through HSBC Bank. HSBC Holdings was aware of these compliance problems but failed to inform HSBC Bank of them. During an earlier period of time, HSBC Holdings and its subsidiaries (all constituting the “HSBC Group”) knowingly caused payments to be processed on behalf of banks and other entities located in Cuba, Libya, and other countries subject to U.S. sanctions. Indirectly owned HSBC affiliates around the world cooperated to assure non-detection by the United States by “altering and routing payment messages in a manner that hid the identities of these sanctioned entities from HSBC Bank USA” as well as other U.S. financial institutions.

Once the dimensions and implications of the scandal became evident, HSBC made major changes in its leadership teams, including the CEO, CLO, and Head of Global Standards Assurance at HSBC Holdings; and HSBC North America’s CEO, General Counsel, CCO, and AML Director, among other high-level personnel changes. However, characteristics of HSBC’s previous compliance systems and AML programs generally illustrate causes of compliance failure more generally that are distinct from the limitations and foibles of particular individuals, even when the consequences of failure seem likely to injure the reputation of both the firm and the individuals implicated in the fiasco. First, responsibility for compliance was diffused across a large organization, and compliance personnel at the overall group level lacked authority to mandate actions at the group-affiliate level. Additionally, at the affiliate level, lines of responsibility were not crisply drawn; it was “unclear” whether responsibility for AML compliance ultimately rested with AML officers or the bank’s business personnel. Second, compliance within HSBC Bank USA was understaffed because since 2007, bank-wide initiatives to cut costs and increase the bank’s return on equity led to freezes on staffing levels and the non-replacement of senior officers, including the regional

11. Id. at *8–9.
12. Id. at *8.
13. Id. at *9.
14. Id.
15. Id.
16. Id. at *10.
17. On the importance of overall organizational coherence in compliance systems beyond particular business units, see Ben W. Heineman, Jr., Don’t Divorce the GC and Compliance Officer, CORP. COUNS., Jan. 2011, at 48, available at http://www.law.harvard.edu/programs/plp/pdf/Dont_Divorce_the_GC_and_Compliance_Officer.pdf.
19. Id.
compliance officer. Thus, compliance problems with Mexican transactions went unreported to personnel at HSBC Bank USA because personnel at Holdings, aware of the problems, did not inform their colleagues at Bank USA. At HSBC Bank USA, formal policy did not permit conducting due diligence on other group affiliates, which inhibited Bank USA’s ability to assess the AML risks to which it was exposed. Indeed, some affiliates structured transactions so that HSBC Bank USA could not review them adequately even when it requested full details.

These details illustrate features of organizational structure and culture that could undercut the effectiveness of any complex organization’s compliance program. The details are also telling indicators of the status of compliance programs and personnel. The vulnerability of compliance staffing to spending freezes driven by cost-cutting/return-on-equity concerns is inconsistent with placing a high organizational priority on compliance, as is a formal policy that inhibits asking questions about transactions originating elsewhere within a dispersed organization. Lack of clarity about responsibility for AML compliance, additionally, may have undermined the power of compliance officers by furnishing a basis on which its exercise could be contested.

2. SAC Capital Advisors: Alleged Infirmities in Compliance Functions

A separate episode freshly suggests the frequency with which compliance failures may be linked to the relative power of CCOs and other compliance personnel within financial services organizations. If true, the SEC’s recent allegations in an order instituting administrative proceedings against Steven A. Cohen, the founder and owner of hedge fund S.A.C. Capital Advisors, L.P. (SAC or SAC Capital), depict conduct in an organization in which visible interventions by compliance personnel were

20. Id.
21. Id.
22. Id.
23. Id.
24. Id.
striking by their absence. In particular, the order details allegations that
Mr. Cohen failed to discharge his duty to supervise personnel; he received
“highly suspicious information” from two portfolio managers who
reported directly to him, in interactions replete with “red flags” indicative
of the possession and proposed use of inside information in violation of
SAC Capital’s own Code of Ethics and federal law. Throughout the
narrative in the order, the firm’s CCO goes unmentioned, as do activities by
any other compliance officer. One interpretation of their absence—of
course others are possible too—is that the invisibility of compliance
personnel corresponded to a lack of relative power within the firm, which
inhibited or shaped their interactions with portfolio managers. In contrast,
among hedge funds more generally, portfolio managers are themselves
treated as a front line of compliance to enforce prohibitions against trading
on inside information because internal rules require that they consult the
firm’s compliance personnel immediately if they suspect they have received
inside information, including from colleagues within the firm. Incentive
structures at SAC Capital may have overpowered some actors’ commitment
to comply with policies that conformed to industry norms.

As it happens, compliance personnel appear frequently in the
allegations made in the federal criminal indictment of SAC Capital and
affiliated entities filed later the same month. The indictment alleges that
the “limited SAC compliance systems” were “overwhelmed” by a business
culture “fostered” by the “relentless pursuit of an information edge” to the
extent that “there was no meaningful commitment to ensure that such
‘edge’ came from legitimate research and not Inside Information.” Allegedly, a portfolio manager was hired over objections expressed by
SAC’s Legal Department; an employee of the hedge fund that previously
employed the portfolio manager warned he was “known for being part of
[that fund’s] ‘insider trading group.’” Indicative of the role compliance
personnel may have played in the firm’s operations is the allegation that a
recently hired portfolio manager apologized to the firm’s owner for a
“cryptic” instant message in which he referred to “recent research” as
the basis for a plan to short a stock because “the head of SAC compliance

27. Id. para. 3, at 1.
28. Id.
29. See Bryan Burrough & Bethany McLean, The Hunt for Steve Cohen, VANITY FAIR, June
2013, at 100, 147.
30. See infra text accompanying notes 31–36.
/usao/nys/pressreleases/July13/SACChargingAndSupportingDocuments/SAC%20Indictment
%20(Stamped).pdf.
32. Id. para. 7, at 4.
33. Id. para. 19, at 15.
'was giving me Rules 101 yesterday—so I won't be saying much,'"34 an episode that is even more troubling if compliance personnel explicitly or implicitly furnished instructions on how best to paraphrase emails and other electronic communications to mask indicia of plans to engage in illegal conduct. Indeed, allegedly until 2009, SAC compliance personnel only rarely reviewed intra-firm electronic communications for signs of problematic conduct, despite a recommendation made in 2005 by SAC’s head of compliance.35 Perhaps due to these limitations, the compliance department conducted only a “few” investigations of insider trading, focusing on interviewing research analysts and portfolio managers and “confirming’ . . . that an e-mail implying access to Inside Information was an inartfully drafted e-mail.”36 Throughout an era in which several insider-trading cases occurred at SAC that have led to guilty pleas by several individual defendants, the compliance department contemporaneously identified only one instance of insider trading by SAC employees in its entire history.37

As acknowledged earlier in this Part, dwelling on such episodes (and so far only alleged episodes concerning SAC Capital) can generate misleading conclusions about the effectiveness of compliance systems and personnel overall as well as the relative power of CCOs and compliance professionals within contemporary financial-services firms; after all, it seems inevitable that a large organization will experience some lapses in compliance that no CLO or CCO could have prevented.38 However, the narrative power of these more extreme episodes as cautionary tales is undeniable, as may be their potential to strengthen the hand of CCOs within their organizations. II. THE CCO'S POSITION AND THE FIRM'S REPUTATION

Legal compliance can fairly be characterized as “integral to the daily operations of large companies,”39 and, in the highly regulated context of

34. Id. para. 23, at 21.
35. Id. para. 24, at 22. SAC did enlarge its cohort of compliance personnel once the SEC began the insider-trading investigation in 2006, from three in 2005 to thirty-six in 2013. Burrough & McLean, supra note 29, at 104. SAC also became “one of the first hedge funds” to create a separate compliance department “led by a well-respected professional.” Id. at 103–04. In 2013, SAC reportedly further enlarged its compliance staff and, by May, had attempted to recruit a new “senior-level compliance executive,” an effort seen by individuals close to SAC as potentially a diminishment of the internal role of the firm’s CCO. See Jenny Strasburg & Michael Rothfeld, Four Top SAC Executives Receive Subpoenas in Probe, WALL ST. J. (May 23, 2013, 9:10 PM), http://online.wsj.com/news/articles/SB10001424127887323975004578501212048252892. The recruitment effort was unsuccessful. Id.
36. SAC Indictment, supra note 31, para. 28, at 25.
37. Id.
38. See James B. Stewart, When Trying to Follow Rules Isn’t Enough, N.Y. TIMES, Sept. 21, 2013, at B1 (commenting on general counsel of JPMorgan Chase & Co. in light of firm’s agreement to admit wrongdoing and pay close to $1 billion in fines for its conduct in “London Whale” incident in which firm lost more than $6 billion and misled bank regulators about its loss).
39. Simmons, supra note 3, at 1145.
contemporary financial-services firms, to have a texture that requires engagement with many specifics—some highly technical, others less so.\textsuperscript{40} And legal and regulatory specifics vary in their degree of determinacy over a spectrum that ranges categorically from stated rules that leave no room for interpretation or discretion to more open-ended standards.\textsuperscript{41} Overall, compliance programs aim to determine whether a firm’s operations meet legal and regulatory requirements, whether indicia of problematic conduct should be investigated, and whether the firm’s internal information flow meets requisite standards for accuracy and processing.\textsuperscript{42} Additionally, when warranted, compliance systems should bring material information to management’s attention.\textsuperscript{43} Many internal functions and personnel aid in the design and implementation of these systems, including the firm’s internal audit department, its CLO and her staff, as well as the firm’s CCO and any other personnel distinctively assigned to compliance functions.\textsuperscript{44} Although a designated CCO bears internal responsibility for the administration of compliance systems and the supervision of compliance-department personnel, the overall efficacy of compliance requires engagement in some form from other internal actors, including the CEO, other members of the senior management team, and the firm’s directors,\textsuperscript{45} as well as the firm’s general counsel or CLO.

A. THE CCO AND THE CLO

For starters, the same person may serve as CCO as well as CLO.\textsuperscript{46} As a consequence, it can be difficult to specify with precision the functions and roles distinctively served by a CCO. One starting point is to compare the

\begin{itemize}
\item \textsuperscript{40} See id. at 1145–46 (noting that compliance systems are not uniform and “differ according to jurisdiction, industry, company, and operational context”).
\item \textsuperscript{41} Id. at 1135.
\item \textsuperscript{42} Id. at 1145.
\item \textsuperscript{43} Id.
\item \textsuperscript{44} See Heineman, supra note 17, at 49.
\item \textsuperscript{45} The Delaware Court of Chancery made clear in 1996 that responsibility for legal and regulatory compliance extended upward to a corporation’s board. See \textit{In re Caremark Int’l Derivative Litig.}, 698 A.2d 959, 970 (Del. Ch. 1996) (stating in dictum that “a director’s obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system . . . exists, and that a failure to do so . . . may . . . render a director liable for losses caused by non-compliance with applicable legal standards”). More recently, the Court of Chancery explained that \textit{Caremark} liability does not encompass internal systems that are flawed because they do not adequately monitor business risks. See \textit{In re Citigroup Inc. S’holder Derivative Litig.}, 964 A.2d 106, 139 (Del. Ch. 2009).
\item \textsuperscript{46} This Article does not address three questions that are relevant to the situation of CCOs: (1) to whom should a CCO report; (2) who should have authority to hire and fire a CCO; and (3) should a firm’s CCO and CLO necessarily be different individuals. Answers to these questions vary, due in part to significant differences among firms and industries. On the third question, the health-care industry has a distinctive history. See John B. McNeese IV, \textit{The Ethical Conflicts of the Hybrid General Counsel and Chief Compliance Officer}, 25 GEO. J. LEGAL ETHICS 677, 692–94 (2012); see also Heineman, supra note 17, at 48 (arguing that CCO should report to the CLO and CFO).
\end{itemize}
functions served by a CCO with those of a firm’s general counsel or CLO. In earlier work I identified four distinct roles—some in tension with each other—that a CLO occupies. These are service as: (1) a legal adviser to the corporation and its constituents, including its senior management and board of directors; (2) a corporate officer and member of the senior management team; (3) the administrator of the firm’s internal legal department; and (4) an agent of the firm in its dealings with third parties, including governmental authorities. Although a CCO’s responsibilities overlap these roles to some extent, overall their focus is narrower, excluding, for example, the negotiation of transactions on behalf of the corporation and the supervision of internal lawyers who work on matters that are not compliance-related. Additionally, when a CCO is not a lawyer, the CCO is not subject to the distinctive self-regulation of the legal profession and the obligations it imposes; whether the work of a CCO who is licensed as a lawyer constitutes “practicing law” is open to dispute. In contrast, a CLO, like any in-house lawyer, has more crisply delineated duties, including the duty to report-up corporate misconduct imposed by section 307 of the Sarbanes-Oxley Act and Rule of Professional Conduct 1.13. Otherwise, hard-and-fast lines are hard to draw. In highly regulated businesses like financial services, advice related to legal compliance may be closely related to business decisions to be made by the firm’s operational management. Additionally, determining when and how to investigate based on information that comes to the attention of compliance personnel implicates judgments to be made by personnel charged with the corporation’s legal function. Pursuing what went wrong requires a degree of independence from the firm’s management; whether and when to bring in external counsel is itself a decision that can be crucial to the credibility of

48. Id. at 965.
49. Id. at 967.
50. Id. at 969.
51. Id. at 970.
52. See Heineman, supra note 17, at 49 (emphasizing “process integration and rigor” as role of CCO and observing that “although substantive lawyers have expertise and knowledge to assess legal and ethical risks in their areas, and to design specific mitigants, they may not have the process skills that great compliance leaders possess”).
54. Id. (manuscript at 27 n.119).
55. See Heineman, supra note 17, at 48 (noting the range of critical decisions made by senior management and directors that have “a legal or ethical component—a new deal, a new product, a new geography, a new government investigation”).
56. See id.
an investigation conducted by an internal compliance officer. In some reported instances, firms use compliance personnel as their agents in communicating with external constituencies, such as clients, to furnish credible assurances about the quality of the firm’s compliance systems and controls.

How compliance functions are perceived and received within firms appears to vary, with some firms’ powerfully situated CCOs and personnel contrasting with their counterparts in firms that, through formal structures or less formal cultures, foreclose interventions by the CCO and the compliance department or resist those interventions as unnecessary impediments to operating the firm’s business. For example, within JPMorgan Chase & Co., major internal restructurings in the aftermath of the “London Whale” debacle led to the empowerment of compliance and control groups “as equals to their business counterparts,” which implies prior inequalities in power within the firm. And personnel in charge of legal, risk-management, and compliance functions “can no longer be overruled by business heads.”

In addition, it may be telling that compliance functions are sometimes associated with modifiers like “rote,” which seems to exclude the

57. See Anton R. Valukas et al., Investigation and Disclosure of Violations, in COMPLIANCE PROGRAMS AND THE CORPORATE SENTENCING GUIDELINES § 15:7 (Jeffrey Kaplan & Joseph Murphy eds., 2013) (discussing considerations that weigh in favor of, and against, the choice of outside counsel to perform internal investigations).

58. See Strasburg & Rothfeld, supra note 35 (reporting that president and CCO of SAC Capital “also hold roles that have been visible to SAC’s clients over the past year, as they have conveyed confidence in SAC’s compliance and trading controls”); see also Peter Lattman, 4 SAC Executives Subpoenaed in Insider Trading Inquiry, N.Y. TIMES, May 24, 2013, at B3, available at http://dealbook.nytimes.com/2013/05/23/4-sac-executives-subpoenaed-in-insider -trading-inquiry/ (reporting that SAC’s CCO, who “oversees the firm’s internal regulatory regime,” has in recent months “been among the SAC executives who have tried to reassure the firm’s concerned investors”).

59. See Monica Langley & Dan Fitzpatrick, Embattled J.P. Morgan Bulks Up Oversight, WALL ST. J., Sept. 13, 2013 at A1, A2. JPMorgan Chase’s COO, at the insistence of regulators, now reports to the firm’s chief operating officer, not its CLO. Id. at A2. The overall cost is an additional $4 billion, with a commitment of 5000 additional employees. Id. at A1.

60. Id. at A1. (contrasting relative autonomy of such personnel at JPMorgan Chase with their counterparts in rival banks).

61. In a recent example, albeit in a different context from the other examples explored in this Article, SEC Commissioner Daniel M. Gallagher criticized undue reliance by institutional shareholders on recommendations generated by proxy advisory firms in deciding how to vote shares on behalf of clients. See Daniel M. Gallagher, Comm’r, SEC, Remarks at Society of Corporate Secretaries and Governance Professionals (July 11, 2013), available at http://www.sec.gov/news/speech/2013/spch071113dmg.htm. His criticisms may be well-founded, but consider the language in which they were couched:

Given the sheer volume of votes, institutional shareholders, particularly investment advisers, may view their responsibility to vote on proxy matters with more of a compliance mindset than a fiduciary mindset.
possibility that compliance functions may require the exercise of nuanced judgment and to deny the reality that a firm’s compliance failures may doom it. It also ignores the fact that the effectiveness of much regulation depends on implementations internal to regulated firms themselves, most likely preceded by discussion within the firm (including its compliance personnel) and productive interactions with the firm’s legal counsel, whether situated internally or externally. These internal conversations, like the decisions they precede, help ensure the effectiveness of regulation by resituating regulated firms as participants in the regulatory process that are able to understand, if not share, the regulator’s perspective and objectives.62

Finally, the status and evolutionary stage of compliance activity as a profession, distinct from the legal profession, may lurk in the background. Unlike lawyers, compliance professionals as such are not licensed by the state, nor is a particular course of formal education requisite to performing their work. Although compliance professionals may choose to be associated with membership organizations,63 these organizations do not (or, at least, do not yet) perform the sorts of self-regulatory functions associated with professional organizations in classic professions, such as law and accounting. Nor has the organized legal profession yet embraced the challenges posed by compliance work performed by licensed lawyers within organizational settings.64

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Id. Again, the Commissioner’s critique of how institutional shareholders determine to vote may be persuasive, but the assumed opposition between “compliance mindsets” and compliance “functions,” on the one hand, and those associated with a fiduciary may carry implications for how compliance personnel and the functions they perform are perceived, at least in some quarters.62 For fuller development of this point, see Annelise Riles, Collateral Knowledge: Legal Reasoning in the Global Financial Markets 234–36 (2011). As Professor Riles explains, regulatory efficacy always depends on implementation; “new architectures historically have never worked at the level of design. Where regulatory reforms have succeeded, it has been because, in one way or another, they enroll the targets or clients of regulation in the regulatory mission and encourage them to take responsibility for the regulatory problem.” Id. at 227.

62. For fuller development of this point, see Annelise Riles, Collateral Knowledge: Legal Reasoning in the Global Financial Markets 234–36 (2011). As Professor Riles explains, regulatory efficacy always depends on implementation; “new architectures historically have never worked at the level of design. Where regulatory reforms have succeeded, it has been because, in one way or another, they enroll the targets or clients of regulation in the regulatory mission and encourage them to take responsibility for the regulatory problem.” Id. at 227.


64. See Remus, supra note 53.
B. THE CCO AND A FIRM’S INVESTMENT IN ITS OWN REPUTATION

Further vantage points on a CCO’s functions are suggested by Jonathan Macey’s recent scholarship on corporate reputation. Tracing a perceived decline in reputation’s significance relative to regulation in financial-services firms, Professor Macey notes concurrent shifts in a “reputational industry” consisting of “products and services specifically designed and engineered for the purpose of lowering the costs of attaining the benefits of a reputation for honesty and integrity.” Although Professor Macey’s account focuses on such service providers as external auditors, law firms, and credit rating agencies, one might conceptualize a CCO and other compliance professionals as internal forces that under optimal circumstances can institutionalize practices that enhance a firm’s reputation and then serve as bulwarks against other internal forces that can jeopardize that reputation. Seen in this way, the position of a CCO, more singly focused than the CLO’s role, constitutes an investment by the firm in the long-term asset that its reputation represents. Additionally, success in a CCO’s role is highly unlikely to stem from an oppositional posture toward regulation. The adversarial posture that a CLO (or another lawyer) may appropriately adopt is inapposite for a CCO because effectiveness will not stem from treating either the relevant law and regulation, or their enforcers, as the firm’s adversaries, as a CLO or external counsel might well be warranted in doing.

66. Id. at 124.
67. Professor Macey’s book does not address internal compliance as such, so the implications I draw in this Article, although sparked by his book, are not necessarily ones he would endorse.
68. On theories of reputation and its effects more generally, see, e.g., Rachel Brewster, Unpacking the State’s Reputation, 50 HARV. INT’L LJ. 231, 259–66 (2009) (arguing that reputation for compliance on the part of states may be issue-specific or may have broader reach); DeMott, supra note 5, at 472–73 (characterizing reputation as “an intuitive and somewhat indeterminate concept” that is often personalized to particular actors and that may operate differently depending on whether the subject is an individual or an organization). Additionally, Professor Macey’s argument emphasizes that individuals’ reputations may be decoupled from the firms for which they work. See MACEY, supra note 65, at 96–99. Thus, individuals’ reputations may not suffer—or may their individual wealth—in the wake of a major scandal that consumes their firm. Id. at 90–96. But this decoupling is not universally true; following the indictment of hedge fund SAC Capital, which allegedly engaged in a pervasive insider-trading scheme, other hedge fund managers were reportedly reluctant to hire SAC veterans as portfolio managers. See Juliet Chung, Funds’ Employees Face Uncertainty, WALL ST. J., July 26, 2013, at A6.
69. Somewhat along the same lines, Professor Macey distinguishes lawyers from auditors and accountants more generally, writing:

Although intelligence, thoroughness, and attention to detail are important qualities in both professions, the best accountants are those who stay firmly within the lines when they take up their brushes and paint for clients. In sharp contrast, the very best lawyers are those who develop new ways of doing deals or develop new strategies and tactics to advance their clients’ interests and to surprise and confound the opposition.
III. LAW, REGULATION, AND THE CCO’S PRECARIOUS POSITION

If the effectiveness of the CCO is integral to creating and preserving a firm’s reputation over time for integrity, as well as to assuring the firm’s compliance with applicable law and regulation, it is important that the CCO’s position not be undermined by unforeseen consequences that stem from the law, regulatory strategy, or lacunae in professional self-regulation.70 Seen in this light, the position of CCOs and other compliance professionals has not been strengthened by recent developments, in particular in the common-law doctrine applicable to compliance personnel, and, in a more diffused way, in the patchwork of federal statutes applicable to individuals who bring to light within a firm information that is suggestive of illegal behavior by others.71 Together these developments call into question how secure a CCO’s position may be when the CCO’s actions prove unwelcome to those in control of a firm. Separately, to the extent that a CCO can be characterized as the “supervisor” of a firm’s miscreant employee for SEC regulatory purposes, the CCO faces the risk of personal liability for failing reasonably to supervise that employee even when the firm’s allocation of power situates the employee within the protective ambit of another officer.72

A. THE CCO AND THE COMMON LAW OF EMPLOYMENT

Consider first the status of a CCO from the standpoint of the common law of employment. In most jurisdictions within the United States, an employer commits a tort when it fires or otherwise retaliates against an employee who reports or inquires in a reasonable manner about conduct the employee reasonably and in good faith believes violates either the law or an established principle of professional conduct that protects the public

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See Macey, supra note 65, at 153. For accountants, “creativity” or “creative accounting” has negative connotations (“is a very bad thing”) whereas “[c]reative lawyering” is a good thing.” Id. Although I do not propose conflating CCOs and other compliance officers with accountants, “creative compliance” may not strike the same positive notes as “creative lawyering.” As Professor Macey observes, “regulators, lenders, and investors do not want to be known to be associated with accounting firms or accountants that are thought to interpret the accounting rules creatively or aggressively” while “many lawyers pride themselves . . . as being particularly creative and aggressive in asserting and defending their clients’ views.” Id.

70. See id. at 248 (“Regulation and reputation are closely connected. A thoughtful, well-considered regulatory strategy might . . . use scarce enforcement resources in order to reinforce rather than to undermine the value of companies’ investments in their own reputations for honesty and fair dealing with customers.”).

71. For a brief treatment of some of the same cases, see Deborah A. DeMott, Internal Compliance Officers in Jeopardy?, 87 AUSTL. L.J. 451 (2013).

72. See infra Part III.C.
interest. Although some states require that employees report internally before “reporting out” to governmental authorities and a few do not protect employees who report only internally, in many states the nature of the wrongdoing indicated by the information is determinative. Regardless, under New York law, an employer’s retaliation under these circumstances is not tortious, even when the point of an employee’s job is detecting and reporting problematic conduct. In Sullivan v. Harnisch, a majority of the Court of Appeals held in 2012 that a CCO had no tort claim against his former employer, a group of hedge funds with a common investment adviser, when the CCO was fired after confronting the funds’ controlling shareholder about trading activity on behalf of that shareholder and members of his family that appeared to front-run client orders. The court reasoned that the CCO, as an employee at will, had no claim for wrongful discharge and, unhappily for him, fell outside of New York’s narrow exception to the state’s especially robust employment-at-will doctrine. Sullivan underlines the narrowness of this exception, articulated by the court in 1992 in Wieder v. Skala. In Wieder, the court held that a law firm breached an implied contractual obligation when it discharged an associate who insisted that the firm comply with the applicable professional disciplinary rules and report the professional misconduct of a fellow associate. Representing as it does a claim for breach of contract, the exception to employment-at-will recognized by Wieder limits a discharged employee’s remedies to those available for breach of contract.

Tellingly, the Sullivan majority distinguished Wieder largely on the basis of a compliance officer’s professional status compared with that of a lawyer like the law-firm associate in Wieder. In the majority’s reasoning, a CCO, “not associated with other compliance officers in a firm where all were subject to self-regulation as members of a common profession,” is too unlike an associate lawyer whose regulatory and ethical responsibilities are so closely linked to his or her duties as an employee that they are

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74. See id. cmt. f.
75. Sullivan v. Harnisch, 969 N.E.2d 758, 759 (N.Y. 2012). To front-run a client’s order breaches an advisor’s fiduciary duty to the client; front-running consists of executing a purchase (or sale) of a security in anticipation of executing a client’s order to buy (or sell). See ALAN R. BROMBERG ET AL., BROMBERG & LOWENFELS ON SECURITIES FRAUD § 6:77 (2013). In Sullivan, the CCO believed that the controlling shareholders’ sales improperly excluded clients from a trading opportunity. See Sullivan, 969 N.E.2d at 760.
76. Sullivan, 969 N.E.2d at 759–60.
78. Id. at 108–09.
79. Id. at 110.
80. Sullivan, 969 N.E.2d at 761.
81. Id.
inseparable. Of course, this distinction assumes, as a prototype, a particular mode of professional practice—association together in a firm solely dedicated to furnishing a professional service—that appears to delegitimate the professional stature of work done by members of a profession who are also their clients’ employees. Additionally, the majority’s reasoning implicates the less developed state of the compliance professions by emphasizing the absence of a defined profession with self-regulatory functions. Further unhelpful to the CCO in *Sullivan* was the fact that he wore multiple hats, serving also as Executive Vice-President, Chief Operating Officer, Secretary, and Treasurer, which made him “not even a full-time compliance officer” in the majority’s assessment. 84 This line of reasoning is especially troubling because multiple-hatted status seems more likely to typify CCOs in smaller firms that lack the resources or the practical necessity for a CCO who serves exclusively in that role. That is not to suggest that compliance problems occur disproportionately within smaller firms, only that smaller firms with less hierarchy and less-elaborated management structures may make a CCO particularly vulnerable when his or her interventions prove unwelcome. Underscoring this point, terminating a CCO is a reportable event that a registered investment advisor (like the employer in *Sullivan*) must report to the SEC and FINRA if the firm is regulated as a broker-dealer. Although it is likely that such a report would trigger investigations into the firm, these foreseeable regulatory consequences did not deter the CCO’s employer in *Sullivan*, although they may temper conduct within larger registered firms with investor clienteles to whom the firm’s reputation for probity is highly material.

82. See *Wieder*, 609 N.E.2d at 108. In *Wieder*, the court held that

in any hiring of an attorney as an associate to practice law with a firm there is implied an understanding so fundamental to the relationship and essential to its purpose as to require no expression: that both the associate and the firm in conducting the practice will do so in accordance with the ethical standards of the profession.

83. See *Sullivan*, 969 N.E.2d at 761.

84. Id.

B. THE CCO AND WHISTLEBLOWERS UNDER FEDERAL SECURITIES LAW

Both Dodd-Frank and the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) amended earlier federal securities law to add protections for “whistleblowers,” in particular prohibiting retaliation against employees who report information that establishes violations of the law.\(^{86}\) However, the language stating these prohibitions, like its subsequent interpretation by federal courts, does not necessarily strengthen the position of CCOs and other compliance personnel who, like the CCO in Sullivan, are employees-at-will, especially those to whom New York law would apply. More generally, these developments may risk undercutting the effectiveness of internal compliance programs, distinct from the position of the CCO and other compliance personnel. In Sullivan, the CCO did not report to the SEC the information concerning suspected front-running.\(^{87}\) Instead, and as one

\(^{86}\) Specifically, Sarbanes-Oxley provides:

No company with a class of securities registered under section 12 of the Securities Exchange Act of 1934 . . . , or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 . . . , or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee . . . because of any lawful act done by the employee—

1. to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of section 1341, 1343, 1344, 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to or the investigation is conducted by—

A. a Federal regulatory or law enforcement agency;

B. any Member of Congress or any committee of Congress; or

C. a person with supervisory authority over the employee (or such other person working for the employer who has authority to investigate, discover, or terminate misconduct . . . .

18 U.S.C. § 1514A (2012). Section 922(a) of Dodd-Frank amended the Exchange Act by creating section 21F, which pertains to incentives and protections for securities whistleblowers. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. 111-203, sec. 922, § 21F, 124 Stat. 1376, 1841-49 (2010) (codified as amended at 15 U.S.C. § 78u-6). Section 21F(a)(6) defines a “whistleblower” as “any individual who provides, or 2 or more individuals acting jointly who provide, information relating to a violation of the securities laws to the Commission, in a manner established, by rule or regulation, by the Commission.” 15 U.S.C. § 78u-6(a)(6). Section 21F(b) authorizes the SEC to make monetary rewards to whistleblowers to be computed on the basis of percentages of any monetary sanctions imposed in an action stemming from the voluntary provision of information by a whistleblower. Id. § 78u-6(a)(6). Although auditors are among those excluded from eligibility for monetary rewards, see id. § 78u-6(c)(2)(C), internal compliance personnel are not expressly excluded. Section 21F(b)(1)(A) prohibits retaliation by an employer against a whistleblower “because of any lawful act done by the whistleblower . . . in providing information to the Commission . . . [or] in making disclosures that are required or protected under . . . Sarbanes-Oxley . . . , the Securities Exchange Act of 1934 . . . , and any other law, rule, or regulation” subject to the SEC’s jurisdiction. Id. § 78u-6(h)(1)(A).

87. See Sullivan, 969 N.E.2d at 761 (observing that “Sullivan does not claim to have blown a whistle—i.e. to have told the SEC or anyone else outside of [firm] about . . . alleged misconduct”).
would think a CCO should generally do, he reported upward within his firm to the firm’s CEO.88 Both the majority and dissenting opinions in *Sullivan* read Dodd-Frank’s prohibition of retaliatory firings to require reporting-out, that is, to the SEC.89 Likewise, in the sole decision on point from a federal appellate court, the Fifth Circuit held in *Asadi v. G.E. Energy (USA), L.L.C.* that Dodd-Frank’s protections for whistleblowers do not encompass an employee who reports information concerning a violation internally within the firm but not to the SEC.90 The Fifth Circuit also declined to defer to the SEC’s rule to the contrary that construes Dodd-Frank’s anti-retaliation provision not to require reporting to the SEC because, in the court’s analysis, the rule redefined the statutory term “whistleblower” to include individuals who never report information to the SEC, whereas the statutory definition itself includes only “any individual who provides . . . information relating to a violation of the securities laws to the Commission.”91

Ironically, some commentators feared that Dodd-Frank’s whistleblower provisions would “undermine the effectiveness of . . . internal compliance programs” because Dodd-Frank created incentives in the form of a monetary reward program (not at issue in *Asadi*) to report directly to the SEC.92 However, as *Asadi* illustrates, the efficacy of internal compliance confronts a greater challenge because Dodd-Frank’s anti-retaliation provision protects only individuals who report-out to the SEC, whether those individuals are compliance personnel or other employees. This appears to create an incentive to bypass internal compliance mechanisms altogether, or to inform the SEC prior to internal reporting or the completion of any internal investigation, in order to avoid jeopardizing an anti-retaliation claim.93 Although most employees as of 2012 at least

88. Id.
initially raised concerns about illegal conduct within their employer’s organization. Asadi underscores the importance of reporting to the SEC.

In contrast, although the remedies are more limited and the enforcement mechanisms more cumbersome under Sarbanes-Oxley’s anti-retaliation provisions, the statutory language, which does not formally define “whistleblower,” also does not require reporting-out to the SEC. However, Sarbanes-Oxley covers only employees of public companies and companies required to file reports with the SEC by section 15(d) of the Securities Exchange Act of 1934. Among other issuers of securities, section 15(d) applies to issuers of mutual fund shares that may be sold to the public. Given the structure of mutual funds, a question freighted with implications for the effectiveness of internal compliance is whether an “employee” for this purpose includes an individual employed, not by the reporting fund itself (which typically may have no employees), but by the investment adviser that manages and markets the fund. In Lawson v. FMR LLC, the First Circuit treated the question as one of first impression in 2012, holding that Sarbanes-Oxley’s protections did not extend to employees of firms that contract with public or reporting

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94. William McLucas et al., Dispatches from the Whistleblower Front: Five Common Pitfalls to Avoid, 45 BNA SEC. REG. & L. REP. 1345, 1348 (2013) (reporting 2012 study by Ethics Resources Center which found that eighteen percent of reporters choose to report externally, and of those, eighty-four percent did so following attempt to report internally).

95. See Yin Wilczek, Employers Seize on Fifth Circuit Decision to Ask for Dismissal of Whistleblower Cases, 45 BNA Sec. Reg. & L. Rep. 1597, 1597–98 (2013) (quoting lawyer who represents whistleblowers, who commented, “In a way, the decision does a service to whistleblowers by giving them a legitimate reason to file with the SEC even as they provide information internally” and observing that an employer’s attempts to discourage employee contacts with the SEC could be seen as an attempt to interfere with Dodd-Frank’s anti-retaliatory protections).


97. The statute of limitations under Sarbanes-Oxley, see 18 U.S.C. § 1514A(b)(2)(D) (between 180 days after violation occurs and 180 days after employer becomes aware of it), is relatively shorter than the three- to ten-year limitations period under Dodd-Frank, see 15 U.S.C. § 78u-6(h)(1)(B)(iii). Additionally, a claim under Sarbanes-Oxley must be filed first with the Secretary of Labor. See 18 U.S.C. § 1514A(b)(1).


99. Id. § 1514A(a).

100. Id.

101. See Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2299, 2305 (2011) (noting that mutual fund’s adviser provided all management and administrative services necessary for fund’s operation, which included drafting statements in prospectus at issue in case).

companies. The court noted that Congress itself could have expressly encompassed employees of mutual-fund advisors or other contractors but did not do so. The allegedly retaliatory terminations in Lawson occurred prior to the enactment of Dodd-Frank; had they occurred after Dodd-Frank’s effective date, recall that its anti-retaliatory protections have been held to apply only to those who report-out to the SEC, bypassing or delaying any internal reporting whether to a compliance officer or otherwise.

Overall, it is hard to resist the conclusion that, viewed in retrospect, these statutory protections against retaliation do not appear to be optimally crafted to strengthen internal compliance systems. The Dodd-Frank protection is cast in statutory language open to the interpretation that an employee is unprotected against retaliation unless the employee reports-out to the SEC, not only (or at all) through internal compliance systems. The protection in Sarbanes-Oxley does not contain this limitation, but it has been held not to apply to the most likely sources of relevant information within the typical mutual fund, who would be the employees of the fund’s investment adviser, charged as the adviser is with managing and marketing the fund. And Sullivan illustrates the perils of employee-at-will status for CCOs, and for others who may report-up compliance-relevant information, in a prominent jurisdiction for financial-services firms.

C. THE CCO AS A “SUPERVISOR” WITHIN FEDERAL SECURITIES REGULATION

As noted above, one basis on which the SEC may institute administrative proceedings is that the respondent failed reasonably to supervise a person who committed underlying violations of the federal securities laws. Whether a person in an advisory and support role who is not directly involved in operating a business—such as a CCO—should be characterized as a supervisor is not a question that the SEC has addressed through a general rule. In Urban, a 2010 decision finding a broker-dealer’s CCO/General Counsel to have been the supervisor of a broker, the administrative law judge (ALJ) relied on the facts that the

103. Id. at 68. This interpretation of the statute appears to exclude from its protection external lawyers who advise public companies on securities-law issues as well as employees of auditing firms with public-company clients, inconsistently with Congress’s intent. See Brief of United States as Amicus Curiae, Lawson v. FMR, LLC, 2013 WL 4049264 (U.S. Aug. 7, 2013).
104. Lawson, 670 F.3d at 76.
105. See supra notes 86–104 and accompanying text.
106. See supra notes 101–104 and accompanying text.
107. See supra notes 101–104 and accompanying text.
108. See supra notes 70–87 and accompanying text.
C CO’s opinions on legal and compliance issues were viewed as authoritative within the firm and were generally followed by personnel in its business units. 111 Although the CCO did not direct the firm’s response to the broker in question, he served on the firm’s credit committee and dealt with the broker on its behalf. 112 The ALJ additionally found that the CCO discharged his duty reasonably to supervise the broker. On appeal, the Commission itself dismissed the proceeding against the CCO but with no substantive ruling; three Commissioners did not participate, and, under the SEC’s rules, an initial decision is of no effect when “a majority of participating Commissioners do not agree to a disposition on the merits.”113

Reading through the extensive findings of fact in Urban, one sympathizes both with the plight of the CCO and the frustration of the SEC’s enforcement staff, confronted as both were by a firm with business management unwilling to jettison a productive but highly problematic broker. The miscreant broker in Urban divided his efforts between two geographically separate offices of the firm and between retail and institutional clients. 114 A known protégé of the firm’s head of private client accounts, the broker was not adequately supervised by the branch managers assigned to him, and many within the firm believed that only the head of private client accounts or a branch manager going through him had power to direct the broker’s conduct or terminate his employment. 115 Additionally, the head of private client accounts frequently expressed hostility toward compliance personnel and programs. 116 The CCO intervened when red flags indicated that the broker had engaged in improper conduct, which triggered investigations by other compliance personnel. 117 On behalf of the firm’s credit committee, the CCO acted when customer accounts controlled by the broker became over-margined. 118 He also recommended that the head of private client accounts take on direct supervision of the broker. 119 The head of private client accounts failed to do so despite assuring CCO that he would assume special supervision over the broker. 120 The broker’s transgressions continued. 121 Although the CCO

111. Id. One exception noted by the ALJ was the firm’s Retail Sales unit. See id. at 52.
112. See id. at 52.
115. Id. at 7.
116. Id. at 4.
117. Id. at 11.
118. Id. at 11–13.
119. Id. at 27.
120. Id.
121. Id. at 30–31.
recommended that the firm fire the broker, he did not share this recommendation with the firm’s board or CEO because he thought doing so would be futile given the CEO’s deference to the head of private client accounts. Following customer complaints, employment terminated for both the broker and the CCO—for the CCO because the CEO had lost confidence in him when the CEO realized the CCO had left him uninformed about the CCO’s recommendation that the broker be fired. The CCO’s forced resignation deprived him of the opportunity to participate as an equity holder when the firm was sold to a larger financial-services firm. His ordeal continued until the SEC, as noted above, dismissed the proceeding.

One potentially troubling implication of Urban is the evident risk to a CCO who intervenes, but without success, in response to indicia of wrongdoing. If through more active engagement a CCO may be characterized as a “supervisor,” some CCOs may conclude that a more passive or hands-off stance is preferable to defending the reasonableness of their actions as a respondent in proceedings before the SEC. The SEC’s leading precedent, Gutfreund, states a general and fact-sensitive test for whether an individual is a “supervisor”: “whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.” Focusing specifically on compliance personnel and internal lawyers, Gutfreund states that “persons occupying positions in the legal or compliance departments of broker-dealers have been found by the Commission to be ‘supervisors’ . . . under certain circumstances.” The ALJ in Urban found Gutfreund readily distinguishable on its facts; in Gutfreund the firm’s general counsel, to whom the CCO reported, was informed by senior management that an employee had committed a federal crime by submitting a false bid in an auction for U.S. Treasury securities in an attempt to corner the market.

The broker and his major client (who ran a Ponzi scheme) both pleaded guilty to charges of securities fraud and were incarcerated. The firm paid $7.2 million in damages to customers invested in the Ponzi scheme. The high quality of Mr. Urban’s defense has been applauded without addressing whether his former employer bore its cost. See Thomas O. Gorman, When Doing the Right Thing Pays Off: The Ted Urban Case, LEXISNEXIS LEGAL NEWSROOM (Sept. 13, 2010, 8:19 AM), http://www.lexisnexis.com/legalnewsroom/securities/b/securities/archive/2010/09/13/when-doing-the-right-thing-pays-off-the-ted-urban-case.aspx. The broker and his major client (who ran a Ponzi scheme) both pleaded guilty to charges of securities fraud and were incarcerated. Id. The firm paid $7.2 million in damages to customers invested in the Ponzi scheme. Id.

122. Id. at 28.
123. Id. at 32.
124. Id. at 38.
125. The high quality of Mr. Urban’s defense has been applauded without addressing whether his former employer bore its cost. See Thomas O. Gorman, When Doing the Right Thing Pays Off: The Ted Urban Case, LEXISNEXIS LEGAL NEWSROOM (Sept. 13, 2010, 8:19 AM), http://www.lexisnexis.com/legalnewsroom/securities/b/securities/archive/2010/09/13/when-doing-the-right-thing-pays-off-the-ted-urban-case.aspx. The broker and his major client (who ran a Ponzi scheme) both pleaded guilty to charges of securities fraud and were incarcerated. Id. The firm paid $7.2 million in damages to customers invested in the Ponzi scheme. Id.
127. Id.
address the problem, which proved to be grossly ineffective.\footnote{The employee, although reprimanded, was returned to his position with no change in duties, authority, or supervision; he repeated his criminal conduct in a subsequent bond auction. The general counsel did not inform the CCO of the known misconduct, nor did he recommend any changes that might have constrained the employee. The senior management group also failed to do as they had agreed, which was to inform the relevant governmental official about the earlier crime. For a fuller account, see DeMott, supra note 5, at 478–83.} In *Urban*, in contrast, many of the firm’s business leaders either lied to the CCO or withheld information from him, excluding him from any collective that might have worked together to deal with the crisis presented by the misbehaving broker. In short, despite relatively weak facts of culpability by the CCO, the *Urban* proceedings illustrate multi-faceted risks for a CCO, which include proceeding in a setting in which senior colleagues in the firm withhold or misrepresent information, jeopardizing employment, and hazarding a defense in a later SEC proceeding.

**CONCLUSION: INCENTIVES TO ENHANCE REPUTATION BY STRENGTHENING COMPLIANCE**

The narratives recounted in this Article suggest that enhancing the effectiveness of CCOs and the compliance systems for which they are responsible requires as a fundamental matter that internal compliance become a more visible focus for concern. However, the potential of strong internal compliance to enhance a firm’s reputation—and to mitigate the risk of penalties in the wake of a major compliance failure—does not seem likely by itself to lead to improvement. The episodes in this Article suggest, instead, that changes in law, regulation, and industry-level practices are crucial. More specifically, federal legislation could define “supervisor” for purposes of failure-to-supervise liability (as could the SEC). Legislation in New York could oust *Sullivan* and insulate CCOs from the risk of termination without good cause, as presumably could federal legislation by preempting the state common-law of employment as applicable to CCOs within financial services firms that are subject to federal regulation. Congress could also redraft the relevant language in Dodd-Frank to clarify that reporting-out to the SEC is not a precondition for protection from an employer’s retaliation when an employee reports-up within an organization information that the employee reasonably believes to be indicative of a violation of federal securities law. And Congress could also clarify the application of Sarbanes-Oxley’s protection against employment retaliation when the employee in question works for an adviser to a mutual fund.

Formal legislative (and regulatory) solutions aside, compliance professionals themselves might consider potential reform strategies. In light of *Sullivan*, and given the prominence of New York for financial-services firms, contractual solutions might be promising. Employment contracts may of course modify or replace the default rule of employment-at-will by...
requiring cause to terminate employment, defining cause, and providing for severance payments in the event of non-cause termination. Contractual provisions requiring that an employer advance attorney’s fees in the event of litigation (including a SEC proceeding) that follows a not-for-cause termination could also reduce risk to a CCO.

Further maturation in the compliance professions would also strengthen the quality of internal compliance systems and the individuals responsible for their operation, including their capacity to exercise independent judgment and to resist internal threats to the effectiveness of the systems for which they are responsible. A self-regulatory organization could bring several benefits, including a vantage point from which to express professional disapproval of sub-optimal performance by compliance personnel, as well of retaliatory firings of CCOs and other compliance professionals. A code of conduct for compliance professionals, articulated by a self-regulatory organization, could undergird the exercise of independent judgment, an effect enhanced for members of a licensed profession (like lawyers) who risk the loss of the license if they fail to fulfill their professional duties.130 Additionally, the professional obligations of CCOs and other compliance officers who are licensed as lawyers have long been murky; clarifying the obligations they owe as licensed professionals is likely to prompt a clearer articulation of obligations owed by compliance personnel more generally.

130. Remus, supra note 53 (manuscript at 32).
SELF-REGULATION OF INSIDER-TRADING IN MUTUAL FUNDS AND ADVISERS

Tamar Frankel *

INTRODUCTION

Financial services providers such as investment advisers, investment managers, underwriters, and brokers produce or possess financial insider-information. Insider-information is inherent in their very services for a number of reasons. First, as part of their work financial services providers should glean as much information as they can about target investments, including nonpublic information. Second, financial services create a temporary or lasting effect on securities market prices by offering investment advice to a large number of followers or to large clients. Third, the performances of some financial services, such as mutual funds management and investment advice, may affect the securities prices markets in which they determine to trade or guarantee for their clients or for their institutions’ trading. After all, at the end of 2012, mutual funds alone held over $26 trillion in worldwide assets.¹

Thus, by definition, financial services either gain nonpublic information or create it. In fact, financial services are similar to legislators. Legislators, too, receive insider-information and may make decisions that enhance or reduce the profitability of enterprises and, consequently, the price of the enterprises’ securities.²

It is not surprising that financial services and their personnel must grapple with a strong and continuous temptation to use insider-information for their own benefit or for the benefit of selected others, such as family members or friends. In contrast, the law that prohibits insider-trading often remains unenforced. The reason is that outside regulators face great difficulty and high costs in detecting and preventing the use of insider-information by those related to financial services’ institutions. Therefore, the legal prohibition on insider trading is enforced after the fact or remains a dead letter. A legal prohibition in and by itself might deter violations. But in this case the prohibition is not very effective. The possibility of quick collections of large sums of money and the low risk of discovery may trump the prohibition.

And yet, throughout the years, there have been relatively few cases concerning insider-trading by regulated mutual funds and advisory service personnel. From 1980 to 2012, according to a LEXIS search, the U.S.

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Securities and Exchange Commission (SEC) filed thirty-one enforcement actions under Rule 17j-1 of the Investment Company Act of 1940.\(^3\) Significantly, the most recent proceedings are dated from 2007,\(^4\) and none were found for the past five years before that date. Eight of the thirty-one proceedings involved violations of the substantive provision of Rule 17j-1, that is, the direct prohibition on certain fraudulent activities.\(^5\) Twelve of the proceedings involved violations of the individual companies’ established codes of ethics (Codes of Ethics or Codes) requirements,\(^6\) including one case in which performing transactions in violation of a Code was deemed aiding and abetting a violation of the Code requirements.\(^7\) There was one insider-trading case against an investment company in 1990,\(^8\) one against an investment adviser and a portfolio manager in 1995,\(^9\) and another against an investment adviser in 1997.\(^10\)

In 2012 the SEC alleged that a consulting firm and its manager obtained material nonpublic information and provided it to clients, who were “portfolio managers and analysts at prominent hedge funds and other nationally recognized investment advisors.”\(^11\) In 2011 the SEC claimed that an employee’s trades followed the trades at his former employer’s exchange-traded fund (ETF) desk.\(^12\) When the SEC focused on insider-trading in the last four years, regulated mutual funds and their managers and employees took a back seat to corporations, hedge funds, investment banks, bank managers, and their employees.\(^13\)

\(^3\) Result of LEXIS search performed Feb. 1, 2013, in “SEC Decisions, Orders & Releases.”
\(^7\) Gintel Release, supra note 6.
\(^8\) SEC v. Unifund SAL, 910 F.2d 1028 (2d Cir. 1990).
Mutual funds are required to impose Codes of Ethics on many of their employees. Did this requirement make a difference? After all, similar Codes proliferate in many other financial and business corporations\(^{14}\) with fairly miserable results. In fact, the temptations facing employees and managers of many business corporations that published self-imposed Codes are relatively weaker than the temptations facing employees and managers of mutual funds. Yet as compared to mutual funds, these business companies have failed to prevent insider-trading!

I believe that regulated mutual funds are less prone to insider-trading than non-regulated funds and traders because their Codes of Ethics have introduced enforcement mechanisms and have influenced their culture. Regulated mutual funds’ Codes of Ethics are accompanied by four features that may have helped reduce the zeal of temptation for insider-trading:

1. The Codes are far from voluntary. They are required by law.
2. The Codes contain both general principles and self-enforcement mechanisms.
3. Mutual funds depend not only on their performance but, like other financial services, are heavily dependent on investors’ trust. The managers of regulated mutual funds recognize that a hint of unfair treatment can decimate their entire business and may result in “runs.” Similar to banks, open-end funds must offer investors redemption within seven days of demand, with few exceptions.\(^{15}\) Mutual funds receive investors’ demands, and in seven days investors must receive their money!\(^{16}\)
4. The Investment Company Institute—the professional and trade organization of investment advisers that manage mutual funds—has supported the legally required provisions of the Code.

It may well be that these four conditions help increase the deterrent effect, reduce temptation within an organization, strengthen the prohibition on insider-trading, and—most importantly—establish a culture of compliance.


\(^{16}\) See 15 U.S.C. § 80a-22(e).
This Article concludes with two questions. First: what is not included in the Code of Ethics? And second: does it pay to internalize enforcement, and if so, to whom? The following is a discussion of each of these four components.

I. THE CODES OF ETHICS IMPOSED ON MUTUAL FUNDS HAVE BEEN INDUCED AND SUPPORTED BY LAW

A. INVESTMENT COMPANY ACT OF 194017 (RULE 17J-1)18

Rule 17j-1 requires investment companies to establish Codes of Ethics.19 The Rule’s requirement applies both to the investment company’s investment adviser and principal underwriter.20 The principal underwriter is very important to open-end investment companies because these companies issue redeemable securities.21 Investors may demand their money, not because they are dissatisfied with the performance of their funds but because they need the money.22 Yet, heavy demand may shrink the fund’s portfolio and raise the cost of managing it.23 The dependency of mutual funds on principal underwriters is the main reason for regulating their Codes of Ethics.24

B. RULE 17J-1 PROVIDES DETAILED REQUIREMENTS REGARDING THE SUBSTANCE OF CODES OF ETHICS

Codes must contain specific self-enforcing provisions. These provisions must be implemented not only to punish violators but to prevent violations of the federal securities laws. The requirements include oversight of compliance by the investment adviser, principal underwriter, administrator, and transfer agent.25 Under Rule 38a-1, the funds’ boards of directors are required to approve the policies and procedures—the Codes—of the

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17. Id. §§ 80a-1 to -64.
18. 17 C.F.R. § 270.17j-1.
19. Id.
20. Id. § 270.17j-1(c)(1)(i).
22. See Mutual Fund Redemption Fees, Investment Company Act Release No. 26,782, 70 Fed. Reg. 13,328, 13,328 (Mar. 18, 2005) (noting that mutual funds’ “redemption right makes funds attractive to fund investors, most of whom are long-term investors, because it provides ready access to their money if they should need it”).
23. See, e.g., Meyer v. Oppenheimer Mgmt. Corp., 915 F.2d 861, 865 (2d Cir. 1990) (“[A]n enormous and rapid shrinkage in asset size is potentially very damaging . . . . Lower total assets would also result in a higher effective advisory charge to remaining shareholders because of the economies of scale of fund management.”).
24. See supra note 21 and accompanying text.
25. 17 C.F.R. § 270.38a-1(a)(1).
investment adviser, principal underwriter, administrator, and transfer agent.26 A few details are interesting:

1. The Code must subject “access persons” to reporting of their personal securities transactions and holdings.27 An access person is a “supervised person who has access to nonpublic information regarding clients’ purchase or sale of securities, is involved in making securities recommendations to clients or who has access to such recommendations that are nonpublic.”28 “A supervised person who has access to nonpublic information regarding the portfolio holdings of affiliated mutual funds” is an access person as well.29

Thus, access persons include “portfolio management personnel and, in some organizations, client service representatives who communicate investment advice to clients” (even if they did not prepare the advice).30 “These employees [gain] information about investment recommendations whose effect may not yet be felt in the marketplace; [therefore], they may be in a position to take advantage of their inside knowledge.”31 “Administrative, technical, and clerical personnel may also be access persons if their functions or duties [require] access to nonpublic-information.”32

There is no specific and fixed definition of the word “access” with respect to insider-information. Access is measured by the organizations’ controls and structures.33 If an organization has a large number of employees with broad responsibilities, yet imposes on them few barriers to insider-information, the organization may have to consider a larger percentage of its staff to be access persons.34 In contrast, if an organization keeps strict controls on sensitive information, it may be deemed to have fewer access persons.35 Thus, the position of the employees is not the only consideration. The internal controls of the organization play a part in the definition of “access” as well. Rule 204A-1 provides a “presumption that, if the firm’s primary business is providing investment advice, then all of its directors, officers and partners will also be access persons.”36 Therefore, in many

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26. Id.
27. Id. § 270.17j-1(d).
29. Id.; see also 17 C.F.R. § 270.17j-1(a)(1) (general definition); id. § 270.17j-1(a)(1)(i) (incorporating definition of “Advisory Person of a Fund or of a Fund’s investment adviser”); id. § 270.17j-1(a)(2) (defining “Advisory Person of a Fund or of a Fund’s investment adviser”).
31. Id.
32. Id.
33. See id. (noting relationship between access and information barriers or controls).
34. Id.
35. Id.
36. Id. (emphasis added) (citing 17 C.F.R. § 275.204A-1(e)(1)(ii)).
2. The Code should impose on an adviser’s access persons a requirement to periodically report their personal securities transactions and holdings.\textsuperscript{37}

The report should be forwarded to the adviser’s chief compliance officer or other designated persons.\textsuperscript{38} The adviser should review the reports to ensure that the adviser and the SEC examiner would be able to “identify improper trades or patterns of trading by access persons.”\textsuperscript{39} The reports are modeled largely on the requirements in Rule 17j-1.\textsuperscript{40}

3. Even though Rule 17j-1 contains no requirement to adopt many of the detailed, prophylactic measures common to many Codes, advisory firms usually include in their Codes many of the following elements:

a. Access persons must have prior written approval (or “pre-clearance”) before they can place a personal securities transaction and may trade in securities only through particular brokers. These persons could be limited with respect to the number of brokerage accounts they may hold.\textsuperscript{41}

b. Advisers should prepare “duplicate trade confirmations and account statements” and set forth procedures for assigning new securities analyses to employees. These employees’ personal holdings should not present apparent conflicts of interest.\textsuperscript{42}

c. An advisory firm should maintain lists of the issuers of securities that the Advisory firm is analyzing or recommending for clients. Advisers are prohibited from “personal trading in securities of those issuers.”\textsuperscript{43} In addition, the firm must maintain “restricted lists” of issuers

\footnotesize{37. Investment Advisers Code of Ethics Release, supra note 28, at 41,698.}
\footnotesize{38. Id.}
\footnotesize{39. Id.}
\footnotesize{40. Id.; 17 C.F.R. § 270.17j-1(d).}
\footnotesize{42. Investment Advisers Code of Ethics Release, supra note 28, at 41,698; REPORT OF THE ADVISORY GROUP ON PERSONAL INVESTING, supra note 41, at viii, 45.}
about which the Advisory firm has inside information, and prohibitions on any trading (personal or for clients) in securities of those issuers.44 The firm should impose “blackout periods” when client securities trades are being placed” or recommended. Access persons may not personally engage in transactions in these securities.45

d. Access persons must be reminded that investment opportunities should be offered to clients first, before the adviser or its employees may act on such opportunities.46 The Adviser must have procedures to implement this directive.47

4. The Code should prohibit “short-swing” trading and market timing.48

5. The Code should require initial and annual holdings and quarterly transaction reports,49 with three exceptions: “transactions effected pursuant to an automatic investment plan,”50 “securities held in accounts over which the access person had no direct or indirect influence or control,”51 and a report that would “duplicate information contained in [broker] trade confirmations or account statements” provided that recordkeeping

http://www.cfp.net/for-cfp-professionals/professional-standards-enforcement/standards-of-professional-conduct/code-of-ethics-professional-responsibility (last visited Nov. 17, 2013) (“Protect the confidentiality of all client information. Confidentiality means ensuring that information is accessible only to those authorized to have access. A relationship of trust and confidence with the client can only be built upon the understanding that the client’s information will remain confidential.”); Code of Ethics, FIN. PLANNING ASS’N, http://www.fpanet.org/AboutFPA/CodeofEthics/ (last visited Nov. 17, 2013) (“An FPA member shall not disclose any confidential client information without the specific consent of the client unless in response to proper legal process, to defend against charges of wrongdoing by the FPA member or in connection with a civil dispute between the FPA member and client.”); see FINRA Manual: Contents, FINRA, http://finra.complinet.com/en/display/display.html?rdbid=2403&element_id=8849 (last visited Nov. 17, 2013) (FINRA Rule 2060, which has superseded NASD Rule 3120); cf. W. E. SELL, AGENCY § 136, at 123 (1975) (“An agent has a duty not to reveal or use any confidential information received from his principal for his own or another’s benefit.” The term “confidential information” has been construed to include all information that the agent should be aware the principal would not want revealed, for example, a list of preferred customers or a manufacturing process. “Confidential information” does not include generally known information.); John Howat & Linda Reid, Compensation Practices for Retail Sale of Mutual Funds: The Need for Transparency and Disclosure, 12 FORDHAM J. CORP. & FIN. L. 685 (2007).


45. Id.; see also REPORT ON THE ADVISORY GROUP ON PERSONAL INVESTING, supra note 41, at 36.


47. Id.; see also REPORT ON THE ADVISORY GROUP ON PERSONAL INVESTING, supra note 41, at 27 (stating principle that client interests should come first).

48. Investment Advisers Code of Ethics Release, supra note 28; see also INV. CO. INST., supra note 41, at vii.


requirements are met. There is an additional exception if the advisory firm "has only one access person, so long as the firm maintains records of the holdings and transactions that Rule 204A-1 would otherwise require be reported."  

6. The Code "must require that access persons obtain the adviser’s approval before investing in an initial public offering ('IPO') or private placement." This issue is debated. Because "[m]ost individuals rarely have the opportunity to invest in these types of securities[,] an access person’s IPO or private placement purchase raises issues." To what extent does the employee "misappropriat[e] an investment opportunity that should first be offered to eligible clients"? Or is a portfolio manager "receiving a personal benefit for directing client business or brokerage"? Yet it seems that these actions should generally be prohibited. One signal is Rule 204A-1’s exception for advisory firms with only one access person.  

C. THE CODES IMPOSE ENFORCEMENT MECHANISMS SUCH AS REPORTING VIOLATIONS AND EDUCATING EMPLOYEES

"[E]ach adviser’s code of ethics must require prompt internal reporting of any violations of the code. Violations must be reported to the adviser’s chief compliance officer." Further, "an adviser’s code of ethics must require the adviser to provide each supervised person with a copy of the code of ethics and any amendments." This requirement reduces the cost of government examiners.

Nonetheless, a Code of Ethics differs from a statute or regulation by offering more flexibility. Instead of requiring evidence in writing and a review by independent experts, the Codes may offer, for example, to include mechanisms that help the institutions enforce the Code rules. This flexibility allows for adjusting the rules to fit the particular functions, size, and culture of subject institutions. Advisers have more discretion to design their Codes and facilitate enforcement of the rules.

54. Investment Advisers Code of Ethics Release, supra note 28, at 41,700; see also REPORT OF THE ADVISORY GROUP ON PERSONAL INVESTING, supra note 41, at 32–34.
56. Id.
57. Id.
58. Id. at 41,699; cf. 17 C.F.R. § 275.204A-1(d) (exempting a company with a single access person from the requirement of obtaining approval for investments in any security in an IPO or in a limited offering).
60. Investment Advisers Code of Ethics Release, supra note 28, at 41,700; see also 17 C.F.R. § 275.204A-1(a)(5).
It is interesting that the SEC did not prohibit insiders within advisory organizations from securities trading. After all, such a requirement would have made the issues and enforcement simpler. Yet it was recognized that a prohibition (like the prohibition on alcohol drinking) will be difficult, if not impossible, to enforce. People who deal with securities trading and management are engrossed in their activities. The assumption seems to have been that a total prohibition might lead to increased avoidance and costlier enforcement.

The sanctions for violating a Code of Ethics are crucial to its viability. Employers must enforce the rules and punish its violations. The SEC backs these sanctions with more severe ones, such as disqualification from engaging ever again in the service or trade. Rule 17j-1 requires compliance procedures and practices to prevent Code violations. These requirements apply only to registered investment companies and their advisers and principal underwriters. Lawyers and compliance officers play a role in enforcing the law. While legal provisions may disqualify violators from continuing to practice, they rarely impose termination of the violators’ employment. In contrast, private enforcement by employers for violations of Codes of Ethics can involve reduced bonuses, demotion, and termination of employment, among other disciplinary actions. Thus, to this extent the employers’ enforcement power is not only vested in them but provides more, alternative enforcement measures.

II. THE ROLE OF THE PRIVATE SECTOR IN STRENGTHENING THE LEGALLY REQUIRED PROVISIONS OF THE CODE

The requirement to establish a Code was negotiated with the Investment Company Institute, and that led to an agreement before Congress. The

62. See id. at 20 (noting that such a ban may be a “clear standard to follow” and “relatively easy to implement and administer and less burdensome and costly than the alternatives”).
65. Id. (requiring “Fund, investment adviser and principal underwriter” to institute procedures to prevent violations of Code of Ethics); Id. § 270.17j-1(a)(5) (defining “Fund” as “an investment company registered under the Investment Company Act”).
67. Investment Company Act Amendments of 1967: Hearings on H.R. 9510 Before the Subcomm. on Commerce & Fin. of the H. Comm. on Interstate & Foreign Commerce, 90th Cong. 73 n.27 (1967) (statement of the SEC); see id. at 80, 84–85 (the SEC recommended changes to provisions of Senate Bill 1659, reflecting upon how both SEC staff and representatives of the Investment Company Institute had agreed “that the purposes intended by the proposed amendment would be more precisely delineated if the amendment prohibited insider trading in contravention of such rules as the Commission may adopt to define fraudulent, deceptive and manipulative practices and to prescribe means reasonably necessary to prevent such practices.” The Investment Company Institute agreed that SEC would be authorized “to adopt rules with respect to minimum
Code’s provisions are supported by private organizations. The Investment Company Institute—the professional/trade organization of investment advisers that manage mutual funds—has established a Code which is intended to prevent insider-trading and sets higher standards than the Code required by regulations. Similarly, the Investment Adviser Association (the IAA) has established a Code prohibiting violations of general fiduciary duties (e.g., conflicts of interest and non-disclosure). Membership in the IAA is not required, but membership requires endorsement of the standards.

In sum, pressured by the public, the professional organizations, combined with a shadow of SEC enforcement and specific internal enforcement, may be able to increase the strength of enforcement by the management and reduce government enforcement.

III. WHAT IS NOT INCLUDED IN THE CODE OF ETHICS?

Just as interesting as the contents of Codes of Ethics is what is not included in the requirements concerning the Code. Open many books on Codes of Ethics and you will find at the outset a discussion of ethics. This requirement is missing here. The word “Ethics” appears in the title of the Code. Yet, there is no direct requirement to behave in an ethical way. This is not, in my opinion, an error. It is intentional.

The reason may have been spelled out in another examination of effective Codes of Ethics. The advice in that source is to avoid “positions that are generally held in society” such as: “obey the law.” A Code is also a piece of literature. Its writing and expressions can be inspirational or deadly boring. Therefore, avoidance of well-trodden words is desirable. Highly generalized expressions do not lend help when applying the rules to everyday, specific activities. Highly detailed rules are mind-numbing, but also invite circumvention. Although precision can be understood, everyday work involves activities that do not necessarily fall into the precise standards for codes of ethics governing insider trading by insiders of investment companies to prevent such practices, and the statute so specifies.”); Hearings on S. 1659 Before the S. Comm. on Banking & Currency, 90th Cong. (1967).

68. See REPORT OF THE ADVISORY GROUP ON PERSONAL INVESTING, supra note 41, at 8 (noting industry support of adoption of section 17(j) of the Investment Company Act of 1940, authorizing SEC to require Codes of Ethics).

69. Id. app. 1.


language of Codes of Ethics. Therefore, something in-between is most desirable.

Have these materials decreased the prevalence of insider-trading? They have not. Have I assumed that the rate of insider-trading by advisory firms is related to their Codes of Ethics? I have not. Arguably, the reason for the lower use of insider-trading is that employees in these organizations are well rewarded. I reject this argument. People who deal with money are usually hungry for money. For such people there is never enough. For people who are envious of richer people, there are always those who have more. Therefore, the explanation must be different for people who deal with money and make enormous returns for others but are not likely to use the easier path to financial success by insider-trading.

Codes of Ethics contribute to the low incidence of insider-trading for a number of reasons. In this Article I deal with just one contribution: culture. Culture is a social habit. Our culture requires us to wear clothes in public. A social habit is beneficial in that it leads to a “knee-jerk reaction” rather than to an evaluation of the pros and cons of a particular action. Every society has leadership, from a family to a club, a school, or Congress. And in each such group there is a leader or a group of leaders, from fathers (or fathers and mothers) to teachers and party leaders. They are the ones who establish or induce others to follow a certain group-culture.

In a business organization, the leadership is usually endowed with rank signals to clarify and establish their position (although there are controlling persons who bear no title). To some extent, Codes of Ethics help leaders in financial advisory services to establish a culture that prohibits insider-trading. It may be the culture that causes every access person to say: “We do not do this here!” Such a culture finds many reasons to justify the prohibition, such as the support of the law; the approval of the professional and the leadership of business organizations; public reputation; trust, loyalty, and devotion of investors and employees; significant profits; and the satisfaction of controlling much money and affecting the social welfare. If violations by insider-trading threaten the strength of all these factors, then insider-trading is a danger to be prevented. And the best way to prevent it is to make clear to the rank and file as well as co-management that such an action will not be tolerated.

When these benefits to high-ranking leadership exist, there is a good chance that insider-trading can be reigned-in, if not eradicated entirely. The Codes of Ethics in the financial advisory area may demonstrate this.

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75. Id. at 190.
76. Id. at 193–94 (role of leaders in culture).
CONCLUSION

As money managers serve more investors, pool more securities, and combine their securities-pools with other pools, investors and outside regulators are less able to uncover, let alone control, the activities of these money managers. Many financial services can be carried out without detection; many wrongful actions can be justified as good business practices and efficient services. The danger to the financial system from wrongful activities can be devastating. Societies cannot afford to wait until the harm of such activities is done.

Codes of Ethics are focused on prevention rather than punishment. Compliance Officers and top management can more easily detect possible violations and uproot them. Effective compliance might be practiced within the institutions in the shadow of the law. Mutual funds and advisers’ Codes of Ethics and their enforcement offer one fairly effective model.
CUSTODIAL REQUIREMENTS FOR CUSTOMER FUNDS

Jerry W. Markham*

If any one place his property with another for safe keeping, and there, either through thieves or robbers, his property and the property of the other man be lost, the owner of the house, through whose neglect the loss took place, shall compensate the owner for all that was given to him in charge. But the owner of the house shall try to follow up and recover his property, and take it away from the thief.

Code of Hammurabi (c. 1772 B.C.E.)

INTRODUCTION

A series of bankruptcies by large financial institutions in recent years resulted in massive shortages of customer funds. The first of those failures, Refco, Inc. (Refco), occurred in 2005 after the exposure of a massive fraud by its officers.1 That debacle was followed in 2007 by the failure of Sentinel Management Group, Inc. (Sentinel), which had used several hundred million dollars of customer assets to leverage the firm’s trading position.2 The failure of Lehman Brothers Holdings Inc. (Lehman or Lehman Brothers) during the Financial Crisis in 2008 was the largest bankruptcy in U.S. history and resulted in extensive litigation over rights to customer funds held in custody here and abroad.3 The Lehman debacle was soon followed by the unraveling of Bernie Madoff’s massive Ponzi scheme, which led to billions of dollars of losses in customer funds.4 Only a few months later, U.S. authorities charged that R. Allen Stanford had been running another giant Ponzi scheme out of Antigua that involved $7 billion in customer funds.5 A shortage of some $1.2 billion in customer funds was discovered after MF Global Inc. (MF Global) declared bankruptcy in

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2. See In re Sentinel Mgmt. Grp., Inc., 689 F.3d 855, 857 (7th Cir. 2012) (describing this failure).


October 2011.\(^6\) That highly publicized failure was followed by a massive fraud at Peregrine Financial Group Inc. (Peregrine or PFG), where the firm’s owner simply looted nearly $215 million in customer funds held in custody.\(^7\)

These shortfalls have raised widespread concerns over custodial arrangements for customer funds held at financial institutions. In Parts I–III, this Article describes custodial requirements for customer funds under the Commodity Exchange Act of 1936 (the CEA),\(^8\) federal securities laws,\(^9\) and banking regulations.\(^10\) Part IV then addresses the gaps in those regulations that allowed losses of customer funds to occur, and Part V recounts regulators’ efforts to prevent future failures. In Parts VI and VII, this Article will also recommend the creation of a universal custody arrangement that can be more readily monitored and provide greater protection of customer funds. This proposal would require that each customer account be treated as a separate trust that would be ring-fenced from the losses of other customers all the way from deposit at a broker or other intermediary to the bank or clearinghouse where the funds are held in custody. Improper use of customer funds by intermediaries and custodians would be addressed by requiring a tri-party custodian arrangement, which would allow independent reporting of funds held in custody for each customer.

I. CEA CUSTODIAL REQUIREMENTS

A. DOMESTIC FUTURES CUSTOMERS

The CEA requires futures commission merchants (FCMs) to register with the Commodity Futures Trading Commission (the CFTC) and to comply with CFTC rules governing the treatment of customer funds.\(^11\) An FCM is the analogue in the futures industry to broker-dealers in the securities industry. An FCM accepts customer orders and funds for trading...
in commodity futures and commodity options. FCN customers often have excess margin funds (excess funds) in their commodity futures and options accounts that are not needed to margin their open positions. Excess funds occur for many reasons, such as the closing of an open position, which frees up the funds that were used to margin that position. A favorable gain from variation margin can also create excess funds.

Section 4d(2) of the CEA requires that funds of FCM customers be separately accounted for and be held in specially segregated accounts. This provision was intended to require that customer funds be held in a trust account. As Senator James Murray, the Senate sponsor of the CEA, noted in 1936, this requirement was needed because FCM customers were "rank[ed] only as general creditors. Surely they thought their margins were regarded as trust funds and would be handled with a reasonable degree of integrity." This mandatory trust fund status was intended to stop the then-common practice in the industry whereby futures "commission merchants receiving margin monies in excess of the amount required by the exchanges to be deposited use[d] these excess margin deposits as their own capital, for any purpose they [chose]."

The CFTC has explained that the CEA requirements for handling customer funds in the futures industry are that:

1. Customer funds must be separately accounted for by the FCM,
2. must not be commingled with the FCM's own funds,
3. must be held for the benefit of customers,
4. must be available to the customer and the FCM [when held by a custodian] immediately upon demand, and
5. must be

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12. For a description of these contracts and their trading and the role of FCMs, see JERRY W. MARKHAM, THE HISTORY OF COMMODITY FUTURES TRADING AND ITS REGULATION 204 (1986) [hereinafter MARKHAM, COMMODITY FUTURES TRADING]. Section 724(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) also required funds of Cleared Swaps Customers that secure swaps to be segregated. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 724(a), 124 Stat. 1376, 1682–84 (codified as amended at 7 U.S.C. § 6d(f)).

13. MARKHAM, COMMODITY FUTURES TRADING, supra note 12, at 204–05.

14. Id.

15. Id.


17. FCMs were required by this provision to "treat their customers' money as trust funds." H.R. REP. NO. 73-1637, at 6 (1934).

18. 80 CONG. REC. 7858 (1936) (statement of Sen. James Murray) (stating that section 4d(2) "merely provides that the public's money put up for margin shall in fact be treated as belonging to the customer, and held in trust. Who can object to this?").


The language of the statute and its legislative history indicate that Section 4d was designed for the broad purpose of protecting customers from having their money, securities or property appropriated by a futures commission merchant, or some other depository, without adequate legal basis, and the more specific purpose of ensuring the integrity of the futures market by preventing the use of customer funds to finance market transactions by a futures commission merchant for its own account or for other customers.
calculated so as to prevent the use of one customer’s funds to margin or secure another customer’s position.\(^{20}\)

Additionally, (6) customer funds may not be used to secure a loan of the FCM.\(^{21}\)

These requirements are implemented through a series of rules administered by the CFTC. CFTC Rule 1.20 imposes the basic requirement that customer funds be separately accounted for and segregated.\(^{22}\) That rule further requires that any bank receiving commodity customer funds must provide a written acknowledgement that the bank was informed that “the customer funds deposited therein are those of commodity or option customers and are being held in accordance with the provisions of the [CEA] and this part.”\(^{23}\)

The Commodity Exchange Authority, the predecessor to the CFTC, opined after the adoption of the segregation requirement in 1936 that a third-party depository of segregated customer funds of an FCM could have no claim against those funds.\(^{24}\) To assure this result, the Commodity Exchange Authority required banks to acknowledge that customer assets would in fact be segregated from the accounts of the FCM.\(^{25}\) Banks acting in this depository capacity were required to waive any offset rights for credit extensions made to the FCM or anyone else.\(^{26}\) That waiver requirement was subsequently rendered unnecessary when the CEA was amended in 1968 to apply its segregation requirements directly to banks and other depositories of FCM customer funds.\(^{27}\)

Rule 1.20 prohibits the commingling of customer funds with those of the FCM or any other person, except that customer funds may be commingled with those of other customers—a form of collective trust.\(^{28}\) However, CFTC Rule 1.23 allows FCMs to keep their own funds in customer segregated accounts to serve as a cushion in the event of an unexpected shortfall.\(^{29}\) The FCM may also invest the customer funds held in segregation in securities specified in CFTC Rule 1.25, which includes


\(^{22}\) 17 C.F.R. § 1.20(a) (2013).

\(^{23}\) Id.

\(^{24}\) Commodity Exch. Auth., Administrative Determination No. 12 (Nov. 30, 1936).

\(^{25}\) Id.

\(^{26}\) Id.


\(^{28}\) 17 C.F.R. § 1.20(a).

\(^{29}\) Id. § 1.23.
obligations of the U.S. government and of the states. At variance with traditional trust principles, CFTC Rule 1.29 allows FCMs to keep for themselves the interest or other return from such investments.

CFTC Rule 1.32 requires that FCMs make a computation of the amount required to be held in segregation as of the close of business each day. That computation must be made by noon of the following day. The CFTC requires that computation to be made by using the net liquidating value (the NLV) of all futures and options customers trading on domestic exchanges. The NLV is computed by adding customer ledger balances, open trade equity, net option value, securities, and other property (excluding letters of credit), which is then grossed-up for any customer debit/deficit balances. The ledger balance is computed by subtracting debits from credits to the account on the day of calculation. CFTC Rule 1.12(h) requires the FCM to notify the CFTC if funds and securities on deposit in segregated accounts are less than the requirement.

The Bankruptcy Reform Act of 1978 and CFTC part 190 rules promulgated under that statute seek to give customer funds held in segregated accounts under section 4d of the CEA priority over the claims of creditors of the FCM. The House Report for this legislation stated that the relationship between a commodity broker and its customers “is not unlike the relationship between a stockbroker and his customers. Yet the current Bankruptcy Act provides no special protection for customers of commodity brokers as it does for stockbroker customers.”

30. 17 C.F.R. §§ 1.25–.26 (requiring such investments to be held in segregated accounts).
31. Id. § 1.29. See, e.g., Bibbo v. Dean Witter Reynolds, Inc., 151 F.3d 559 (6th Cir. 1998) (FCM could retain the interest from such investments); Marchese v. Shearson Hayden Stone, Inc., 822 F.2d 876 (9th Cir. 1987) (same); Crabtree Invs., Inc. v. Merrill Lynch, Pierce, Fenner & Smith Inc., 577 F. Supp. 1466, 1473 (M.D. La. 1984), aff’d 738 F.2d 434 (5th Cir. 1984) (same). However, most sophisticated customers with bargaining power will demand at least a portion of such returns. See Craig v. Refco, Inc., 816 F.2d 347, 348 (7th Cir. 1987) (discussing such arrangements).
32. 17 C.F.R. § 1.32.
33. Id.
36. FORM 1-FR-FCM INSTRUCTIONS, supra note 35, at 5-1.
37. 17 C.F.R. § 1.12(h).
As described below, customers of broker-dealers are covered by an account insurance scheme administered by the Securities Investor Protection Corporation (SIPC) that provides up to $500,000 in insurance in the event of a broker-dealer’s bankruptcy that results in a shortage of customer funds. No such insurance is available under the CEA for FCM customers.

The CFTC’s so-called Part 190 rules govern the treatment of customer funds and securities when a FCM declares bankruptcy. In proposing the Part 190 Rules, the CFTC stated:

The proposed regulations are intended to implement these customer and market protections and in this regard to achieve several specific purposes, including: (1) To promote equitable treatment of customers; (2) to enhance certainty as to the effects of a bankruptcy distribution; (3) to limit the period during which the bankrupt estate is at risk from fluctuations in value of the commodity contracts and other property contained therein; (4) to permit certain transactions which may be effected between customers without the intervention of the debtor to take place outside the bankrupt estate; (5) to maximize recovery in kind; and (6) to provide an understandable and workable method for operating the estate pending liquidation.

An important element of those rules allows for the immediate transfer of open customer futures and options positions to another solvent FCM. That ability is often critical in fast-moving markets where customers can experience large losses if they do not have control over their accounts. Identifiable customer property may also be transferred. Customer losses will be measured by the shortfall in the FCM’s segregated account.

**B. CUSTOMERS TRADING ON FOREIGN COMMODITY EXCHANGES**

The CFTC created a separate regime for the protection of domestic customers trading on foreign exchanges through an FCM. This action was taken when an extensive series of problems with such trading arose after the creation of the CFTC. The CFTC initially acted by adopting an anti-fraud
rule for foreign futures transactions.\(^49\) There was concern, however, as to whether the CFTC had authority to take such action.\(^50\) Congress, therefore, amended the CEA in 1982 to clarify that authority.\(^51\) That amendment also granted the CFTC authority broadly to regulate foreign futures trading, including requirements for minimal financial standards, book and record keeping requirements, and the “safeguarding of customer funds.”\(^52\)

To implement that authority, the CFTC adopted Rule 30.7, which imposed limited custody requirements for domestic customers trading on foreign commodity exchanges.\(^53\) This rule required FCMs to set aside a “Secured Amount” as protection for the funds of such customers.\(^54\) Like those governed by section 4d of the CEA, funds of customers trading foreign futures must be placed in a separate account identified as a secured amount account and commingling of FCM funds is prohibited, except to the extent the FCM places funds in the Secured Amount account to serve as a cushion against shortfalls.\(^55\) However, unlike section 4d, CFTC Rule 30.7 was not intended to make those accounts trust funds where all of the Rule 30.7 customers’ excess funds would be held.\(^56\)

The FCM must set aside the Secured Amount only as a form of security or deposit, somewhat akin to a margin requirement where only a portion of the contract price is set aside as security for performance.\(^57\) The CFTC staff has thus noted that the funds in a Secured Amount account are a “security deposit only;” it “is not customer money per se as are segregated funds;” it “is ‘security’ and not a ‘trust’ of funds explicitly denominated as belonging to customers.”\(^58\) Moreover, until recently, the FCM could invest those funds unconstrained by the investment restrictions for segregated funds of domestic customers under CFTC Rule 1.25.\(^59\)

The amount required to be set aside in Secured Amount accounts could be considerably less than that required to be segregated for customers trading on domestic exchanges. The CFTC defined the secured amount in

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49. 17 C.F.R. § 30.9.
50. See id.
51. This background is described in Foreign Options and Foreign Futures Transactions, 51 Fed. Reg. at 12,104.
53. 17 C.F.R. § 30.7.
54. Id. § 30.7(a).
55. Id. § 30.7(a), (d).
56. Id.
57. See Jerry W. Markham, Federal Regulation of Margin in the Commodity Futures Industry—History and Theory, 64 Temp. L. Rev. 59, 97 (1991) (describing the role of margin).
Rule 1.3 to be money, securities, and property required by a FCM to margin, guarantee, or secure open foreign futures contracts, plus or minus any unrealized gain or loss on foreign futures or options contracts and option premiums. This formula in Rule 1.3 varied from the NLV’s for the section 4d segregation computation in that customer securities or excess funds need not be included in the calculation. As a result, the Secured Amount computed under Rule 1.3 would be less than the figure computed by the NLV method. Nevertheless, for reasons of convenience, most FCMs used the NLV method to meet their Rule 30.7 requirements. For the most part, only the larger firms had sufficient customers to justify the expense of a separate Rule 1.3 calculation.

The CFTC complicated the situation by allowing those firms making a Rule 1.3 calculation to use the lesser of the Rule 1.3 calculation or of a NLV calculation on an account-by-account basis. Further complexity was added by another formula to be used where the Secured Amount account included funds of foreign customers trading on foreign exchanges. Again, the lesser of the Rule 1.3 calculation, NLV, or foreign person calculation could be used on an account-by-account basis. These calculations were referred to as the “Alternative Method.”

II. FEDERAL SECURITIES LAWS CUSTODY REQUIREMENTS

A. BROKER-DEALER CUSTODY REQUIREMENTS

The U.S. Securities and Exchange Commission (the SEC) adopted Rule 15c3-3 to require broker-dealers to account for customer funds and

60. 17 C.F.R. § 1.3(p)(1).
62. As the CFTC has noted:
[Section] 30.7 requires an FCM to maintain in separate accounts an amount of funds only sufficient to cover the margin required on open foreign futures contracts, plus or minus any unrealized gains or losses on such open positions, plus any funds representing premiums payable or received on foreign options (including any additional funds necessary to secure such options, plus or minus any unrealized gains or losses on such options) (i.e., the “Alternative Method”). Thus, under the Part 30 Alternative Method an FCM is not required to maintain a sufficient amount of funds in such separate accounts to pay the full account balances of all of its foreign futures or foreign options customers at all times.

Id.
64. CFTC Proposed Rules, Enhancing Protections, supra note 61, at 172.
66. Id. at 5-2.
67. Id. at 12-2.
68. JOINT AUDIT COMM., supra note 63, at 5-6.
securities and hold them in specially designated accounts. This requirement “was designed to assure that customers’ funds (as well as securities) held by broker-dealers are protected against broker-dealer misuse or insolvency.” SEC Rule 15c3-3 is generally referred to as the SEC’s “Customer Protection Rule.” It was adopted in the wake of the so-called “Paper Work Crisis” that occurred at the end of the 1960s.

Over 100 New York Stock Exchange firms failed during that crisis as a result of their inability to deal with increased trading volumes. Many brokerage firms lost control of their customer securities, and lost and stolen securities were widespread problems. Concern was also raised that broker dealers were using customer free credit balances for their own purposes, and those securities and funds were lost when their broker-dealer failed. Congress responded to these problems by enacting the Securities Investor Protection Act of 1970 (SIPA), which directed the SEC to adopt rules designed to protect customer funds in the custody of registered broker-dealers.

SIPA also created an insurance scheme that provided account insurance of up to $100,000 per customer (later increased to $500,000, including $100,000 of customer cash) for losses caused by their broker-dealer’s insolvency—it does not insure against investment losses. That insurance fund is administered by SIPC, a private non-profit corporation that is funded by assessments on broker-dealers.

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69. 17 C.F.R. § 240.15c3-3 (2013).
71. 17 C.F.R. § 240.15c3-3.
73. Id. at 364.
74. See id. (describing the Paper Work Crisis).
75. See generally HURD BARUCH, WALL STREET SECURITY RISK (1971) (criticizing these practices).

Following a period of great expansion in the 1960’s, the securities industry experienced a business contraction that led to the failure or instability of a significant number of brokerage firms. Customers of failed firms found their cash and securities on deposit either dissipated or tied up in lengthy bankruptcy proceedings. In addition to its disastrous effects on customer assets and investor confidence, this situation also threatened a “domino effect” involving otherwise solvent brokers that had substantial open transactions with firms that failed. Congress enacted the SIPA to arrest this process, restore investor confidence in the capital markets, and upgrade the financial responsibility requirements for registered brokers and dealers.

77. 2 MARKHAM, FINANCIAL HISTORY, supra note 72, at 364–65.
In the event of a failure of a covered broker-dealer, SIPC is authorized to seek its liquidation by a court-appointed trustee.\textsuperscript{79} The claims of general creditors are subordinated to the claims of the broker-dealer’s customers.\textsuperscript{80} The trustee will return all securities held in the names of specific customers, and it then pools remaining securities for a pro rata distribution to customers.\textsuperscript{81} In the event of a shortfall, SIPC will cover the loss up to the $500,000/$100,000 limits.\textsuperscript{82}

The Customer Protection Rule includes a requirement that broker-dealers maintain special accounts “in the nature of a trust fund through which a broker-dealer must effectuate all transactions with regard to all ‘funds carried for the account of any customer.’”\textsuperscript{83} SEC Rule 15c3-3 requires that broker-dealers maintain at a bank a “‘Special Reserve Bank Account for the Exclusive Benefit of Customers’ (‘Reserve Bank Account’) and deposit in this account its reserve requirement as computed in accordance with the Formula for Determination of Reserve Requirement For Brokers and Dealers (‘Reserve Formula’).”\textsuperscript{84}

The Reserve Formula is a complex one that totals the aggregate customer credits and debits with the broker-dealer.\textsuperscript{85} The amount of any excess credits must then be made to the Reserve Bank Account.\textsuperscript{86} Generally, the Reserve Formula must be completed by Tuesday of each week as of close of business at the end of the preceding week: usually Friday.\textsuperscript{87} “In addition, before making a withdrawal from the Reserve Bank Account, a broker-dealer must make a computation which shows that after the withdrawal there is an amount remaining in the Reserve Bank Account at least equal to that required to be on deposit.”\textsuperscript{88} As the Eleventh Circuit has noted:

The specifics of the Reserve Formula are fairly arcane, but its operation is straightforward. On a weekly basis, firms must balance customer credits against customer debits. 17 C.F.R. § 240.15c3-3(e)(3). Subject to some adjustments, the Rule requires that firms hold an amount equal to the excess of credits over debits in the Reserve Account. 17 C.F.R. § 240.15c3-3a. As defined by the regulations, “customer credits” captures the amount the firm owes its customers while “customer debits” refers to

\textsuperscript{79} See id. at 261.

\textsuperscript{80} See id. at 261 n.1.

\textsuperscript{81} See id. at 261.


\textsuperscript{84} Customer Protection Release, supra note 70, at *2.

\textsuperscript{85} SEC v. Goble, 682 F.3d 934, 940 (11th Cir. 2012) (citing 17 C.F.R. § 240.15c3-3(e)(3)).


\textsuperscript{87} 17 C.F.R. § 240.15c3-3(e)(3).

\textsuperscript{88} Customer Protection Release, supra note 70.
amounts the customers owe the firm. If, after the firm makes the reserve computation, it discovers that the Reserve Account balance is higher than the amount required by the Reserve Formula, the firm may make a withdrawal from the Reserve Account.17 C.F.R. § 240.15c3-3(g).89

On July 31, 2013, the SEC adopted rule changes that require broker-dealers having custody of customer assets to file a Compliance Report with the SEC to verify they are properly protecting those assets and periodically sending account statements to customers.90 Such broker-dealers must engage an independent public accountant to examine the broker-dealer’s compliance report.91 Further, broker-dealers must file a new, quarterly Form Custody report with the SEC that describes the broker-dealers’ custodial arrangements.92 Broker-dealers must also allow SEC staff to examine the work papers of their accountants and to interview those accountants.93

B. INVESTMENT ADVISER CUSTODY REQUIREMENTS

The SEC has adopted custody requirements for the funds of clients of investment advisers under the Investments Advisers Act of 1940.94 An investment adviser is a fiduciary to its customers.95 In order to assure that investment advisers met their fiduciary duties, the SEC adopted a custody requirement for client funds (the IA Custody Rule).96 It imposes strict and robust custody requirements for customer assets held by registered investment advisers.

The IA Custody Rule seeks to impose protections for the custody of investment adviser funds that are comparable to those available for other statutory trust funds.97 The IA Custody Rule thus seeks to “enhance the protections afforded to advisory clients’ assets, harmonize the rule with

89. Goble, 682 F.3d at 940–41.
91. Id.
92. Id.
93. Id.
94. Id.
current custodial practices, and clarify circumstances under which advisers have custody.\textsuperscript{98}

The IA Custody Rule was designed to require “an investment adviser who has custody of funds or securities of any client to maintain them in such a way that they will be insulated from and not be jeopardized by financial reverses, including insolvency, of the investment adviser.”\textsuperscript{99} The IA Custody Rule requires “investment advisers who have custody or possession of funds or securities of clients to segregate the securities and to hold them in safekeeping and to set up a separate trust account in a bank for funds belonging to each client.”\textsuperscript{100} Alternatively, customer funds can be held in a collective account in the name of the investment adviser as agent or trustee for the clients.\textsuperscript{101} The IA Custody Rule does not permit an investment adviser to route proprietary and customer assets through the same clearing and custodial accounts held with a bank.\textsuperscript{102}

The IA Custody Rule requires investment advisers to maintain customer assets with “qualified custodians,” which “include the types of financial institutions that clients and advisers customarily turn to for custodial services. These include banks and savings associations and registered broker-dealers.”\textsuperscript{103} The IA Custody Rule requires the qualified custodian to hold customer funds or securities in an account, either under the client’s name or under the adviser’s name as agent, or as trustee for its clients.\textsuperscript{104}

The IA Custody Rule requires that investment adviser customers be given periodic reports by the qualified custodian of the amounts held in segregation.\textsuperscript{105} Alternatively, the investment adviser may make such reports, but in such a case the accounts of the investment adviser that contain customer funds must be verified by an independent public accountant annually through a surprise audit.\textsuperscript{106} A report on that examination must be filed with the SEC.\textsuperscript{107}

\textsuperscript{100} Custody or Possession Release, supra note 99, at 2149.
\textsuperscript{101} 17 C.F.R. § 275.206(4)-2(a)(1)(ii).
\textsuperscript{103} Custody of Funds Release, supra note 98, at 56,693–94 (footnotes omitted).
\textsuperscript{104} See id. at 56,692–93 (discussing this requirement).
\textsuperscript{105} 17 C.F.R. § 275.206(4)-2(a)(3).
\textsuperscript{106} Id. § 275.206(4)-2(a)(4).
\textsuperscript{107} Id.
C. INVESTMENT COMPANY ACT CUSTODY REQUIREMENTS

The IA Custody Rule\textsuperscript{108} exempts from its reach investment advisers to investment companies registered with the SEC under the Investment Company Act of 1940 (the IC Act).\textsuperscript{109} The IA Custody Rule is unneeded for those exempted advisers because the SEC has adopted custodial requirements for customer funds and securities held by mutual funds and other registered investment companies under the IC Act.\textsuperscript{110}

For example, SEC Rule 17f-1 prohibits registered management investment companies from placing securities or other investments in the custody of a member of a national security exchange unless there is a written agreement in place governing that custody.\textsuperscript{111} That agreement must provide that the securities held in custody must be individually identified, marked, and segregated from the securities and investments of other persons.\textsuperscript{112} The securities segregated under Rule 17f-1 may not be subject to any lien or charge of any kind by the custodian.\textsuperscript{113} The securities investments must also be verified by actual examination periodically and must be subject to inspection by the SEC staff.\textsuperscript{114}

SEC Rule 17f-2 imposes requirements on investment companies that deposit securities or other assets with a bank to be held in custody.\textsuperscript{115} The investments deposited at such custodians must be able to be withdrawn upon demand by the investment company.\textsuperscript{116} Investments deposited at the bank custodian must be kept physically separate and segregated at all times from the assets of other persons.\textsuperscript{117} This rule also imposes restrictions on the persons who may withdraw securities from segregation. In addition, the existence of the securities must be verified at least three times each year through actual examination by an independent public accountant.\textsuperscript{118} Two of those inspection dates must be selected by the accountant.\textsuperscript{119}

SEC Rule 17f-3 prohibits free cash accounts held at a bank by the investment company except for petty cash in an amount not to exceed $500.\textsuperscript{120} SEC Rule 17f-4 imposes requirements on investment companies that deposit fund assets with a securities depository or clearing

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\textsuperscript{108} Id. § 275.206(4)-2(b)(5).
\textsuperscript{110} See 17 C.F.R. §§ 270.17f-1 to -7.
\textsuperscript{111} Id. § 270.17f-1(a).
\textsuperscript{112} Id. § 270.17f-1(b)(1).
\textsuperscript{113} Id. § 270.17f-1(b)(3).
\textsuperscript{114} Id. § 270.17f-1(b)(4).
\textsuperscript{115} Id. § 270.17f-2.
\textsuperscript{116} Id. § 270.17f-2(a).
\textsuperscript{117} Id. § 270.17f-1(b)(1).
\textsuperscript{118} See id. § 270.17f-1(b)(4).
\textsuperscript{119} Id.
\textsuperscript{120} Id. § 270.17f-3.
\end{flushleft}
In order to be eligible to be a custodian, those depositories, and any intermediate custodian, must be obligated to exercise due care in accordance with reasonable commercial standards in maintaining the assets held in custody. SEC Rule 17f-5 imposes restrictions on the custody of funds held outside the United States, and Rule 17f-7 regulates the deposit of funds with foreign securities depositories.

### III. BANK CUSTODY REQUIREMENTS

#### A. IN GENERAL

General banking practices have long required funds placed on “special deposit” by one party for the benefit of others to be segregated and not used for securing the debts of the depositing party. A contract for a special deposit is not required to be in any particular form; it being a matter of intention and understanding of the parties. All that is required is notice to the bank of the special nature of the deposits:

A bank has knowledge of a special purpose account if the depositor labels the account in such a way that it is clear that the account is a special account. The bank also has knowledge of a special purpose account if the depositor and the bank have entered into an agreement giving the bank notice of the special purpose of the account. A special purpose account defeats a bank’s right to setoff because a third party who is not a debtor of the bank has an interest in the account. Since a party other than the bank’s debtor has an interest in the funds on deposit in a special account, the bank may not exercise its right to setoff the property not belonging to the debtor.

Notice of a special deposit thus has important consequences for a bank. “It has universally been held that knowledge upon the part of a bank that deposits made by a debtor in his own name belong to a third person

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121. Id. § 270.17f-4.
122. Id.
123. Id. § 270.17f-5.
124. Id. § 270.17f-7.
125. 5B MICHEIE ON BANKS AND BANKING § 331, at 547 (2002).
126. Id. (citing Bryan v. Coconut Grove Bank & Trust Co., 132 So. 481 (Fla. 1931); Fogg v. Tyler, 82 A. 1008 (Me. 1912).
127. S. Perry Thomas, Jr., Comment, Bank’s Right of Setoff in Virginia, 41 WASH. & LEE L. REV. 1603, 1619 (1984) (footnotes omitted; see also Union Stock-Yards Nat’l Bank v. Gillespie, 137 U.S. 411, 422–23 (1890) (“The circumstances surrounding the deposits, and the relations between the depositor and the bank, were such as to impart notice to the bank that the beneficial ownership was outside of the legal title. With that notice, it had no right to appropriate the deposits to pay the obligations of the depositor to the bank . . . .”); Cent. Nat’l Bank v. Conn. Mut. Life Ins. Co., 104 U.S. 54, 63–64 (1881) (discussing special deposits); Cassedy v. Johnstown Bank, 286 N.Y.S. 202, 205 (App. Div. 1936).
absolutely precludes the bank from applying such funds to the individual indebtedness of the depositor to it.”128

There is general agreement that if a person who has a claim against the trustee in his individual capacity accepts from the debtor, in payment of the debt, or as security therefor, property which the creditor knows or should know is trust property, the recipient takes part in a breach of the fiduciary obligation.129

B. BANKING REGULATION

Banks may act as trustees for customer assets. Those activities are governed by state trust laws but are overseen by the Office of the Comptroller of the Currency (the OCC) and the Federal Deposit Insurance Corporation (the FDIC).130 The FDIC thus requires its consent before an insured bank may exercise trust powers; it examines bank trust activities and may sanction banks that engage in fiduciary breaches.131 It also insures trust accounts as bank deposits.132

OCC Regulation 9 governs fiduciary activities of national banks.133 Such fiduciary activities include national banks that act as trustees.134 Regulators distinguish between banks in their role as trustees and as a deposit institution. The relationship between the beneficiaries of a trust and the trustee is a fiduciary relationship.135 That is not the case for bank depositors.136 A bank may invest funds deposited by customers but may not do so for trust beneficiaries, except for their benefit.137 This means, among other things, national banks must keep fiduciary assets separate from all other accounts.138 However, individual trust accounts may be held collectively with other trust accounts.139

Large banks provide custodial services for other institutions, which involve the safekeeping of funds as collateral for a loan, credit exposure, or other reasons. “Banks provide custody services to a variety of customers,

128. B. C. Ricketts, Annotation, Bank’s Right to Apply Third Person’s Funds, Deposited in Debtor’s Name, on Debtor’s Obligation, 8 A.L.R.3d 235, 239 (1966).
129. GEORGE GLEASON BOGERT ET AL., BOGERT’S TRUSTS AND TRUSTEES § 904 (3d ed. 2007) (footnotes omitted).
131. Id. § 10.B.
132. Id. § 10.A–.B.3, .G.7.
134. Id. § 9.2.
135. Id.
137. Id.
139. Id. § 9.18; see Jerry W. Markham, Mutual Fund Scandals—A Comparative Analysis of the Role of Corporate Governance in the Regulation of Collective Investments, 3 HASTINGS BUS. L.J. 67, 121–22 (2006) [hereinafter Markham, Mutual Fund Scandals] (describing development of bank collective trust funds).
including mutual funds and investment managers, retirement plans, bank fiduciary and agency accounts, bank marketable securities accounts, insurance companies, corporations, endowments and foundations, and private banking clients.” The OCC has noted:

National banks’ custody activities developed from providing safekeeping and settlement services to customers for a fee, and historically are viewed as permissible incidental [banking] activities . . . and often are in conjunction with the delivery of fiduciary services. A custody relationship is a contractual arrangement, and the services performed for customers vary. Services traditionally provided include the settlement, safekeeping, and reporting of customers’ marketable securities and cash. A custodian also may invest cash balances as directed, collect income, process corporate actions, price securities positions, and provide recordkeeping services. As custody services are contractual in nature, a bank must ensure compliance with the provisions of all applicable agreements. The custody industry has grown significantly in recent years, and now global custodians control trillions of dollars in assets in offices around the world. 141

“Services provided by a bank custodian are typically the settlement, safekeeping, and reporting of customers’ marketable securities and cash.” A custodian providing core domestic custody services typically settles trades, invests cash balances as directed, collects income, processes corporate actions, prices securities positions, and provides recordkeeping and reporting services.” 143 Custodians may provide securities lending services that allow them to earn fees from the lending of their securities. 144 Custodians may also conduct daily sweeps of customer accounts and invest excess cash. 145 Global custodians provide other services such as cross-border settlements and foreign exchange transactions. 146

The concept of safekeeping of customer funds held in segregated accounts is well recognized by banking regulators. 147 The OCC has thus noted that the term “segregation” has been defined as the “[o]ptional or compulsory separation of a participant’s own securities from those held on

140. COMPTROLLER’S HANDBOOK, supra note 10, at 1.
142. COMPTROLLER’S HANDBOOK, supra note 10, at 1.
143. Id. at 2.
144. Id.
146. See COMPTROLLER’S HANDBOOK, supra note 10, at 2 (acknowledging that global custodians perform typical services such as settling trades and executing foreign exchange transactions).
147. See, e.g., id. at 15.
behalf of its customers." The OCC has opined, however, that “[a] custodian is not a trustee, and generally is not subject to the strict fiduciary standards that govern the relationship between a trustee and beneficiary.”

The OCC has stated that “a custodian may perform functions that are fiduciary in nature,” but the OCC appears to limit such a role to those instances where the bank is exercising discretion over the trading of an account or providing investment advice. This raises an issue: is the bank acting as a “trustee” when it holds customer assets in segregation under the CEA or federal securities laws? In that regard, the CEA does apply directly to custodians of excess customer funds. There is no corresponding requirement in the federal securities laws, but the SEC views such arrangements to be trust accounts.

The OCC has also pointed out that “[c]ustody services are contractual in nature, and a bank must ensure compliance with the provisions of all applicable agreements.” The federal securities laws, at the least, require the custodian bank to recognize contractually the fact that funds held under SEC Rule 15c3-3 are to be kept in segregated accounts. Further, the custodian bank must “ensure that assets of each custody account are kept separate from the assets of the custodian and maintained under joint control.” The recordkeeping by the custodian bank must also comply with applicable laws.

The interrelated nature of bank custodian roles and SEC segregation requirements is evidenced by the fact that banks may use SEC-regulated broker-dealers as custodians of fiduciary assets, and those funds will be protected by SEC Rule 15c3-3. Conversely, as described above, banks are designated as qualified custodians under CFTC and SEC segregation requirements.

IV. CUSTODIAL FAILURES

A. REFCO’S FAILURE

The revelation of a massive fraud at Refco in October 2005 stunned the financial community. That firm had made a successful initial public

148. Id. at 84.
149. Comptroller Interpretive Letter No. 1078, supra note 141, at 3 n.8.
150. COMPTROLLER’S HANDBOOK, supra note 10, at 11; Comptroller Interpretive Letter No. 1078, supra note 141, at 3 n.8 (citations omitted).
152. See Custody or Possession Release, supra note 99.
154. Id. at 2 n.2; 17 C.F.R. § 240.15c3-3(b)(4)(D)(iii) (2013).
155. COMPTROLLER’S HANDBOOK, supra note 10, at 15.
156. Id. at 21.
157. See TRUST EXAMINATION MANUAL, supra note 132, § 10.F.1.a.1.b.1.
offering of its stock only a few months before its bankruptcy. Refco failed after it announced a previously undisclosed loss from uncollectible receivables in the amount of $430 million and advised that investors could not rely upon its financial statements. The uncollectible receivables had arisen from customer losses in the late 1990s, which eventually reached some $1 billion. Refco hid those losses on its books through an elaborate "round robin" loan scheme that took the receivable off Refco’s book at the end of each accounting period and restored it immediately afterwards. This scheme was carried out over a period of several years by two Refco chief executive officers, both of whom were sentenced to long prison terms.

Refco was the parent company of Refco, LLC, the largest independent futures commission merchant in the United States. After Refco announced its previously undisclosed account receivable loss, customers at Refco’s affiliates began seeking to withdraw their funds, resulting in a "[p]roverbial 'run on the bank'" that Refco sought to stop by declaring a fifteen-day moratorium on withdrawals. However, Refco declared bankruptcy only a few days later. The customer accounts at Refco, LLC

159. Id.
160. Id.
161. Id.
162. See id. at 223 (describing this scheme). The Refco bankruptcy examiner described these transactions as follows:

The Round Trip Loans were two short term loans of several weeks duration that spanned the end of Refco’s fiscal year-end or quarterly financial reporting periods. The first loan was made by a Refco entity to a third party at a certain interest rate for a certain period of time. The second one was made by that same third party to RGHI for the same period of time, but at a higher interest rate. The repayment of the loan by RGHI to the third party was guaranteed by RGL and the third party was also indemnified by RGL against any loss or expense for entering into the Round Trip Loan.

The funds or credit advanced for the loan to the third party were deposited into the third party’s account with RCM. Those funds were then transferred at the third party’s request from the third party’s account at RCM to RGHI’s account at RCM. The effect of these transactions was to reduce RGHI’s receivable balance owed to RCM by the amount of the Round Trip Loan, and to substitute a receivable in that amount from the third party. In most cases, these were bookkeeping entries and no cash actually "moved." After the end of the applicable reporting period, the process was reversed and unwound.

164. Refco had previously settled a case with the CFTC over its failure to properly segregate customer funds. The CFTC charged in that case that Refco removed customer funds from segregation each day and used those funds to pay down its bank loans. Refco deposited a check from an affiliate to cover the amounts required to be segregated, but the bank account of the affiliate had insufficient funds to cover the checks. See Refco, Inc., CFTC Docket 95-2, 1994 CFTC LEXIS 348, at *5 (Dec. 20, 1994) [hereinafter Refco, Inc.].
166. Id.
were held in segregation under the Commodity Exchange Act of 1936.\(^{167}\) Those accounts were quickly auctioned off to Man Group for $323 million and were transferred in bulk to a Man Group affiliate, Man Financial.\(^{168}\) That transfer was accomplished without significant loss to Refco, LLC customers.\(^{169}\)

Customers at another Refco affiliate were not so fortunate. One of Refco’s affiliates was Refco Capital Markets, Ltd., a Bermuda-chartered securities and foreign exchange broker that traded over-the-counter derivatives for clients.\(^{170}\) RCM’s operations were conducted “under the leadership of, and through a sales force of account officers and brokers employed by, its affiliated corporation, Refco Securities, LLC, (‘RSL’), a wholly-owned subsidiary of Refco that operated as a U.S.-based broker-dealer registered with the SEC.”\(^{171}\)

Customer funds were transferred to RCM from accounts at Refco, LLC, an FCM that was segregated under the CEA.\(^{172}\) RCM held itself out as an unregulated offshore broker, and “RCM Customers’ securities and other property deposited in their accounts were not segregated but were commingled in a fungible pool. As a result, no particular security or securities could be identified as being held for any particular customer.”\(^{173}\)

It was charged in class action lawsuits that RCM had used customer funds totaling several hundred million dollars to fund Refco’s operations and help conceal the unreported uncollectible receivable loss.\(^{174}\) Charges were also made by hedge fund investors, including celebrity investor James B. Rogers, that funds were improperly transferred out of Refco, LLC-segregated accounts to unsegregated accounts at RCM.\(^{175}\) Rogers’s funds had some $362 million on deposit with Refco,\(^{176}\) but he was able to recover all of those funds through various recovery efforts.\(^{177}\)

The Refco bankruptcy trustee negotiated the return to the Refco bankruptcy estate of $263 million of the $312 million that a group of hedge funds had withdrawn from RCM two days after Refco announced its previously undisclosed account receivable loss.\(^{178}\) Those investors brought

\(^{167}\) Refco, Inc., \textit{supra} note 164, at *5–6.


\(^{169}\) Id.

\(^{170}\) Bennett, 680 F.3d at 220.

\(^{171}\) Id. at 223.

\(^{172}\) Id. at 220.

\(^{173}\) Id.

\(^{174}\) Id. at 224.

\(^{175}\) Barr, \textit{supra} note 168.


\(^{178}\) In re Refco Inc., 505 F.3d 109, 112 (2d Cir. 2007).
litigation seeking damages from Refco’s auditors, lawyers, and other professionals, claiming they aided and abetted Refco’s fraud. A district court denied a motion to dismiss by Refco’s auditors on the aiding and abetting claims in that litigation. The court also allowed claims for secondary liability brought against Refco’s auditors, lawyers, and underwriters to proceed but narrowed the duties claimed to be owed by those professionals.

Various class actions were brought to challenge those transfers, and some of that litigation is still pending. In Capital Management Select Fund v. Bennett, the Second Circuit affirmed the dismissal of claims brought by hedge funds against Refco’s officers and auditors. The court held that the RCM customer agreement allowed customer securities to be rehypothecated. The court could find no strong inference of scienter where the firm used customer funds and securities to fund its trading operations.

The Refco failure raised few concerns with the CFTC’s segregation requirements because they worked remarkably well in protecting customer funds and securities. The transfer of customer positions to MF Global also went smoothly. That being said, those customers who removed their funds from segregation at Refco, LLC to unregulated accounts at RCM did suffer massive losses. Those losses evidenced that all custody and safekeeping arrangements do not provide the same protections as those available under the CEA.

B. THE SENTINEL FAILURE

The failure of Sentinel in August 2007 was one of the first casualties stemming from the Financial Crisis, which peaked a few months later. Sentinel was headquartered in Northbrook, Illinois, and was registered with the CFTC as an FCM and the SEC as an investment adviser.

182. In re Refco Inc., 505 F.3d at 115.
184. Id. at 219.
185. See Kirschner v. KPMG LLP, 626 F.3d 673, 677–78 (2d Cir. 2010) (affirming dismissal of other claims).
186. Bennett, 680 F.3d at 214.
day-to-day operations involved the management of cash investments for proprietary and customer funds of FCMs, hedge funds, financial institutions, pension funds, and individuals.\textsuperscript{191}

The CEA defines an FCM to be an entity that accepts both customer orders and funds.\textsuperscript{192} Sentinel did not execute customer orders and registered with the CFTC as an FCM only because this would make it a permissible depository of customer funds segregated under the CEA.\textsuperscript{193} The CFTC gave Sentinel special no-action relief that allowed Sentinel to operate without meeting the CFTC’s onerous net capital requirements,\textsuperscript{194} which were deemed unneeded because Sentinel would have no exposure from commodity futures or options positions.\textsuperscript{195}

Sentinel’s selling point was its claim that its investment expertise allowed it to produce the highest available returns on customer funds held in custody under the CEA.\textsuperscript{196} FCMs like this approach because it means that they do not have to incur the costs of developing their own investment expertise, while still receiving high returns from the investment of their customer funds.\textsuperscript{197} Other money managers also bought into Sentinel’s claims of expertise.\textsuperscript{198}

Sentinel then divided its investment programs into three groups. Its “SEG I” accounts were for the funds and properties of customers of other FCMs; “SEG II” accounts were for customers of other FCMs trading on foreign exchanges; and “SEG III” accounts were for all other clients, including proprietary FCM funds and the funds and property of hedge funds, trust accounts, endowments, and individuals that invested directly with Sentinel rather than through another FCM.\textsuperscript{199} These groups were then subdivided into various trading programs offered by Sentinel.\textsuperscript{200}

The Bank of New York Mellon (BONY) was the depository used by Sentinel for the safekeeping of the customer funds held in the SEG I–III accounts.\textsuperscript{201} BONY signed separate, but virtually identical, letters in which it agreed that all of the funds and securities held in the SEG I–III accounts

\begin{footnotes}
\item[192.] 7 U.S.C. § 1a(28) (2012).
\item[193.] See 17 C.F.R. § 1.20 (2013) (setting forth this requirement).
\item[194.] See id. § 1.12 (setting forth this requirement).
\item[195.] Letter from James L. Carley, Dir., Div. of Clearing & Intermediary Oversight, CFTC, to Eric A. Bloom, President & CEO, Sentinel Mgmt. Grp. n.2 (Jan. 21, 2004), in Comm. Fut. L. Rep. (CCH) ¶ 29,691.
\item[196.] In re Sentinel Mgmt. Grp., Inc., 689 F.3d 855, 857 (7th Cir. 2012), vacated by 704 F.3d 1009 (7th Cir. 2012).
\item[197.] See id. at 858–59.
\item[198.] Id. at 858.
\item[200.] Id. at 860.
\item[201.] Id. at 861.
\end{footnotes}
would be segregated in accordance with the provisions of the CEA.\textsuperscript{202} This meant that even the SEG III accounts, which were not otherwise covered by the CEA, were required to be held in segregation in the same manner as the SEG I accounts under the CEA.\textsuperscript{203}

Sentinel’s business model proved to be successful after its creation in 1981.\textsuperscript{204} Sentinel took advantage of a decision by the CFTC in 2004 to expand the permitted range of investments for customer segregated funds that are identified in CFTC Rule 1.25.\textsuperscript{205} The CFTC then allowed FCMs to engage in repurchase agreements (repos) of customer-deposited securities.\textsuperscript{206} That expanded list of permitted investments improved returns at Sentinel, but the company also found a way to leverage customer funds in a way that had not been envisioned by the CFTC.\textsuperscript{207}

In its repo transactions, Sentinel typically sold a security it was purchasing to a repo dealer with an agreement that Sentinel would buy the security back at some specified time in the future.\textsuperscript{208} The repo dealer kept a haircut on the value of the security as collateral to protect itself in the event of a decline in the value of the security and a default by Sentinel.\textsuperscript{209} Because Sentinel did not have the resources to fund this haircut, it financed the haircut through loans from BONY.\textsuperscript{210} For example, if Sentinel purchased a $10 million security from Dealer A, it had to pay that amount for the security. To acquire those funds, Sentinel did two things. It first transferred the security under an agreement to repurchase to either Dealer A or another dealer and received back cash in an amount less than $10 million because of the haircut.\textsuperscript{211}

Because Sentinel could not fully fund the purchase of a security through a repo transaction, Sentinel then used a loan facility supplied by BONY to finance the remaining portion of the purchase price not received from the repo counterparty.\textsuperscript{212} Customer assets that should have been segregated were used to collateralize these loans from BONY to Sentinel.\textsuperscript{213} As the bankruptcy court later found:

\begin{itemize}
\item \textsuperscript{202} In re Sentinel Mgmt. Grp., Inc., 689 F.3d at 858–59.
\item \textsuperscript{203} Id. at 859.
\item \textsuperscript{204} See id. at 857–58; Complaint at ¶ 8, No. 08CV2410, CFTC v. Sentinel Mgmt. Grp., Inc., 2008 WL 2113281 (N.D. Ill. 2008).
\item \textsuperscript{205} 17 C.F.R. § 1.25 (2013).
\item \textsuperscript{208} In re Sentinel Mgmt. Grp., Inc., 689 F.3d at 859.
\item \textsuperscript{209} Sentinel Mgmt. Grp., Inc., 2012 U.S. Dist. LEXIS 57579, at *8.
\item \textsuperscript{210} See id.
\item \textsuperscript{211} Id.
\item \textsuperscript{212} Id.
\item \textsuperscript{213} In re Sentinel Mgmt. Grp., Inc., 398 B.R. 281, 289 (Bankr. N.D. Ill. 2008).
\end{itemize}
As a FCM, and an entity managing other FCM investments, Sentinel was required to strictly segregate the investments of its customer groups from each other and from Sentinel’s own funds. In fact, however, it did not segregate customer funds. Rather, Sentinel commingled customer funds with its own funds and used the customer funds as collateral for its loans from [BONY].

Sentinel experienced high returns from this program but found itself in difficulty when dealers began demanding higher haircuts on the securities being repoed by Sentinel and in some cases refusing to deal at all in those securities. Sentinel then failed, and BONY seized the SEG I–III securities that Sentinel had used to secure its loan with BONY.

Sentinel’s Liquidation Trustee sued BONY to recover the customer property it had seized. The Trustee contended that section 4d(b) of the CEA, which had been added to the CEA in 1968, made the segregation provisions of the CEA directly applicable to depository banks such as BONY. The trustee claimed that BONY breached its duties when it used customer segregated securities to secure its loan to Sentinel. However, the district court refused to impose such a duty, and the Seventh Circuit initially agreed with the district court in In re Sentinel Management Group, Inc. The Seventh Circuit held that a depository of CEA customer segregated funds need not return funds that were taken out of customer accounts and used to secure a loan to the FCM where it was not shown that the bank had acted fraudulently. However, the panel rendering that decision withdrew it a few months later. In August 2013, the Seventh Circuit issued a new opinion, which held that the improper transfer of customer funds out of segregation evidenced an actual intent to hinder,

214. Id. (citation omitted).
216. Id.
218. 7 U.S.C. § 6d(b) (2012).
220. In re Sentinel Mgmt. Grp., Inc., 689 F.3d at 865. The CFTC subsequently noted:

The language of the statute and its legislative history indicate that Section 4d was designed for the broad purpose of protecting customers from having their money, securities or property appropriated by a futures commission merchant, or some other depository, without adequate legal basis, and the more specific purpose of ensuring the integrity of the futures market by preventing the use of customer funds to finance market transactions by a futures commission merchant for its own account or for other customers.

221. In re Sentinel Mgmt. Grp., Inc., 689 F.3d at 865.
222. Id. at 866–67.
223. Id.
224. In re Sentinel Mgmt. Grp., Inc., 704 F.3d 1009, 1009 (7th Cir. 2012).
delay, or defraud creditors. The case was remanded to reconsider the liquidation trustee’s claim that the bank should be equitably subordinated to the claims of customers.225

Another issue raised by the Sentinel Liquidation Trustee was the priority to be given to the remaining Sentinel assets as between SEG I and SEG III customers—there were almost no SEG II customer funds.226 This dispute arose after it was discovered that Sentinel had been largely taking securities from the SEG I accounts to collateralize the BONY loan.227 However, only a few weeks before its failure, Sentinel substituted those securities for securities taken from the SEG III customer accounts, so that when Sentinel failed, it was the SEG III securities that were seized by BONY rather than the SEG I securities.228

The Sentinel Liquidation Trustee sought to have the SEG I and SEG III customers share losses from Sentinel on a pro rata basis.229 The Trustee contended that those losses should not be borne solely by the SEG III customers merely because of Sentinel’s last-minute and arbitrary decision to substitute the SEG III for the SEG I securities that Sentinel had previously used to fund the BONY loan.230 The Liquidation Trustee also argued that equal protection was appropriate because the SEG III customer funds were held in custody under the Investment Advisers Act of 1940.231 The Trustee contended that SEC’s IA Custody Rule should be given equal status and protection as customer funds held in segregation under the CEA.232 This claim gave rise to a battle of the experts over whether the segregation requirements of the CEA were more robust than those under the IA Custody Rule. Another issue was whether the CEA created a “floating trust” that preempted all other trusts.233 The district court ruled that the Sentinel customers would share pro rata in the remaining proceeds of the estate and that the CEA segregation requirements did not trump the IA Custody Rule or create a floating trust.234

C. LEHMAN BROTHERS

The failure of Lehman Brothers on September 15, 2008, was the largest bankruptcy in U.S. history and resulted in the largest liquidation of a

225. In re Sentinel Mgmt. Grp., Inc., 728 F.3d 660, 672 (7th Cir. 2013).
227. Id. at 289.
228. Id. at 292–93.
229. Id. at 293.
232. See Grede, 485 B.R. at 870; see also Grede, 441 B.R. at 886–900.
233. The floating trust concept is found in the Perishable Agricultural Commodities Act, which creates a statutory trust model in which “[t]rust assets are to be preserved as a nonsegregated ‘floating’ trust. Commingling of trust assets is contemplated.” 7 C.F.R. § 46.46(b) (2013).
234. See Grede, 485 B.R. at 871.
broker-dealer ever.\textsuperscript{235} About $92 billion in funds and securities were almost immediately transferred out of Lehman for the benefit of customers.\textsuperscript{236} Customers were allowed to move those funds and their accounts to other brokerage firms.\textsuperscript{237} The bulk of the remaining Lehman Brothers securities customers and their assets (about $40 billion) were transferred to Barclays Bank, giving rise to "the largest, most expedited and probably the most dramatic asset sale that has ever occurred in bankruptcy history."\textsuperscript{238}

That sale worked well for most of the accounts transferred. However, Barclays refused to take many large accounts totaling several billion dollars; those accounts were subject to long delays in resolving their treatment and encountered conflicting treatment under bankruptcy laws in various countries.\textsuperscript{239} A dispute also arose over whether the sale to Barclays included $769 million in Lehman accounts that were segregated under SEC Rule 15c3-3 and $507 million held at the Options Clearing Corp. as customer margins.\textsuperscript{240} After extended litigation, the district court held that those assets should not have been included in the transfer of assets to Barclays.\textsuperscript{241}

Numerous Lehman Brothers customers, including several hedge funds and banks, were not paid their funds held at Lehman Brothers, but the bankruptcy trustee was able to obtain settlements over the course of several years of litigation that allowed the return of virtually all of their funds.\textsuperscript{242} For example, the trustee reached a $38 billion settlement over funds held in London by a Lehman affiliate and a $6 billion settlement over funds held at a Swiss affiliate.\textsuperscript{243} The Lehman bankruptcy trustee reached a settlement late in 2012 with Citigroup Inc., which required that bank to return $435 million of a disputed $1 billion in funds that it held in connection with the clearing of foreign exchange trades for Lehman’s broker-dealer affiliate.\textsuperscript{244}

JPMorgan Chase Bank, N.A. (JPMorgan) also became ensnared in litigation over its role as custodian of customer plans segregated under the CEA. In \textit{In re JPMorgan Chase Bank, N.A.}, the CFTC found by consent that respondent had improperly delayed the return of segregated funds of Lehman Brothers’ customers.\textsuperscript{245} The CFTC further charged that JPMorgan


\textsuperscript{236} See Fitzgerald, supra note 3, at C3.

\textsuperscript{237} See id.


\textsuperscript{241} See id. at 599.

\textsuperscript{242} See Fitzgerald, supra note 3, at C3.

\textsuperscript{243} See id.

\textsuperscript{244} See id.

had been making improper loans to Lehman based on those segregated funds.\textsuperscript{246} JPMorgan thereafter entered into a settlement with Lehman’s liquidators in which the bank agreed to pay $100 million in settlement of claims by the estate against that bank.\textsuperscript{247}

Otherwise, customer positions and funds segregated at Lehman Brothers under the provisions of the CEA and CFTC rules went smoothly and were transferred out over a five-day period.\textsuperscript{248} However, customer segregated assets that were subject to U.K. customer rules were not able to be transferred and remained tied up in lengthy litigation in the United Kingdom for several years.\textsuperscript{249} The U.K. Supreme Court eventually held that customer funds that were supposed to have been segregated under U.K. Financial Services Authority rules would be treated as being segregated even if the firm did not actually segregate the funds.\textsuperscript{250} A settlement was also reached that provided for the return of all U.S. customer funds.\textsuperscript{251} The new U.K. Financial Conduct Authority has proposed rules that will allow the prompt return of customer funds when a financial services firm fails.\textsuperscript{252} Hopefully, this will avoid a repeat of the Lehman debacle.

**D. BERNIE MADOFF**

On December 10, 2008, the sons of Bernie Madoff reported to authorities that their father had confessed to them that he had been running the largest Ponzi scheme in history.\textsuperscript{253} Madoff was a well-known figure in the securities industry and had been innovative in introducing electronic trading to the securities markets.\textsuperscript{254} Madoff operated a securities broker-dealer, Bernard L. Madoff Investment Securities LLC (BLMIS).

\textsuperscript{246} See id.
\textsuperscript{249} See id.
\textsuperscript{253} See HENRIQUES, supra note 4 (describing Madoff’s background and fraud).
\textsuperscript{254} MARKHAM, supra note 235, at 609–13.
“Outwardly, BLMIS functioned both as an investment advisor to its customers and a custodian of their securities.”

Madoff was able to attract billions of dollars in investor funds through claims of high returns from his so-called “split-strike conversion strategy.” In reality, there was no such strategy. Madoff failed to segregate customer funds in accordance with either the SEC Customer Protection Rule for broker-dealer customers or the SEC IA Custody Rule for investment adviser customers. Profits were also fabricated and redemption requests were paid out of other customers’ funds until the whole scheme came apart during the Financial Crisis in 2008. Madoff’s failure gave rise to over 15,000 customer claims totaling over $68 billion. Actual out-of-pocket losses were eventually determined to total over $17 billion, and as of November 15, 2013, the SIPC trustee has recovered a little over one-half that amount through various recovery actions. That amount also included a $708 million commitment from SIPC for its insurance coverage.

After Madoff’s fraud was exposed, SIPC sought the appointment of a trustee to liquidate BLMIS. That touched off a lengthy fight over how customer claims for SIPC insurance would be computed. The SIPA trustee used the “Net Investment Method,” which computed customer account balances by crediting the amount of cash deposited by the customer and debiting the amounts withdrawn by the customer. Customers who

256. In re Bernard L. Madoff Inv. Sec. LLC, 424 B.R. at 129.
257. Id. at 129 n.17.
258. The Second Circuit has described Madoff’s scheme as follows:

When customers invested with Bernard L. Madoff Investment Securities LLC (“BLMIS”), they relinquished all investment authority to Madoff. Madoff collected funds from investors, claiming to invest those funds pursuant to what he styled as a “split-strike conversion strategy” for producing consistently high rates of return on investments. The split-strike conversion strategy supposedly involved buying a basket of stocks listed on the Standard & Poor’s 100 Index and hedging through the use of options. However, Madoff never invested those customer funds. Instead, Madoff generated fictitious paper account statements and trading records in order to conceal the fact that he engaged in no trading activity whatsoever. Even though a customer’s monthly account statement listed securities transactions purportedly executed during the reporting period and purported individual holdings in various Standard & Poor’s 100 Index stocks as of the end of the reporting period, the statement did not reflect any actual trading or holdings of securities by Madoff on behalf of the customer.

In re Bernard L. Madoff Inv. Sec. LLC, 654 F.3d at 231–32 (citations and footnote omitted).
261. Id.
262. In re Bernard L. Madoff Inv. Sec. LLC, 654 F.3d at 231.
263. Id. at 233.
264. Id.
withdraw more than they deposited would have no claim for SIPC insurance. The issue of whether funds could be clawed back from investors who were paid out more than they invested in their accounts at BLMIS was also the subject of litigation.

E. SIR R. ALLEN STANFORD AND OTHER PONZI SCHEMES

Another shoe dropped on February 17, 2009, when the SEC charged that Sir R. Allen Stanford had been running a giant $7 billion Ponzi scheme out of the Caribbean island of Antigua, where he had been knighted. Stanford was charged with and convicted of a criminal fraud involving approximately 30,000 investors in 113 countries through fraudulent high-return certificates of deposit (CDs) issued by the Stanford International Bank of Antigua. This fraud was the second largest in history, trailing only Bernie Madoff in size.

The SEC and SIPC found themselves embroiled in a fight over whether SIPC was required to insure customers suffering losses from those CDs. A federal district court judge rejected the SEC’s effort to force SIPC to commence proceedings to liquidate the Stanford operations and provide insurance coverage to victims. Stanford owned a Houston-based broker-dealer that was registered with the SEC, but the Antigua bank, which issued the CDs, was not so registered. The district court held that the victims of Stanford’s fraud were not customers of a broker-dealer, even though the CDs were sold through Stanford’s registered broker-dealer in Houston, which was a member of SIPC. The Court held that the broker-dealer was not performing a custodial function in selling the CDs. Rather, customers made checks directly payable to the Stanford bank and their CDs were not held at the broker-dealer.


266. See Jessica D. Gabel, Midnight in the Garden of Good Faith: Using Clawback Actions to Harvest the Equitable Roots of Bankrupt Ponzi Schemes, 62 CASE W. RES. L. REV. 19, 61 (2011) (citing In re Bernard L. Madoff Inv. Sec. LLC, 424 B.R. at 125) (stating that Madoff trustee wanted the “net equity” method and demanded that the ‘net winners’ return their ‘profits'” to ensure a more equitable distribution of funds).


268. Krauss, supra note 5, at B3.

269. Id.


271. Id. at 12.

272. Id. at 7.

273. Id. at 8.

274. Id. at 7–8.
The Madoff and Stanford fraud schemes were preceded and succeeded by a number of Ponzi schemes in which customer funds were misappropriated. To name just a few, Kenneth Kasarjian raised over $800 million in a Ponzi scheme; J.T. Wallenbrock & Associates raised over $230 million in a Ponzi scheme; the Reed Slatkin Investment Club Ponzi scheme took in over $600 million; and Kevin Leigh Lawrence raised $90 million in his Ponzi scheme. The Manhattan Investment Fund in Florida defrauded investors of $350 million; the Maricopa Index Hedge Fund raised $120 million through a Ponzi scheme; and the KL Group turned out to be a $200 million Ponzi scheme. In 2005, the Bayou Hedge Fund Group was unmasked as a classic Ponzi scheme that cost investors some $200 million. Danny Pang’s Ponzi scheme involved some $700 million in investor funds. The CFTC has also brought numerous cases in recent years against commodity pool operators who were engaged in Ponzi schemes.

F. MF Global’s Failure

MF Global and its fifty affiliated entities failed on October 31, 2011. That firm was headed by Jon S. Corzine, the former governor and U.S. Senator from New Jersey and a former leader of Goldman Sachs. Corzine had tried to shore up MF Global’s declining profits by investing in European government debt in Greece and other faltering euro zone countries on the theory that the European Union would bail them out at 100 cents on the dollar. MF Global’s $6 billion plus bet on that debt resulted in large losses and a ratings downgrade that caused a decrease in the firm’s liquidity. A takeover of MF Global by Interactive Brokers Group Inc. fell through after a massive amount of customer funds could not be located.

MF Global’s failure was the eighth-largest bankruptcy in the United States and the largest failure of a financial services firm since Lehman

275. 5 MARKHAM, FINANCIAL HISTORY, supra note 235, at 487–89.
276. Markham, Mutual Fund Scandals, supra note 139, at 120.
277. United States v. Marino, 654 F.3d 310, 311 (2d Cir. 2011).
278. See 5 MARKHAM, FINANCIAL HISTORY, supra note 235, at 631 (describing that scheme).
281. Id. at 20.
282. Id. at 31–32, 35.
283. See id. at 36–42, 47 (describing the timeline of MF Global’s expansion of its European sovereign debt portfolio and the subsequent losses therein).
284. Id. passim. (describing MF Global’s failure).
Brothers. 285 There was also a massive shortfall in customer funds totaling some $1.6 billion. 286 This included about $900 million of customer segregated funds in commodity and securities accounts and $700 million in funds that were subject to CFTC Rule 30.7, i.e., customers of MF Global’s CFTC-regulated futures commission merchant who were trading on foreign exchanges. 287 As described above, under Rule 30.7, only a limited amount of their funds were required to be held in a Secured Amount account and were not required as excess margin funds for trading on regulated U.S. commodity option and futures exchanges. 288

An SIPC trustee was appointed for MF Global, Inc. (MFGI), a dually registered broker-dealer and futures commission merchant. 289 Other MF Global units were subject to liquidation by other trustees, and their claims over remaining customer funds were conflicting and led to disputes in the United States and in London. 290 MFGI asserted customer claims of some $910 million against MF Global UK. 291 Customer funds that were held in MF Global UK were claimed by the London trustee to be unprotected funds, which meant they would be treated as general creditors only. 292 However, the U.S. trustee was able to reach an agreement that allowed the return of roughly $500 million at issue in the London proceeding for the benefit of the Rule 30.7 customers. 293 Before that settlement, the SIPC trustee had returned eighty percent of customer funds that were segregated under section 4d of the CEA, but only five percent of Rule 30.7 funds had been returned. 294 Nevertheless, the MF Global bankruptcy trustee predicted that these customers would eventually be made whole. 295 The SIPC trustee

286. STAFF REPORT, supra note 280, at 1.
287. See Trustee’s Investigation and Recommendations, supra note 6, at 2.
288. Id. at 10.
289. Id. at 1.
290. Id. at 21–22, 47, 48, 111, 161, 169.
291. Id. at 157.
292. Id. at 158.
also predicted that the customers covered by SIPC insurance could be made whole. 296

The CFTC filed a civil injunctive action against Jon Corzine and a former Assistant Treasurer of MF Global. 297 Corzine was charged with a failure to supervise and with controlling person liability. 298 MF Global was also sued and agreed to settle the CFTC’s charges, including 100% restitution of all remaining commodity customer claims, assuming there were any assets available for return. 299 “The proposed order also include[d] the imposition of a $100 million penalty, which [could] be paid to the extent MF Global ha[d] not fully exhausted all available funds and assets paying customers and then other creditors entitled to priority under bankruptcy law.” 300

G. PEREGRINE FINANCIAL GROUP AND OTHER SEPARATION FAILURES

Another large shortfall in customer funds occurred in the failure of Peregrine, an Iowa firm that declared bankruptcy on July 10, 2012. 301 It was discovered that over $200 million in customer funds that were supposed to be segregated under the CEA had been misappropriated by the owner of that firm: Russell Wasendorf, Sr. 302 That conversion occurred over a period of some twenty years. 303 There were over 17,000 customer accounts affected by this fraud. 304

Purportedly, Wasendorf had submitted false bank statements to regulators showing that the customer funds were properly segregated. 305 A CFTC complaint charged that “in July 2012 during an NFA examination PFG falsely represented that it held in excess of $220 million of customer

299. CFTC Press Release, supra note 298.
300. Id.
303. Saphir, supra note 301.
304. Id.
funds when in fact it held approximately $5.1 million.306 Wasendorf, age 64, pleaded guilty to criminal charges and was sentenced to fifty years in prison.307

The CFTC filed a civil injunctive action against U.S. Bank, N.A., the depository of Peregrine’s segregated funds.308 The CFTC charged that the bank had used customer segregated funds as collateral for personal loans to Wasendorf and his wife.309 The CFTC further charged that the bank allowed Peregrine to treat its customer segregated funds as being held in a commercial bank account that was used to pay for Wasendorf’s personal expenses, including an airplane, a restaurant, and a divorce settlement.310 Customer funds were also used to fund construction of Peregrine’s offices.311

In a separate matter, Farr Financial Inc., the CFTC found by consent that the respondent had invested customer funds in securities not authorized by CFTC Rule 1.25.312 These investments included a money market mutual fund from which funds could not be withdrawn by the next business day; five savings or money market deposit accounts that were not permitted investments; and a certificate of deposit whose issuer did not meet the then-existing credit rating requirement of Rule 1.25.313 In another case, Cantor Fitzgerald & Co.,314 the CFTC found by consent that the respondent had failed to maintain adequate funds in segregation when it inadvertently transferred $3 million from customer-segregated funds to a house account.315 This under-segregation was only belatedly reported, and a failure to supervise was found.316 In ABN AMRO Clearing Chicago LLC, the CFTC found by consent that the respondent failed to segregate or secure customer funds, meet net capital and bookkeeping requirements, and supervise its employees.317 In CFTC v. MBF Clearing Corp., a district court by consent found that the defendant had placed customer funds that were not properly segregated in an account at an institution.318

306. CFTC Proposed Rules, Enhancing Protections, supra note 61, at 67,869 (citation and footnote omitted).
309. Id. paras. 51–60, at 13–14.
310. Id. paras. 70–79, at 16–17.
311. Id. para. 51, at 13.
313. Id.
315. Id.
316. Id.
V. REGULATORS ACT TO IMPROVE SEGREGATION

Following the Sentinel and other failures, the CFTC and the industry began working on proposals to prevent such events in the future. In December 2011, the CFTC amended Rule 1.25 to remove from the list of permitted investments for customer segregated funds corporate debt obligations not guaranteed by the United States; foreign sovereign debt; and in-house and affiliate transactions. The CFTC also changed its rules to require that FCMs collect margins on a “gross” basis. This means that FCMs cannot merely transmit the “net” amount of customer margins owed to a clearinghouse after offsetting short and long positions of clearing firm customers. That requirement had been considered by the National Futures Association (the NFA) in 1986 after a series of failures at FCMs raised concerns over losses of customer funds. As that study found, however, the Chicago Mercantile Exchange (the CME) and some of the other exchanges had already imposed such a requirement. Presently, the CME is dominating futures trading in the United States.

The CFTC still allows swap customer funds to be commingled, but those funds must now be treated as individual accounts and protected individually “all the way to the clearinghouse.” This is a change from the preexisting regime for customer funds segregated for trading commodity futures. “Under the traditional futures margining model, [derivatives clearing organizations] hold an FCM’s customer funds on a collective basis and are permitted to use the collective margin funds held for the FCM’s customers to satisfy a margin deficiency caused by a single customer.” This change underscored a flaw that has troubled the industry in the past, i.e., the failure of a customer to meet a margin call will result in a loss to other customer funds held collectively in segregation if the FCM does not have the assets to cover the loss.

Another reform the CFTC imposed was heightened risk management and other responsibilities on SROs, including a requirement that they increase their access to FCM segregation records. The National Futures Association (the NFA) had already acted to require that FCMs no longer

319. Investment of Customer Funds, supra note 59, at 78,778.
322. Id.
323. Id.
324. CFTC Proposed Rules, Enhancing Protections, supra note 61, at 67,869.
325. Id.
use the alternative method in computing the Secured Amount under Rule 30.7. Instead, they were required to use the Net Liquidating Equity Method that is required for domestic futures accounts. The CFTC also proposed such a requirement. It would also eliminate the alternative method for computation of the Secured Amount under Rule 30.7.

The NFA now requires FCMs to create a targeted amount of excess funds held by the FCM as a cushion to assure that segregation is not breached by a customer default. This was already a common practice by many FCMs. Restrictions were also placed on withdrawals by the FCM from segregated accounts that are not for the benefit of customers and are in excess of twenty-five percent of the FCM’s excess funds held in segregation.

The NFA further required FCMs to provide their Designated Self-Regulatory Organization with view-only access through the Internet to account information for each of the FCM’s customer segregated funds and Secured Amount accounts held at a bank or trust company depository. The NFA planned to use such reports to conduct a daily comparison of what the FCM was reporting as being required to be segregated and the amount actually segregated. The NFA and Chicago Mercantile Group, the industry’s other principal SRO, were working to develop a computerized system for monitoring segregation compliance.

The CFTC has further proposed revisions to its FCM reporting requirements for net capital and segregation compliance. It also proposed to add to its own rules a requirement like that of the NFA, which mandates that FCMs set a targeted amount of FCM excess funds to serve as a cushion for customer defaults or withdrawals. The CFTC further proposed a requirement that FCMs establish a risk management program to manage its risks and that a risk management unit independent of the business unit be established to monitor the program.

The CFTC proposed other restrictions, including a mandate of “moment-to-moment” segregation, which means that FCMs could not use customer segregated funds in their operations or to cover a margin call of a

328. 17 C.F.R. § 30.7.
329. Interpretive Notice 9066, supra note 34.
330. CFTC Proposed Rules, Enhancing Protections, supra note 61, at 67,896.
331. Id.
332. Id.
333. CFTC Proposed Rules, Enhancing Protections, supra note 61, at 67,896.
334. Id. at 67,915.
335. Id. at 67,870–71.
337. See CFTC Proposed Rules, Enhancing Protections, supra note 61, at 67,899 n.95.
338. Id.
339. Id. at 67,874.
customer between daily segregation calculations. Rather, the FCM would have to post its own funds to cover margin deficiencies until the customer meets a margin call. The head of the CME, however, has complained that FCMs do not have the appropriate systems to make moment-to-moment calculations. Rather, margin calls are usually issued and collected overnight. Further, most FCMs do not have the capital to cover every momentary deficit in customer accounts, and they do not wish to incur the expense.

The CFTC proposals would prohibit the FCM from withdrawing its excess funds held in segregation until a calculation of its segregation requirement is made. The proposals would also adopt the NFA requirement restricting withdrawals for the FCM's own purposes of more than twenty-five percent of the FCM's excess funds held in segregation. The CFTC proposals would confirm that FCMs were liable for any losses on investments of customer segregated funds that are made under CFTC Rule 1.25.

VI. INSURANCE AND OTHER PROPOSALS FOR COMMODITY ACCOUNT CUSTODIANS

Segregation requirements under the CEA are critical to customer protection in the commodity futures industry because there is no insurance, such as that available for securities customers under SIPC. There is thus a disparity of treatment between commodity traders and securities customers, who enjoy the protection of the SEC Customer Protection Rule and are also protected by SIPC insurance. There is some history behind that disparity.

340. Id. at 67,886.
341. Id.
343. Id.
344. Id.
345. CFTC Proposed Rules, Enhancing Protections, supra note 61, at 67,887.
346. Id. at 67,870.
347. Id. at 67,888. The CFTC adopted some of these proposals just before publication of this Article. Among other things, FCMs will be required to maintain residual interest equal to its customers’ aggregate under-margined amounts for the prior trade date. This was a shift from the moment-to-moment proposal, but it raises concerns that FCMs would require pre-funding of margin, a requirement that could increase the cost of hedging by farmers and others. This requirement will be phased in over a period of five years. See Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, 78 Fed. Reg. 68,501, (Nov. 14, 2013) (to be codified at 17 C.F.R. pts. 1, 3, 22, 30, 140).
349. Id. at 261–62; see also Customer Protection Rule, 17 C.F.R. § 240.15c3-3 (2013).
Included in the legislation that created the CFTC in 1975 was a provision that required the CFTC to determine whether account insurance was needed for commodity futures customers, such as that provided to securities customers under SIPA. 350 The CFTC conducted a study on this issue and issued a report in 1976, which examined the failures of FCMs between 1938 and 1974. 351 The CFTC report compared losses to customers in government-sponsored insurance programs with loss ratios for commodity futures accounts. 352 The CFTC found that loss ratios in uninsured commodity futures accounts were substantially lower than those in insured accounts. 353 The CFTC also concluded that the loss rate for customers of FCMs was so low that government account insurance would not be cost-effective. 354

As described above, the Bankruptcy Act was amended in 1978 to provide customers more protection in the event of their FCM’s failure. 355 That legislation was followed by the failure of some FCMs, which raised concerns over the efficacy of the CFTC’s segregation requirements. Those failures included Incomco, Inc.; Chicago Discount Commodity Brokers Inc.; and Volume Investors, Inc. 356 Those failures again raised concerns as to whether account insurance was needed for commodity futures customers and resulted in a recommendation by the CFTC staff that further study be given to whether account insurance was needed for commodity futures accounts. 357

In 1985, the CFTC staff found that failures by FCMs had increased since the CFTC’s prior report on account insurance. 358 Twenty-four FCMs failed during that period with losses averaging $2 million annually. 359 Nevertheless, the estimated losses from FCM bankruptcies between 1938 and 1985 amounted to less than $10 million, and no action was taken by the CFTC to seek additional legislation for account insurance. 360

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352. Id.
353. Id.
354. Id.
356. See MARKHAM, COMMODITY FUTURES TRADING, supra note 12, at 88 (describing those events).
357. Id.
358. Id.
359. 23 JERRY W. MARKHAM & THOMAS LEE HAZEN, BROKER-DEALER OPERATIONS UNDER SECURITIES AND COMMODITIES LAW § 5.8, at 5-137 (2012).
The massive failures that occurred in this century again raised concerns over whether account insurance was needed for commodity accounts. The NFA and other industry groups agreed to conduct a study of the costs and benefits of creating an insurance game for commodity futures investors comparable to that available for securities investors.\textsuperscript{361}

The call for account insurance must necessarily clash with concerns over the introduction of more moral hazards into the financial system. FDIC and SIPC insurance pose the threat that customers depositing their funds at an insured institution will no longer monitor the finances of the depository in order to protect their assets. There is no need for such vigilance if the customer is insured. Instead, regulators will assume the role of monitor and adopt more costly regulations that the regulator believes will better allow it to monitor the financial condition of insured funds—a process that, as described above, is already underway.\textsuperscript{362}

Another cost issue is the funding of the insurance scheme. That can be done by assessments, as is the case for FDIC and SIPC insurance, but someone will have to bear that cost. Undoubtedly, that someone will ultimately be the consumer. There will also be, undoubtedly, calls for greater assessments on larger financial institutions than those for small operations, as has been the case at the FDIC.\textsuperscript{363}

Other proposals include the creation of customer guaranty funds. This proposal is an extension of the current guarantee funds that have been created by clearinghouses to provide a backstop in the event a clearing firm fails. These funds are built up over time through transaction fees, and clearinghouses may also have the power to assess non-defaulting clearing firms additional amounts to cover losses. The CME Group had about $3 billion in its largest guaranty fund and authority to assess an additional $8.1 billion at year-end 2011.\textsuperscript{364} Presumably, a customer guaranty fund would operate in much the same manner but would be in addition to the clearinghouse funds.

What is unanswered is whether the customer guaranty fund would be firm-specific or industry-wide. It would, in any event, probably be financed through transaction fees paid by customers as they trade. Such fees, if paid to a firm-specific customer guaranty fund, would drive high frequency traders, who are now responsible for a majority of futures transactions, to firms that do not charge such fees. That problem could be solved by


\textsuperscript{362} See MARKHAM,\textit{ COMMODITY FUTURES TRADING,} supra note 12, at 89 (stating causes of volume investor default and the need for additional customer and market protection).

\textsuperscript{363} See 5 MARKHAM,\textit{ FINANCIAL HISTORY,} supra note 235, at 662 (describing disproportionate assessment of large banks in order to increase FDIC insurance fund during the Financial Crisis).

mandating such fees and placing them in an industry-wide fund, but that would only drive high-frequency traders offshore.

Another proposal would seek to protect customer funds through tri-party custodial accounts. Section 4d of the CEA creates a bilateral custodian arrangement between the FCM and the bank depository. Presumably, a tri-lateral arrangement would require reporting by the bank to the FCM’s customers, telling them how much is held in custody for their account at the bank. This would require that the bank be given access to the customer directly, and the bank would have to be told by the FCM what amounts are to be held in custody for each account. In years past, that would have been a costly task, especially for large FCMs, which may carry over 100,000 accounts. Computerization of records now makes such a process more doable.

Still another proposal concerns the creation of central customer fund repositories. This would replicate in some manner the process used by the Depository Trust and Clearing Corporation (DTCC) for maintaining custody of securities beneficially owned by customers of SEC-regulated broker-dealers. That entity was created after the so-called “paperwork crisis” that occurred at the end of the 1960s and was the result of the requirement to exchange a paper security whenever a security was bought and sold. At that time, the brokerage community was not automated and could not keep up with the paper flow.

The DTCC was created to avoid paperwork by allowing “street name” securities, i.e., securities beneficially owned by a customer but held in the name of the customer’s broker-dealer, to be maintained in a central depository so that the paperwork involved in issuing a paper certificate could be eliminated. Centralization also provided more security, whereas before the creation of a central depository theft of securities was endemic to the securities industry. Clearing services, i.e., payment and delivery functions, were also centralized through the DTCC.

The futures industry has long used central clearinghouses that clear and carry all customer trades. Those clearinghouses also hold in custody customer margin funds required by the exchanges to secure customer

367. See 2 MARKHAM, FINANCIAL HISTORY, supra note 72, at 367–68 (describing the creation of the DTCC).
368. See id. at 362–64 (describing that crisis).
369. Id. at 366–68.
370. See id. at 368.
371. See id. at 367–68 (describing the creation of the DTCC).
372. See id. at 367.
However, the clearinghouse does not hold in custody excess customer margin funds that are not needed at the clearinghouse level to secure trades. Those excess funds are required to be segregated under the CEA and have been the source of the losses from the FCM failures described above.

Current proposals would expand the role of the clearinghouse to include maintaining custody of excess customer funds, as well as those required for exchange margins. This proposal poses a threat to the revenues of FCMs, which are currently allowed to keep the interest earned on permitted investments for customer segregated funds. Removing customer segregated funds and securities from the control of the FCM to the clearinghouses would threaten that revenue stream. To be effective such an arrangement would also require that the clearinghouse act as a tri-party custodian. Centralization of custody arrangements also increases the risk of systemic failure should a clearinghouse fail.

One troubling problem that arose in the Lehman Brothers and MF Global bankruptcies was the disputes between U.S. and English authorities over customer funds held in London. The Bank of England subsequently agreed to defer to the United States and refrain from seizing London assets when a U.S. financial institution fails. The two countries were also working on a plan to develop procedures for liquidating cross-border financial institutions. James Giddens, the MF Global and Lehman Brothers trustee, wrote an op-ed piece in the Wall Street Journal advocating that customer funds held outside of the United States be subject to the same requirements as funds held here and that there should be greater coordination among the international regulatory bodies. He also argued...
that company officers should face the risk of personal liability in the event that segregation laws are broken.\footnote{Id.}

The Ponzi scheme problem remains, but some efforts are being undertaken to limit their operation. Many Ponzi schemes have been carried out under the guise of hedge fund investments.\footnote{Gabel, \textit{supra} note 266, at 31–32.} The SEC had tried to regulate hedge funds by requiring them to register as investment advisors.\footnote{Goldstein v. SEC, 451 F.3d 873, 877 (D.C. Cir. 2006).} Numerous hedge funds registered with the SEC under that rule before it was struck down by the District of Columbia Court of Appeals.\footnote{Id. at 877, 884.} Many of those hedge funds then deregistered.\footnote{Edward Pekarek, Comment, \textit{Pruning the Hedge: Who is a “Client” and Whom Does an Advisor Advise?}, 12 FORDHAM J. CORP. & FIN. L. 913, 960 (2007).} Ironically, however, Bernie Madoff, who had registered under that rule, did not resign his registration and continued to carry out his Ponzi scheme under SEC and Financial Industry Regulatory Authority (FINRA) oversight until it collapsed during the Financial Crisis.\footnote{5 Markham, \textit{Financial History}, \textit{supra} note 235, at 613.} This did not discourage Congress from including a provision in Dodd-Frank that requires large hedge funds to again register with the SEC under the Investment Advisers Act of 1940.\footnote{Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 403, 124 Stat. 1376, 1571 (2010) (codified as amended at 12 U.S.C. § 5301 (2012)).}

The International Organization of Securities Commissions (IOSCO) issued a report in 2013 that raised concerns with custodial arrangements in which customers knowingly or unknowingly waive a statutory trust fund protection.\footnote{Richard Hill, \textit{IOSCO Report Proposes Principles to Protect Client Assets}, 45 SEC. REG. & L. REP. (BNA) 247, 247 (2013).} That was a matter at issue in litigation arising from the Refco failure.\footnote{Craig v. Refco, Inc., 816 F.2d 347, 348 (7th Cir. 1987).} IOSCO was also concerned with instances where a broker deposits customer funds in a foreign jurisdiction.\footnote{Hill, \textit{supra} note 390, at 247.} IOSCO recommended that custodians be required to obtain explicit written consent for any waiver or modification of a custodial arrangement.\footnote{Id.} It also recommended that brokers take into account and understand the characteristics of foreign custodial arrangements.\footnote{Id.}

\section*{VII. UNIFYING CUSTODY ARRANGEMENTS FOR SECURITIES AND DERIVATIVES}

The reforms presently being proposed in the wake of the MF Global, Madoff, and other failures in this century are all piecemeal attempts to patch a system that has outlived its usefulness. The securities, asset
management, derivatives, and banking custody needs are inextricably intertwined with each other and should be regulated uniformly. As it is now, bank deposits of customers and customer securities and funds of broker-dealers are insured but under different regulatory schemes and in different amounts. In contrast, there is no insurance for the assets of futures and other CEA-regulated derivatives customers or for those managed by an investment advisor. Instead, those customers have only the protection of SEC and CFTC segregation requirements.

These differing regulatory schemes for custody of customer assets may also result in competition among customer classes where a dually regulated entity fails, as was the case in the Sentinel bankruptcy. A uniform approach to the protection of customer custody requirements is needed. The first step in that process is to correct the flaws in the existing systems. For example, there should be a uniform requirement that customer funds and assets be kept separate from those of the financial services firm. That rule should extend across all asset classes.

The next requirement should be that customer funds be treated individually at all levels, from FCM/broker-dealer/investment advisers to the clearinghouse and bank depository. This would mean that, if one customer failed to meet a margin call, other customer funds could not be used to meet that call even at the clearinghouse level. This would require a tri-party custody arrangement to assure its efficacy. Another needed reform is third-party reporting to customers. This would involve independent reports to customers of the funds or securities held in custody at either a clearinghouse or at a bank or other custodian.

This arrangement will not assure that intra-day blowups will not occur that will cause customer losses. Nevertheless, if such losses are caused by a shortfall in one customer’s account, funds of other customers will not be available to meet that shortage. Where there is a general shortfall from fraud or other reasons, a requirement that losses be shared pro rata should be adopted. Such pro rata sharing would also be appropriate where other statutory trusts are affected by a shortfall, as in the Sentinel case.

Of course, these and other reforms will not stop future Ponzi schemes, which flourish during boom times and are exposed on economic downturns. There is simply no way to stop these frauds except through customer vigilance when they are solicited by promises of large repeated gains. Bona fide asset managers can make no such claims because they know markets are unpredictable. Even a favorable track record over a period of years does

395. See Kesling, supra note 361.
397. See In re Sentinel Mgmt. Grp., Inc., 689 F.3d 855, 857 (7th Cir. 2012).
not provide assurance that gains will continue. Any asset manager suggesting otherwise should be avoided. A good example of this reality was Bill Miller’s stewardship of the Legg Mason Value Fund. He had made returns for that fund that topped the S&P 500 Index’s growth for fifteen years in a row. However, that streak ended in 2006, and in 2008 investors lost fifty-eight percent of their investment. The loss in 2008 wiped out all past gains and turned Miller’s fund into the worst performing mutual fund over the prior ten years.

Regulated firms that run off-book operations, like Madoff, that are not reported to their regulators can also evade this net by falsifying documents sent to customers and regulators. There is little that can be done here except to use surprise inspections as a possible deterrent and to look for customer complaints that might reveal the off-the-books arrangements.

CONCLUSION

The debacles in recent years that resulted in the tying up and loss of customer funds evidence a need for reform. In this era of computers, there is no reason why customer funds cannot be tracked on a per-account basis at depositories, as well as at the FCM. This would better assure customer protection.

399. 5 MARKHAM, FINANCIAL HISTORY, supra note 235, at 501.
400. Id.
401. Id.
403. See, e.g., Ernst & Ernst v. Hochfelder, 425 U.S. 185, 189 (1976) (describing an off-the-books investment program operated for a period of almost twenty-five years by the head of a registered broker-dealer until he revealed the scheme in a suicide note).
NOTES

THE JOBS ACT: INVESTOR PROTECTION, CAPITAL FORMATION, AND EMPLOYMENT IN AN INCREASINGLY POLITICAL ECONOMY

INTRODUCTION

On April 5, 2012, President Obama signed the Jumpstart Our Business Startups Act (the JOBS Act or Act).1 The purpose of the Act was “[t]o increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies.”2 The Act sought to lower the cost of raising capital by deregulating current securities laws.3 It was passed against the backdrop of a classic struggle of balancing free markets with investor protection,4 a debate that was exacerbated by the financial crisis and ensuing recession.5

The main criticism of the Act alleged that decreased regulation would lead to decreased investor protection and thus to increased fraud.6 The purpose of this Note is to show that this criticism is misplaced. A more legitimate criticism of the Act should question the effect it will have on job creation. The Note will accomplish this by arguing that (1) the JOBS Act, by deregulating certain securities offerings, will have a positive impact on capital formation without significantly impairing investor protection, and (2) the Act, as drafted and sold to the public, may not actually increase employment.

Part I of this Note provides an overview of the federal securities laws as well as the JOBS Act as a whole. Part II examines the background and legislative history of three provisions that seem to have caused the most

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2. Id.
3. See id.
commentary and controversy. This Part also analyzes the investor protection mechanisms the Act provides. Part III discusses additional investor protections outside the JOBS Act. In Part IV, this Note evaluates the effect the Act will have on job creation and argues that deregulation will not lead to a significant increase in employment. Finally, Part V reviews the political climate surrounding the JOBS Act and provides some alternative explanations of the Act’s true purpose.

I. OVERVIEW OF THE FEDERAL SECURITIES LAWS AND THE JOBS ACT

A. THE SECURITIES ACT OF 1933 AND THE SECURITIES AND EXCHANGE ACT OF 1934

The Securities Act of 1933 (the Securities Act) requires that all securities offered or sold must be registered with the U.S. Securities and Exchange Commission (the SEC) or must fall under an exemption. The cost of registration can be prohibitively expensive, especially for small businesses. The theory behind the registration process under the Securities Act is to provide investors with disclosure, which grants investors access to all material information required to make an informed decision. While the Securities Act governs a one-time disclosure for initial offerings, the Securities and Exchange Act of 1934 (the Exchange Act) requires continued disclosure for companies with securities that trade in the secondary market and have a certain number of shareholders and assets. As with the Securities Act, the goal of the reporting requirements of the Exchange Act is to allow investors to accurately value a company’s shares.

B. OVERVIEW OF THE JOBS ACT

The JOBS Act expanded many existing exemptions and created several new ones, thereby increasing access to capital for small businesses. Title I of the JOBS Act scaled down the reporting requirements of Securities Act registration statements for any entity that qualifies as an “emerging growth company.” This category was defined in extremely broad terms, which

8. See, e.g., infra note 103 and accompanying text.
12. JOBS Act § 102 (codified as amended at 15 U.S.C. §§ 77g(a), 78m(a), 78n(i), 78n-1(c); 17 C.F.R. § 229.402 (2013)).
includes any issuer with “total annual gross revenue” of under $1 billion. The continued reporting requirements of the Exchange Act and Sarbanes-Oxley Act (SOX) are also scaled down as long as the company keeps its status as an emerging growth company. In addition, such entities are allowed to “test the waters” by communicating with qualified institutional buyers and institutional accredited investors before a registration statement is filed. Draft versions of registration statements can also be submitted to the SEC confidentially.

Title II of the JOBS Act changed the way private funds, including hedge funds, private equity funds, and venture capital funds, will be able to offer securities by lifting the previous ban on general solicitation and advertising. These funds rely on an exemption to the Securities Act under Rule 506 of Regulation D. In order to claim the exemption, the securities must only be sold to accredited investors.

13. Id. § 101(a) (codified as amended at 15 U.S.C. § 77b(a)(19)).
15. JOBS Act § 105(c) (codified as amended at 15 U.S.C. § 77e(d)).
16. Id. § 106(a) (codified as amended at 15 U.S.C. § 77f(e)).
17. The President’s Working Group on Financial Markets explains:

The term “hedge fund” is commonly used to describe a variety of different types of investment vehicles that share some common characteristics. Although it is not statutorily defined, the term encompasses any pooled investment vehicle that is privately organized, administered by professional money managers, and not widely available to the public.

18. Private equity funds invest in, by definition, private equity. These are

[e]quity securities of companies that have not “gone public” (are not listed on a public exchange). Private equities are generally illiquid and thought of as a long-term investment. As they are not listed on an exchange, any investor wishing to sell securities in private companies must find a buyer in the absence of a marketplace.

21. See 17 C.F.R. § 230.506. This Note will focus mainly on hedge funds rather than all private funds.
22. Id.; see infra note 40 (defining “accredited investor”).
Title III of the Act created a brand new exemption to securities laws by allowing companies to raise money through “crowdfunding” platforms. This is accomplished through websites that allow businesses to raise up to $1 million from a large number of investors. Although each contribution may be small, the Internet allows a business owner to reach an unlimited number of investors, and thus crowdfunding may revolutionize the way small businesses raise capital. The website must register with the SEC as either a broker-dealer or a “funding portal.”

Title IV of the Act amended section 3(b) of the Securities Act by creating a new class of exempted securities for small businesses that are raising a limited amount of capital. Prior to the Act, a similar exemption existed under Regulation A. The new exemption created under the JOBS Act, dubbed Regulation A+, has been viewed as an expansion of Regulation A, although it is technically a new exemption. The JOBS Act increased the amount of money that may be raised in these offerings from $5 million to $50 million. The issuer may rely on general solicitation, and the securities may be freely resold, but the issuer must comply with several requirements, which include providing investors with a simplified offering circular and simplified financial statements.

Titles V and VI amended sections 12(g) and 15(d) of the Exchange Act by raising the threshold of shareholders for mandatory registration. Registration with the SEC is required from companies with over $10 million in assets and over 2000 shareholders, increased from 500. Lastly, Title VII simply instructs the SEC to make information regarding the JOBS Act available.
Act available online and to direct this information towards small businesses and those owned by minorities, women, and veterans.\(^{34}\)

II. BACKGROUND OF THE JOBS ACT'S PROVISIONS AND RESULTANT INVESTOR PROTECTION MECHANISMS

The three provisions of the JOBS Act analyzed here came about for slightly different reasons, but all were passed with the general intent of increasing small businesses' access to capital and increasing employment.\(^{35}\) Although these provisions seek to ease the requirements for certain companies issuing equity, several of the Act’s requirements seek to limit the scope of each provision and safeguard investors.\(^{36}\)

A. TITLE II: PRIVATE FUNDS AND THE LIFTING OF THE BAN ON GENERAL SOLICITATIONS

i. Background and Legislative History

Hedge funds, although not a new concept, have seen substantial growth in recent years.\(^{37}\) This growth, combined with the government’s lack of information regarding their operations,\(^{38}\) led to several proposals in the last decade to regulate the industry.\(^{39}\) For many years hedge funds have been able to avoid registration under the Securities Act by not offering their securities publicly, not advertising or engaging in general solicitation, and only selling to accredited investors.\(^{40}\) Funds can also avoid the requirements of the Investment Company Act of 1940 and the Investment Advisers Act of 1940 by limiting the number of beneficial owners and requiring investors to meet investment minimums and the definition of a “qualified purchaser.”\(^{41}\)

Although much of the commentary on Title II of the JOBS Act focuses on hedge funds, the original legislative intent does not appear to consider

\(^{34}\) Id. § 701.

\(^{35}\) See infra Part II.A–C.

\(^{36}\) Id.

\(^{37}\) PRESIDENT’S WORKING GRP., supra note 17, at 1.


\(^{40}\) STAFF REPORT, supra note 38, at x. “Accredited investor” is defined by Rule 501(a) of the Securities Act. Besides certain institutional investors and insiders of the issuer, a natural person may be accredited if he has a net worth of more than $1 million or has income of more than $200,000 in each of the previous two years and a reasonable expectation of the same income level for the current year. 17 C.F.R. § 230.501(a) (2013).

\(^{41}\) STAFF REPORT, supra note 38, at x.
this sector of the financial industry. The bill was introduced by Representative Kevin McCarthy as the Access to Capital for Job Creators Act, which “would improve capital formation by expanding financing options”—a purpose couched in general terms not unlike the JOBS Act as a whole. The justification for the bill was that, due to the heightened lending standards resulting from the financial crisis, traditional commercial bank loans were increasingly difficult to obtain by small businesses. Congressional testimony of industry experts favored the proposal, asserting that raising capital under the current regulation was too burdensome, as a ban on general solicitation meant that investors needed a preexisting relationship with the issuer. Furthermore, because these investors were required to qualify as accredited, they typically had a bigger appetite for risk and needed fewer protections than less wealthy or sophisticated investors.

Still, a problem remained—although purchasers would need accreditation status, allowing advertising and general solicitation would result in offers being extended to unaccredited investors, who might then mislead the issuer as to their true level of wealth or sophistication. To assuage these concerns, the bill was amended to include a provision directing the SEC to adopt rules requiring “the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors.”

ii. Investor Protection Mechanisms

Despite these safeguards, critics warned that the proposed SEC rules threatened to undermine investor protection. These new rules for hedge funds come at a time when, for many years, proposals have been made to

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45. Id. at 123; but see Pat Huddleson, Keeping Vigilant for Investment Fraud, PHYSICIAN’S MONEY DIG. (Oct. 18, 2011), http://www.physiciansmoneydigest.com/personal-finance/Keeping-Vigilant-for-Investment-Fraud (noting that doctors are often targets of investment fraud because of their high wealth levels and lack of financial expertise).
46. Legislative Proposals Hearing, supra note 44, at 64 (statement of Heath Abshure, Arkansas Securities Commissioner and Chairman of the Corporation Finance Committee of the North American Securities Administration Association).
increase, not decrease, regulation of the hedge fund industry.\textsuperscript{49} There are several valid reasons why regulating hedge funds is not a high priority. First, despite their recent growth, hedge funds remain a relatively small part of the financial sector.\textsuperscript{50} In a 2007 speech, Federal Reserve Chairman Ben Bernanke disagreed with these proposals for increased regulation and argued that the invisible hand of the market would regulate itself.\textsuperscript{51} He noted that “[t]hus far, the market-based approach to the regulation of hedge funds seems to have worked well, although many improvements can still be made.”\textsuperscript{52} This is not to say that hedge funds can never pose systemic risk to the financial system.\textsuperscript{53} In 1998, a hedge fund run by Long Term Capital Management nearly collapsed.\textsuperscript{54} A failure of the fund could have had a broader impact on the already fragile financial markets.\textsuperscript{55} Nine years later, the subprime mortgage crisis led to the near collapse of two hedge funds at Bear Stearns,\textsuperscript{56} which was one factor that led to the firm’s fire sale to JPMorgan eight months later.\textsuperscript{57}

Even if regulators agreed that hedge funds posed too great a risk, increased regulation would pose several problems. First, it is not clear that increased regulation would even be able to contain risk in the industry, or whether it would disrupt the existing market-based discipline.\textsuperscript{58} A balanced proposal is that while highly burdensome regulations may not be in the economy’s best interest, regulations should, at a minimum, try to understand the industry better. This decrease in opaqueness would allow for a more tailored oversight regime. However, hedge funds are notoriously secretive,\textsuperscript{59} and by making more information publicly available, the effect

\begin{itemize}
  \item \textsuperscript{49} See, e.g., Gogoi & Hagenbaugh, supra note 39.
  \item \textsuperscript{50} President’s Working Grp., supra note 17, at 1.
  \item \textsuperscript{52} Id.
  \item \textsuperscript{53} President’s Working Grp., supra note 17, at 2 (“Although individually and as an industry, hedge funds represent a relatively small segment of the market, their impact is greatly magnified by their highly active trading strategies and by the leverage obtained through their use of repurchase agreements and derivative contracts.”).
  \item \textsuperscript{54} Id. at 12–14.
  \item \textsuperscript{55} Id. at 20.
\end{itemize}
may be to decrease funds’ competitive advantage, which again would distort the current laissez-faire environment. Thus, the benefits of hedge funds would be reduced.

Once the disadvantages of increased regulation are understood, the next step is to focus on determining the effects of decreased regulation. Critics to the Act contend that allowing private funds to solicit to the general public will cause unsophisticated investors to be inundated with advertisements and offers for funds, which will lead to increased fraud. However, as mentioned, hedge funds prefer to remain out of the public eye. This aspect of the industry is even more evident as the financial crisis has brought negative attention to the financial sector and the “one percent” of wealthy Americans. For this reason, some commentators have speculated that private funds may not wish to advertise.

Another concern is whether increasing the solicitation opportunities of these private funds will result in larger numbers of investments in such funds as investors divert funds that ordinarily would have been invested in safer vehicles such as mutual funds or tax-qualified accounts such as IRAs or 401(k)s. Private funds are often riskier than traditional funds and have much less liquidity, making it more difficult for investors to access their funds for extended periods of time. However, many hedge funds already have more than enough capital and often must turn away new investors. Additionally, hedge funds are typically only available to accredited

60. See Bernanke, supra note 58 (“If several funds had similar positions, how would authorities avoid giving a competitive advantage to one fund over another in using the information from the database?”).
62. See, e.g., Phil Niles, The JOBS Act: Why It May Mean Nothing for Hedge Funds, FINALTERNATIVES (June 11, 2012, 8:05 AM), http://www.finalalternatives.com/node/20741; see also Schmidt, supra note 59.
67. Niles, supra note 62.
investors, making it unlikely that the average person would have access to these investments.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or the Dodd-Frank Act) is an additional safeguard on the hedge fund industry. As part of the overall effort to regulate hedge funds, or at least to increase their transparency, Dodd-Frank requires that hedge funds now register with the SEC and increases the amount of information reported to the agency. The Act also allows the SEC to conduct audits and collect information on systemic risk.

B. TITLE III: USING CROWDFUNDING PORTALS TO RAISE CAPITAL THROUGH THE INTERNET

i. Background and Legislative History

The JOBS Act, by improving access to capital, addressed a problem present in many small businesses. That is, when raising capital, the cost of compliance with securities regulations may outweigh the benefit of the financing. One proposed solution was crowdfunding:

The concept of crowdfunding finds its root in the broader concept of crowdsourcing, which uses the “crowd” to obtain ideas, feedback and solutions in order to develop corporate activities. In the case of crowdfunding, the objective is to collect money for investment; this is generally done by using social networks, in particular through the Internet (Twitter, Facebook, LinkedIn and different other specialized blogs). In other words, instead of raising the money from a very small group of sophisticated investors, the idea of crowdfunding is to obtain it from a large audience (the “crowd”), where each individual will provide a very small amount.

Although crowdsourcing is attractive to small business startups, the securities laws prior to the JOBS Act did not contain an exemption for such a financing method. Rule 506 of Regulation D, discussed in Part II.A, was not a possibility before the JOBS Act because of the ban on general

68. See supra note 40 (defining “accredited investor”).
70. 15 U.S.C. §§ 80b-2(a), -3(b), -4(b).
71. Id. § 80b-4.
74. Hazen, supra note 25, at 1744–49.
solicitation and advertising.\textsuperscript{75} Even after the Act lifted this ban, the rule requires that all purchasers be accredited investors, and issuers must take reasonable steps to verify such accreditation.\textsuperscript{76} Rules 504 and 505 have similar problems, which include bans on general solicitation, accreditation standards, and a restricted securities status, meaning the securities may not be freely resold by purchasers.\textsuperscript{77} Regulation A, discussed in Part II.C, is another exemption for small businesses that allows for general solicitation.\textsuperscript{78} Although the exemption does not require issuers to complete the full registration process, some financial statements and offering circulars must be filed,\textsuperscript{79} the cost of which may not be conducive for a small startup seeking limited funding.\textsuperscript{80}

ii. Investor Protection Mechanisms

Crowdfunding became explicitly legal through Title III of the JOBS Act.\textsuperscript{81} Several requirements pertaining to funding amounts must be met in order to rely on this exemption. The Act limits the aggregate amount of capital raised through the offering during any twelve-month period to $1 million.\textsuperscript{82} The Act also limits the amount that may be sold to any one investor.\textsuperscript{83} If either the annual income or net worth of the investor is less than $100,000, that investor may only invest up to the greater of $2000 or five percent of his annual income or net worth.\textsuperscript{84} If either the annual income or net worth is greater than $100,000, the investor may not invest more than ten percent of his annual income or net worth, and in no instance may he invest more than $100,000.\textsuperscript{85}

Congress had at least two purposes in drafting the investment limits.\textsuperscript{86} First, the general concept of crowdfunding was a response to the demand of startups and small businesses for which the traditional methods of capital raising were not accessible.\textsuperscript{87} By allowing these companies to seek funding from the “wisdom of the crowd,” businesses could seek small investments


\textsuperscript{77} 17 C.F.R. §§ 230.504–05.

\textsuperscript{78} Id. §§ 230.251–63.

\textsuperscript{79} Id. §§ 230.252–53.

\textsuperscript{80} See infra Part II.C.

\textsuperscript{81} JOBS Act §§ 301–05 (codified as amended at 15 U.S.C. §§ 77d(a)(6), 77d-1, 77r(b)(4), (c)(1), (c)(2)(F), 78c(a)(80), (h), 78l(g)(6), 78o(i)(2)).


\textsuperscript{83} See id. § 77d(a)(6)(B).

\textsuperscript{84} Id. § 77d(a)(6)(B)(i).

\textsuperscript{85} Id. § 77d(a)(6)(B)(ii).


\textsuperscript{87} Id.
from a large number of investors.88 Second, by explicitly limiting the investment amount, Congress limited the exposure and thus the risk borne by any individual investor.89

A further condition requires that the transactions take place through an intermediary designated as a broker or “funding portal,”90 either of which must be registered with the SEC.91 Both the issuer and intermediary are subject to additional requirements.92 For example, an intermediary may not compensate promoters or lead generators for providing identifying information of any potential investor.93 The issuer, in keeping with the overall goal of disclosure and transparency, must register certain information with the SEC pertaining to the identity of the issuer and its officers,94 the financial condition of the company,95 and a description of the nature and purpose of the offering;96 this information must be made available to investors as well.97 The importance of these registrations becomes more apparent due to a private cause of action created by the statute: issuers are liable to investors for any material misstatements or omissions.98

C. TITLE IV: REGULATION A+ OFFERINGS FOR SMALL BUSINESSES

i. Background and Legislative History

Regulation A+ increased the amount of capital available through a limited offering from $5 million to $50 million.99 One of the main reasons for increasing this ceiling was that very few companies were actually using

88. Id.
89. See id.
90. “Funding portal” is a new term defined by section 3(a)(80) of the Exchange Act:

The term “funding portal” means any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to section 4(6) of the Securities Act of 1933 (15 U.S.C. 77d(6)) that does not— (A) offer investment advice or recommendations; (B) solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal; (C) compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; (D) hold, manage, possess, or otherwise handle investor funds or securities; or (E) engage in such other activities as the Commission, by rule, determines appropriate.

91. 15 U.S.C. § 77d-1(a)(1). The broker or funding portal must be registered, not the securities themselves.
92. Id. § 77d-1.
93. Id. § 77d-1(a)(10).
94. Id. § 77d-1(b)(1)(A)–(C).
95. Id. § 77d-1(b)(1)(D).
96. Id. § 77d-1(b)(1)(E).
97. Id. § 77d-1(b)(1).
98. Id. § 77d-1(c).
99. Id. § 77c(b)(2)(A).
the exemption. Although Regulation A is an exemption to the traditional registration process, it still requires that some financial statements and offering circulars be prepared and filed with the SEC, albeit a much less rigorous process than a full public offering. Because of this, the process is sometimes referred to as a “mini-registration.” However, this results in an offering cost which, when combined with the $5 million limit, becomes prohibitively expensive. By some estimates, between three and seven companies completed Regulation A offerings in 2010. Indeed, Congress had this issue in mind previously and has raised the initial exemption of $100,000 several times. The ceiling was raised to $300,000 in 1945, $500,000 in 1972, $2 million in 1978, and $5 million in 1980. The new Regulation A+ contains a similar provision that allows the SEC to review the amount every two years and raise the maximum if necessary.

The purpose behind the original Regulation A exemption, like the purpose behind the JOBS Act, was to grant small businesses easier access to capital. Small businesses are an integral part of the economy, but the current state of the credit markets makes it difficult for many to obtain financing. Regulation A+ lowers many of the barriers to capital raising that were present in its predecessor. The Act raises the cap of the offering from $5 million to $50 million. Further, Regulation A+ securities will be treated as “covered” securities, meaning they will be exempt from state blue sky laws if they are listed on a national exchange or if offers and sales are made to “qualified purchasers.”

103. Id. at 507.
104. H.R. REP. NO. 112-206, at 3 (2011); SEC Advisory Comm. on Small & Emerging Buss., supra note 100.
106. Id. Although Congress authorized the SEC to use the $5 million maximum in 1980, the SEC did not actually raise it to this level until 1992. Id.
108. Frank, supra note 102, at 507.
111. See JOBS Act § 401; 17 C.F.R. § 251–63 (2013).
112. JOBS Act § 401.
113. 15 U.S.C. § 77r(b)(4)(D). “Qualified purchasers” is a term to be defined by the SEC. Id. § 77r(b)(4)(D)(ii).
As with the old Regulation A, the securities may be publicly sold.114 The securities may also be resold freely by the purchaser.115 Another provision included from the old Regulation A allows issuers to “test the waters” by soliciting interest before filing the offering statement.116

ii. Investor Protection Mechanisms

The increased availability of the exemption has led to criticism that fewer requirements for raising capital will lead to an increase in fraud.117 Although many provisions favor issuers, the Act also includes some protections for investors. First, issuers must provide audited financial statements with the offering circulars and must file updated audited financial statements with the SEC annually.118 The SEC can also require the issuers to file and disseminate non-financial information such as a discussion of business operations and corporate governance principals.119 Regulation A only requires unaudited financial statements, and those statements need to be filed once, rather than continuously.120

Second, although the JOBS Act grants certain Regulation A+ offerings an exemption from blue sky laws, the exemption only applies if the securities are listed on a national exchange or sold only to qualified investors;121 therefore, many Regulation A+ offerings will still be subject to state securities laws. The Act also requires that a study be performed on the effect of blue sky laws on Regulation A+ offerings,122 which may affect SEC rulemaking in the future.123

Third, a disqualification rule exists for certain “bad actors.”124 Regulation A has a similar provision under Rule 262, which bars issuers, affiliates, or underwriters who are subject to administrative orders or injunctions involving certain securities laws from utilizing the exemption.125 Certain criminal convictions also prevent a party from using the exemption.126 Regulation A+ directs the SEC to promulgate a rule substantially similar to regulations found in the Dodd-Frank Act, which

114. Id. § 77c(b)(2)(B).
115. Id. § 77c(b)(2)(C).
116. Id. § 77c(b)(2)(E).
119. Id. § 77c(b)(2)(G)(i).
125. 17 C.F.R. § 230.262.
126. Id.
prohibit certain actors from using Rule 506. \(^{127}\) Practitioners have recommended that the SEC amend Rule 262, which applies to Regulation A offerings, to conform to the new rule concerning Regulation A+ offerings. \(^{128}\)

III. INVESTOR PROTECTIONS OUTSIDE THE JOBS ACT

COMMON TO ALL EXEMPTIONS

A. EXTRA-STATUTORY MECHANISMS: NEGOTIATION AND VALUATION IN SMALL BUSINESS INVESTMENTS

In addition to the investor protections built into the JOBS Act, the current investing environment provides several other safeguards. Investing in a small business is usually done through an arm’s-length transaction; investors will do their own due diligence and understand the risks. \(^{129}\)

Indeed, investing in small businesses is inherently risky—a majority of small businesses fail within a few years. \(^{130}\) However, risk is valued into investment: the riskier the proposition, the less investors will be willing to pay for it (through lower share prices for equity investments), and the more protections they will demand (through higher interest rates and other covenants for loans). \(^{131}\) As a result, some companies are choosing to go beyond what the JOBS Act requires. \(^{132}\) Unlike Titles II, III, and IV, which still require SEC rulemaking in order to be implemented, Title I of the JOBS Act went into effect immediately. \(^{133}\) From the time that the Act was


\(^{131}\) The Capital Asset Pricing Model (CAPM) is a theory of modern finance which uses risk and expected return to value an investment. For a discussion of this theory and others, see Samuel C. Thompson, Jr., A Lawyer’s Guide to Modern Valuation Techniques in Mergers and Acquisitions, 21 J. CORP. L. 457, 460 (1996).

\(^{132}\) See Jessica Holzer, Some Firms Shun Looser IPO Rules, WALL ST. J. (Nov. 14, 2012), http://online.wsj.com/article/SB10001424127887324595904578117322881014396.html. Fifty-five eligible companies were used in the calculation. Id.

passed in April 2012 until November of the same year, eighty-five percent of companies who were eligible to qualify as an “emerging growth company” chose not to use the less demanding reporting requirements because the cost savings did not outweigh the negative perception from investors, who would attach a lower valuation to the security.\footnote{Holzer, \emph{supra} note 132.} If investors lack confidence because of a perception of increased fraud, then the cost of capital would actually increase, which in turn would hurt job growth.\footnote{Id. ("[T]he law would have the perverse effect of hurting job growth because it would cause investors to place a lower value on companies that cut back on disclosures. That would, in turn, raise their cost of capital.").} Interestingly, this suggests that the JOBS Act may not achieve its intended purpose.

\section*{B. STATUTORY MECHANISMS UNDER EXISTING SECURITIES LAWS}

Existing securities laws provide some potential protections for investors that remain in effect after the passage of the JOBS Act. Even if a securities offering is exempt from registration requirements, the anti-fraud provisions of the securities laws still apply.\footnote{See, e.g., Harry S. Gerla, \emph{Issuers Raising Capital Directly from Investors: What Disclosure Does Rule 10b-5 Require?}, 28 J. CORP. L. 111, 112 (2002).} However, such protections are not without limitation. The SEC is authorized to bring civil actions seeking injunctions or damages for violations of the securities laws.\footnote{15 U.S.C. § 78u(d) (2012).} However, the resources of the agency are limited, and enforcement actions may not uncover all ongoing violations or deter future offenses.\footnote{Troy A. Paredes, Commissioner, SEC, Remarks at “The SEC Speaks in 2009” (Feb. 6, 2009), available at http://www.sec.gov/news/speech/2009/spch020609tap.htm.} The Securities Act also provides investors with private causes of action under certain circumstances.\footnote{See, e.g., 15 U.S.C. §§ 77k, 77l.} However, the Private Securities Litigation Reform Act of 1995 heightened the pleading standard for some such claimants.\footnote{Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C.).} One private action arises in section 11 of the Securities Act, under which an issuer is liable for an untrue statement or omission of a material fact in a registration statement.\footnote{15 U.S.C. § 77k. Section 11(a) provides:} Purchasers are required to prove neither reliance

\footnote{\textit{Id}.}
on the omission or misstatement nor intent of the issuer. Damages are limited to the difference between the offering price and the price of the securities at the time of the suit. Purchasers also have a cause of action against the underwriter or any other parties who signed the registration statement, though these parties can claim a “due diligence” defense that they had no reason to believe the registration statement had a misstatement or omission. A clear limitation on this cause of action is that only purchasers who acquired a security sold pursuant to a registration statement may bring claims.

Although a registration statement is required for section 11, issuers who sell securities without registering them in violation of the securities laws may face liability under sections 5 and 12(a)(1). Purchasers have a cause of action against a seller who issues a non-exempt security without registering it. Section 12(a)(2) of the Securities Act creates liability for anyone who sells a security through a prospectus containing a material misrepresentation or omission. The definition of “prospectus” is

In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue

enumerated parties, including those who signed the registration statement, directors of the issuer, accountants, and underwriters. Id. § 77k(a).

An exception is that the presumption of reliance is rebutted if the plaintiff acquired the security more than twelve months after the effective date of the registration statement. Id. § 77k(a); see also Todd R. David et al., Heightened Pleading Requirements, Due Diligence, Reliance, Loss Causation, and Truth-On-The-Market—Available Defenses To Claims Under Sections 11 and 12 of the Securities Act of 1933, 11 TRANSACTIONS: TENN. J. BUS. L. 53, 68 (2010).

Any person who—offers or sells a security, whether or not exempted by the provisions of section 3, other than paragraphs (2) and (14) of subsection (a) thereof, by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable, subject to subsection (b), to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the securities.
extremely broad and includes nearly any communication that offers a security for sale. The purchaser must not know of the misstatement or omission at the time of the transaction.

Section 17(a) of the Securities Act is a key antifraud provision making it unlawful “to employ any device, scheme, or artifice to defraud,” “obtain money or property” through misstatements or omissions, or “engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.” Although courts previously found an implied private right of action in section 17(a), that position has become more disfavored. The SEC, however, continues to use this provision.

While the Securities Act and Exchange Act provide a backbone, more recent legislation has added to this body of law. In response to the accounting scandals at Enron and several other companies, the Sarbanes-Oxley Act of 2002 (SOX Act) was passed with the goal of protecting investors by “improving the accuracy and reliability of corporate disclosures.” This law primarily concerns public companies, their board of directors and management, and their accounting firms; thus many small businesses would not be affected. The Dodd-Frank Act, however, affords a more recent and sweeping change of the legal landscape. Dodd-Frank, signed just two years before the JOBS Act, ushered in a new era of financial regulation and undoubtedly increased government oversight of, and regulatory requirements for, companies that affect the financial stability of the United States. These changes include the consolidation and creation of regulatory agencies, consumer protection reforms, and an increased availability of tools for financial crises. Perhaps the JOBS Act was a way to ensure that smaller companies would not be overburdened by the increased regulations of Dodd-Frank. When viewed in this light, the amount of regulation as a whole for capital raisers has increased, not decreased.

Id. § 77l(a)(2).
149. Id. § 77b(a)(10).
150. Id. § 77l(a)(2).
151. Id. § 77q(a).
155. See 15 U.S.C. §§ 7211–20 (establishing the Public Company Accounting Oversight Board); id. §§ 78j-1(g)–(l) (regarding auditors); id. §§ 7241–44 (imposing obligations of corporate responsibility on officers and directors).
158. Id.
In addition to using federal securities laws, purchasers may be able to state a fraud claim under common law. This cause of action differs from state to state and often requires a plaintiff to prove eight or nine elements. However, certain class action securities lawsuits may be preempted by federal law under the Securities Litigation Uniform Standards Act (SLUSA).

IV. THE EFFECT OF THE JOBS ACT AND SUPPLY-SIDE ECONOMICS ON EMPLOYMENT

A. THE EMPLOYMENT SITUATION LEADING UP TO THE JOBS ACT

The American unemployment rate hit 4.4% in October of 2006—the lowest point in a decade. However, the recession officially began on December 1, 2007, and in the spring of 2008, rising unemployment began to shed light on this fact. In October 2008, President Bush signed a $700 billion bailout of the financial system through the Emergency Economic Stabilization Act of 2008, which established the Troubled Asset Relief Program (TARP). President Obama then signed an $831 billion

160. Douglas M. Branson, Securities Litigation In State Courts—Something Old, Something New, Something Borrowed . . . ., 76 WASH. U. L.Q. 509, 512 (1998); see also RESTATEMENT (SECOND) OF TORTS § 531 (1977) (“One who makes a fraudulent misrepresentation is subject to liability to the persons or class of persons whom he intends or has reason to expect to act or to refrain from action in reliance upon the misrepresentation, for pecuniary loss suffered by them through their justifiable reliance in the type of transaction in which he intends or has reason to expect their conduct to be influenced.”).
162. Persons are considered unemployed “if they do not have a job, have actively looked for work in the prior 4 weeks, and are currently available for work.” Labor Force Statistics from the Current Population Survey, U.S. BUREAU LAB. STAT. http://data.bls.gov/timeseries/LNS14000000 (last visited Nov. 17, 2013) [hereinafter Labor Force Statistics]. As a result, the category does not include those who are underemployed or not currently seeking employment.
163. Id. The unemployment rate reached 4.4% again in December 2006, March 2007, and May 2007. Id.
stimulus package known as the American Recovery and Reinvestment Act of 2009. The stimulus included tax cuts, extended unemployment benefits, and direct investments in infrastructure. Despite these efforts, the unemployment rate reached 10% in October 2009 and was 8.1% in April 2012 when the JOBS Act was passed.

**B. DEREGULATION AS A TOOL AGAINST UNEMPLOYMENT**

The stated purpose of passing the JOBS Act, as the title suggests, was to create jobs. The sponsors of the Act contended that allowing small businesses to avoid regulations while raising capital would have the effect of those enterprisers hiring a larger workforce. The assertion that businesses need access to capital is not subject to much debate. A report to the President noted that “[e]conomists have modeled a link between the supply of credit and macroeconomic activity” and that “[c]redit conditions have been shown to affect a variety of specific macroeconomic outcomes, including investment spending, inventories, and economic growth and development.” However, another link in the chain is needed to get from general economic growth to increased employment.

Proponents of the JOBS Act assert that decreasing the amount of regulations that companies face will increase hiring. Instituting deregulation in an attempt to increase economic activity is part of a strategy known as supply-side economics. This approach is achieved mainly through lower marginal tax rates, which in turn increases after-tax returns.
on labor and investment. The increased supply is thought to have a “trickle down” effect. The broader policy mix of supply-side economic theory asserts that, besides lower tax rates, free trade and decreased regulation are key to economic growth. Many economists, however, disagree with the ability of a deregulatory policy to increase economic growth in general and doubt it can create a positive effect on employment specifically.

While it is true that securities regulations create barriers to capital access for small businesses, these enterprises frequently cite to other problems as having a higher priority. In a 2012 survey, small business owners ranked “cost of health insurance” and “uncertainty over economic conditions” as their top two problems, with “unreasonable government regulations” ranked fifth. As a category, tax concerns ranked higher than regulatory concerns, suggesting that taxes are increasingly complex and more costly to deal with than regulations. But lowering taxes may not have the impact on employment that some policy makers expect. The Center on Budget and Policy Priorities noted that “[s]mall business employment rose by an average of 2.3 percent (756,000 jobs) per year during the Clinton years, when tax rates for high-income filers were set at very similar levels to those that would be reinstated under President Obama’s budget.”

However, during the Bush administration, when the tax rates were lower, “employment rose by just 1.0 percent (367,000 jobs).”

Admittedly, while these responses suggest that taxes are more of a priority than regulations, government intrusion clearly still plays a role in decision-making and attempts at growth in small businesses. One reason is that it costs small businesses more per employee to comply with federal regulations than larger firms. Although regulations are a concern of small

175. Id.
180. “Uncertainty over Government Actions” was fourth. Id.
181. See id. at 6.
183. Id.
business owners, statistical analysis suggests that government regulation does not have the effect on employment that the Act’s sponsors claimed. Numbers from the Congressional Budget Office estimate that in 2011, only 0.4% of jobs lost were due to “government regulation/intervention.” Moreover, economists and policy makers, even those who once championed deregulation, have begun to reverse position. Bruce Bartlett, a former economist to the Reagan administration, recently claimed the idea that deregulation would lead to significant job growth is “just nonsense. It’s just made up.”

V. THE POLITICAL ECONOMY: THE RELATIONSHIP BETWEEN SPECIAL INTERESTS AND ECONOMIC THEORY

In the first presidential debate of 2012, President Obama stood by his position that the financial system lacked sufficient control prior to the recession: “Does anybody out there think that the big problem we had is that there was too much oversight and regulation of Wall Street? Because if you do, then Governor Romney is your candidate. But that’s not what I believe.” Yet just six months prior to making this statement, the President signed a JOBS Act that was described as one which was “premised on the dangerous and discredited notion that the way to create jobs is to weaken regulatory protections.” This conundrum can be partially understood by analyzing the various interests that went into the JOBS Act. Although the surface of this analysis seems to point to a balance between access to capital, job creation, and investor protection, several other interests came into play with the passage of the JOBS Act. The Act was as much a creature of politics as economic theory.

188. President Barack Obama & Former Governor Mitt Romney, Presidential Debate at the University of Denver 29 (Oct. 3, 2012), available at http://www.debates.org/modules/Printing/createpdf.php?pageid=111&returnid=111. Governor Romney’s position was that certain regulations needed to be rolled back in order to help small business. In the same debate he stated one part of his five-point plan was to “champion small business. It’s small business that creates the jobs in America, and over the last four years, small business people have decided that America may not be the place to open a new business because new business startups are down to a 30-year low.” Id. at 4.
“Political economy” is defined as “[t]he study and use of how economic theory and methods influences political ideology.” This discipline covers a broad group of competing interests because various individuals and groups are often competing for a finite number of resources. Because competing groups have different interests and yield influence in various ways, there often seems to be a disconnect between economic theory and politics. So what explanations account for the Act’s passage, and which groups benefited?

One possible explanation is that Republicans simply pushed a bill through to further their goal of deregulation. Jesse Rothstein, an economics professor at the University of California, Berkeley, believed that “[i]t’s game playing to try to pretend like they’re doing something” and “they know they have to put up something that has the label ‘job creation’ on it, whether or not it would work.” Republicans pushed a similar package of jobs bills in the months leading up to the 2012 election, and many of these were aimed at reducing environmental regulations, analogous to the securities regulations that were relaxed through the JOBS Act. This suggests that the JOBS Act may have been part of a broader partisan strategy of deregulation.

However, this view may be too cynical and even hints at deceptiveness on the part of politicians. While the two-party system of the American legislative branch often leads to partisan conflict, the role of politics and of special interests is to allow for the representation of parties who hold differing views on the role of government and the extent of free-market capitalism. At the same time, politicians understand the give-and-take nature of negotiations and must often compromise to further their ultimate goals. An inquiry into the different groups served by the JOBS Act and the overall political landscape provides more clues.

191. See id.
194. See id.
196. See, e.g., Donald J. Boudreaux & Dwight R. Lee, Politics as the Art of Confined Compromise, 16 CATO J. 365 (1997).
One such party-in-interest was the labor movement, which—one would think—ordinarily favors laws aimed at increasing employment. However, the nation's largest labor organizations were opposed to the Act's passage.\textsuperscript{197} The American Federation of Labor asked Congress "to set aside the politics of the 1%, the old game of special favors for Wall Street, and turn to the business of real job creation. The labor movement strongly opposes the JOBS Act and any other effort to weaken the Dodd-Frank Act."\textsuperscript{198}

And deceptiveness does not seem present as Republican politicians, for their part, made no effort to disguise their agenda of rolling back regulations imposed by Dodd-Frank.\textsuperscript{199} Thus, as mentioned in Part III.B, perhaps the purpose of this deregulation was to assist small businesses that may be overburdened by costly laws and rules. As outlined in Part IV.B, federal regulations are usually more costly for small businesses because of the economies of scale.\textsuperscript{200}

One particularly noteworthy subset of small businesses is technology startups. As manufacturing jobs continue to be outsourced to emerging economies,\textsuperscript{201} Silicon Valley continues to play an increasingly important role in U.S. economic growth.\textsuperscript{202} But after the recessions of 2001 and 2008, increased regulations that were perhaps unwarranted may have impacted the industry.\textsuperscript{203} The JOBS Act, therefore, may have been an attempt for Congress and Obama to win back the technology sector, which is driven in large part by small start-ups. Even larger technology companies like Google welcomed the new law.\textsuperscript{204}

\begin{itemize}
  \item \textsuperscript{198} Id.
  \item \textsuperscript{200} See supra note 184.
  \item \textsuperscript{203} Eric Alden, Primum Non Nocere: The Impact of Dodd-Frank on Silicon Valley, 8 BERKELEY BUS. L.J. 107, 127 (2011).
\end{itemize}
A reason for this attempt at “winning back” certain sectors of business has to do with the negotiation aspect of politics mentioned above. These events all transpired during an election year. In effect, Obama and his Democratic supporters may also be a beneficiary of the JOBS Act, albeit indirectly.

CONCLUSION

Employment has been at the forefront of political and economic debate as a result of the recent recession. The JOBS Act was passed with the express purpose of increasing employment. As commentators and representatives of various industries assailed the new legislation as dangerous to investor protection, many did not see the simple truth directly in front of them: the act may not fulfill its purpose of creating jobs. Some other areas of the law seem not to add up as well. One example discussed was that while many think allowing hedge funds to no longer face a ban on general solicitation will harm investors, others think the industry will not be affected. Additionally, companies are choosing to go beyond what is necessary when disclosing to investors because they know the entity’s value will increase.

While safeguarding investors is important, it must be balanced against other policy interests. The SEC, in its own mission statement, declares that its purpose is to “protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.” On top of these public policy concerns, unemployment continues to hurt many citizens. As a result, the government should continue efforts to increase employment. However, having too many interests involved with the passage of this law has turned it into what will amount to an unsuccessful attempt at job creation. At the same time, the JOBS Act will likely not harm investors to the extent many commentators believed.

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205. See supra note 196.
206. See supra Part IV.
207. See supra Part II.A.
208. See supra Part III.A.

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BLACKOUT OR BLACKMAIL?
HOW GARBER V. MLB WILL SHED LIGHT
ON MAJOR LEAGUE BASEBALL’S
BROADCASTING CARTEL

INTRODUCTION

Baseball fans across North America are all too familiar with seeing the same message displayed across the screen of their TV, computer, tablet, or other electronic device: “We’re sorry, this game is not available in your area.”¹ Even Bud Selig, Major League Baseball’s longtime commissioner, is not impervious to antiquated and complicated blackout policies that leave millions of baseball fans in the dark while league executives, teams, and media outlets continue to bring in billions of dollars in revenue.² Major League Baseball (MLB or the League) and its member teams can continue to drive up the cost for consumers and prevent fans from watching their favorite teams through anticompetitive, exclusive broadcasting license agreements because baseball is in the unique position of being exempt from antitrust law.³

In 1922, the Supreme Court held in its landmark ruling, Federal Baseball Club of Baltimore v. National League of Professional Base Ball Clubs, that professional baseball is exempt from federal antitrust law.⁴ Nearly a century later, the exemption still stands, largely unchanged, despite Justice Douglas referring to it as “derelict in the stream of the law,”⁵ and Justice Clark stating it “at best was of dubious validity . . . , unrealistic, inconsistent, or illogical.”⁶ As the broad exemption has continued to be upheld by the Supreme Court and various lower courts, so has the League’s ability to limit the broadcasting of live games.⁷ However, more recent jurisprudence in American Needle v. NFL on the application of antitrust law to professional sports has put this

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² Jeff Passan, Selig’s Promise, YAHOO! SPORTS (July 11, 2006), http://sports.yahoo.com/mlb/news?slug=jp-blackouts071106 [hereinafter Passan, Selig’s Promise] (At a 2006 luncheon with the Baseball Writers Association of America, Selig responded to a question about blackout policies by stating, “I don’t understand (blackouts) myself . . . . I get blacked out from some games . . . . I don’t know what to do about it. We’ll figure it out.”).
antitrust exemption in jeopardy. As a result, four fans are taking on the League to challenge these non-competitive agreements in Garber v. MLB.

This Note contends that the Southern District of New York should rule in favor of the Garber plaintiffs in their suit against MLB and should hold that the League’s broadcasting policies unreasonably restrain trade. Part I explores the legal precedent and history of MLB’s antitrust exemption from Federal Baseball, including the Supreme Court’s recent decision in American Needle. Part II describes how the various baseball broadcasting agreements for in- and out-of-market games operate. Part III argues that the Garber plaintiffs should prevail in their suit against the League because the court should apply American Needle to MLB and its member clubs, overturn professional baseball’s antitrust exemption, and hold that the League’s noncompetitive broadcasting policies unreasonably restrain trade in violation of the Sherman Antitrust Act. Finally, Part IV proposes steps that the League can take in future broadcasting procedures, whether or not the Garber plaintiffs are victorious in their suit, for the mutual benefit of the League and fans, as well as to maintain the competitive balance among the MLB clubs.

I. HISTORY OF THE ANTITRUST EXEMPTION

In order to properly understand the issues being raised in Garber, it is necessary to first examine the basis for MLB’s antitrust exemption and its scope under current law. This muddled history can be traced through two distinct periods: the creation and preservation of the exemption through its first fifty years from 1922 to 1972, and a narrowing of the exemption from 1972 to the present through various lower court decisions and federal legislation.


In 1922, the Supreme Court created the League’s exemption from antitrust law in Federal Baseball Club of Baltimore v. National League of Professional Base Ball Clubs. Although the first professional
baseball team, the Cincinnati Red Stockings, played as early as 1869. the League as we know it was not formed until 1903 when the independent American and National Leagues signed the “National Agreement” to work together in furtherance of the sport.

During these early stages of professional baseball, the American and National Leagues were challenged by rival independent leagues, which fought for players, fans, and business. Many of these smaller independent leagues, the most popular of which was the eight-team Federal League, were driven out of business by the more renowned American and National Leagues. In 1915, the American and National Leagues reached a settlement with the Federal League in which some Federal League owners would accept a buyout or be allowed to buy franchises in one of the two major leagues.

The publicly owned Baltimore Terrapins (the Baltfeds) opted out of this settlement, instead initiating the Federal Baseball lawsuit in 1917 against the American and National Leagues. In that case, the plaintiffs alleged under section 4 of the Clayton Act that the defendants “conspir[ed] to destroy its franchise by monopolizing the baseball business and restraining trade therein.” In the brief opinion by Justice Oliver Wendell Holmes—writing on behalf of a unanimous Court—the Supreme Court denied application of federal antitrust law to organized baseball on the grounds that it did not constitute commerce under the scope of congressional authority. The Court specifically stated that the

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13. *Id.* at 186.
14. *Id.* at 185.
15. *Id.* at 186.
16. *Id.* at 189.
17. *Id.* As part of the settlement, the Baltfeds were only offered their “equitable distribution” of the Federal League’s value: a sum of $50,000—a disappointment compared to the Brooklyn franchise’s owner who received a $400,000 buyout. *Id.* In fact, transcripts from the settlement meeting imply that the Baltfeds did not even have a representative present, in part because

[the major leagues did not need to eliminate every franchise in order to hobble their competitor. Moreover, the Baltimore market did not appeal to organized baseball, which had already left the market once in 1903. Charles Comiskey, owner of the White Sox, expressed the view that Baltimore was “a minor league city, and not a hell of a good one at that.”]

*Id.* (quoting Brief on Behalf of Defendants in Error at 155, Fed. Baseball Club of Balt. v. Nat’l League of Prof’l Base Ball Clubs, 259 U.S. 200 (1922) (No. 204)).
18. *Id.* at 190.
“business is giving exhibitions of base ball, which are purely state affairs.”22 First, the Court reasoned that, because of the nature of baseball as a sporting event that is “personal effort, not related to production,” it could not be considered commerce.23 Second, even if baseball games did constitute commerce, according to the Court, transportation of players and equipment across state lines, as well as attendance of fans from out of state, were “a mere incident.”24 As stated more clearly by the Circuit Court, “[n]ot until [the players] come into contact with their opponents on the baseball field and the contest opens does the game come into existence. It is local in its beginning and in its end.”25

By the time the Supreme Court reviewed baseball’s antitrust exemption again in Toolson v. New York Yankees26 thirty-one years later, the way baseball was presented to the public, as well as jurisprudence behind Federal Baseball, had changed significantly.27 Through technological developments in the 1930s and 1940s, baseball games were now being broadcast across state lines using radio and television.28 Furthermore, in the decades following Federal Baseball, Supreme Court jurisprudence on the scope of congressional power had expanded drastically—the Court shifted away from the narrow concepts of interstate commerce in E. C. Knight29 and Hammer v. Dagenhart30 to its more expanded view in United States v. Darby31 and Wickard v. Filburn,32 which rejected the direct/indirect standard of commerce from Dagenhart.33

22. Id. at 208.
23. Id. at 209.
24. Id. at 208–09.
27. Hylton, supra note 3, at 395.
29. United States v. E. C. Knight Co., 156 U.S. 1, 12 (1895) (holding that a sugar manufacturer did not violate the Sherman Act because manufacturing occurred before the goods entered the stream of commerce and, therefore, was only incidentally and indirectly related to commerce).
30. Hammer v. Dagenhart, 247 U.S. 251, 276 (1918) (holding that a law barring child labor in factories was invalid because manufacturing has no direct effect on commerce and, therefore, cannot be regulated by Congress).
31. United States v. Darby, 312 U.S. 100, 118–19 (1941) (holding that some intrastate activities affect interstate commerce and can be regulated by Congress, overruling Dagenhart, and abandoning the “stream of commerce” argument).
32. Wickard v. Filburn, 317 U.S. 111, 123–24 (1942) (holding that a farmer growing extra wheat for personal consumption would have a significant aggregate effect on interstate commerce and rejecting the direct/indirect test from Dagenhart).
33. See Hylton, supra note 3, at 395 (“[T]he 1922 United States Supreme Court decision which had held that baseball was not a form of interstate commerce, had been seriously
Nevertheless, in a one-paragraph, 7-2 opinion, the Supreme Court found in Toolson that baseball’s antitrust exemption should be upheld. Because Congress had not done anything to alter the decision of the Supreme Court in Federal Baseball, “[t]he business has thus been left for thirty years to develop, on the understanding that it was not subject to antitrust legislation.” The Toolson Court then held that, because over thirty years had passed since the Court’s decision in Federal Baseball, and no legislation was passed to remove the judicially created exemption (even though it was not enumerated in the Sherman Antitrust Act in the first place), “Congress had no intention of including the business of baseball within the scope of the federal antitrust laws.”

This last section of the opinion is significant because it effectively changed the core of the Court’s holding in Federal Baseball. Instead of saying that baseball was not part of interstate commerce, and thus could not be regulated by Congress, the Toolson Court held that it was never the intent of Congress to regulate baseball through the Sherman Act at all. In fact, despite stating that the opinion was based almost completely on the opinion of Federal Baseball, the Court in 1922 did not discuss congressional intent at all, prompting one critic to call the Toolson opinion “the greatest bait-and-switch scheme in the history of the Supreme Court.”

In spite of the Supreme Court’s preservation of the exemption on completely different grounds, the Court continued to sustain organized baseball’s antitrust exemption over the next several decades. During this time, the Court considered four separate cases that discussed and solidified the antitrust exemption without involving organized baseball at all. In the 1955 case, United States v. Shubert, the Court considered an antitrust suit brought against a theater company and held that the Toolson decision was a “narrow application of the rule of stare decisis.” However, the Supreme Court did not just refuse to apply Toolson to non-sporting events. Over the next sixteen years the Court

35. Id.
36. Id.
37. Id.
38. See Hylton, supra note 3, at 397.
40. Toolson, 346 U.S. at 357.
42. Id. at 571–73.
43. Id.
45. Grow, supra note 10, at 571–73.
refused to extend the exemption to boxing, \textsuperscript{46} football, \textsuperscript{47} and basketball, \textsuperscript{48} and thus continued to hold that it was only baseball that received this preferred status. In fact, despite stating in \textit{Radovich v. NFL} that the \textit{Federal Baseball} holding “at best was of dubious validity,” and was “unrealistic, inconsistent, or illogical,”\textsuperscript{49} the Court maintained its puzzling position and continued to uphold baseball’s antitrust status.\textsuperscript{50}

The last time the Supreme Court specifically addressed baseball’s exemption was in the 1972 case, \textit{Flood v. Kuhn}.\textsuperscript{51} Curt Flood, an all-star outfielder who earned success while playing for the St. Louis Cardinals for twelve seasons, was traded to the Philadelphia Phillies in 1969 without any type of notice.\textsuperscript{52} Disappointed about the trade, he unsuccessfully appealed to the Commissioner of Baseball, arguing that he should be allowed to try and strike his own bargain with a major league team of his choosing as a free agent.\textsuperscript{53} Although today the ability for athletes to form their own contracts with teams as a free agent is commonplace, at that time baseball operated under the “reserve clause” system, where players’ rights were kept by the team with which they had been playing when their original contract expired.\textsuperscript{54} As a result, Flood brought a suit against the League, charging violations of federal antitrust law, civil rights statutes, and the Thirteenth Amendment’s prohibition of involuntary servitude.\textsuperscript{55}

Following Justice Blackmun’s sweeping glorification of baseball in the opinion’s introduction,\textsuperscript{56} the Court fully conceded that “[p]rofessional baseball is a business and it is engaged in interstate commerce.”\textsuperscript{57} Nevertheless, the Court stubbornly upheld baseball’s exemption again by stating:

\begin{quote}
We continue to be loath, 50 years after \textit{Federal Baseball} and almost two decades after \textit{Toolson}, to overturn those cases judicially when
\end{quote}

\begin{thebibliography}{9}
\bibitem{46} United States v. Int’l Boxing Club, 348 U.S. 236, 244 (1955).
\bibitem{48} Haywood v. NBA, 401 U.S. 1204, 1205–06 (1971).
\bibitem{49} \textit{Radovich}, 352 U.S. at 450, 452.
\bibitem{50} \textit{Id.} at 453.
\bibitem{52} \textit{Id.} at 265.
\bibitem{53} \textit{Id.}
\bibitem{55} \textit{Flood}, 407 U.S. at 265–66.
\bibitem{56} Justice Blackmun begins his opinion with a look back at the history of baseball, including information about the 1869 Cincinnati Red Stockings, who had only one Cincinnatian on the roster and traveled over 11,000 miles that season. \textit{Id.} at 260–62. He then goes on to list over eighty former players, reference works about sports such as \textit{Casey at the Bat}, refer to baseball as the “national pastime;” and cite from the lower court’s opinion that “[t]he game is on higher ground; it behooves every one to keep it there.” \textit{Id.} at 260–67 (citing Flood v. Kuhn, 309 F. Supp. 793, 797 (S.D.N.Y. 1970)).
\bibitem{57} \textit{Id.} at 282.
\end{thebibliography}
Congress, by its positive inaction, has allowed those decisions to stand for so long and, far beyond mere inference and implication, has clearly evinced a desire not to disapprove them legislatively. . . . If there is any inconsistency or illogic in all this, it is an inconsistency and illogic of long standing that is to be remedied by the Congress and not by this Court. 58

The crux of Justice Blackmun’s holding was that even though the precedent from *Federal Baseball* was an “anomaly” and an “aberration,” organized baseball had grown and flourished for so many decades because of its reliance on this antitrust exemption.59 As a result, the Court was concerned with retroactivity problems and believed that Congress would be the best forum to make any adjustments.60

**B. 1972–PRESENT: LOWER COURT LIMITS ON THE SCOPE OF BASEBALL’S EXEMPTION**

Since the ruling came down in 1972, the Court’s decision in *Flood* has been highly criticized.61 As a result, the years following this decision were marked primarily by a rolling back of the scope of baseball’s exemption through judicial action and legislation.62

The most notable area where baseball’s antitrust status began to decline was in regard to labor.63 The *Flood* decision not only raised awareness to the public about the reserve clause, but also ignited the players to take action.64 In 1975, players Andy Messersmith and Dave McNally argued that, under the reserve clause, they were free to negotiate their own contracts with other teams because neither of them had signed a contract during that year.65 Messersmith and McNally, supported by the MLB Players’ Association, were able to convince baseball’s arbitrator, Peter Seitz, that the reserve clause should be

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58. *Id.* at 283–84.
59. *Id.* at 282–83.
60. *Id.*
61. William N. Eskridge, Jr., *Overruling Statutory Precedents*, 76 GEO. L.J. 1361, 1381 (1988) (“*Flood v. Kuhn* is an almost comical adherence to the strict rule against overruling statutory precedents, particularly considering that the Sherman Act has developed essentially through a common law process.”); David Greenberg, *Baseball’s Con Game: How Did America’s Pastime Get an Antitrust Exemption?*, SLATE (July 19, 2002, 10:36 AM), http://www.slate.com/articles/news_and_politics/history_lesson/2002/07/baseball_con_game.html (“The opinion—for which Blackmun would long be ridiculed—including a juvenile, rhapsodic ode to the glories of the national pastime, sprinkled with comments about legendary ballplayers and references to the doggerel poem “Casey at the Bat.””).
63. *Id.* at 575–76.
overturned. The decision was upheld by the Eighth Circuit one year later, effectively ending the reserve clause system and allowing players to act as free agents when their contracts expired.

Over twenty years later, Congress finally took action by passing the Curt Flood Act of 1998 (the Curt Flood Act)—one year after Flood’s death. Under this law, Congress reacted to Flood v. Kuhn and designated that, at least in the limited area of labor, baseball was not immune to antitrust laws. In doing so, Congress declared that employment of professional players is subject to antitrust law “to the same extent such conduct, acts, practices, or agreements would be subject to the antitrust laws if engaged in by persons in any other professional sports business affecting interstate commerce.” However, section 3 of the Curt Flood Act specifically limited these changes from affecting minor league players, the relationship between major and minor league teams, franchise expansion and relocation, ownership issues, broadcasting, and the employment of umpires.

This act of Congress has been interpreted many ways, with some seeing it as an endorsement of the Court’s precedent thus far on antitrust; others deem Congress’s actions as mere indifference. To make matters more confusing, the Curt Flood Act specifically says that “[n]othing in this section shall be construed to affect the application to organized professional baseball of the nonstatutory labor exemption from the antitrust laws.” During deliberation over the bill in Congress, Senate co-sponsors Orrin Hatch and Patrick Leahy stated that the intention of the Act was “to have no effect other than to clarify the status of major league players under the antitrust laws. With regard to all other context or other persons or entities, the law will be the same after passage of the Act as it is today.” Therefore, the Act largely left the League’s antitrust exemption intact.

66. Id.
67. Id.
69. Acocella, supra note 64.
70. Grow, supra note 10, at 575–76.
72. Id.
73. Grow, supra note 10, at 576.
During floor debate on the Curt Flood Act, Senator Paul Wellstone was concerned that passing the Act would have a chilling effect on decisions from lower courts, including then-pending litigation in the Senator’s home state of Minnesota, which held a more limited view of the antitrust exemption. Indeed, sixteen years before debate on the Curt Flood Act, a federal district court in Texas considered *Henderson Broadcasting Corp. v. Houston Sports Ass’n.* In that case, a local radio station that broadcasted baseball games for the Houston Astros sued the owner of the team. The station contend that, because the team cancelled their broadcast contract and gave exclusive broadcast rights to a competing station, it had violated the Sherman Act and state antitrust law. The franchise’s owner moved to dismiss the case on the basis of the antitrust exemption laid out in the *Federal Baseball* trilogy. The court denied the dismissal and instead relied on the narrow “unique characteristics and needs” standard that the Supreme Court articulated in *Flood.* The court went on to say:

The fact that interstate broadcasting has on the one hand subjected other professional sports to the antitrust laws, but has not on the other hand affected the baseball exemption, is perplexing. Radio broadcasting is not a part of the sport in the way in which players, umpires, the league structure and the reserve system are.

Ten years later, the Southern District of New York also interpreted the Supreme Court precedent in *Flood* as limiting the scope of the antitrust exemption solely to baseball’s “unique characteristics and needs.” However, lower courts have disagreed as to what aspects of baseball were included in this standard.

Notably, in 1993, the Eastern District of Pennsylvania considered the case *Piazza v. MLB.* Here, the League thwarted two Pennsylvania businessmen, as part of a larger partnership, in their attempt to buy the San Francisco Giants franchise for $115 million and relocate the team to a stadium in St. Petersburg, Florida. The League did not approve the

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78. Id. at 264–65.
79. Id. at 264.
80. Id. at 265.
81. Id. at 268–69.
82. Id.
86. Id. at 422–23.
sale, claiming that there were concerns about the financial backgrounds of the businessmen, and sold the team instead for $100 million to another investor who agreed to keep the team in San Francisco. Among the many claims brought by the plaintiffs was a claim of violation of the Sherman Antitrust Act based on the League’s “direct and indirect restraints on the purchase, sale, transfer, relocation of, and competition for such teams.” The League moved to dismiss the suit because of their antitrust exemption under Federal Baseball, Toolson, and Flood. The court, however, denied the League’s motion on the grounds that the Supreme Court precedent on baseball’s antitrust exemption was limited to cases that dealt with the reserve clause.

The Piazza court was not alone in holding that the exemption was limited to the reserve clause. Over the next two years, Florida state courts reached similar decisions on the same issue discussed in Piazza regarding the relocation of a franchise to Tampa Bay. In the 1994 case Butterworth v. National League, the Florida Supreme Court not only reached the same decision but was extremely clear in doing so, stating specifically, “[W]e find that baseball’s antitrust exemption extends only to the reserve system.” One year later, in Morsani v. MLB, plaintiffs filed an antitrust suit against the League for again thwarting their plans to have a baseball franchise in Tampa Bay. Here, the court upheld the Butterworth decision and also ruled that the antitrust exemption was limited to the reserve clause.

What is clear, however, is that, consistent with the standard articulated in Henderson Broadcasting, federal courts have not applied the baseball exemption to cases involving baseball entities and licensing with third parties. In 1972, the Northern District of California applied federal antitrust law to assess a contract between the Oakland Athletics and a concessions company. In 1981, about one year before Henderson Broadcasting, the Third Circuit applied antitrust law to a suit regarding

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87. Id. The League expressed concerns about “out-of-state money” and that the “Pennsylvania People” had “dropped out.” Id. at 422. The two plaintiffs, Vincent Piazza and Vincent Tirendi, were the only investors from Pennsylvania, and they believed that the League’s comments, along with the fact that they were both of Italian descent, gave the implication that they had some association with organized crime. Id. at 422–23.

88. Id. at 424.

89. Id. at 433.

90. Id. at 438; cf. Charles O. Finley & Co. v. Kuhn, 569 F.2d 527, 537 (7th Cir. 1978), cert. denied, 439 U.S. 876 (1978).

91. Grow, supra note 10, at 585–89.


93. Id. at 1022.


95. Id. at 655.

licensing agreements between the players’ union and a baseball card manufacturer.\textsuperscript{97} Three years later, the Eastern District of New York applied antitrust law to evaluate a broadcast licensing contract between Cablevision and the two New York professional baseball teams (as well as other New York professional sports teams), eventually dismissing the claims because the plaintiff (a competing cable company) failed to show injury as a result of these agreements.\textsuperscript{98} In a more recent decision, the Second Circuit evaluated the case \textit{MLB Properties v. Salvino}, where a stuffed animal manufacturer brought an antitrust suit against the League in response to a cease-and-desist letter for the unlicensed use of MLB Club logos.\textsuperscript{99} The League did not even raise the antitrust exemption as a defense, instead moving for judgment on the merits to avoid having the exemption reviewed in court and running the risk of losing it altogether.\textsuperscript{100}

In contrast, federal courts have readily applied the antitrust exemption in cases that fall more squarely within the “business of baseball,” such as those involving league structure and relocation of franchises. In 1974, citing \textit{Flood}, the Ninth Circuit upheld the lower court’s dismissal of an antitrust claim against the League by the owner of a minor league team in Portland who wanted compensation for the League’s expansion into the team’s exclusive territory.\textsuperscript{101} In 1982, the Eleventh Circuit held that the League’s player assignment and franchise location system “plainly concerns matters that are an integral part of the business of baseball” and upheld the exemption.\textsuperscript{102} Two subsequent federal court decisions regarding franchise relocation, \textit{New Orleans Pelicans Baseball v. National Ass’n of Professional Baseball Leagues} and \textit{MLB v. Crist}, also upheld the exemption on the same grounds.\textsuperscript{103} Most recently, in \textit{City of San José v. Office of the Commissioner of Baseball}, an antitrust claim was brought against the League for rejecting relocation of the Oakland Athletics to San José, California.\textsuperscript{104} Although

\textsuperscript{101} Portland Baseball Club, Inc. v. Kuhn, 491 F.2d 1101, 1103 (9th Cir. 1974).
\textsuperscript{102} Prof’l Baseball Sch. & Clubs, Inc. v. Kuhn, 693 F.2d 1085, 1086 (11th Cir. 1982).
Judge Whyte admitted that “[t]he exemption is an ‘aberration’ that makes little sense given the heavily interstate nature of the ‘business of baseball’ today,” he still dismissed the antitrust claim, holding that “[t]he alleged interference with a baseball club’s relocation efforts presents an issue of league structure that is ‘integral’ to the business of baseball, and thus falls squarely within the exemption.”105 The court’s decision in Piazza, the only franchise location case in which the exemption was not upheld, was explicitly rejected in both the New Orleans Pelicans and San José decisions.106

C. 2010: AMERICAN NEEDLE v. NFL

In 2010, the Supreme Court issued a landmark decision in American Needle v. NFL that could put baseball’s unique antitrust position in jeopardy.107 The dispute arose when National Football League Properties (NFLP)—the organization formed by teams in the National Football League (NFL) to market and license their intellectual property and merchandise—granted an exclusive ten-year license to Reebok to “manufacture and sell trademarked headwear for all 32 teams.”108 American Needle, a headwear manufacturer, designer, and dealer,109 enjoyed the benefit of a non-exclusive license with the NFL until 2000.110 That year, the company filed a suit against the NFL, its member teams, NFLP, and Reebok for violation of section 1 of the Sherman Act111 because the license to Reebok effectively shut down this portion of their business.112

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106. New Orleans Pelicans, 1994 WL 631144, at *8–9 (“This Court cannot accept the cramped view of Flood that Piazza takes.”); San José Order, supra note 104, at *10 (“The court disagrees with the Eastern District of Pennsylvania’s opinion in Piazza that Federal Baseball, Toolson and Flood can be limited to the reserve clause because the reserve clause is never referenced in any of those cases as part of the Court’s holdings.”).


108. Id. at 187.


In defending its actions, the NFL relied on the Supreme Court’s decision in *Copperweld Corp. v. Independence Tube Corp.*113 and argued that because the thirty-two individual NFL teams acted as a single entity for the same common interests of the whole league, they were therefore unable to violate antitrust laws.114 The basis of this argument arose from Justice Rehnquist’s dissent from a denial of certiorari in the case *North American Soccer League v. NFL*, arguing that sports leagues do not compete with themselves and instead compete with “other forms of entertainment.”115 This framework was picked up by the Seventh Circuit decision, *Chicago Professional Sports Ltd. Partnership v. NBA*, holding that sports leagues operate as a single entity because of the need to cooperate in the competition and scheduling of games.116

After the lower courts accepted this argument,117 American Needle appealed the case to the Supreme Court, sought a reversal of the lower courts’ decisions, and petitioned the Court to hold that antitrust law applies to all concerted actions of the NFL’s teams rather than just licensing agreements.118 The respondents—as well as the National Basketball Association (NBA) and National Hockey League (NHL)—welcomed this petition, since prevailing in the suit would have allowed the NFL to act as a single entity and be exempt from antitrust laws in all of its actions.119

In the end, American Needle succeeded in their suit, but the Supreme Court’s unanimous decision did not broaden its holding in accordance with the requests of the parties in their respective appeals.120 First, the Court rejected the NFL’s single entity argument from *Copperweld Corp.* and held that

> [t]he NFL teams do not possess either the unitary decisionmaking quality or the single aggregation of economic power characteristic of independent action. Each of the teams is a substantial, independently owned, and independently managed business . . . . The teams compete with one another, not only on the playing field, but to attract fans, for

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113. *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752 (1984) (holding that a parent company and its wholly owned subsidiary are incapable of conspiring, even though they are separately incorporated, because they act as a single entity).
117. *Am. Needle, Inc. v. NFL*, 538 F.3d 736, 743–44 (7th Cir. 2008) (“Simply put, nothing in § 1 prohibits the NFL teams from cooperating so the league can compete against other entertainment providers.”).
119. *Mozes & Glicksman, supra* note 100, at 286.
gate receipts and for contracts with managerial and playing personnel.\textsuperscript{121}

Second, the Court rejected the argument that there was no antitrust violation because the teams granted the exclusive license under the legally separate entity of NFLP, opining that an organization cannot evade antitrust law by simply operating under a different name.\textsuperscript{122} The third argument put forth by the NFL stated that it operated as a joint venture, since no team could fully operate without cooperation with the other teams in the league.\textsuperscript{123} The Court quickly dispatched this argument because although “participation of others is necessary” in a joint venture, parties’ actions can still violate section 1 of the Sherman Act when their interests in a joint venture differ from the interests of the firm as a whole.\textsuperscript{124}

The limitations in the Supreme Court’s opinion—in opposition to the broad arguments put forth by the parties—are particularly relevant in this third point. The Court held that the exclusive licensing of intellectual property at issue in this case constituted illegal concerted activity under section 1 of the Sherman Act.\textsuperscript{125} However, it also conceded parts of the NFL’s argument that, in order for it to be economically successful, teams need to cooperate without being “trapped by antitrust law.”\textsuperscript{126} The Court went on to say that “the interest in maintaining a competitive balance among athletic teams is legitimate and important,”\textsuperscript{127} and as such it is necessary to have cooperation between teams in some areas—including production and scheduling of games—in order for the NFL to operate effectively.\textsuperscript{128} Although this may suggest that sports leagues and teams can engage in some collective decisions in order for the league as a whole to be successful and profitable, the Court did not indicate, other than the two limited areas of production and scheduling of games that were specifically mentioned,\textsuperscript{129} where sports leagues and teams could cooperate without regard to antitrust laws.

\textsuperscript{121} Id. at 196–97.
\textsuperscript{122} Id. at 197.
\textsuperscript{123} Id. at 198.
\textsuperscript{124} Id. at 199–200.
\textsuperscript{125} Id. at 199–202.
\textsuperscript{126} Id. at 202.
\textsuperscript{127} Id. at 204 (internal quotation marks omitted) (citing NCAA v. Board of Regents of the Univ. of Okla., 468 U.S. 85, 117 (1984)).
\textsuperscript{128} Id. at 202.
\textsuperscript{129} Id.
II. MAJOR LEAGUE BASEBALL’S BROADCASTING POLICIES

The current broadcasting procedures of the League are as intricate and confusing as they are archaic. To fully understand the issue at the heart of Garber, it is also necessary to break down MLB’s different broadcasting concepts regarding team territorial rights, in-market games, out-of-market games, and blackout agreements.

A. TEAM TERRITORIAL RIGHTS

The anticompetitive broadcasting policies alleged by the plaintiffs in Garber are manifested through both cable and Internet broadcasts by using the League’s “demarcated territories.” The League developed these territorial-rights rules over forty years ago in order to protect a team’s marketing area, and they were based on the purported local fan base for each MLB team. For example, most of New England is currently listed in the Boston Red Sox market, and much of the Pacific Northwest is part of the Seattle Mariners market.

Each of these territories is used to determine what games are designated as “in-market” or “out-of-market” broadcasts based on what team is playing and where the consumer is located. A fan who lives in Seattle and is trying to watch the Mariners—regardless of whether they were actually playing in Seattle or in some other city—would be in-market. However that same fan would be out-of-market if he tried to watch the San Francisco Giants play the Los Angeles Dodgers. Although some territories are only claimed by one MLB team, there is a great deal of overlap—some territories have up to six teams that are in-market. Both in-market and out-of-market games, as well as the fans who watch them, are affected by the anticompetitive broadcasting practices that MLB employs. Therefore, the plaintiffs in Garber address both types of baseball broadcasts in their complaint.

130. Passan, Blackout Problem, supra note 7.
131. Id.
132. Passan, Selig’s Promise, supra note 2.
134. Passan, Blackout Problem, supra note 7.
136. Id.
137. Id.
138. Passan, Blackout Problem, supra note 7.
139. Garber Complaint, supra note 9, at 23–34.
B. IN-MARKET BROADCASTING

First, the Garber complaint discusses the anticompetitive exclusive license agreements for in-market broadcasts. For most in-market games, MLB teams enter into exclusive broadcasting agreements with Regional Sports Networks (RSNs) such as Comcast Sportsnet Chicago, which broadcasts White Sox and Cubs games, or Yankees Entertainment and Sports (YES) Networks, which broadcasts Yankees games. These exclusive agreements are meant to “divide the market geographically, permitting only the video presentations of a local team’s television partner to be shown in that team’s ‘exclusive territory.’” In doing so, these RSNs have the exclusive right to broadcast games in their designated territory and do not have to be concerned with other broadcasting networks encroaching on their target audience. As a result, consumers who are in-market do not have access to games broadcast by the RSN of another territory and need to purchase out-of-market packages in order to watch these games.

C. OUT-OF-MARKET BROADCASTING

The second aspect of the League’s noncompetitive policies that are alleged by the Garber plaintiffs surrounds the broadcasting of out-of-market live baseball games. As discussed above, the RSNs carry only the local teams that are included within their territorial areas and agree with other sports networks not to broadcast games of other teams. Therefore, consumers who are out-of-market and wish to watch their favorite teams—with a few exceptions—are required to purchase specific “out-of-market packages.”

Currently, there are only two such packages available, both of which are controlled by the League. The first offers a paid subscription to MLB.tv that is streamed on the Internet and provided directly from the League. For the 2013 season, a subscription to the MLB.tv Premium package cost $129.99 for the year, while the basic MLB.tv package cost

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140. Id. at 23.
141. Id. at 15, 24.
142. Id. at 24.
143. Id. at 63. Each team has a designated RSN as their television partner, and this partner has an exclusive monopoly over one team’s games in that territory, except for the cities that have two different teams. Id. Only one out of these four two-team cities—New York City—has two independent RSNs that broadcast baseball games. Id.
144. Id. at 27.
145. Id. at 27–31.
146. Id. at 15, 24.
147. Id. at 27. Consumers do not need to purchase out-of-market packages for nationally broadcasted games. See Blackouts FAQ, supra note 135.
148. Garber Complaint, supra note 9, at 27.
149. Id.
$109.99 yearly. However, the League requires customers to purchase a premium MLB.tv subscription, instead of the basic package, in order to watch live games on mobile devices. The second option is the MLB Extra Innings package, a premium television subscription offered only through cable and satellite distributors. In 2013, DirectTV offered the MLB Extra Innings package for a fee of $139.96 per half season, amounting to $279.92 for the full season.

Yet, despite advertisements that claim out-of-market packages offer “every game . . . everywhere,” or “your season ticket to every MLB game,” these subscriptions are subject to blackout restrictions that prevent customers from watching certain games. The blackout agreements take two different forms: national and territorial blackouts. National blackouts prevent MLB.tv and MLB Extra Innings customers from watching games where the League has licensed exclusive broadcasting rights to national networks, such as the Entertainment and Sports Programming Network (ESPN) and Fox. National broadcasting blackouts occur for any Saturday game starting within three hours before or after a nationally broadcasted game on Fox, any Sunday games beginning after 5:00 PM EST, as well as any other games broadcast on national networks, such as the All-Star Game and postseason games. However, an Internet subscription for postseason games (with the exception of the World Series and National League Championship Series) is available from the League’s postseason.tv

151. Mobile FAQ, MLB.COM, http://mlb.mlb.com/mlb/help/faq_alerts.jsp?c_id=mlb# (last visited Nov. 17, 2013) (“If you purchased MLB.TV at MLB.com and you cannot access At Bat Premium features when accessing Subscriber Login with your MLB.com credentials, you likely purchased MLB.TV Basic, which does not include At Bat Premium access.”).
152. Garber Complaint, supra note 9, at 27.
156. Blackouts FAQ, supra note 135.
157. Id.
159. Blackouts FAQ, supra note 135.
package for a fee of $4.99 for customers in the United States and Canada and $24.99 for all other customers.\footnote{160}

Territorial blackouts are more common and are based on the territorial rights restrictions for RSNs.\footnote{161} For these types of restrictions, “live games will be blacked out in each applicable Club’s home television territory, regardless of whether that Club is playing at home or away.”\footnote{162} This means that, using the same hypothetical fan from Seattle, he or she could watch any televised baseball game, so long as the Seattle Mariners are not one of the teams playing, regardless of where the game is held.\footnote{163} For these games, fans have to subscribe to in-market packages through their local cable provider to watch the game on the local RSNs.\footnote{164}

**III. THE CASE FOR GARBER V. MLB**

Against this backdrop of baseball’s antitrust exemption and the League’s complex broadcasting policies, the U.S. District Court for the Southern District of New York will consider *Garber v. MLB*.\footnote{165} The complaint was filed as a class action by two different classes of plaintiffs, both of which were allegedly charged supra-competitive prices and encountered unreasonable blackout restrictions because of baseball’s antitrust exemption: (1) a television class for those who purchased a cable package through Comcast, DirectTV, or their subsidiaries in order to watch live baseball games within the past four years and (2) an Internet class who purchased a subscription to watch live games through MLB.tv within the past four years.\footnote{166}

The four plaintiffs in the case who represent these two different classes brought antitrust actions for anticompetitive broadcasting practices under sections 1 and 2 of the Sherman Act against the Commissioner of Baseball, the League itself, nine of the thirty individual baseball teams,\footnote{167} and several broadcasting companies.

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\footnote{162}{Blackouts FAQ, supra note 135.}
\footnote{163}{See Blackout Map, supra note 133.}
\footnote{164}{Brown, supra note 161.}
\footnote{165}{Garber Complaint, supra note 9; Laumann v. NHL, 907 F. Supp. 2d 465, 471 (S.D.N.Y. 2012) (The *Garber* case has been consolidated with a similar class-action antitrust lawsuit against the NHL involving many of the same plaintiffs.).}
\footnote{166}{Garber Complaint, supra note 9, at 18–19.}
\footnote{167}{Id. at 13–14. Of the thirty MLB teams, the *Garber* complaint only lists the following nine teams as defendants: Oakland Athletics, Seattle Mariners, Chicago Cubs, Chicago White Sox, Colorado Rockies, New York Yankees, Philadelphia Phillies, Pittsburgh Pirates, and San Francisco Giants. Id. at 10–11.}
including Comcast, DirectTV, Fox Sports Net, Turner Broadcast System (TBS), and ESPN.168 The Sherman Act makes unlawful “[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations.”169 The Garber complaint alleges that the broadcasting agreements of the League are in violation of the Act because of the League’s anticompetitive agreements, blackout policies, and supracompetitive prices.170 In pursuing this action, the plaintiffs hope to receive damages and injunctive relief in order to reclaim the excessive costs of purchasing cable and Internet broadcasting packages, as well as prevent the defendants from furthering any anticompetitive broadcasting policies.171

On December 5, 2012, U.S. District Judge Shira Scheindlin rejected the League’s motion to dismiss against the Garber plaintiffs, stating that the plaintiffs have “plausibly alleged” that they have been harmed by the League’s anticompetitive broadcasting policies.172 In the opinion, Judge Scheindlin held that “[m]aking all games available as part of a package, while it may increase output overall, does not, as a matter of law, eliminate the harm to competition wrought by preventing the individual teams from competing to sell their games outside their home territories in the first place.”173

The Southern District of New York should ultimately rule in favor of the plaintiffs in deciding this case for two reasons. First, after the Supreme Court’s decision in American Needle, baseball’s antitrust exemption should no longer apply or should be narrowed such that it does not include broadcasting of professional baseball games.174 Second, the League’s broadcasting procedures unreasonably restrain trade in violation of the Sherman Antitrust Act.175 As a result of these anticompetitive actions, consumers and fans of baseball pay supracompetitive prices for cable and Internet subscriptions, undergo unfair blackout policies, and subscribe to excessive amounts of broadcasts in order to watch their favorite in-market and out-of-market teams. Accordingly, the League should discontinue anticompetitive

168. Id. at 13–17.
170. Garber Complaint, supra note 9, at 2.
171. Id. at 40–41.
172. Laumann v. NHL, 907 F. Supp. 2d 465, 491–92 (S.D.N.Y. 2012) (The court rejected the plaintiffs’ section 2 claim against the RSN and Multichannel Video Programming Distributor (MVPD) defendants for failure to allege any monopoly power on the part of these defendants, but the section 2 claims against the NHL and MLB were not dismissed.).
173. Id.
174. Mozes & Glicksman, supra note 100, at 288–95.
broadcasting policies and allow fans to subscribe to more targeted viewing packages for the mutual benefit of fans and MLB.

A. REMOVAL OF BASEBALL’S ANTITRUST EXEMPTION AFTER AMERICAN NEEDLE

The Supreme Court’s rejection of the NFL’s single entity defense in American Needle has put the antitrust exemption of professional baseball in jeopardy and is likely one reason why, “according to a number of sources, the league is taking [the Garber case] very seriously.” The antitrust exemption from Federal Baseball was twice upheld by the Supreme Court on the basis of stare decisis. Although the Court’s decision in American Needle did not involve baseball, its holding does prevent future courts from simply hanging their hat on stare decisis when reviewing challenges to the League’s antitrust exemption. Furthermore, the Supreme Court’s holding that baseball did not constitute interstate commerce, which created the exemption in the first place, is no longer true—it can be argued it never was—as the Court admitted in Flood.

This is not to say that the League should be prevented from engaging in anticompetitive measures entirely. Indeed, the Court conceded in American Needle that sports leagues are allowed some degree of cooperation with one another in order to schedule and hold games. However, in terms of licensing, a court presumably would not be so lenient. In fact, the League likely assumed this would be the case when it refused to raise the exemption as a defense in the Salvino case. Any licensing case reviewing the exemption following American Needle would almost certainly pose an even greater risk to the exemption’s removal. As Judge Scheindlin noted in her opinion rejecting the defendants’ motion to dismiss, “[t]he fact that the NHL and MLB are lawful joint ventures does not preclude plaintiffs from challenging the Leagues’ particular policies under the rule of reason . . . . American Needle conclusively established that these kinds of arrangements are subject to Section 1 scrutiny.” Thus, the methodology in American

176. Passan, Blackout Problem, supra note 7.
180. Mozes & Glicksman, supra note 100, at 283.
181. Laumann v. NHL, 907 F. Supp. 2d 465, 485–86 (S.D.N.Y. 2012) The court further stated that “the notion that the exhibition of [ ] league games on television and the Internet is clearly a league issue is contrary to longstanding precedent that agreements limiting the telecasting of professional sports games are subject to antitrust scrutiny, and analyzed under the rule of reason.” Id. at 488 (internal quotation marks omitted).
Needle for applying antitrust law to licensing of merchandise serves as a strong precedent to eliminate baseball’s antitrust exemption by applying the Sherman Act to the licensing of baseball broadcasts as well.

B. NON-COMPETITIVE BROADCASTING AGREEMENTS AND BLACKOUT POLICIES

Without professional baseball’s long-standing shield from federal antitrust law, the Southern District of New York should agree with the plaintiffs in Garber and find that the League’s various broadcasting agreements unreasonably restrain trade in violation of the Sherman Act. The complaint in Garber first examines the exclusive broadcasting agreements between the League’s member clubs and local RSNs for in-market live game broadcasts.182 These exclusive broadcasting contracts bring in billions of dollars of revenue for MLB teams,183 and they are now worth more to these teams than any other source of revenue, including ticket sales, merchandising, and sponsorships.184

For the RSNs, broadcasting agreements are especially valuable because sports are arguably “DVR-proof.”185 In today’s world, many people record live TV and fast-forward through the commercials or watch prerecorded streaming video online.186 However, live sporting events are one of the last television programs to be considered “DVR-proof” because audiences still feel the need to watch the events as they

182. Garber Complaint, supra note 9, at 23–27.
184. Passan, Blackout Problem, supra note 7.
185. Id.
As stated by John Skipper, programming chief at ESPN, “It’s exclusive, one of a kind, and it works for us on every level.” Therefore, live sporting events are much less affected by technological innovations that allow viewers to avoid watching commercials, and television networks can charge higher prices to advertisers. Additionally, these high profits are not limited to just the MLB teams and local RSNs, since some games are also broadcast through national agreements between the League and national broadcasters, including ESPN, Fox, and TBS. MLB teams and the League are making millions and billions of dollars in revenue from the RSNs and national networks, which in turn are earning huge profits from advertising revenues—and these contracts continue to skyrocket. At the MIT Sloan Sports Analytics Conference held in 2012, a panel of sports programming chiefs from ESPN, Fox, and NBC, as well as league media heads from the NFL and MLB, all agreed that “sports media rights are rich and getting richer” and “despite some occasional haggling over game packages . . . , things are working for everyone.”

So in the end, everyone benefits—except for the fans. While the revenues of the League and the broadcasting networks continue to increase, all of the rising costs are passed directly to the fans, who pay higher prices on their bills when subscribing to cable providers.

187. Id.; Mark Reynolds, Major League Baseball Has a Major Problem with Antitrust Lawsuit, BLEACHER REP. (Mar. 9, 2013), http://bleacherreport.com/articles/1559827-major-league-baseball-has-a-major-problem-with-antitrust-lawsuit (“Live sports are basically DVR-proof television because games are obviously more entertaining to watch for the fans when the result is unknown.”).


189. Stableford, supra note 186 (“Live sports is the most DVR-proof programming out there . . . , which is why advertisers pay $100,000 a second to advertise there.”).

190. The League and national networks Fox and TBS have a deal in place through 2021 to broadcast a few national baseball games, including the World Series, various playoff games, and the All-Star Game, for a combined $800 million annually. The League also has a new deal with ESPN to broadcast some games from 2014–2021 that would increase their annual payment from the current rate of $360 million per year to a new rate of $700 million per year. Garber Complaint, supra note 9, at 24; MLB Completes 8-Year Deal with Fox, Turner Sports, ASSOCIATED PRESS (Oct. 2, 2012, 1:45 PM), http://bigstory.ap.org/article/mlb-completes-8-year-deal-fox-turner-sports.

191. The TV rights deal between ESPN and the NFL for ESPN to broadcast Monday Night Football games went up over seventy percent from their previous agreement. Van Riper, supra note 188.

192. Id.

193. Id. (“[C]onsumers, ultimately the ones paying for sports programming, may be nearing their limits. When a network wins a bidding war for a sports property, they recoup that money through subscription fees from cable and satellite carriers. The carriers, in turn, try to pass those costs on to customers through higher rates.”); see also Brian Stelter & Amy Chozick, Paying a ‘Sports Tax,’ Even If You Don’t Watch, N.Y. TIMES (Dec. 15, 2011),
fact, some commentators believe that “American television subscribers pay, on average, about $100 a year for sports programming—no matter how many games they watch.”\footnote{Stelter & Chozick, supra note 193; see also Reynolds, supra note 187 (“Major League Baseball (MLB) and other sports leagues are charging cable companies and networks more for the rights to broadcast their games on television, and those costs are being passed on to consumers—even those who don’t watch sports.”).} Other media analysts have explained that sports programming only makes up about twenty percent of the television viewing for an average household, but it represents about fifty percent of the costs for cable or satellite television subscriptions.\footnote{Van Riper, supra note 188.}

Unfairly high subscription fees resulting from restraining trade are not limited to just in-market packages, as the League can “exploit their illegal monopoly by charging supra-competitive prices” for the out-of-market Internet and premium cable packages as well.\footnote{Garber Complaint, supra note 9, at 6.} Due to the League’s exemption from antitrust laws and “the clubs’ horizontal elimination of competition,” the same anticompetitive pricing that fans are subjected to for in-market baseball broadcasts through subscriptions to local cable providers also apply to how the League can set prices for the Internet and premium cable packages for out-of-market broadcasts.\footnote{Id. at 6, 29.} In just the short period of time since the filing of the Garber lawsuit, the yearly price of the out-of-market packages has increased by ten percent or more.\footnote{Compare id. at 28, 30 (describing the price of the 2011 season of MLB.tv as $99.99 for the basic MLB.tv, $119.99 for MLB.tv Premium, and approximately $200 for the 2011 season of MLB Extra Innings), with 2013 MLB Extra Innings Package, supra note 153, and Newman, MLB.TV, supra note 150 (showing 2013 prices of $109.99 and $129.99 for MLB.tv and $139.96 per half season of MLB Extra Innings).} Furthermore, both the MLB.tv and MLB Extra Innings packages are offered on an “all-or-nothing” basis, meaning that “[p]urchasers of MLB.TV must buy all out-of-market games for all teams even if they are only interested in watching the games of a particular team.”\footnote{Garber Complaint, supra note 9, at 6.} And because both MLB.tv and MLB Extra Innings are licensed directly from the League, subscription fees paid by customers are funneled directly into the coffers of the League and its thirty teams.\footnote{Passan, Blackout Problem, supra note 7 (describing how “every dollar that goes through MLBAM [Major League Baseball Advanced Media], the league’s digital arm that runs MLB.tv, is distributed evenly among the 30 teams”); Barry M. Bloom, Senate Holds Hearing on TV Deal, MLB.COM (Mar. 27, 2007, 4:52 PM), http://mlb.mlb.com/news/article.jsp?ymd=20070327&content_id=1861562&vkey=news_mlb&c_id=mlb&fext=.jsp.}

Yet, “[a]t the core of Defendants’ restraint of competition in the video programming market are the regional blackout agreements.”\footnote{Garber Complaint, supra note 9, at 24.}
This is because in many situations, fans who attempt to watch live baseball broadcasts are unable to avoid paying for the supra-competitive local television subscriptions due to the League’s blackout restrictions. Because the MLB teams and the League are able to enter into exclusive contracts with local and national television networks based on territorial broadcasting rights, fans who wish to watch live games are often required to purchase cable subscriptions at the supra-competitive prices and purchase out-of-market sports packages, rather than having access to games directly from the teams.

The problem with these blackout policies is twofold. Baseball fans who want to watch both in-market and out-of-market games are forced to purchase both out-of-market packages and local cable subscriptions in order to watch these games. As a result, fans that are already paying upwards of $109 for out-of-market packages from the League are now required to also purchase cable subscriptions at their supra-competitive rates in order to watch in-market games. As troubling as this double-dipping by the League may be for fans, the situation is even direr for baseball fans in other market areas. In those areas where a fan is technically within a team’s broadcasting territory but their local RSN does not subscribe to that team’s games, even buying the in-market package would not give access to that team’s games. For example, the territory-rights of much of central and western North Carolina have the Cincinnati Reds listed as one of their in-market teams. However, not only do cable companies in North Carolina have no incentive to carry Fox Sports Ohio (the Reds’ RSN), but that area is already covered by Fox Sports Carolinas, which does not broadcast Reds games. Thus, a Reds fan living in Charlotte would have no possible way of watching live games without making the over seven-hour, 477-mile trip to the Great American Ball Park in Cincinnati. Additionally, nationally televised games—some weekend games, the All-Star Game, and all of the playoffs—are also blacked out for MLB.tv or MLB Extra Innings subscribers.

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204. Id.
The second and most troublesome problem with the League’s blackout policies relates to how many of the demarcated broadcasting territories overlap one other. Although some territories only have one team, other territories that do not have a local team and are geographically in-between different teams’ local markets—such as the entire state of Iowa and the greater Las Vegas area—have as many as six teams claiming in-market broadcasting rights.\(^\text{211}\) Outside of the contiguous United States, the blackout policies are even broader; the entire Canadian market is blacked out from Toronto Blue Jays games (in addition to other teams in certain areas), and the U.S. territories of Guam and the Virgin Islands are blacked out from every game.\(^\text{212}\) Additionally, because the blackouts are enforced “regardless of whether that Club is playing at home or away,”\(^\text{213}\) fans in a market like Las Vegas, which has six different teams claiming territorial rights, can have up to twelve different teams that are blacked out on any given day.

Based on this information, both the non-competitive agreements and the blackout policies in the way the League broadcasts games restrain trade in violation of the Sherman Act. Yet, even with a removal of baseball’s preferred antitrust status, the Garber plaintiffs must still overcome the hurdle of the Sports Broadcasting Act of 1961 (the SBA).\(^\text{214}\) The SBA, passed in 1961 to facilitate an agreement where the NFL would sell a package of games to CBS, provides that

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\text{antitrust laws . . . shall not apply to any joint agreement by or among persons . . . conducting the organized professional team sports of football, baseball, basketball, or hockey, by which any league of clubs participating in [these sports] sells or otherwise transfers all or any part of the rights of such league’s member clubs in the sponsored telecasting of the games of football, baseball, basketball, or hockey, as the case may be, engaged in or conducted by such clubs.}\(^\text{215}\)
\]

Yet, there are two specific reasons why the SBA should not be applied here. The first comes from the Supreme Court’s analysis of sports broadcasting in *NCAA v. Board of Regents of the University of Oklahoma*.\(^\text{216}\) In this decision, the Court stated that, for broadcasts, “[p]rice is higher and output lower than they would otherwise be, and both are unresponsive to consumer preference. This latter point is perhaps the most significant, since Congress designed the Sherman Act..."
as a consumer welfare prescription.”217 Thus, to meet this “Rule of Reason” standard, the Garber plaintiffs would have to prove that the price of broadcasting is higher on consumers and the output of games is “lower than it would otherwise be.”218 As previously described, the skyrocketing broadcasting contracts that are passed on to consumers, as well as those consumers who are blacked out from watching games entirely, would easily meet this standard.

In the NCAA case, however, the Supreme Court did not consider the SBA at all because it only applies to professional sports. The Seventh Circuit considered the SBA in the 1992 case Chicago Professional Sports Ltd. Partnership v. NBA.219 In this case, the Chicago Bulls filed an antitrust suit against the NBA because of a rule limiting the number of games that individual teams could license to network “superstations.”220 The court held that the SBA only applies “when the league has transferred a right to sponsored telecasting,” and the NBA’s national broadcasting contracts did not give a “right to limit broadcasting of other contests.”221 Another federal court reviewing the SBA specifically held that “[s]ponsored telecasting’ under the SBA pertains only to network broadcast television and does not apply to non-exempt channels of distribution such as cable television, pay-per-view, and satellite television networks.”222 Judge Scheindlin’s opinion of the Garber case also addressed this point, stating that the rule of reason “does not give league agreements regarding television rights blanket immunity from antitrust scrutiny” and “may constitute an antitrust violation.”223

Therefore, in light of these interpretations of the SBA’s scope, as well as the “Rule of Reason” standard from NCAA, the Southern District of New York should not apply the SBA to the anticompetitive broadcasting agreements at issue here. Any court reviewing a challenge to the exemption must consider that “[a]ntitrust law is concerned with the market, and hence, the needs of the consumers. The final decision, then, should be more about protecting the rights of another stakeholder, the fans of baseball.”224 Accordingly, the court should find in favor of the Garber plaintiffs, and hold that the League does not have an exemption from antitrust law and conspired to restrict trade in violation of the Sherman Act.

217. Id. at 107 (citing Reiter v. Sonotone Corp., 442 U.S. 330 (1979)).
218. Ross, supra note 175, at 478.
220. Id. at 669.
221. Id. at 671.
224. Mozes & Glicksman, supra note 100, at 291.
IV. PROPOSAL FOR FUTURE BROADCASTING PROCEDURES

This Note has highlighted why the Southern District of New York should rule in favor of the Garber plaintiffs and hold that (1) baseball no longer enjoys the status of being exempt from antitrust law and (2) the broadcasting policies of the League unreasonably restrain trade in violation of the Sherman Act. If the court does rule in favor of the plaintiffs, it would no doubt be a huge blow to the League going forward. However, no matter what the outcome of this case is, there are steps the League can take to change its anticompetitive policies for the mutual benefit of the League and its fans.

Although there are some avid baseball fans who would watch any game being broadcast, arguably the vast majority of fans simply want to watch their favorite team. As a result, the solution that commentators suggest “makes so much sense it’ll never happen” is to offer “a-la-carte” pricing on games. Using this method, fans could have access to just the games they want by being able to purchase packages directly from their favorite teams. As Stephen Ross and Stefan Szymanski write (who were also cited in the Garber complaint):

Absent the exclusive territorial arrangements agreed to by league owners, individual teams would either directly, or more likely through intermediaries, arrange for their own games to be available to out-of-market fans. . . . . Fans wishing to see only their favorite team now pay for more games than they want, so sports leagues are currently using their monopoly power to effectuate a huge wealth transfer . . . . [L]ess fanatic consumers would be willing to pay a more modest sum for their favorite teams’ games only. As to these fans, the current scheme reduces output.

Thus, while broadcasting packages may bring in less revenue on an individual basis, the League would increase output to many more fans by offering them the ability to see the games they want, and this increase in viewership could compensate for lower per capita revenues.

Additionally, there is nothing keeping the League from providing this system to fans because the technology is already available. Through MLB Advanced Media (MLBAM), the League has the ability to stream every live baseball game through the Internet on virtually any device, and MLBAM is already used to show games through the MLB.tv

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226. Passan, Blackout Problem, supra note 7.
If fans were allowed to purchase packages directly from the teams they want to watch, the League could make every game available through MLBAM.

Lastly, as stated in the *American Needle* opinion, “the interest in maintaining a competitive balance among athletic teams is legitimate and important.”\(^{230}\) If live games were offered on an individual basis, it would aid in the competitive balance of the League and make games more interesting to watch.\(^{231}\) As previously mentioned, the vast majority of teams’ revenues come from the massive local television contracts that are arranged with RSNs.\(^{232}\) Because of this, teams that play in larger television markets, such as Los Angeles or New York, can reach agreements for massive television deals and afford to have more elite players.\(^{233}\) On the other hand, MLBAM is equally owned by all thirty of the League’s member clubs,\(^{234}\) and every dollar that goes through the company is distributed evenly.\(^{235}\) Thus, by circumventing the need to go through RSNs entirely, each team would receive an equal share of the broadcasting revenue and not be concerned with the size of the television market where that team is located. In turn, cable companies would not have to be locked into huge contracts with RSNs, where the high costs are passed on to consumers who may not even watch baseball at all.\(^{236}\)

**CONCLUSION**

In this lawsuit, the *Garber* plaintiffs have the chance to make history and bring about significant changes that would improve baseball for years to come. As stated most poignantly by *Yahoo! Sports* writer Jeff Passan:

> *Garber et al v. MLB* is the workaround code for the working person. It is the suit behind which every baseball fan should stand. It’s 2012, where everything is available everywhere, and pure greed is keeping baseball off our TVs, our tablets, our laptops and our phones. If baseball refuses to budge on an issue so archaic, so absurd and so blatant in its indifference toward people who want to buy one of their products, the league should suffer through the embarrassment of getting clowned by the fans whom it clowns with black TV screens. It

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229. Id.
232. Id.
may move slowly—most antitrust lawsuits do—but if this succeeds, it will be a decades-forward leap in one fell swoop.\footnote{Jeff Passan, \textit{TV Blackouts Case Against MLB at Critical Point}, YAHOO! SPORTS (Sept. 21, 2012, 1:41 AM), http://sports.yahoo.com/news/tv-blackout-case-against-mlb-at-critical-point.html.}

\textit{Garber v. MLB} is the chance for the League to finally reexamine their antiquated broadcasting policies and develop a new strategy that works for an increasingly technological and international new generation of baseball fans. No matter the outcome of the case, MLB has the opportunity to make ground-breaking modernizations that would shake up the sports world and solidify its namesake as the “national pastime” for decades to come.

\textit{Nathan M. Hennagin}\textsuperscript{*}

\footnotetext[237]{B.A., The George Washington University, 2010; J.D. Candidate, Brooklyn Law School, 2014. I would like to thank the staff members of the \textit{Journal}, particularly Joshua Wueller and Elizabeth Schauber, for their assistance throughout the note-writing process. I would also like to thank Professor Martin Edel for sharing his guidance. Finally, I would like to give special thanks to my fiancée, Rachel Kafka, for her unwavering love and support throughout law school, without which I could not have produced this Note.}
MORTGAGE TAKINGS AND MUNICIPAL FINANCE: A SOLUTION FOR PRESERVING HOME OWNERSHIP

Necessity alone is not the test by which the limits of state authority in this direction are to be defined, but a wise statesmanship must look beyond the expenditures which are absolutely needful to continue the existence of organized government, and embrace others which may tend to make that government subservo the general well-being of society, and advance the present and prospective happiness and prosperity of the people.¹

INTRODUCTION

Several years into the largest financial crisis since the Great Depression, housing prices and the value of home equity have stabilized.² While the free fall may have been suspended, the stagnant growth of a matured American economy³ and lackluster income growth⁴ have left many homeowners financially overwhelmed by the mortgages they took on when credit was cheap and owning a home appeared to be a sound, if not wildly profitable, investment. That the housing market is still hemorrhaging foreclosures⁵ suggests that the market correction process is nowhere near an end.⁶ It may take years to fully recover.⁷

5. Monthly foreclosures are decreasing in number, but the total number of foreclosures is still quite high. Associated Press, Data Show US Foreclosure Filings Fell to 5-Year Low in September; Homes on Track down 12 Pct., FOX NEWS (Oct. 11, 2012), http://www.foxnews.com/us/2012/10/11/data-show-us-foreclosure-filings-fell-to-5-year-low-in-september-homes-on-track/ (“There were 180,427 foreclosure filings report for September [2012], the fewest since July 2007 in the midst of the housing market bust.”).
If the raw foreclosure data were not bad enough, the mortgages that have not yet defaulted or been foreclosed upon present dismal prospects for the macroeconomy and a possible “housing recovery.” Many homeowners are behind on their mortgages\(^8\) or nearing default.\(^9\) Even homeowners who are current on their mortgages\(^10\) often have little hope or economic incentive\(^11\) to pay down the balance of their mortgage. This disincentive is the result of negative equity, which means the amount still owed on the mortgage exceeds the value of the underlying home.\(^12\) Throughout the country, homeowners who are trying to stay in their homes, and trying to protect what might be their most valuable asset and investment, face the prospect\(^13\) of continuing to make huge mortgage payments relative to their homes’ actual value.\(^14\)

The longer homeowners must contribute large portions of their income just to keep their existing homes, the worse their situation will become; and the longer the cumulative housing-foreclosure strain will weigh on the larger economy, which in turn weighs on homeowners who have no home


\(^8\) Bd. of Governors, U.S. Housing Market, supra note 6, at 21 n.39 (“About 660,000 mortgages are 30 days past due, 310,000 are 60 days past due, 1 million are 90 days or more past due . . . .”).


\(^10\) Bd. of Governors, U.S. Housing Market, supra note 6, at 21 (estimating 8.6 million negative equity mortgages are current on their payments).


\(^12\) A negative equity mortgage is one where the homeowner owes more money on the mortgage than their home is actually worth. This is also referred to as having an “underwater” mortgage. Christopher L. Foote et al., Negative Equity and Foreclosure: Theory and Evidence 1, (Fed. Reserve Bank of Bos., Discussion Paper No. 08-3, 2008), available at http://www.bos.frb.org/economic/ppdp/2008/ppdp0803.pdf. These two terms of art are used interchangeably throughout the Note.


Moreover, the incentive structure for the various constituents affected by the mortgage and housing market is one that makes it unlikely that any one party—the homeowner, the mortgagee, or the servicer—will take any action that preserves the economic fundamentals beyond those that directly impact its individual interests. Homeowners want to keep their homes and maintain home-equity value; mortgagees (investors) want to get the most money out of their mortgage investment, and servicers want to generate fees. One scholar has articulated these divergent interests, and the “self-worsening” cycle that they create, as part of a larger collective action problem that plagues the housing market and stifles economic recovery.

An appropriate solution to the collective action problem must tolerate millions of homeowners with diverse financial circumstances and varying abilities to pay their mortgages as they come due, matched against a smaller and more uniform demographic of mortgage investors, who having cast their bread on the water are tasked with deciding how best to get it back. Consequently, the manifold nature of the housing crisis and impending

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15. Homeowners may lose their homes regardless of their thrift or might pay for them many times over, given the excessive balances of the underlying mortgages. See Hockett, It Takes a Village, supra note 11, at 133–36.
18. Preserving the value of an individual mortgage does not necessarily imply that an investor wants to maintain or improve the actual possibility that they will be paid the amount due under the mortgage’s terms. Rather, it may mean preserving the value merely in accounting terms, by preventing foreclosures or refusing to write-down the mortgage, especially if the investor is an entity composed of shareholders. See generally id. at 4 n.4. Of course, there is a paradox here: mortgage investors might improve their actual expected return on investment by modifying the loan in favor of the homeowner to greatly reduce the likelihood of foreclosure, but this entails writing-down and permanently impairing the very investment they are trying to preserve. See id. at 19.
19. For a succinct explanation of the respective interests in the microeconomics mortgage crisis, see Hockett, It Takes a Village, supra note 11, at 140–41.
20. Id. at 123; see also Hockett, Recursive Collective Action Problems, supra note 16 (describing large “debt overhang” requires collective action); Robert Hockett, Bretton Woods 1.0: An Essay in Constructive Retrieval, 16 N.Y.U. J. LEGIS. & PUB. POL’Y 401 (2012) (discussing Keynesian economic policy in dealing with collective action problems).
21. Hockett, It Takes a Village, supra note 11, at 149 (“The challenge, again, is effectively an enormous coordination problem faced by literally hundreds of thousands, if not millions, of dispersed interested parties. Each of these parties acting individually has good reason to wait for the others to act, and so the group as a whole fails to act.”).
22. For an incredibly pragmatic solution that could easily be implemented at the federal level, see Kenneth C. Kettering, Securitization and Its Discontents: The Dynamics of Financial Product Development, 29 CARDOZO L. REV. 1553 (2008) (arguing that asset-backed securities, in many instances, have themselves become “too big to fail” and should be amenable to the federal Bankruptcy Code).
wave of foreclosures have forced economists and legal scholars alike to propose solutions that consider the many conflicts and issues that a single ramshackle *federal* program could not encompass. Not that the federal government hasn’t tried; it has. However, going forward, plausible solutions to the foreclosure crisis at the federal level require both political-will and consensus—two qualities the federal government does not now possess.

One such proposal, advocated by Professor Robert Hockett, has drawn attention in both public and private circles. Professor Hockett recommends that municipal governments use the power of eminent domain to seize “underwater” mortgages from mortgagees (presumably lenders or investors), after which the municipality will negotiate new mortgage terms with the homeowner-mortgagor dependent upon terms and financing that the homeowner can receive through private refinancing. Unlike the existing mortgages, the refinanced mortgage obligations are intended to reflect the current market value of the underlying properties and similarly to reduce the principal amount owed by homeowners. Essentially, the hope is that condemning the mortgage and then refinancing it at market terms will displace the homeowner’s negative equity. However, in order to achieve that outcome in an economical manner, municipalities must ensure that the amount paid to condemn the mortgage note is substantially below the face value of the mortgage obligation. The benefits of the proposal may be realized only if this condition can be consistently (and legally) satisfied.

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23. For a discussion of various federal programs, see Hockett, *It Takes a Village*, supra note 11, at 143–49 (arguing that the federal government’s plans in the form of the Home Affordable Mortgage Program (HAMP) and the Home Affordable Refinance Program (HARP), along with suggestions by the federal government to expand the mandates of either the government-sponsored enterprises (GSEs) or Federal Reserve System to preserve homeownership, have been ineffectual).


25. Robert C. Hockett is a Professor of Law at Cornell Law School.


27. “We refer to the states and their municipalities—townships, cities, counties, and kindred units of local government.” Hockett, *It Takes a Village*, supra note 11, at 150.

28. *Id.* at 150–52.

29. *Id.*

30. *Id.* at 169.

31. *Id.* at 137–38 (arguing for large-scale principal reductions).

32. “[N]or shall private property be taken for public use, without just compensation.” U.S. CONST. amend. V (Takings Clause); see Chi., B. & Q.R. Co. v. City of Chicago, 166 U.S. 226 (1897).
requires that the mortgagee absorb the negative equity as a loss in the condemnation proceeding.33

Apart from Professor Hockett, the private company Mortgage Resolution Partners (MRP)34 is offering for a flat, per-loan fee to act as an intermediary that will consult municipalities on which mortgages are appropriate to condemn.35 MRP has outlined its prospective role as an advisor to municipalities that are considering condemning mortgages.36 The company foresees “Five Stages of Relief” whereby (1) MRP screens existing mortgages in a municipality so that the municipality can inform homeowners if they qualify; (2) then private investors (mortgage lenders) fund an escrow account while the municipality files a condemnation suit; (3) assuming the lawsuit is successful, the loan is transferred to a trustee (4) to be restructured and (5) (re)securitized as a mortgage-backed security.37

Currently, Richmond, California, is considering implementing Professor Hockett’s general proposal.38 Strangely enough, one of the implicit selling points of Professor Hockett’s proposal is that it retains some of the grace of a free-market,39 or private-sector, solution—with the role of local government limited to condemning the mortgage, while private mortgage lenders and homeowners take on the risk of newly issued mortgages.40 Unsurprisingly, not everyone sees mortgage condemnation as an appropriate use of government power, even if it is legally sound.41

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33. See Hockett, It Takes a Village, supra note 11, at 156 (describing municipalities as possible conduits to negotiate write downs between lenders and borrowers).


36. Id.

37. Id. at 11.


40. Hockett, It Takes a Village, supra note 11, at 152 (emphasis added) (“Municipalities or authorities acting on the [eminent domain] Plan will pay for the mortgage-associated loans and liens of which they take legal possession with funds supplied by the aforementioned private sector investors. Among these investing institutions—which, notably, may include current loan and lien holders themselves, indirectly through MBS—will be one or more of the following: public and private pension funds, insurance companies, mutual funds and other investment firms.”); see also David Reiss, Eminently Reasonable, NAT’L L.J., Sept. 24, 2012, at 35, available at http://www.law.com/jsp/nlj/PubArticleNLJ.jsp?id
The balance of this Note will first demonstrate the contingencies of a plan where the local government serves as an intermediary, condemning a mortgage from one recalcitrant mortgagee so that another lender may refinance or underwrite a new mortgage that reflects the current market value of the underlying home. Second, I propose a novel and comprehensive plan that utilizes the unique role that municipalities can play in the mortgage takings context. My proposal, too, foresees local governments condemning underwater mortgages. But instead of leaving them to be refinanced by private mortgage lenders, who will operate at arm’s length, I argue that it might be more beneficial for local governments to simply hold onto such mortgages for their term of years, using them as collateral to secure municipal bonds, which will provide the primary source of financing for the mortgage takings.

Throughout the exposition of my proposed publicly financed mortgage takings, I outline the legal issues that both my and Professor Hockett’s plan face. It is better left to economists to address the possible impact that publicly financed mortgage takings could have on society beyond those affected at the local level.42

Part I highlights the effect that home prices and homeownership have on the financial integrity of local governments.43 Communities with depressed home prices and high foreclosure rates often cannot generate sufficient tax revenues for their local government to provide a desirable level of public services. In short, the economic problem becomes a civic problem that further serves to reduce the incentive for existing and
prospective homeowners to inhabit that locality. With that in mind, municipalities considering mortgage condemnations are not doing so to remediate a nation-wide housing slump; they are doing what is in their own best interest and, at the same time, the best interests of their residents or constituencies—the public.\footnote{Hockett, \emph{It Takes a Village}, supra note 11, at 150 (“It is \emph{cities} that must watch their residents being evicted, their homes being emptied, their houses deteriorating, their property values plummeting, their tax bases dwindling, their services retrenching, their crime levels spiking, and so on. But they don’t have to lie back and watch. They can act, and act now. They \emph{exist} to address the problems like these. Protecting the citizenry and heading off blight is what municipal \emph{eminent domain} authority is for.”).}

Part II outlines the condemnation proceeding that municipalities could exercise along with the constitutional and legal basis for that power at both federal and state levels. Specifically, I demonstrate that there is ample precedent for municipalities to condemn residential mortgages.\footnote{\emph{E.g.}, Omnia Commercial Co. v. United States, 261 U.S. 502 (1923); City of Cincinnati v. Louisville & Nashville R.R., 223 U.S. 390, 400 (1912).} In addition, I argue that states should have the constitutional authority to condemn mortgages even where the original promissory note is outside the state, so long as the real property securing the note is within the state. Part II also covers the refinancing of the condemned home mortgages to the extent that municipalities can write-down mortgages. But which mortgages \emph{ought} to be condemned or, alternatively, which homeowners should be the beneficiaries of the condemnation proceeding is beyond the scope of this Note—these are tough decisions which ultimately the citizens and leaders of local governments will have to make.\footnote{Professor Hockett has some recommendable suggestions regarding which mortgages should be condemned:

First, the Plan will apply only to single family, owner-occupied residences within each municipality’s jurisdiction. Second, all existing qualifying lien mortgage loans will have loan to value ratios (LTVs) greater than 100%. Third, the aggregate fair market value of loans or liens secured by any qualifying home should total 85% or less of the value of the home itself. . . . Finally, the value of the qualifying homes will not exceed 105.3% of FHA approved loan amounts—thus permitting a 95% new loan to value ratio.}

Part III explores the benefits of using public finance at the municipal level to fund mortgage condemnations, along with the prospective advantages that exist for municipalities retaining mortgages for the mortgages’ term of years. There is also a brief overview of the legal capacity of municipalities to issue tax-exempt municipal bonds. I argue that municipalities will be able to get cost-effective financing because of their \emph{possible} tax-exempt status and the fact that they can secure their bonds with the existing home mortgages—essentially, municipal bonds that are mortgage-backed securities.
I. THE MUNICIPALITY AND ITS HOMEOWNERS

The housing crisis, given the scale of the U.S. housing market as an investment for both domestic and international investors, has produced consequences on a local, national, and global scale. The increasing macroeconomic relevance of home prices in the United States is largely due to the proliferation of mortgage-backed securities, which repackage portfolios of home mortgages into more fungible securities. Individual mortgages have unique qualities and risks that are diversified away or offset when aggregated with other mortgages that are facially similar—having borrowers and contract terms that are approximate. Indeed, the securitization of mortgages into mortgage-backed securities gives investors from all around the world an opportunity to gain exposure to the U.S. housing market; the influx of investors simultaneously gives home buyers in the United States greater access to credit (investment capital) that may enable them to purchase a house.

Regardless of the ubiquity of mortgage-backed securities, the financial perils that ensue when housing prices and home values decline are quite asymmetrical between investors and homeowners. The investors’ mortgage-backed securities might be only fractionally composed of mortgages that face the prospect of default or a write-down in value.


48. As of 2011, of the approximately $10.5 trillion of residential mortgage debt, about $7.1 trillion is securitized in some form of a mortgage-backed security, while only $3.4 trillion is “Not Securitized.” Id. at 2.


51. See Anna Gelpern & Adam J. Levitin, Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities, 82 S. CAL. L. REV. 1075, 1084 (2009) (“Securitization can further reduce borrowing costs through financial engineering. Techniques such as the division of the [special purpose vehicle’s (SPV)] securities into senior and subordinate ‘tranches’ expand the potential investor base. They allow the SPV to target new investors with tailored payment structures and credit enhancements. In particular, they permit the issuance of some securities at a higher credit rating than the overall quality of the assets in the SPV. Such senior securities can be sold to institutional investors that may only buy investment-grade paper. Adding potential investors boosts overall demand and lowers the cost of financing.”).

52. “One study has found that even a single foreclosed home depresses prices of nearby homes from just under one to as high as 8.7 percent.” Hockett, It Takes a Village, supra note 11, at 173 (citing U.S. GOV’T ACCOUNTABILITY OFFICE, NO. GAO-12-34, VACANT PROPERTIES: GROWING NUMBER INCREASES COMMUNITIES’ COSTS AND CHALLENGES 44–45 (2011), available at http://www.gao.gov/assets/590/586089.pdf). Cf. Weinstein, supra note 42, at 267 (citing Dan Immergluck & Geoff Smith, The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values, 17 HOUSING POL’Y DEBATE 57, 67, 72 n.1 (2006)) (“[T]he value of surrounding properties declines by 0.9% on average for each foreclosed house in the vicinity, with the decline even greater in low-income neighborhoods at 1.44%.”).
ability to diversify by including mortgages with varied credit risks reduces investors’ potential losses from mortgages likely or certain to default.53

In contrast, given that a residential property is typically a homeowner’s largest investment, only residence, and the collateral underlying their mortgage, a volatile housing market poses substantial financial risks for homeowners.54 Homeowners who can make their mortgage payments and who have positive home equity are incentivized to continue making payments so long as they think that their home’s value will remain stable or rise.55 Whereas those homeowners with negative equity may benefit from selling their home or defaulting on their mortgage in order to divert their existing mortgage payments to the purchase of an asset (perhaps another home) that will accumulate equity.56 Alternatively, depressed home prices or comparatively cheap rentals may make the opportunity cost of continuing homeownership much higher, thereby altering the transitive preferences of homeowners as they seek to reduce their living expenses.57

In several states the preference default is considerably enhanced because lenders have no legal recourse against homeowners for the unpaid mortgage debt or deficiency.58 For those homeowners who cannot make their payments, default is the consequence and foreclosure is imminent—whether they have negative or positive home equity, they face the grim reality of losing their home.59

The risk of default or foreclosure is generally going to have a stronger correlation with default and foreclosure rates at the local rather than national level.60 More importantly, the consequences of default and

53. See Schwarcz, supra note 50, at 141–44.
54. Foote et al., supra note 12, at 22.
55. Id. at 12 (emphasis added) (“Economic theory poses one categorical prediction about the relationship between negative equity and default, which is that negative equity is a necessary condition for default . . . . This conclusion follows simply from the fact that positive equity implies that a borrower can sell the house, pay off the mortgage, and keep the difference, a better outcome under any circumstance compared with stopping payment on the mortgage and leaving the home.”).
56. Id. at 12 (“The idea that one should continue making monthly mortgage payments even when the market value of the house is worth less than the outstanding balance on the mortgage seems puzzling to many people. Some commentators view the fact that most people with negative equity keep their homes as a ‘failure’ of the theory . . . .”).
57. See id. at 3.
foreclosure are not diffuse or well-distributed across the broader housing market. Rather, foreclosures, defaults, and negative equity produce externalities that are felt first and foremost at the local level. The onset of defaults and foreclosures can further depress home values at the local level as more and more houses go on the market, which are either sold or remain in inventory. Again, this can drastically alter financial incentives for existing homeowners because they are often paying significantly more money for their home than it would cost them to buy at the reduced market price. Reducing their “housing expense” to a level commensurate with the market becomes the rational alternative, since homeowners in plighted communities can no longer expect to preserve their home equity and may potentially lose their wealth as homes prices fall.

A. MUNICIPALITIES HAVE A VESTED INTEREST IN PRESERVING HOMEOWNERSHIP AND HOME EQUITY

The problem, of course, for municipalities is that much of the revenue and budget planning for conducting local government—or municipal infrastructure generally—is dependent upon residential property values as a function of property taxes. Also of great significance is the psychological malaise that homeowners and citizens deal with as a result of worrying about the future.


62. “By any measure, the epidemic of home losses is severe, and will not only harm the families who lose their homes, but also nearby homeowners who suffer drops in their property values and communities who suffer the impact of lower tax revenues.” Subprime Spillover: Foreclosures Cost Neighbors $223 Billion; 44.5 Million Homes Lose $5,000 on Average 5, CENTER FOR RESPONSIBLE LENDING (Nov. 13, 2007), http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Subprime_mortgages/subprime-spillover111307.pdf.

63. Thomas Deutsch of the American Securitization Forum provided his insights to Congress:

The primary factors our members have identified that have combined to put severe strain on homeowners and drive rising delinquencies, defaults and foreclosures include: 1) unavailability of mortgage credit for refinancing opportunities; 2) declining home values; 3) high levels of non-mortgage credit outstanding (e.g., credit card, auto loan, other debt); 4) prevalence of 2nd liens; and 5) rising unemployment levels and reductions in income, making mortgage payment unaffordable.


64. Kingsley et al., supra note 59, at 19 (citing numerous effects of local foreclosures).

65. See Foote et al., supra note 12, at 3, 12.

66. Id.

67. “The most obvious repercussion from the housing/credit crisis for local government is its affect [sic] on municipal revenues.” Weinstein, supra note 42, at 266.
about the value of their homes. Homeowners who are not confident in their largest investment (their home) are more conservative consumers, which may negatively impact local economies and tax revenues. Municipalities, therefore, have incentives to stave off the continued collapse of property values and, at the same time, contain the conflagration of ill effects resulting from a fiscal crisis in local government. The encompassing communities, too, surely want to see home values stabilize, along with preserving homeownership and the demographics or social fundamentals that homeownership helps to anchor within communities. Though each community is in a unique position to assess the equities and challenges posed by the housing crisis, “[f]or the problem itself is essentially, in its first instance, local in character.”

B. LOCAL GOVERNMENTS ARE PROPERLY SUITED TO PLAY THE ROLE OF AN INTERMEDIARY FOR CONDEMNNG MORTGAGES AND FORCING PRINCIPAL REDUCTIONS

Those who oppose the use of eminent domain to condemn mortgages are correct to point out that the promise, and indeed the risk, of exercising municipal power in such a situation is relative to the time, expense, and overall efficiency of the condemnation proceedings. By definition, a

68. Foote et al., supra note 12, at 22 (describing instances when homeowners with negative equity “remained vulnerable to adverse life events, like job loss, illness, and divorce, all of which create cash-flow problems”).

69. Weinstein, supra note 42, at 267–68. In a sense, homeowners dealing with negative equity have already taken a big risk and lost. They are therefore less able to borrow money and engage in commerce or start new business ventures. However small or inconsequential a small entrepreneur might seem, small businesses run by such individuals help maintain both the social and economic fabric of communities. Foote et al., supra note 12 (discussing the homeowner’s financial “inertia” when owning a home with negative equity).

70. “First, as homes are the most valuable asset for most families, the reduction in home value makes them feel less wealthy and reduces their ability to tap into the home’s equity—factors that lead households to cut back on expenditures.” Weinstein, supra note 42, at 266.


72. See Dan Immergluck & Geoff Smith, The Impact of Single-family Mortgage Foreclosures on Neighborhood Crime, 21 HOUSING STUD. 851, 859–62 (2006); Kingsley et al., supra note 64, at 15–21 (listing crime, social disorder, population turnover, and deterioration of governmental services as negative effects associated with foreclosures).

73. See Christopher Serkin, Big Differences for Small Governments: Local Governments and the Takings Clause, 81 N.Y.U. L. REV. 1624, 1648 (2006) (“The source of homeowners’ incentive to control local politics is their common goal of preserving the value of their property. The financial stakes alone are enormous.”).

74. Hockett, It Takes a Village, supra note 11, at 150.

75. See OMM Memorandum, supra note 42, at 12–15; see also Judicial Versus Non-Judicial Foreclosure, MORTGAGE BANKERS ASS’N, http://www.mbaa.org/files/ResourceCenter
municipality is a devolutionary form of government subject to overriding county and state law, which means that a municipality’s administrative authority, including the power of eminent domain, is likely constrained by state and county law. As a result, local governments should evaluate the legal and economic viability of a mortgage takings plan by first examining eminent domain law in their respective jurisdictions. Furthermore, since local governments are mainly administrative entities, many of the bureaucratic functions required for carrying out the condemnation proceedings, along with finalizing mortgage principal reductions, are within the capacity of a municipal corporation or can be sought at the local or county level. Basic procedural matters such as serving process or notice, attaching the mortgage note and underlying deed of trust, or recording changes therein are functions that a municipality can often handle directly without having to seek prior approval from a state legislature.

Additionally, municipalities that levy property taxes are in an advantageous position to decide whether or not to use their eminent domain power because they already have annual assessments of property values. The assessments, as well as the factors that are used to determine real estate values in a locality, can be used during the condemnation proceeding as evidence of the mortgage collateral’s “fair value.” Part III of this Note covers some of the aspects of property valuation for condemnation proceedings.

Even before the condemnation proceeding begins, establishing the fair value of a particular residential property is essential for ascertaining the value of the mortgage instrument and the corresponding likelihood that a homeowner will default or have any chance of realizing positive home-

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76. E.g., N.Y. GEN. CONSTR. LAW § 66 (McKinney 2012) (“A ‘municipal corporation’ includes a county, city, town, village and school district.”). Similarly, California law puts emphasis on a unit of government’s incorporation status. Counties and cities are incorporated, while towns are unincorporated, with counties being the largest unit of incorporated political government. CAL. GOV. CODE §§ 19–21 (West 2012).

77. Again, this varies amongst the states. Some states vest eminent domain powers with counties, and the small subunits within the county, such as cities and school districts. E.g., WASH. REV. CODE § 8.08.010 (West 2013) (“Every county is hereby authorized and empowered to condemn land and property within the county for public use . . . .”). Other states, like New York, focus on the delineation of incorporated local government to provide a measure of uniformity throughout the state, rather than county-by-county balkanization. E.g., N.Y. EM. DOM. PROC. LAW § 101 (McKinney 2012) (Eminent Domain’s Purpose).

78. E.g., CAL. CIV. PROC. § 1255.410 (West 2012) (California’s “quick take” provision).

79. See OSBORNE M. REYNOLDS, JR., LOCAL GOVERNMENT LAW § 96 (3d ed. 2009).

80. See id. §§ 129–30.

81. See id. § 96.

equity over the life of the mortgage.\textsuperscript{84} Local governments are well positioned to account for the cumulative factors that can be used to ascertain property values and to screen homeowners\textsuperscript{85} who are the most eligible for condemnation proceedings.\textsuperscript{86} That local governments are already properly scaled to assess property values adds to both the efficiency and efficacy of the mortgage taking’s proposal because the benefits of the combined condemnation proceedings and principal reductions are precisely relative to both (1) the ability of target homeowners to afford their restructured mortgages and (2) the stability of the new loan-to-value ratio on the restructured mortgages.\textsuperscript{87} Local government’s role in property assessment is vital for assuring that both of those elements are met. Realizing the value of (or revaluing) residential properties is the very thing that many financial institutions or investors in mortgage-backed securities have been unwilling to accept, as it may implicate a write-down on their investment.\textsuperscript{88}

For those wary of eminent domain being used to condemn mortgage notes without paying just compensation, a municipality’s interest in securing low property assessments is checked by the amount of property taxes that it can levy with that same assessment.\textsuperscript{89} A municipality is deterred from making fraudulently low assessments solely to condemn property on the cheap because it would effectively nullify the municipality’s ability to raise revenues and engage in budget planning.\textsuperscript{90}


\textsuperscript{85} Recall that the Mortgage Resolution Partners’ proposed role as an intermediary was to screen homeowners that were good candidates for mortgage condemnation. See Mortgage Resolution Partners, supra note 35, at 9. Given that the local governments have as good an estimation of property values as any other organization, it is not beyond comprehension that municipalities themselves could also handle some of the aspects of credit screening homeowners for the appropriate loan modifications, pursuant to the mortgage condemnation.

\textsuperscript{86} Hockett, \textit{It Takes a Village}, supra note 11, at 154–55.

\textsuperscript{87} See Foote et al., supra note 12, at 1–5.

\textsuperscript{88} Hockett, \textit{Six Years}, supra note 42, at 10 n.19 (discussing the “extend and pretend” mentality of financial institutions).

\textsuperscript{89} Sterk & Engler, supra note 82, at 1066–74 (discussing the difficulties of reassessing property values for tax purposes).

\textsuperscript{90} \textit{Id.} at 1070 (“[T]ax assessment is a political process; the ultimate responsibility for assessments rests on the shoulders of elected officials, and they have incentives to minimize any damage to their political careers that reassessment might generate.”). It is “fairly easy to forecast in advance the amount of revenue that the real-property tax in a particular locality will produce, thus facilitating the budget process.” \textit{Id.}
C. JURISDICTION-TO-JURISDICTION, EMINENT DOMAIN POWERS
VARY WITH RESPECT TO ONE-TO-ONE PROPERTY TRANSFERS

It is important to point out that Professor Hockett’s plan may run afoul of many states’ “anti-
Kelo” statutes because it advocates one-to-one property transfers. 91 Such statutes limit local
governments’ ability to condemn the property of one private party for the purpose of transferring it
to another private party. 92 Prohibitions on one-to-one property transfers are not necessarily specific to either tangible or intangible property and are
certainly not limited to condemned mortgages. 93 However, local
governments can satisfy anti-
Kelo provisions if they can keep the mortgages without making a private transfer or conveyance. 94

II. MORTGAGE TAKINGS

Part II first demonstrates that the use of eminent domain to take intangible property such as contracts and mortgages is constitutional and given the same legislative deference as the taking or condemnation of real property. 95 Local governments and municipalities that wish to condemn home mortgages have to overcome the same constitutional hurdles to legitimately effect a taking but are subject to other limitations by the states. Secondly, this Part outlines condemnation proceedings generally and

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91. E.g., CAL. CONST. art. I, § 19 (“The State and local governments are prohibited from acquiring by eminent domain an owner-occupied residence for the purpose of conveying it to a private person.”); MICH. CONST. art. X, § 2 (“‘Public use’ does not include the taking of private property for transfer to a private entity for the purpose of economic development or enhancement of tax revenues.”); Norwood v. Horney, 853 N.E.2d 1115, 1140–42 (Ohio 2006) (agreeing with Justice O’Connor’s dissent in 
Kelo v. City of New London, 545 U.S. 469 (2005)).

92. It has been suggested that Professor Hockett’s proposal would not work in the case of San Bernardino County because of a provision in the county charter that prohibits one-to-one property transfers by the county where the owner does not consent. OMM Memorandum, supra note 42, at 11. However, article VI, section 5 of the San Bernardino Charter lists the “Owner” as the
“owner(s) of the fee title interest in the property to be acquired.” SAN BERNARDINO CNTY.
CHARTER art. VI, § 5, available at http://www.co.sanmateo.ca.us/bos.dir
/CharterReviewCommittee/SanBernardinoCharter.pdf. In the case of either a deed of trust or a
mortgage, the mortgagor-borrower is going to have equitable title. More importantly, the property
being acquired is not the real estate property itself, as the San Bernardino Charter suggests, but the
mortgage note, in which there is no “fee title interest” to speak of.

93. 

94. If the property is not transferred, then 
Kelo analysis is avoided. Where there is a transfer, arguments that the taking advances local economics may not be sufficient. See Bd. of Cnty. Comm’rs v. Lowery, 136 P.3d 639, 642 (Okla. 2006) (holding in part that economic development was not considered a public use where the condemned property was transferred to a private party).

95. “The state or federal legislature may initially determine what constitutes a public use, but the courts have the final authority to decide whether this legislative determination is correct.” Shelley Ross Saxer, Eminent Domain, Municipalization, and the Dormant Commerce Clause, 38 U.C. DAVIS L. REV. 1505, 1514 (2005).
expounds the legal precedent for condemning intangible property, like mortgage notes. Part II also surveys the procedural and jurisdictional challenges that are specific to condemnation proceedings of intangible property, as opposed to real property.

A. THE TAKINGS CLAUSE OUTLINED: PUBLIC PURPOSE, NECESSITY, AND COMPENSATION

The Fifth Amendment’s Takings Clause requires that a taking of private property have a public purpose,96 that the taking is in fact necessary to achieve that purpose,97 and that just compensation98 is made to the property owners for the taking.99 For prospective mortgage condemnations under Professor Hockett’s proposal, the most pertinent of these requirements is the public purpose requirement because mortgages will be condemned from one mortgagee to be refinanced by a new (private) mortgagee.100

1. Public Purpose

In 2005, the Supreme Court addressed the legitimacy of one-to-one takings in *Kelo v. City of New London*:

On the one hand, it has long been accepted that the sovereign may not take the property of A for the sole purpose of transferring it to another private party B, even though A is paid just compensation. On the other hand, it is equally clear that a State may transfer property from one private party to another if future “use by the public” is the purpose of the taking . . . .101

The Court held that the City of New London’s taking of residential properties, which the city intended to give to private developers as part of a larger economic program,102 was constitutional.103 The Court reasoned that promoting economic development was a traditional government power and sufficient public purpose given that the city had “carefully formulated” an economic plan aimed at creating jobs and increasing tax revenue.104 Just as

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96. *Kelo*, 545 U.S. at 480 (“The disposition of this case therefore turns on the question whether the City’s development plan serves a ‘public purpose.’ Without exception, our cases have defined that concept broadly . . . .”).

97. By inference, if a taking is for a public purpose, then it was necessary to accomplish that public purpose. *E.g.*, Berman v. Parker, 348 U.S. 26, 36 (1954) (stating that it is not for the courts to determine whether a taking is necessary to achieve the legislature’s goal).

98. United States v. Commodities Trading Corp., 339 U.S. 121, 123 (1950) (“This Court has never attempted to prescribe a rigid rule for determining what is ‘just compensation’ under all circumstances and in all cases. Fair market value has normally been accepted as a just standard.”).

99. See REYNOLDS, supra note 79, at 525.


102. Id. at 483–85.

103. Id. at 477.

104. Id. at 483–85.
important, the Court acknowledged that the use of eminent domain to effect a one-to-one transfer of property may benefit private parties and that such benefit is often incidental but necessary to achieving the underlying public purpose.105

The *Kelo* decision—besides its analysis of one-to-one property transfers—was a reminder that the Supreme Court’s conception of public purpose is expansive enough to allow for novel justifications for the use of eminent domain. Two crucial precedents the *Kelo* Court cited, *Berman v. Parker*,106 and *Hawaii Housing Authority v. Midkiff*,107 were also cases in which eminent domain was used to make one-to-one transfers of property interests. In *Berman v. Parker*, the Court upheld the District of Columbia Redevelopment Act of 1945,108 which sought to condemn blighted areas for redevelopment, with some of the property being sold or leased to private parties.109 The *Berman* Court characterized the District of Columbia’s exercise of eminent domain as a legitimate use of its “police power.”110 The Court further described it as “fruitless” to “attempt to define” the police powers with exactitude, including eminent domain, because such a “definition is essentially the product of legislative determinations addressed to the purposes of government—purposes neither abstractly nor historically capable of definition.”111

In *Hawaii Housing Authority v. Midkiff*, the Court followed the *Berman* approach, upholding a Hawaii statute that condemned fee title in real property from lessors and transferred to lessees “in order to reduce the concentration of ownership of fee simple in the State.”112 The statute’s purpose was to mitigate the “evils” of Hawaii’s centuries-old land oligopoly.113 The Court reiterated that its role is not to determine if the taking will actually fulfill the public purpose,114 nor is it for the Court to second-guess the legislature and its judgment about what steps should be taken to advance such purposes or whether those steps include eminent

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110. *Id.* at 32.

111. *Id.*


113. *Id.* at 242.

114. *Id.*
domain.\textsuperscript{115} In sum, like \textit{Kelo, Berman} and \textit{Midkiff} exemplify the notion that eminent domain is “merely”\textsuperscript{116} a means to an end.\textsuperscript{117}

The Supreme Court’s “broad and inclusive”\textsuperscript{118} conception of public purpose bodes well for mortgage condemnation proposals that envision private lenders stepping in to assume the condemned mortgages. In fact, much of what Professor Hockett has written about mortgage condemnations gets at the very core of the public purpose and welfare that is at stake for homeowners, mortgagees, and municipalities that consider mortgage takings as an option.\textsuperscript{119} The social consequences of foreclosure, default, and large sums of negative equity implicate the traditional purview of a local government’s police powers. Condemning mortgages to mitigate such circumstances is certainly no more novel an exercise of the eminent domain power than the aforementioned Supreme Court precedents. However, many state constitutions specifically limit one-to-one property transfers to a much greater extent than the Takings Clause.\textsuperscript{120} Consequently, my proposal of publicly financed mortgage condemnations, with the mortgages held indefinitely by the municipalities, completely ameliorates the restrictions on one-to-one transfers and will likely reduce judicial scrutiny.

2. Necessity

The requirement of necessity for property takings is not centrally concerned with the Fifth Amendment’s Takings Clause as much as it is with constitutional or legislative obstacles posed by the states.\textsuperscript{121} Some states do not impose judicial scrutiny for the necessity requirement, while others require a taking to be \textit{reasonably necessary} to carry out the designated public purposes.\textsuperscript{122} Generally, with the exception of egregious

\begin{itemize}
  \item \textsuperscript{115} \textit{Id.} at 244 (“In such cases, government does not itself have to use property to legitimate the taking; it is only the taking’s purpose, and not its mechanics, that must pass scrutiny under the Public Use Clause.”); \textit{cf. Berman}, 348 U.S. at 33 (“We do not sit to determine whether a particular housing project is or is not desirable.”).
  \item \textsuperscript{116} \textit{Berman}, 348 U.S. at 33.
  \item \textsuperscript{117} This turn of phrase “means to an end” is used later in the discussion of possible dormant Commerce Clause challenges. \textit{See infra} text accompanying note 200. In both instances, the phrase represents the idea that eminent domain itself is neither legitimate nor illegitimate, but rather the essential inquiry is in regards to the broader goals that condemnation accomplishes.
  \item \textsuperscript{118} \textit{Berman}, 348 U.S. at 33.
  \item \textsuperscript{119} \textit{See Hockett, It Takes a Village, supra} note 11, at 171–75.
  \item \textsuperscript{120} \textit{See REYNOLDS, supra} note 79, at 547 (“These measures, which have been enacted in one form or another in at least 42 states, have limited, or outright prevented, the use of condemnation to acquire property for economic development, and many have also re-defined what constitutes ‘blight’ for purposes of condemning property for urban renewal.”).
  \item \textsuperscript{121} In \textit{Berman v. Parker}, the necessity language is used in passing when referring to the legislatures determinations. \textit{Berman}, 348 U.S. at 36. The necessity requirement has been somewhat collapsed into the public purpose analysis. \textit{Id.} (“If the Agency considers it necessary in carrying out the redevelopment project to take full title to the real property involved, it may do so.”).
  \item \textsuperscript{122} \textit{REYNOLDS, supra} note 79, at 547–48.
\end{itemize}
abuses of eminent domain not consistent with plausible public purposes, courts accord great deference to a legislature or municipality’s finding of necessity.\textsuperscript{123}

3. Just Compensation

The “Armstrong principle\textsuperscript{124} animates the just compensation provision of the Fifth Amendment’s Taking Clause, ensuring that the government does not make individual citizens bear the cost of a taking.\textsuperscript{125} But this principle does not determine what compensation ought to be paid, or what compensation might be called just.\textsuperscript{126} Rather, the Supreme Court has held that just compensation is synonymous with “fair market value.”\textsuperscript{127} In United States v. Miller,\textsuperscript{128} the Court explained fair market value as “what a willing buyer would pay in cash to a willing seller.”\textsuperscript{129}

The Supreme Court’s market-oriented language seems to assume a degree of efficiency and liquidity that permits a monetary value to be assigned as in an arm’s-length transaction. But the Miller Court recognized that condemnations, given the timing of the condemnations or the type of property or its location, present untold vagaries when assessing fair market value.\textsuperscript{130} Each situation requires its own fact-intensive inquiry. This is certainly true for mortgage condemnations, where the value of the mortgage is not based on the underlying home’s value but on the present value of future payments—adjusted for the risk that those payments will not be made.\textsuperscript{131}

\begin{align*}
PV_{\text{due}} &= C \left( \frac{1 - \frac{1}{(1+i)^n}}{i} \right) (1+i), \quad \text{where } PV = \text{present value; } n = \text{number of periods; } C = \text{monthly mortgage payment;} \text{ and } i = \text{interest rate. KENT A. HICKMAN ET AL., FOUNDATIONS OF CORPORATE FINANCE 117 (2d ed. 2001).}
\end{align*}
A good analogy to valuing a single mortgage is the manner in which a bond market values a single bond issuance—the value of the single issuance is relative to the value of all other possible investments. The liquidity and efficiency of the market, of course, influence what a “willing” purchaser would pay, but so do the hard numbers that lay behind the mortgage: the term of years, the mortgage’s interest rate, the risk-free rate, the yield curve, the mortgagor’s income, the home value, prospects for the housing market, and so on. As important are the soft characteristics of the mortgage, such as the mortgagor’s marital status, job security, health, and credit history. Consequently, valuing a mortgage is an actuarial feast for analysts, mathematicians, and speculators. In a condemnation proceeding, the financial engineering is left to the judge or the jury, who can review evidence and arguments submitted by the government and the condemnee to decide the monetary value.

B. THE POWER TO CONDEMN INTANGIBLE PROPERTY AND MORTGAGES

The power of both federal and state governments to condemn intangible forms of property under the Fifth Amendment’s Taking Clause is longstanding. The abundance of Supreme Court precedent supporting

132. Individual mortgages are not fungible instruments, unlike mortgage-backed securities or bonds. See Schwarz, supra note 50, at 143 (explaining how the structure of mortgage-backed securities can permit more variance among parties and debt obligations).

133. See generally Hickman et al., supra note 131, at 137–57 (“Time Value Applications: Security Valuation and Expected Returns”).

134. Yuliya Demanyk et al., Determinants and Consequences of Mortgage Default, SSRN, 2–18 (Jan. 2011), http://ssrn.com/abstract=1706844 (demonstrating that a mortgagor’s credit score, which accounts for many factors, is a good predictor of default).

135. See Jason N. Houle & Danya Keene, Getting Sick and Falling Behind: Health and the Risk of Mortgage Default and Home Foreclosure 13 (Apr. 12, 2013) (unpublished manuscript), available at http://paa2013.princeton.edu/papers/130301 (“The findings of this study show that worsening health, as measured by changes in health limitations from 2006-2008 and changes in chronic conditions from the age of 40-50 significantly increases the risk of default and home foreclosure between 2007-2010.”).

136. See CAL. CON. art. I, § 19 (“Private property may be taken or damaged for a public use and only when just compensation, ascertained by a jury unless waived, has first been paid to, or into court for, the owner.”). Cf. N.Y. EM. DOM. § 512 (West 2013) (“The court, after hearing the testimony and weighing the evidence, shall determine the compensation due the condemnees for damages as the result of the acquisition.”); CAL. CIV. PROC. § 1263.320 (West 2013) (“The fair market value of property taken for which there is no relevant, comparable market is its value on the date of valuation as determined by any method of valuation that is just and equitable.”).

137. For a comprehensive overview of contract takings, see Echeverria, supra note 124.

the condemnation of intangibles, including franchises, contracts, options, rights of way, and titles in real property, demonstrates that the ability of local governments to condemn home mortgages is a natural and foreseen extension of the power of eminent domain. Indeed, the Court has explicitly recognized that the power of eminent domain embraces all forms of property to the extent that the condemned property (or property rights) can be defined:

[T]he right of every state to authorize the appropriation of every description of property for a public use is one of those inherent powers which belong to state governments, without which they could not well perform their great functions. It is a power not surrendered to the United States, and is untouched by any of the provisions of the Federal Constitution, provided there be due process of law; that is, a law authorizing it, and provision made for compensation. This power extends to tangibles and intangibles alike. A chose in action, a charter, or any kind of contract, are, along with land and movables, within the sweep of this sovereign authority.

Even so, eminent domain is often confounded in the context of contract takings because the Contract Clause prohibits state governments from altering contract rights. But the Contract Clause “is not a limitation upon the power of eminent domain.” In Omnia Commercial Co. v. United States, the Supreme Court divined the modern standard for determining when a contract is effectively condemned or “appropriated.” In Omnia, the federal government “requisitioned” a steel company’s production of steel for an entire year, effectively displacing a purchaser who had contracted with the steel company to lock in a price for the entirety of 1918. World War I, of course, made steel a very scarce and valuable commodity, which meant that the purchaser, having lost the contract to the

139. Dix, 47 U.S. 507.
140. Lynch v. United States, 292 U.S. 571, 579 (1934) (“Valid contracts are property, whether the obligor be a private individual, a municipality, a state, or the United States.”).
144. Legal Tender Cases, 79 U.S. 457, 561 (1870) (“Can the poor man’s cattle, and horses, and corn be thus taken by the government when the public exigency requires it, and cannot the rich man’s bonds and notes be in like manner taken to reach the same end . . . ? Is it anything more than putting the securities of the capitalist on the same platform as the farmer’s stock?”).
145. Louisville & Nashville R.R., 223 U.S. at 400 (emphasis added).
146. See Echeverria, supra note 124, at 654.
148. U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 29 n.27 (1977) (“The States remain free to exercise their powers of eminent domain to abrogate such contractual rights, upon payment of just compensation.”).
150. Id.
151. Id. at 507.
government, was forced to buy steel at higher market rates. The Court held that the requisition terminated the contract and that there was no taking because the government was not filling the shoes of one of the parties to the contract. The Court distinguished between the “appropriation” and “frustration” of contracts, reasoning that the contract at issue was frustrated because the government was condemning the steel and not the contract rights to the steel—the subject matter of the contract instead of the contract itself.

The Omnia appropriation/frustration distinction elucidates a fundamental difference between the taking of real property and the taking of contracts. When real property is condemned, the rights of all possible parties—in fact the entire world—are affected by the taking. Conversely, when contracts such as promissory notes (debt) are condemned, only the rights of the contracting parties are affected.

These conceptual differences have crucial implications for the procedural aspects of mortgage condemnations, even though municipalities need only proceed in personam against the mortgagee to extinguish the mortgagee’s rights in the note. In order to adjudicate those rights, municipalities must first establish their authority or jurisdiction over both the mortgagee and the mortgage note.

C. SUBJECT-MATTER JURISDICTION

Unlike real property, the original mortgage notes owned by non-resident mortgagees are often physically outside the territorial jurisdiction or geographic boundaries of a state. A state’s power to condemn property within its boundaries is well established. Outside that territorial jurisdiction, courts have been unwilling to allow states to take movable

152. Echeverria, supra note 124, at 641.
154. Id. at 511 (“If the steel company had failed to comply with the requisition, what would have been the remedy? Not enforcement of the contract, but enforcement of the statute.”).
155. See Echeverria, supra note 124, at 667–69.
156. Id. at 642.
157. Id.
158. Id. at 642–43.
159. Id. at 667–69.
160. Id.
161. NICHOLS ON EMINENT DOMAIN § 2.02 (3d ed. 2013) (providing extensive case law).
personal or intangible property, as it abrogates the sovereignty of other states. Thus, each state’s geographic borders also represent the scope of its subject-matter jurisdiction when exercising eminent domain. Within each state, local or municipal governments can be authorized to condemn property beyond their territorial limits. But extraterritorial takings must fulfill a local purpose, or be necessary to effect that purpose, for the condemning governmental authority.

Knowing the scope of subject-matter jurisdiction, it is still necessary to determine where the movable or intangible property is located, since unlike real property it can exist as a legally cognizable interest under multiple states’ jurisdictions or can be physically moved from one jurisdiction to another. Both federal and state laws traditionally have assigned a location or situs to the various forms of movable property in the varied contexts of property taxation, escheatment, and distribution of property in divorce proceedings. For taxation and divorce, situs can exist in multiple jurisdictions simultaneously, but in the eminent domain context there is thought to be only one legal situs for each type of property. This prevents multiple states from condemning such property and protects property owners from multiple condemnation actions against the same property. But it requires using a situs rule, like in escheatment, that permits only one location, which consequently allows only one state to exercise subject-matter jurisdiction over the property. For example, the doctrine of mobilia sequuntur personam is one method for determining situs that follows “the general principle that rights of ownership and transfer of movable property are determined by the law of the owner’s domicile.” In short, the owner’s last known domicile determines which state has subject-matter jurisdiction over the owner’s movable property.

Although it is somewhat antique, limiting situs to a single location is a fairly intuitive approach for most types of movable property and in most

163. NICHOLS ON EMINENT DOMAIN, supra note 161, § 2.07.
165. City of Oakland v. Oakland Raiders, 646 P.2d 835, 844 (Cal. 1982) (“[E]xtraterritorial condemnation has been acknowledged when necessary to implement local condemnation.”).
166. See Ellen Mufson, Jurisdictional Limitations on Intangible Property in Eminent Domain: Focus on the Indianapolis Colts, 60 IND. L.J. 389, 395–99 (1985) (discussing the situs of intangibles for tax purposes and arguing that intangibles should have the same situs as they would under the law of escheat).
168. NICHOLS ON EMINENT DOMAIN, supra note 161, § 2.07.
170. See Mufson, supra note 166, at 403–07.
171. BLACK’S LAW DICTIONARY 1094 (9th ed. 2009).
cases wouldn’t seem to offend either states’ interests or property owners.\textsuperscript{173} But it rests upon the legal fiction\textsuperscript{174} that all condemned property interests are in only one place at any given time.\textsuperscript{175} Again, for most forms of property this fiction is quite workable, but I argue that for modern mortgages it is unwieldy.\textsuperscript{176} One need only consider the numerous and rarified property rights to which a mortgage note appertains, including the right to be paid, the right to a security interest, and the right to foreclose on real property.\textsuperscript{177} These rights are formed under the state law where the homeowner and real property are located; and, perhaps more importantly, the enforcement of such rights, especially foreclosure, is naturally accomplished in the jurisdiction (forum) where the homeowner and real property are located.\textsuperscript{178}

The equities of adopting a bright-line situs rule for mortgage notes sufficiently ameliorate concerns that the exercise of eminent domain would violate states’ rights and the due process rights of a non-resident mortgagee. First, the bright-line rule would provide the certainty to both states and mortgagees that, for the purposes of condemnation, the property rights in the mortgage note are not severable from the location of the real property. As distinguished from the other situs rules, like \textit{mobilia sequuntur personam}, this proposed rule extinguishes any further inquiries into where the mortgagee is and their current domicile. Eminent domain purists can continue to proclaim that property can only be condemned in one state’s jurisdiction, to the exclusion of all other states. Inversely, if the situs were determined by \textit{mobilia sequuntur personam}, then the non-resident mortgagee’s state of domicile would be able to exercise subject-matter jurisdiction.

\begin{footnotesize}
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\item \textsuperscript{173} See Mufson, supra note 166, at 395–405.
\item \textsuperscript{174} “An assumption that something is true even though it may be untrue, made esp. in judicial reasoning to alter how a legal rule operates . . . .” \textsc{Black’s Law Dictionary, supra note 171, at 976} (definition of “legal fiction”).
\item \textsuperscript{175} Texas v. Florida, 306 U.S. 398, 429 (1939) (“In view of the enormous extent to which intangibles now constitute wealth, and the increasing mobility of men, particularly men of substance, the necessity of a single headquarters for all legal purposes, particularly for purposes of taxation, tends to be a less and less useful fiction.”).
\item \textsuperscript{176} See \textsc{Restatement (Second) of Conflict of Laws § 222 (1971)} (“The interests of the parties in a thing are determined, depending upon the circumstances, either by the ‘law’ or by the ‘local law’ of the state which, with respect to the particular issue, has the most significant relationship to the thing and the parties . . . .”); \textit{see also Mufson, supra note 166, at 394} (acknowledging that the Supreme Court has never reached the issue of whether it was permissible for states to condemn intangibles that are associated with several jurisdictions).
\item \textsuperscript{177} See Form No. 3200, \textit{Single Family Multistate Fixed Rate Note}, \textsc{Fannie Mae}, at 2, https://www.fanniemae.com/content/legal_form/3200w.doc (last visited Nov. 17, 2013) (“In addition to the protections given to the Note Holder under this Note, a Mortgage, Deed of Trust, or Security Deed (the ‘Security Instrument’), dated the same date as this Note, protects the Note Holder from possible losses which might result if I do not keep the promises which I make in this Note.”).
\item \textsuperscript{178} See \textsc{Grant S. Nelson & Dale A. Whitman, Real Estate Finance Law} 135–44 (5th ed. 2007) (outlining mortgage theories and the rights mortgagees are entitled to under each theory).
\end{itemize}
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jurisdiction to condemn the mortgage (and for what unearthly purpose?), to
the exclusion of the state where the homeowner and real property are
physically located. In sum, a rule like mobilia sequuntur personam does not
account for the legal rights that mortgage transactions embody. 179

Second, the mortgagor’s due process rights would not be obviated by
my proposed bright-line situs rule because, already, the mortgagor’s
substantive rights meaningfully exist only in the state where the real
property is located. Practically, this means that in order to collect on the
debt or foreclose on the home to satisfy that debt, the mortgagor must rely
on the courts and procedure within the same jurisdiction as the real
property. These rights and interests, as will be demonstrated below, also
allow those same courts to exercise personal jurisdiction over the
mortgagor. Moreover, without considering the convenience of each
jurisdictional venue, it is unclear how giving those courts subject-matter
jurisdiction to condemn a mortgage note from a non-resident mortgagor
would be either unconstitutional or unfair. In such a scenario, the mortgage
note is condemned and the mortgagor can contest the taking. If the
condemnation is affirmed, then the mortgagor will receive compensation.

Regardless of the mortgage note’s situs, mortgagors already face the
prospect that they will lose their security interest in the event that the
mortgaged real property is condemned. 180 Condemning the mortgage note
would present no additional hardships for the mortgagor.

D. DUE PROCESS & PERSONAL JURISDICTION

In addition to having subject-matter jurisdiction and complying with
substantive due process when condemning notes, municipalities must
accord mortgagors adequate procedural due process as guaranteed by the
Fourteenth Amendment’s Due Process Clause. 181 A court or tribunal
condemning the promissory note will be proceeding in personam against
the mortgagor to take and extinguish their ownership interest in the note
and mortgage. 182 The preliminary issue then is whether state courts can

179. ROBERT KRATOVIL & RAYMOND J. WERNER, MODERN MORTGAGE LAW AND PRACTICE
147 (2d ed. 1981) (“The mortgage was drafted as an instrument given to secure a separate
document that evidenced the mortgage debt. This separate document ultimately took the form a
negotiable note. If default and foreclosure occurred, the sale reduced part, but not all, of the
mortgage debt.”).
180. NICHOLS ON EMINENT DOMAIN, supra note 161, § 5.03 (“When mortgaged property is
taken by eminent domain, the mortgagor’s rights against the land follow the award in equity, and
he or she may, in suitable proceedings, have the mortgage debt satisfied out of that fund in
advance of other creditors of the mortgagor or of an assignee of the award.”).
182. Shaffer v. Heitner, 433 U.S. 186, 199 (1977) (“If a court’s jurisdiction is based on its
authority over the defendant’s person, the action and judgment are denominated ‘in personam’ and
can impose a personal obligation on the defendant in favor of the plaintiff. If jurisdiction is based
on the court’s power over property within its territory, the action is called ‘in rem’ or ‘quasi in
rem.’”).
assert personal jurisdiction over a mortgagee or other party holding the promissory note, who is presumably a real person, a corporation, or a securitization trust; again, particularly when that party is outside the state’s territory. Though states may choose to permit their respective courts to assert personal jurisdiction over litigants to the extent that the Constitution allows, states can also curtail that jurisdiction with a “long-arm” statute. Such long-arm statutes vary by state, but are probably not an obstacle to condemnation proposal. Instead, greater challenges are posed by explicit state level limitations on eminent domain as discussed above.

In order to assert personal jurisdiction over a defendant, due process requires that a defendant—here the mortgagee—have sufficient or “minimum” contacts with the state that is exercising jurisdiction. Determining whether there are minimum contacts requires an analysis of the “quality and nature of the activity” that a defendant has in or with the state. In the context of condemning a mortgage note, the fact that a note is by definition a contract secured or collateralized by the underlying real property—the house within the municipality’s jurisdiction—gives local courts a plausible means to assert jurisdiction over an out-of-state mortgagee, whose only connection with the forum is ownership of the mortgage’s promissory note. The in personam nature of asserting personal jurisdiction over the mortgagee’s promissory note and the in rem nature of the real property, as the security interest embodied in the mortgage, seems to be an adequate combination of contacts and interests, which the Supreme Court said in Shaffer v. Heitner could sustain quasi in rem (personal) jurisdiction. The Shaffer Court foresaw a situation where

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183. E.g., CAL. CIV. PROC. § 410.10 (West 2013) (“A court of this state may exercise jurisdiction on any basis not inconsistent with the Constitution of this state or of the United States.”); N.Y. C.P.L.R. § 302 (McKinney 2013).

184. Int’l Shoe Co. v. Wash., Office of Unemployment Compensation & Placement, 326 U.S. 310, 316 (1945) (quoting Milliken v. Meyer, 311 U.S. 457, 463 (1940) (“[D]ue Process requires only that in order to subject a defendant to a judgment in personam, if he be not present within the territory of the forum, he have certain minimum contacts with it such that the maintenance of the suit does not offend ‘traditional notions of fair play and substantial justice.’”)).

185. Id. at 319.

186. “The note and mortgage are inseparable; the former as essential, the latter as an incident. An assignment of the note carries the mortgage with it, while an assignment of the latter alone is a nullity.” Carpenter v. Longan, 83 U.S. 271, 274 (1872); cf. Hockett, It Takes a Village, supra note 11, at 165 (citing Carpenter and arguing that mortgage debt has situs in the state where the debtor is domiciled).

187. “[T]he Court’s decision] should not be read to invalidate quasi in rem jurisdiction where real estate is involved.” Shaffer, 433 U.S. at 219 (Stevens, J. concurring); but see id. at 220 (Brennan, J. concurring in part and dissenting in part) (declaring that quasi in rem jurisdiction was no longer “constitutionally viable”).

188. RESTATEMENT (FIRST) OF JUDGMENTS § 32 (1942) (“Where a thing is subject to the power of a State, a proceeding may be brought to affect the interests in the thing not merely of particular persons but of all persons in the world. Such a proceeding is called a proceeding in rem, as distinguished from a proceeding brought to affect the interests in the thing of particular persons only, which is called a proceeding quasi in rem.”).
personal jurisdiction could not be sustained purely in personam, though a party’s rights to property within the forum would permit a court to legitimately assert jurisdiction:

[P]resence of property in a State may bear on the existence of jurisdiction by providing contacts among the forum State, the defendant, and the litigation. For example, when claims to the property itself are the source of the underlying controversy between the plaintiff and the defendant, it would be unusual for the State where the property is located not to have jurisdiction. In such cases, the defendant’s claim to property located in the State would normally indicate that he expected to benefit from the State’s protection of his interest.  

So similar to the Court’s hypothetical is a local government’s condemnation of a mortgage or the mortgagee’s promissory note where the mortgagee is a non-resident or otherwise unsusceptible to personal jurisdiction because the secured interest (in real property) is a significant contact with the forum. Crucially, the Court discouraged dependence on the traditional forms of personal jurisdiction that attempt to rigidly classify contacts as between persons (or property) and a state.

The case for applying to jurisdiction in rem the same test of “fair play and substantial justice” as governs assertions of jurisdiction in personam is simple and straightforward. It is premised on recognition that “[t]he phrase, ‘judicial jurisdiction over a thing’, is a customary elliptical way of referring to jurisdiction over the interests of persons in a thing.” This recognition leads to the conclusion that in order to justify an exercise of jurisdiction in rem, the basis for jurisdiction must be sufficient to justify exercising “jurisdiction over the interests of persons in a thing.”

If this were not enough, there is precedent supporting personal jurisdiction over a non-resident defendant on the sole basis that the resident

189. Shaffer, 33 U.S. at 207–08.

190. The Shaffer Court also suggests a separate policy argument: “The State’s strong interests in assuring the marketability of property within its borders and in providing a procedure for peaceful resolution of disputes about the possession of that property would also support jurisdiction, as would the likelihood that important records and witnesses will be found in the State.” Id. at 208.

191. Shaffer, 33 U.S. at 207.

192. THOMAS D. ROWE, JR. ET AL., CIVIL PROCEDURE 433 (2d ed. 2008) (citing FleetBoston Fin. Corp. v. fleetbostonfinancial.com, 138 F. Supp. 2d 121, 131–35 (D. Mass. 2001) and Cable News Network L.P. v. cnnews.com, 162 F. Supp. 2d 484, 491 (E.D. Va. 2001)) (“Language in Shaffer suggests that minimum contacts analysis applies to both in rem and quasi in rem cases, and the whole approach of Shaffer seems to emphasize contacts rather than formal rules. But true in rem suits—those that are about ownership of the property, including ownership of a trademarked domain name—are quite different from Shaffer: A court determining ownership of property within its jurisdiction can argue that it must have jurisdiction over anyone with claims on the property. Courts are split on this question.”)
plaintiff was indebted to the defendant. Also, in McGee v. International Life Insurance Co., the Supreme Court held that a California court asserting personal jurisdiction over a Texas insurance company was valid, where the insurer never maintained an office or agent in California, nor had it ever solicited or done business in California to obtain the disputed insurance policy. The Court reasoned, “It is sufficient for purposes of due process that the suit was based on a contract which had substantial connection with that State.” For condemnation purposes, this suggests that a mortgagee or an assignee who owns the mortgage’s promissory note ought to have some inclination that her rights are likely subject to the jurisdiction of the state or forum where the mortgaged residential property is located. The municipality’s (or forum’s) interest in the real property and in having the power to adjudicate the rights of the resident-mortgagor validates the exercise of jurisdiction.

E. POSSIBLE DORMANT COMMERCE CLAUSE CHALLENGES ARE VAGUE AND CONTINGENT UPON THE ACTIONS OF EACH INDIVIDUAL STATE AND LOCAL GOVERNMENT

As is evident from the jurisdictional analysis, mortgage condemnation has the possibility of including mortgagees who are non-residents of a forum. Any extraterritorial effects from condemning mortgages bring concerns that local governments could directly or indirectly impact interstate commerce and thus violate the dormant Commerce Clause. Without existing factual examples, a likely argument is that “eminent domain will be viewed as ‘merely the means to the end’ and courts would focus on whether the end, protecting the state interest . . . , violates the dormant Commerce Clause.” Of course, under the proposed mortgage condemnation plans, nothing, and especially not interstate commerce, is being regulated. However, it is important to clarify that any power, no

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195. Id. at 223.
197. “The State’s strong interests in assuring the marketability of property within its border and in providing a procedure for peaceful resolution of disputes about the possession of that property would also support jurisdiction, as would the likelihood that important records and witness will be found in the State.” Shaffer, 433 U.S. at 208 (1977).
198. OMM Memorandum, supra note 42, at 9–12.
199. Saxer, supra note 95, at 1523 (quoting Berman v. Parker, 348 U.S. 26, 33 (1954)).
less than eminent domain, can be ill-used as a pretext for otherwise unconstitutional ends.201

The Supreme Court’s dormant Commerce Clause jurisprudence cautions local governments that their undertakings, if they cause extraterritorial effects or regulatory consequences for interstate commerce, must possess a legitimate local purpose and have an impact that is not disproportionately burdensome to interstate commerce.202 Where both the underlying real property and homeowner-mortgagor are physically within the same municipality, there is no a priori basis to sustain a dormant Commerce Clause challenge.203 Moreover, municipalities have broad discretion when selecting which mortgages to condemn and can therefore avoid conflict; at least facially, there isn’t a systematic preference for in-state mortgagees versus out-of-state mortgagees.204 But here, precedent provides minimal guidance.

F. THE CONDEMNATION PROCEEDING

In most jurisdictions, the first step on the path to condemnation is filing a petition, after which notice is given to the property owners.205 Condemning residential real estate typically has few obstacles regarding notice.206 However, with intangible properties like a mortgage, notifying the owner is less practical;207 with real estate, one knows at the very least where the property is located.208 Certainly, providing notice in mortgage condemnation proceedings requires notifying the homeowner (mortgagor),

Clause is awakened only when Congress has not acted “to regulate Commerce . . . among the several States.”).

201. Calder v. Bull, 3 U.S. 386, 400 (1798) (Iredell, J. concurring) (“Without the possession of this power the operations of Government would often be obstructed, and society itself would be endangered. It is not sufficient to urge, that the power may be abused, for, such is the nature of all power, such is the tendency of every human institution . . . . We must be content to limit power where we can, and where we cannot, consistently with its use, we must be content to repose a salutary confidence. It is our consolation that there never existed a Government, in ancient or modern times, more free from danger in this respect, than the Governments of America.”).


204. See Urbine, 554 S.E.2d at 344 (“We find no case law that supports the proposition that the Commerce Clause is a sustainable defense to the condemnation of real property.”).

205. JESSE DUKEMINIER & JAMES E. KRIER, PROPERTY 1116 (5th ed. 2002).

206. CAL. CIV. PROC. § 1240.030 (West 2012) (requirements of eminent domain); id. § 1245.235 (notice requirement for eminent domain); N.Y. EM. DOM. PROC. LAW § 501 (McKinney 2012) (vesting exclusive jurisdiction over eminent domain proceedings with the court of claims); id. § 202 (notice requirements for real property).

207. “In all acquisitions in which the court of claims has jurisdiction . . . , the condemnor . . . shall serve either by personal service or by certified mail, upon each condemnee a notice of acquisition . . . .” N.Y. EM. DOM. PROC. LAW § 502 (McKinney 2012) (service of notice of acquisition); cf. CAL. CIV. PROC. § 1245.235 (West 2012) (requiring first-class mail).

208. See Pennoyer v. Neff, 95 U.S. 714 (1878) (a good example of real property being the object of notice rather than the defendant).
lender (mortgagee), and, if need be, any third party that carries the deed of trust on the mortgage. This could be the original lender or some other institution like a title company or escrow service. Barring the unforeseen, finding the homeowner is elementary—he or she lives in the house. However, with the advent and proliferation of mortgage-backed securities, effecting notice may require an inquiry as to where the mortgagee is and who they are, since the original mortgage lender of record has sold the mortgage to a securitization trust or some other investor.

It was once common for deeds to be recorded with the actual or original mortgagee as the mortgagee of record, with any future assignment of the mortgage being recorded afterward. As the secondary market for mortgages has grown in recent years, it is more common for mortgage lenders to record a nominee, like Mortgage Electronic Registration Systems, Inc. (MERS), as the mortgagee of record so that assignees of the mortgage—often securitization trusts—are able to identify which mortgage they actually own. Besides acting as a nominee for the original lender and for subsequent purchasers of the mortgage note, MERS has developed its own private recording system that has effectively displaced the function of public land recording offices. Participants in both the primary and secondary mortgage markets have become accustomed to MERS, so much so that it is the de facto recording and information system


210. Statutes requiring that the condemnee (here the mortgagee) be notified by certified mail is likely enough to rule out due process challenges. See Mullane v. Cent. Hanover Bank & Trust Co., 339 U.S. 306, 314 (1950) (ruling that notice must employ a means that actually desires to inform the party and reasonably apprise them of suit). Where the condemnee is a large financial institution, Rule 4(h)(1)(B) of the Federal Rules of Civil Procedure provides some guidance. FED. R. CIV. P. 4(h)(1)(b) (providing that summons can be made on an agent authorized by law).

211. See MBA Fact Sheet, supra note 209, at 1–2.

212. See id. at 2–3. For an excellent example of the legal ambiguities that surround Mortgage Electronic Registration Systems’ (MERS’) role in the mortgage market, see Bain v. Metro. Mortgage Grp., Inc., 285 P.3d 34, 36–41 (Wash. 2012) (Where MERS was listed as the “beneficiary” of the deeds of trust, the court held that MERS was in fact not the lawful beneficiary because it was not the holder of the promissory note on the mortgage.).


214. FAQ, MERSCORP HOLDINGS, INC., http://www.mersinc.org/information-for-homeowners /faq-information-for-homeowners/whatismers (last visited Nov. 17, 2013); see also MBA Fact Sheet, supra note 209, at 2–3 (“Allowing [MERS] to serve as the mortgagee of record has relieved the pressures on the public land records caused by repeated transfers of mortgage rights (such as servicing and ownership rights), and thereby helps protect the accuracy and integrity of the chain of title.”).
for mortgages. A large portion of mortgage assignments that were once recorded in public record offices (for a fee) are now handled by MERS, the perpetual nominee. The practical consequence of the shift away from public recording is that it’s no longer obvious (or publicly known) who the actual mortgagee is—the real party in interest.

Mortgage investors and securitization trusts that hold the mortgage notes can simply use MERS’s eighteen-digit “mortgage identification number” to get the record information of the homeowner, as well as the trustee or custodian holding the deed underlying the mortgage. Likewise, when a homeowner defaults, a lender or servicer can notify the mortgage investor so that the investor can exercise its rights in the mortgage—foreclosure, forbearance, loan modification, etc. Fortunately, this private recording system can also be accessed by homeowners and government entities that are trying to find out who owns a particular mortgage.

After finding the parties with an interest in the mortgage note—the homeowner, mortgage investor, and mortgage servicer—providing notice is typically no more than sending them a notice of acquisition. In many jurisdictions this can be done by mail, either first-class or certified. Notified parties have an opportunity to protest the condemnation, sometimes first at a formal public hearing, then at trial.

The procedural variations of condemnation trials are as numerous as the different jurisdictions. A summary of the trial is as follows:

[A] trial is held, at which the government must establish its authority to condemn (which means, in some jurisdictions, that the government must show that a taking is “necessary”). The court can give the government permission to enter and inspect the subject property; it may require the government to make a deposit as security for the eventual condemnation, in an amount based on the compensation estimated to be awarded at the end of the proceedings. Jurisdictions differ on the availability of a jury trial in condemnation actions (none is required under the United States Constitution). If there is a jury trial, it is typically the jury that determines just compensation; issues of public use and necessity are decided by the court. At the conclusion of a successful condemnation action (or within a prescribed time thereafter), the government must pay the compensation.

215. See MBA Fact Sheet, supra note 209, at 2–3.
216. See id.
218. FAQ, supra note 214.
220. MBA Fact Sheet, supra note 211, at 2–3.
221. E.g., N.Y. EM. DOM. PROC. LAW § 502 (McKinney 2012).
222. E.g., id.; CAL. CIV. PROC. § 1245.235(b) (West 2012).
223. E.g., CAL. CIV. PROC. § 1245.235(a).
awarded, plus interest, if any, accrued from the time of the taking . . . .
Dissatisfied condemnees may, of course, appeal.224

The trial often requires the condemning authority to provide extensive
documentation that helps to determine and define the property being
condemned.225 Here, a copy of the promissory note or mortgage documents
is necessary, the taking of which may not be so much physical as legal.226
The judgment would extinguish the mortgagee’s rights in the mortgage.227
The corollary here is that if the taking is deemed legitimate, the condemnee
will spend much of her effort at trial arguing the fair market value of the
property.228 In fact, both the government and the condemnee are mainly
looking to the trial as a means to establish the requisite, or just,
compensation—the condemnee desires as much compensation as possible,
and the government seeks to pay what it can afford or a lesser amount.
Again, valuing a mortgage is actuarial in nature and fact-intensive.229 Both
local governments and sophisticated mortgage investors are well-suited to
argue the value of mortgage notes, each having access to information that
indicates the relevant value of the mortgages.230 The condemnee can appeal
a condemnation judgment, though an appeal is almost certainly going to be
a replay of the just compensation inquiry.231

III. FINANCING MORTGAGE TAKINGS WITH MORTGAGE-
BACKED MUNICIPAL BONDS

Municipalities are well advised to exhaust all of their options in
pursuing a mortgage condemnation plan,232 and Professor Hockett is right
to point out that private lenders are a viable source of refinancing for
condemned mortgages intended to be modified.233 The cost of private
refinancing is totally dependent on the homeowner’s financial
circumstances and the value of residential property at the time of
refinancing.234 Both the value of the residential property and a

224. DUKEMINIER & KRIER, supra note 205, at 1116.
225. CAL. CIV. PROC. § 1250.310 (listing what must be in the condemnation complaint); N.Y.
     EM DOM. §§ 401–06.
226. CAL. CIV. PROC. § 1268.210; N.Y. EM. DOM. § 405.
227. CAL. CIV. PROC. § 1268.210 (court order for possession); N.Y. EM. DOM. §§ 403–05.
228. CAL. CIV. PROC. §§ 1260.210–.250 (compensation procedure); N.Y. EM. DOM. §§ 501–14
     (compensation procedure).
229. See Part II’s discussion of just compensation and fair market value, supra notes 131–135.
230. See Part I’s discussion of local government. Expert witnesses, such as financial analysts,
     might be capable of shedding light on the value of the mortgage. However, valuing one mortgage
     is an entirely different task than valuing a pool of mortgages. See supra notes 131–135.
231. CAL. CIV. PROC. § 1255.470; N.Y. EM. DOM. § 604.
232. Hockett, It Takes a Village, supra note 11, at 143–49.
233. Id. at 150.
234. Id. at 151 (describing how the municipalities can discount the condemned mortgage to the
     amount “corresponding to the level at which the mortgagor can obtain new financing in the
     mortgage loan market”).
homeowner’s finances are subject to fluctuation, especially considering that the residential property is likely a distressed asset, and homeowners’ finances can dramatically change if they are no longer overburdened by their existing mortgage. The implication is that private lenders are given the extremely difficult task of deciding rational lending terms for homeowners who could not afford their previous mortgages.

Private lending, therefore, is certainly an option, but it cannot be evaluated in a vacuum. The benefits and risks require a fact-intensive inquiry relevant to each situation, specific to each individual locality, residential property, and homeowner. Relatedly, my proposal to publicly finance mortgage condemnations through municipal bonds cannot be said to be inherently more economical than private lending. However, it does offer local governments a degree of certainty if they are concerned that private lenders will not be prepared to refinance the condemned mortgages on a scale that materially preserves homeownership in their community. It also assures that homeowners and citizens cannot be forced from their homes on the whim of a bank or servicer, since the mortgages, promissory notes, and deeds of trust would be all effectively under the ownership of the municipality.

The basic concept of publicly financed mortgage condemnations is to issue municipal bonds that will be used either to fund mortgage condemnations or to offset funds already used to condemn mortgages. The bonds that finance condemnations would be in a form very similar to revenue bonds in that refinanced mortgages would be used to pay down the bonds with their payment streams, while the residential property (or deeds) would collateralize the bond issuance. Functionally, this is quite similar to a mortgage-backed security. But unlike the private, mortgage-backed security, some municipal bond issuances allow for federal tax subsidy—or, more accurately, federal tax exemption.

Federal tax exemptions for municipal bonds are governed by the Internal Revenue Code (the IRC). In order for municipal bonds to maintain federal tax exemptions, it is generally required that proceeds from bond issuances are neither used to fund private business nor made as loans to private entities. This policy of non-exemption for “private activity” bonds is designed to ensure that government entities do not subsidize

235. Foote et al., supra note 12, at 12.
237. See generally id. at 93–106 (explaining federal taxation of municipal bonds).
240. See I.R.C. § 141(a).
their projects with tax proceeds the federal government would otherwise collect. Still, there are certain exceptions or qualifications to the private activity policy, allowing for so-called “qualified” bonds, which use bond proceeds to fund private activities that the IRC specifically subsidizes through federal tax exemption. The IRC even recognizes a municipal bond used to fund mortgage lending called a *qualified mortgage bond*. Unfortunately, these qualified mortgage bonds cannot be used to finance mortgage condemnations in the manner I propose because of two caveats stipulating that the bonds (1) cannot be used to replace existing mortgages and (2) the mortgagor-homeowner cannot recently have had a present ownership interest in the financed property. Qualified mortgage bonds are an ingenious carve-out in the tax code but are mainly designed for first-time homebuyers. Meeting the stipulations and requirements for a valid issuance of qualified mortgagor bonds is probably too onerous for the purposes of mortgage condemnations, though the IRC does admit some exceptions.

A more appropriate bond for financing mortgage condemnations appears to be the *qualified redevelopment bond*. Qualified redevelopment bonds allow for tax-exempt municipal bond issuances where there is an adequate “redevelopment purpose” for designated areas of blight. The two general requirements to achieve tax-exempt status under the qualified

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241. Sean Carey, Note, *Post-Davis Conduit Bonds: At the Intersection of the Dormant Commerce Clause and Municipal Debt*, 78 FORDHAM L. REV. 121, 131 (2009) (“While the federal government ultimately bears the cost of this exemption, it gains a foothold in the municipal bond market. By setting the parameters for the federal tax exemption, the federal government can influence the purchases of bondholders; by influencing these purchases, the federal government influences the type of projects state and local governments fund.”).

242. See I.R.C. § 141(e); Knepper, *supra* note 239, at 1649 (“The Code calls these private activity bonds that are eligible for tax exemption ‘qualified private activity bonds.’”).


244. I.R.C. § 143.

245. Id. § 143(i)(A).

246. Id. § 143(d) (stating 3-year requirement).

247. The requirement that financing not be used for those who have had a present property interest in the underlying property for the previous three years infers a preference for first-time homebuyers.

248. Section 143(d)’s “3-year requirement” excepts financing that involves “targeted area residents.” I.R.C. § 143(d)(A), (j). Section 143(i)(1)’s requirement for new mortgages admits exceptions where the financing is for “bridge loans or similar temporary initial financing” and for the “qualified rehabilitation” of the underlying property. Id. § 143(i)(1)(B)(ii), (iii).

249. See id. §§ 141(e)(1)(F), 144(c).

250. See id. § 144(c)(3)(A). The redevelopment purpose conceivably satisfied by mortgagor condemnations is “the acquisition (by a governmental unit having the power to exercise eminent domain) of real property located in such area . . . .” Id. § 144(c)(3)(A)(1). Although a municipality would not be taking possession of the real property as such, it would be taking (acquiring) an interest in real property as a result of the mortgage condemnation.

251. Under section 144(c), blight is a broad condition “on the basis of the substantial presence of factors” including abandoned or vacant buildings and, most crucially, “delinquencies in payment of real property taxes.” Id. § 144(c)(4)(B).
redevelopment bond provision are (1) state authorization of such bond issuances and (2) the formulation of a redevelopment plan that outlines how the blighted area will be remediated. Municipalities that intend to use qualified redevelopment bonds can first assess the level of economic distress or blight within their community, after which they can conjunctively structure their redevelopment plans and mortgage condemnation proposal to legitimize a bond issuance.

The practical limitation for qualified redevelopment bonds is that they are capped at the state level to ensure that municipalities are not overusing the bonds as a loophole to excessive redevelopment—or development veiled as redevelopment. Whatever the limitations, municipalities should consult the IRC to see if their community could benefit from qualified bonds because the tax exemptions for such bonds ostensibly provide the cheapest cost of capital for refinancing condemned mortgages.

If municipalities cannot achieve tax-exempt status specifically for mortgage condemnation, they might nevertheless benefit from holding a portfolio of mortgages. Municipalities that have enough capital reserves to condemn and refinance mortgages might be able to attract lower interest rates on their general obligation bonds (that are tax-exempt). Local governments that demonstrate they are committed to reversing the housing decline in their respective communities may persuade investors that their local economies are stabilizing. Preserving homeownership, after all, is likely to improve property tax revenues and the overall fiscal health of a locality, making it a more attractive credit risk and a better place to reside.

Municipalities that engage in mortgage condemnation as part of a larger economic plan would be able to sell publicly refinanced mortgages at a later date—allowing municipalities to avoid the threat of insolvency or illiquidity as a result of holding too many mortgages. Even if none of these opportunities present themselves, municipalities could still use taxable municipal bonds to procure capital for mortgage condemnations.

CONCLUSION

The fate of mortgage condemnation proposals is uncertain. Such proposals have never been implemented, and there is no case law specific to the aforementioned legal issues in the context of mortgage takings. Moreover, tremendous public and private pressure may ultimately render mortgage condemnations as unpopular schemes of local governments or, more likely, financially and politically impractical. That I or anyone else finds plausible the condemnation proposals considered by Richmond,
California, does not vitiate the very real obstacles posed outside the world of legal theory. Beyond the bounds of a mere academic or political exercise, the worst can and does happen, even when the law appears uniform and unambiguous. Accordingly, it is recommendable to be vigilant of legal contingencies that arise in the context of mortgage takings. For these reasons, the successful implementation of mortgage condemnation proposals would require—even more than plausible legal arguments—extremely adroit statecraft on the part of municipalities. And with conditions so variable at the local level, defining “success” is a judgment call to be made by citizens, who are unlikely to provide a consensus. Finally, it is a fair admonition that mortgage condemnations are not ideal. But I implore the reader to bear in mind that those unfortunate enough to be involved in circumstances fraught with financial and likely other personal or social conflicts might not be looking for an ideal solution.

*Jourdain B. Poupore*
#IHATEMYBOSS:

RETHINKING THE NLRB'S APPROACH TO SOCIAL MEDIA POLICIES

INTRODUCTION

North Carolina, 1960: Four black college students order coffee at a restaurant counter. Service is denied because of their race, but they remain seated and refuse to leave. News of the sit-in spreads—first by word-of-mouth, then by local newspaper coverage. What begins as a small sit-in gains momentum, spreading protests to four states within the week and as far as Texas by the end of the month. It was not until four years later that the Civil Rights Act of 1964 was passed, which outlawed discrimination based upon “race, color, religion, sex or national origin.”

Tahrir Square, Cairo, Egypt, January 25, 2011: A small group of protesters gather to protest against the regime of Egyptian President Hosni Mubarak. News of the resulting demonstrations spreads through the social media platform Twitter. Within hours, tens of thousands of people gather throughout Egypt, and within days, millions of people march in protest. The government attempts to stop the protests by blocking all social media sites, but the attempt fails. As one protester states, “We use Facebook to schedule the protests, Twitter to coordinate, and YouTube to tell the world.” Social media thrusts the Egyptian uprising to the front pages of

1. "#" is a Twitter symbol called a “hashtag,” which is used to categorize messages by keyword or topic in a “tweet.” See Using Hashtags on Twitter, TWITTER HELP CENTER, https://support.twitter.com/articles/49309-what-are-hashtags-symbols (last visited Nov. 17, 2013).
3. Id.
4. Id.
5. The second morning, Tuesday, there were thirty-one protesters. On Wednesday, the number of protesters increased to eighty. By Thursday, there were 300. By Saturday, there were 600. One week later, the sit-ins had spread fifty miles away to Durham. By Thursday and Friday, the protest crossed state lines and reached Virginia, South Carolina, and Tennessee. By the end of the month, the sit-ins spread as far as Texas. Id.

Social media has also blurred the line between people’s private and professional lives. Increasingly, employees use social media to discuss issues arising in the workplace.\footnote{Bryan Russell, Facebook Firings and Twitter Terminations: The National Labor Relations Act as a Limit on Retaliatory Discharge, 8 WASH. J.L. TECH. & ARTS 29, 30 (2012).} A worker might use social media to announce a promotion, report rumors of downsizing, complain about a co-worker or boss, or discuss dangerous working conditions.\footnote{See id.} In response, many employers have issued social media policies, which set forth rules or guidelines on what is appropriate for employees to post online about their workplace.\footnote{See EchoStar Technologies, L.L.C., No. 27-CA-066726, 2012 WL 4321039 (NLRB Div. of Judges, Sept. 20, 2012); Three d, LLC, No. 34-CA-12915, 2012 WL 76862 (NLRB Div. of Judges, Jan. 3, 2012).} A social media policy might, for example, provide that an
employee may not divulge trade secrets,\textsuperscript{19} use company computers to access social media sites,\textsuperscript{20} or speak disrespectfully of co-workers.\textsuperscript{21}

As social media and the workplace increasingly intersect, the National Labor Relations Board (the NLRB) has struggled to apply the now seventy-eight-year-old National Labor Relations Act (the NLRA or Act)\textsuperscript{22} in this new world. Most cases in this area deal with whether the discharge or discipline of an employee for statements made on a social media site violates section 7 of the NLRA, which protects an employee’s right to “engage in . . . concerted activities for the purpose of collective bargaining or other mutual aid or protection.”\textsuperscript{23} More recently, the NLRB has addressed the related issue of whether, apart from its application to a particular employee, an employer’s social media policy violates section 8(a)(1) of the NLRA, which prohibits an employer from “interfer[ing] with, restrain[ing], or coerced[ing] employees in the exercise of the rights guaranteed in Section 7,”\textsuperscript{24} thereby chilling the employee’s exercise of section 7 rights.\textsuperscript{25} The inquiry in a typical section 8(a)(1) facial challenge to a social media policy is whether some provision of the policy is so general or ambiguous that an employee would reasonably construe the provision as prohibiting or restricting a section 7-protected activity, such as the discussion of working conditions.\textsuperscript{26}

This Note will analyze, and critique, the NLRB’s approach to challenges to an employer’s social media policy under section 8(a)(1) of the Act. As discussed below, the NLRB’s approach fails to recognize the unique nature of conversing over social media and has failed to give either employees or employers adequate guidance in this critical area. This failure is particularly important because of the widespread use of social media and the extensive reach of the NLRA, which broadly covers employees in the

\textsuperscript{19} See EchoStar, 2012 WL 4321039.
\textsuperscript{23} Section 7 rights, as they are commonly known, are codified at 29 U.S.C. § 157.
\textsuperscript{24} 29 U.S.C. § 158(a)(1). Section 158 is commonly referred to as section 8.
\textsuperscript{25} Costco Wholesale Corp., 358 N.L.R.B. No. 106 at 2.
\textsuperscript{26} For instance, in Costco, the Board found that although the rule did not explicitly reference section 7-protected activity,

by its terms, the broad prohibition against making statements that “damage the Company, defame any individual or damage any person’s reputation” clearly encompasses concerted communications . . . . [T]here is nothing in the rule that even arguably suggests that protected communications are excluded from the broad parameters of the rule. In these circumstances, employees would reasonably conclude that the rule requires them to refrain from engaging in certain protected communications.

Id.
I. BACKGROUND

A. THE NATIONAL LABOR RELATIONS ACT

Congress enacted the NLRA in 1935 “to protect the rights of employees and employers, to encourage collective bargaining, and to curtail certain private sector labor and management practices, which can harm the general welfare of workers, businesses and the U.S. economy.” The NLRA applies to private sector employees, regardless of whether they are represented by a union, subject to certain exceptions.

The purpose of the Act was to “prohibit unfair labor practices by employers” at a time when employees had little bargaining power. Before the Act’s passage, employees were subjected to dangerous working conditions, low wages, and violence. It was much easier for an employer to hire a new employee than it was for an employee to find a new job, so

27. See 29 U.S.C. § 152; see also infra note 29 (discussing exceptions to NLRA coverage).
29. The NLRA does not include
any individual employed as an agricultural laborer, or in the domestic service of any family or person at his home, or any individual employed by his parent or spouse, or any individual having the status of an independent contractor, or any individual employed as a supervisor, or any individual employed by an employer subject to the Railway Labor Act.
31. Id.
employees had virtually no bargaining power.\textsuperscript{33} Thus, the Act significantly leveled the playing field between employers and employees.\textsuperscript{34}

\textbf{B. THE NATIONAL LABOR RELATIONS BOARD}

The NLRB is made up of three divisions: the General Counsel, Administrative Law Judges (ALJs), and a five-member board consisting of presidential appointees (the Board).\textsuperscript{35} When an employee believes he or she was the victim of an unfair labor practice, that employee can file a charge against the employer.\textsuperscript{36} The NLRB General Counsel investigates charges and determines whether they are legitimate and should be prosecuted.\textsuperscript{37} If the General Counsel decides the claim has merit, it will generally begin the process of prosecuting the case by issuing a complaint.\textsuperscript{38} If the case is not settled, the claim is brought before an ALJ, who issues a decision on the claim.\textsuperscript{39} An ALJ decision is not considered precedent but can be useful in predicting how the full Board might decide a case.\textsuperscript{40} The ALJ decision can be appealed to the full Board by either the General Counsel or the charged party.\textsuperscript{41} Decisions of the Board are appealed directly to a Court of Appeals.\textsuperscript{42}

\textbf{II. BEYOND THE WATER COOLER}

The NLRA was enacted in 1935, in a world vastly different from the world of Twitter and Facebook.\textsuperscript{43} The vast majority of the NLRA caselaw was decided in the pre-Internet era and involved employee telephone usage,\textsuperscript{44} employee gatherings in the parking lot after the shift,\textsuperscript{45} or union activities during nonworking hours.\textsuperscript{46} The NLRB has been applying the

\begin{itemize}
\item \textsuperscript{33} \textit{National Labor Relations Act, supra} note 30.
\item \textsuperscript{34} Rojas, \textit{supra note 32}, at 665.
\item \textsuperscript{35} \textit{Who We Are, NLRB,} http://www.nlrb.gov/who-we-are (last visited Nov. 17, 2013).
\item \textsuperscript{36} Id.
\item \textsuperscript{38} Id.
\item \textsuperscript{39} Id. at 4.
\item \textsuperscript{40} Protected Speech and the Rights of Private Sector Employees: Social Media Postings: Are They Protected Speech?, Bogatin, Corman & Gold, http://bogattorneys.com/protected-speech-and-the-rights-of-private-sector-employees-social-media-postings-are-they-protected-speech/ (last visited Nov. 17, 2013) [hereinafter Protected Speech].
\item \textsuperscript{41} Eastman, \textit{supra} note 37, at 4.
\item \textsuperscript{42} 29 U.S.C. § 160(f) (2012). In addition to an appeal by a party of a proceeding, the Board can petition a Court of Appeals for an order of enforcement if a party fails to comply with a Board order. Id. § 160(e).
\item \textsuperscript{43} See National Labor Relations Act, \textit{supra} note 28.
\item \textsuperscript{44} Kenrich Petrochems, 294 N.L.R.B. 519, 525 (1989).
\item \textsuperscript{45} See Eastex, Inc. v. NLRB, 437 U.S. 556, 558 (1978) (employees engaged in union activities in nonworking areas of petitioner’s property during nonworking hours).
\item \textsuperscript{46} See id. (Employees “sought to distribute a union newsletter in nonworking areas of petitioner’s property during nonworking time urging employees to support the union and
standards and test developed in the pre-Internet context to online activities, with little or no acknowledgment of how social media activities differ from more traditional employee activities and how those differences might be legally significant.\textsuperscript{47} Other federal agencies, including the Food and Drug Administration (the FDA)\textsuperscript{48} and the Federal Trade Commission (the FTC),\textsuperscript{49} have recognized that social media is different, and these agencies are undertaking an open, inclusive study of social media, holding public hearings, and taking public comment in an effort to determine how the traditional rules may need to be modified in light of the unique nature of social media.\textsuperscript{50}

In contrast, the NLRB is “operating under the false assumption that online activity mirrors offline activity” \textsuperscript{51} and is applying its traditional rules discussing a proposal to incorporate the state ‘right-to-work’ statute into the state constitution and a Presidential veto of an increase in the federal minimum wage.”).


\textsuperscript{48} For example, in U.S. DEP’T OF HEALTH & HUMAN SERVS. ET AL., GUIDANCE FOR INDUSTRY RESPONDING TO UNSOLICITED REQUESTS FOR OFF-LABEL INFORMATION ABOUT PRESCRIPTION DRUGS AND MEDICAL DEVICES: DRAFT GUIDANCE (2011), available at http://www.fda.gov/downloads/Drugs/GuidanceComplianceRegulatoryInformation/Guidances/UCM285145.pdf, a coalition of health agencies and organizations addresses the use of social media by pharmaceutical companies to promote their products, and specifically focuses on the duties and limitations that apply when a company responds on social media to a question about “off-label,” or unapproved, use of their product. Prior to issuing this Guidance, the FDA held two days of hearings, at which representatives of the drug industry, social media companies, and consumers testified, and the FDA then issued proposed guidelines for public comment. Bob Pearson, Perspective on the FDA Social Media Hearing, COMMON SENSE (Nov. 16, 2009, 9:35 AM), http://www.csmg.us/2009/11/perspective-on-the-fda-social-media-hearing.html (last visited Nov. 17, 2013).

\textsuperscript{49} For example, in 2009, the FTC updated its Guides Concerning the Use of Endorsement and Testimonials in Advertising (Guides) to address the unique issues posed by the expanding use of social media for advertising. Guides Concerning the Use of Endorsements and Testimonials in Advertising, 74 Fed. Reg. 53,124, 53,124 (Oct. 15, 2009). The Guides deal with such issues as the disclosure of a “material connection,” such as payments or free use of a product, between the advertiser and the endorser. Id. at 53,133. The updated Guides address such social media issues as blog comments by celebrities. Id. at 53,128, 53,133. Prior to issuing the updated Guides, the FTC issued a draft of the proposed changes for public comment. Guides, Proposed Plans, 73 Fed. Reg. 72,374, 72,374 (Nov. 28, 2008).

\textsuperscript{50} In many other areas of the law, the unique characteristics of social media are requiring an examination of whether, and if so, how, traditional rules must be modified to apply to this new medium. See, e.g., H. Christopher Boehing & Daniel J. Toal, Authenticating Social Media Evidence, N.Y.L.J., Oct. 2, 2012, at 5 (“Because social media is often stored on remote servers, is assessed through unique interfaces, can be dynamic and collaborative in nature, and is uniquely susceptible to alteration and fabrication, evidentiary standards developed for other types of electronically stored information [ESI] may not be adequate.”); see also Peter A. Crusco, An Impartial Jury in the Milieu of Social Media Networks, N.Y.L.J., Oct. 23, 2012, at 5.

\textsuperscript{51} Ariana C. Green, Privacy Law: Using Social Networking to Discuss Work: NLRB Protection for Derogatory Employee Speech and Concerted Activity, 27 BERKELEY TECH. L.J. 837, 885 (2012).
to social media cases without considering public comment, a study of social media, or an analysis of how online activity differs from water cooler conversations, pamphletting, or other traditional types of concerted activities. In fact, Board Chairman Mark G. Pearce recently stated that “many view social media as the new water cooler. . . . [A]ll we’re doing is applying traditional rules to a new technology.”

A. WHAT’S DIFFERENT ABOUT SOCIAL MEDIA

However, there are a number of very significant differences between posting a comment on Twitter and engaging in a verbal, face-to-face exchange.

1. Here, There, Everywhere

First, unlike a conversation with a person or a few people, a statement posted on the Internet can potentially be read by millions of people. Even before the proliferation of social media, it was possible, albeit difficult, for an ordinary person to make a public statement that would reach a large audience. Anyone can put on a thirty-second commercial during the Super Bowl and reach an audience of more than 100 million viewers. However, the theoretical availability of these fora never posed a real problem because of their high cost. Social media differs in that almost everyone has access to the Internet, and through it, a virtually unlimited audience.

2. Spreads Like Wildfire

The Internet is “marvellously efficient.” Something posted to the Internet can “go viral” and be viewed by countless people very quickly, particularly because of the ability to “share” or “re-tweet” a posting without having to ask permission. For example, during the 2012 Obama-Romney

52. Greenhouse, supra note 47.
53. Gladwell, supra note 2, at 45 (“Twitter is a way of following (or being followed by) people you may never have met. Facebook is a tool for efficiently managing your acquaintances, for keeping up with the people you would not otherwise be able to stay in touch with. That’s why you can have a thousand ‘friends’ on Facebook, as you never could in real life.”).
55. “There is strength in weak ties, as the sociologist Mark Granovetter has observed. Our acquaintances—not our friends—are our greatest source of new ideas and information. The Internet lets us exploit the power of these kinds of distant connections with marvellous efficiency.” Gladwell, supra note 2, at 45.
56. One NFL player posted to Twitter regarding the replacement referees, and within twelve hours his tweet had been retweeted 85,000 times. See Nick Carbone, Monday Night Football: The 14 Best Tweets About the Controversial Packers-Seahawks Call, TIME NEWSFEED (Sept. 25, 2012), http://newsfeed.time.com/2012/09/25/monday-night-football-the-14-best-tweets-about-the-controversial-packers-seahawks-call/slide/interception-explosion/.
presidential election, television stations recognized that the early broadcasting of exit poll data could influence the election’s result. To avoid that risk, television stations agreed not to release early exit poll data—"[t]hat means no tweeting exit polls, posting on Facebook, or re-tweeting figures reported by others."58

3. Cheap ‘n’ Easy

In addition, social media is easily and inexpensively available. Over the past two decades there have been major changes in technology and in the availability of social media. In the 1990s home-computer ownership more than doubled, from fifteen percent of households to thirty-five percent. Now many people own or have access to a computer or a smartphone, often Internet-enabled for easy access to the Internet—anytime, anywhere. The widespread availability of these devices means that people can constantly be in touch with anyone in the world for little or no cost.

4. There for the Long Haul

A post to Facebook or Twitter lingers; it never disappears unless it is deleted, and even then, in the complex world of technology and cyberspace, it may never actually cease to exist. Once something is posted, the poster might not be able to delete or control it. In contrast, a face-to-face conversation, unless recorded, is fleeting and lasts only as long as the words are being spoken.

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58. Id.
61. See, e.g., Cajun Boy, Tori Spelling’s Husband Accidentally Tweeted a Photo of Her Breasts, UPROXX (Nov. 17, 2011), http://www.uproxx.com/webculture/2011/11/tori-spellings-husband-accidentally-tweeted-a-photo-of-her-breasts/. Though Ms. Spelling’s husband immediately deleted the photo, the image is still easily found with a simple Internet search.
62. Even erroneous online statements that are quickly corrected can have serious consequences. For instance, for several hours following Adam Lanza’s mass murder of children and staff members at Sandy Hook Elementary School in Newtown, Connecticut, police mistakenly named Ryan Lanza—Adam Lanza’s brother—as the shooter. Even after authorities corrected themselves later that day, Ryan’s picture continued to be sent all over the world, and he was the target of online death threats and condemned as a murderer by a "jury of Internet denizens." Helen A.S. Popkin, Social Media Quick to Judge, Slow to Absolve Shooter’s Brother, NBC NEWS, http://www.nbcnews.com/technology/technology/social-media-quick-judge-slow-absolve-shooters-brother-1C7621187 (last visited Nov. 17, 2013).
5. Is Anyone There?

It is often unclear who the audience is when using social media. In contrast to a personal conversation, a communication over social media does not require an audience. In fact, often when people post something online, they are not addressing a particular person but rather post with the idea that someone will read the post. Although the poster might not be attempting to communicate with anyone in particular, the potential audience on a social media website could be the entire world.

6. “Online Disinhibition Effect”

Finally, many people behave differently online and will say things that they would never say in a direct, in-person exchange. Internet addiction disorder has now been formally recognized by the American Psychological Association as a disorder. Though research in the area has only just begun, the medical profession has recognized that the Internet makes people act differently from how they would act in person.

[I]f inhibition is when behavior is constrained [sic] or restrained through self-consciousness, anxiety about social situations, worries about public evaluation, and so on, then disinhibition can be characterized by an absence or reversal of these same factors. . . . With regard to an individual’s behavior on the Internet, disinhibition could be summarized as behavior that is less inhibited than comparative behavior in real life.

People do and say things on the Internet that they would not even consider doing or saying in person. This phenomenon has been widely discussed in the popular press and has also attracted scholarly attention, where it has been labeled the “online disinhibition effect.” The effect operates in two

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63. Britney Fitzgerald, Facebook Psychology: 7 Reasons Why We Act Differently Online, HUFFINGTON POST (Oct. 11, 2012, 6:41 PM), http://www.huffingtonpost.com/2012/10/11/facebook-psychology-7-reasons_n_1951856.html (“But why exactly do we feel empowered enough to act in a certain way on social networking platforms like Facebook? The site requires users to sign up with their real names, so we’re not truly anonymous or far removed from virtual conversation. Even so, our behavior online can be . . . less than charming.”).


68. See generally Fitzgerald, supra note 63 (discussing reasons we act differently online).

69. Suler, supra note 67; see generally Adam N. Joinson, Self-Disclosure in Computer-Mediated Communication: The Role of Self-Awareness and Visual Anonymity, 31 EUR. J. SOC.
directions; sometimes people will reveal personal information about themselves online that they would not share in a one-on-one conversation (so-called benign disinhibition), and sometimes people will act out online and make statements, including obscene, vicious rants, that they would not make directly (known as toxic disinhibition).  

B. WHY THESE DIFFERENCES MATTER

These differences have practical implications. Risks are amplified on social media. After a difficult day in the workplace, an employee may impulsively and angrily post a message that he or she would never communicate in person and may soon regret, yet have no way to delete or retract the message. Without the employee’s permission or knowledge, the statement can be forwarded. Confidential information can be disclosed, privacy violated, and reputations damaged.

70. Suler, supra note 67. Professor Suler has identified six factors that interact to create the online disinhibition effect:

1. “Dissociative anonymity.” When you do things on the Internet, most people you encounter cannot easily tell who you are. Id. at 322.

2. “Invisibility.” Many online social media environments are “text-driven,” and the participants do not see or hear each other. In such an environment, even if one’s identity is known, the “opportunity to be physically invisible amplifies the disinhibition effect.” Id.

3. “Asynchronicity.” Most social media interaction does not take place in “real time.” As a result, there are not the same interpersonal “cues” as in a face-to-face exchange, and the person posting a statement does not have to react to the immediate reaction of others. Id. at 322–23.

4. “Solipsistic introjection.” This is the idea that people view online activity as being similar to daydreaming or fantasizing, which can cause people to believe that online conversations take place in their mind rather than with another human being. Id. at 323.

5. “Dissociative imagination.” Many social media participants believe that they are operating in a “make-believe dimension, separate and apart from the demands and responsibilities of the real world.” As a result, they “split or dissociate online fiction from offline fact.” Id. at 323–24.

6. “Minimization of status and authority.” The Internet is the ultimate “level playing field,” where there are no monitors, and anyone, “regardless of status, wealth, race, or gender,” is free to speak. As a result of this minimization of authority and the perception of a peer environment, “people are much more willing to speak out and misbehave.” Id. at 324.

71. These risks are not unique to rank and file employees. Clothing designer Kenneth Cole is notorious for using global events as opportunities for promoting his brand. For instance, during the violent protests in Egypt in 2011, Cole tweeted: “Millions are in uproar in #Cairo. Rumor is they heard our new spring collection is now available online . . . -KC.” The Cole tweet immediately became “the target of the Internet's collective wrath,” condemned as “repulsive” and “in poor taste.” Ken Sweet, Kenneth Cole Egypt Tweets Ignite Firestorm, CNNMoney (Feb. 4, 2011, 9:59 AM), http://money.cnn.com/2011/02/03/news/companies/KennethCole_twitter/index.htm. Within an hour of the post, Cole apologized: “[W]e weren't intending to make light of a serious situation. We understand the sensitivity of this historic moment.” Id.
Employers’ reputations are at stake, as employees represent the company they work for and can cast their employer in a negative light with one distasteful comment.72 Similarly, employees put themselves at risk with comments they make and can damage their own reputations.73 Statements that an employee makes and later regrets may not be erasable. With social media, what used to be a private gripe about work can now become a message heard around the world, which once sent cannot easily be retrieved. The Third Circuit Court of Appeals recently noted that there are differences between online communication and in-person communication, “given that the universe of individuals who are able to see and respond to a comment on Facebook or a blog is significantly larger.”74

These unique characteristics of social media create dangers for both employees and employers. An employee might say something on Facebook that she would never say in person in the employee lunchroom or at the water cooler. The posting might be re-posted by someone else, so the employee is unable to retrieve, delete, or control the message. As a result, the company’s proprietary or confidential information may be disclosed, personal information may be revealed, reputations tarnished, relationships harmed, and legal vulnerability created (e.g., for harassment, defamation, or the creation of a hostile work environment).

The unique characteristics of social media, and the potential dangers to both employee and employer, have significant implications for the NLRA and how it is applied in this new area. Most of the Board’s decisions in this area deal with whether the discharge or discipline of an employee for social media activity violated the section 7 protection of concerted activity.75 In this context, cases have turned on such novel issues as whether clicking the “like” button on Facebook in response to an employee message qualifies as protected “concerted activity”76 and the significance of “LOL” in a

72. See Wesley Lowery, Woman Explains Obama Assassination Facebook Posting, L.A. TIMES (Nov. 10, 2012, 7:36AM), http://latimesblogs.latimes.com/lanow/2012/11/woman-obama-assassination-facebook-posting.html?dlvrit=649324 (An employee posted “maybe [Obama] will get assassinated” along with a racial slur on her personal Facebook page and was fired after the post went viral, prompted a secret service investigation, and the national ice cream chain received more than twenty angry voicemails from customers. The chain attempted to distance itself from the comments made by the employee, stating that “[t]he employee is no longer w/the company. We were as shocked as you were by her outrageous & completely unacceptable comments.”).

73. See id. (“If the Secret Service were to determine her remarks were a legitimate threat toward the president, Helms would face a felony.”).

74. United States v. Fumo, 655 F.3d 288, 305 (3d Cir. 2011); see also Crusco, supra note 50.

75. The Boards in Meyers Indus., Inc., 268 N.L.R.B. 493, 497 (1984) (Meyers I) and Meyers Indus., Inc., 281 N.L.R.B. 882, 885 (1986) (Meyers II) held that an employee’s activity is concerted if engaged “with or on the authority of other employees, and not solely by and on behalf of the employee himself.” In Meyers II, the Board emphasized that concerted activity included activity where “individual employees seek to initiate or to induce or to prepare for group action, as well as individual employees bringing truly group complaints to the attention of management.” Meyers II, 281 N.L.R.B. at 887.

response. Because of the unique nature of social media, scarcity of guiding precedent, and varied interpretations of what constitutes group action and concerted activity, decisions in this area have been inconsistent, and it appears to be form over substance that counts.

In response, some commentators are advising employees to say “we,” not “I” in messages, which has the effect of bringing a statement that might otherwise not be concerted activity within the reach of section 7. Employees are also being advised to include a call for group action in a post—an employee gripe is not protected, but if the employee adds a call for group action, the statement is likely to be found protected, concerted activity.

This Note addresses the related issue of employers’ attempts to prophylactically guard against the danger of employee activity on social media by issuing policies. The next Part of this Note addresses, first, the Board’s traditional approach to section 8 challenges to workplace rules and policies, and, second, the Board’s application of its traditional rules to social media policies.


78. Compare Three d, 2012 WL 76862 (ALJ held that an employee clicking the “like” button on Facebook was “an assent to the comments being made, and a meaningful contribution to the discussion”), with Wal-Mart Advice Memorandum, supra note 77, at *1–2 (NLRB dismissed case brought by a Wal-Mart employee who was fired for posting “Wuck Falmart! I swear if this tyranny doesn’t end in this store they are about to get a wakeup call because lots are about to quit!” Co-workers’ responses included “bahaha like!” and “What the hell happens after four that gets u so wound up??!! Lol.” The fired employee responded: “You have no clue [Employee 1] [Assistant Manager] is being a super mega puta! Its retarded I get chewed out cuz we got people putting stuff in the wrong spot and then the customer wanting it for that price . . . [T]hat’s false advertisement if you don’t sell it for that price . . . I’m talking to [Store Manager] about this shit cuz if it don’t change walmart can kiss my royal white ass!”); see also NLRB Gen. Couns. Adv. Mem., Case No. 34-CA-12576 (October 5, 2010) (EMT calls boss a “dick” on Facebook and is protected by section 7); but see NLRB Gen. Couns. Adv. Mem., Case No. 11-CA-22936 (July 28, 2011) [hereinafter Buel Advice Memorandum] (truck driver stuck on a road, unable to get in touch with dispatch to help, so he posted about the situation on his Facebook page and was fired and was not protected by section 7).

79. See, e.g., Green, supra note 51, at 840 (“[M]inor variations in language used in a post can have profound consequences.”); see also Protected Speech, supra note 40 (advising employees to make sure comments about employer and work issues made on social media are “in a context of protected concerted activity and on topics concerning terms and issues of employment that you have been discussing with co-employees”).

80. Cowan Hamada, supra note 47, at 15.

81. See Buel Advice Memorandum, supra note 78, at *4 (“[T]he Charging Party plainly was not seeking to induce or prepare for group action. Instead, he was simply expressing his own frustration and boredom while stranded by the weather, by griping about his inability to reach the on-call dispatcher.”).

82. Cowan Hamada, supra note 47, at 15.
III. WORKPLACE RULES AND THE NLRB

In reviewing challenges to employee policies, including workplace rules, the NLRB has traditionally followed the test adopted in Martin Luther Memorial Home and Lafayette Park Hotel. The NLRB has adopted, without modification, this traditional test in cases challenging social media policies. As a result, there has been confusion as to what the law is and what an employer may lawfully include in a social media policy. One commentator has criticized the NLRB’s approach to social media policies as an “unrealistic, hair-splitting mess,” in which the legality of a policy rises or falls based on subtle nuances in wording. For example, a social media policy that “encourages” employees to first use internal workplace procedures for resolving disputes are found to violate section 7, but it is lawful for employers to “suggest” that employees use such procedures before posting about a workplace dispute online.

A. THE MARTIN LUTHER MEMORIAL HOME/LAFAYETTE PARK TEST

In ruling on permissible workplace rules, the Board considers if a rule violates section 8(a)(1) of the Act, which prohibits an employer from infringing on an employee’s section 7 rights. A rule that an employee would reasonably construe to chill the exercise of section 7 rights is a violation of section 8(a)(1). To determine if a work rule would have such an effect, the Board uses the two-step inquiry developed in Martin Luther Memorial Home and Lafayette Park. First, a rule that explicitly restricts section 7-protected activities is clearly unlawful. If the rule does not explicitly restrict section 7-protected activities, “it will only violate Section 8(a)(1) upon a showing that: (1) employees would reasonably construe the language to prohibit Section 7 activity; (2) the rule was promulgated in response to union activity; or (3) the rule has been applied to restrict the

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88. Id. at 3 (citing Lafayette Park Hotel, 326 N.L.R.B. at 825).
89. Id.
90. 343 N.L.R.B. at 647.
91. 326 N.L.R.B. at 825.
exercise of Section 7 rights.” In making this determination, the Board must “give the rule a reasonable reading . . . , refrain from reading particular phrases in isolation, and . . . not presume improper interference with employee rights.”

In a number of decisions pre-dating its recent social media rulings, the NLRB found section 8 violations based on workplace rules that included language similar to that now found in many employers’ social media policies, such as provisions prohibiting “abusive or threatening language” in the workplace. The Board has consistently found such provisions ambiguous, and therefore unlawful, on the ground that an employee “could” interpret it as applying to section 7 activity and that the provision would therefore tend to chill such protected activity.

The Board’s position that such facially neutral phrases as “abusive language” extend to communications protected by section 7 has been subject to stinging judicial criticism. For example, in Adtranz, the NLRB held that the employer’s policy prohibiting the use of “abusive or threatening language to anyone on company premises” violated the NLRA because it had the “unrealized potential to chill the exercise of protected activity [and] could reasonably be interpreted as barring lawful” activity that is protected by section 7. On review, the Court of Appeals vacated the NLRB’s determination, stating that “the Board’s position that the imposition of a broad prophylactic rule against abusive and threatening language is unlawful on its face is simply preposterous.”

The Adtranz court also accused the Board of being “remarkably indifferent to the concerns and sensitivities which prompt many employers to adopt” rules prohibiting abusive language in the workplace. The court found that many employers adopt such workplace courtesy rules not to restrict section 7 activity, but rather to protect themselves from liability under federal and state statutes for failing “to maintain a workplace free of racial, sexual, and other harassment.” The court criticized the Board for

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93. Memorandum OM 12-59, supra note 87, at 3; see also Martin Luther Mem’l Home, Inc., 343 N.L.R.B. at 647.
95. The NLRB affirmed an ALJ’s ruling that abusive or threatening language was in violation of section 8, but the decision was later vacated by the D.C. Circuit Court of Appeals. Adtranz ABB Daimler-Benz Transp., N.A., Inc. v. NLRB, 253 F.3d 19, 24–25 (D.C. Cir. 2001), vacating as moot 331 N.L.R.B. 291 (2000).
96. See, e.g., Memorandum OM 12-59, supra note 87, at 20; see also Karl Knauz Motors, Inc., 358 N.L.R.B. No. 164, 2 (2012) (quoting Flex Frac Logistics, LLC, 358 N.L.R.B. No. 127, 2 (2012) (“Board law is settled that ambiguous employer rules—rules that reasonably could be read to have a coercive meaning—are construed against the employer.”).
97. Adtranz, 331 N.L.R.B. at 293.
98. Adtranz, 253 F.3d at 28.
99. Id. at 27.
100. Id.
holding that employers’ “zero tolerance” rules, adopted to avoid liability under workplace harassment laws, in fact violate section 7 of the NLRA, which places employers in a “catch-22” situation.\(^{101}\)

Two years later, the D.C. Circuit denied the Board’s application for enforcement of its determination that an employer policy that prohibited “insubordination, refusing to follow directions, obey legitimate requests or orders, or other disrespectful conduct towards a supervisor or other individual” violated section 7.\(^{102}\) In rejecting the Board’s determination that an employee “might interpret the term ‘disrespectful conduct’” to cover section 7 activities,\(^{103}\) the court found that the rule “clearly” did not apply to section 7 activity and that “any arguable ambiguity” in the rule “arises only . . . [by] attributing to the [employer] an intent to interfere with employee rights.”\(^{104}\)

As discussed in the next section, in its recent decisions finding social media policies in violation of section 7, the NLRB has, without any discussion or meaningful consideration of the unique characteristics of social media, utilized the Martin Luther Memorial Home/Lafayette Park test, and it has taken the same rigid interpretative approach criticized by the D.C. Circuit in Adtranz and Community Hospitals.

B. NEW WINE IN OLD WINESKINS: THE NLRB’S APPLICATION OF THE MARTIN LUTHER MEMORIAL HOME/LAFAYETTE PARK TEST TO SOCIAL MEDIA POLICIES\(^{105}\)

The Board did not issue a decision in an 8(a)(1) challenge to an employer social media policy until the fall of 2012. Then in September 2012, the Board issued three decisions in less than one month.\(^{106}\) However, prior to that time there were a number of decisions by ALJs and three

101. Id.
103. Id. at 1088.
104. Id. at 1089 (quoting Lafayette Park Hotel, 326 N.L.R.B. 824, 825 (1998), enforced 203 F.3d 52 (D.C. Cir. 1999)).
105. The expression “new wine in old wineskins” is based on a biblical passage in which Jesus responds to a question about why he and his followers do not follow traditions regarding religious fasting. In his response, Jesus explained the dangers of mixing the new with the old:

And he spake also a parable unto them; No man putteth a piece of a new garment upon an old; if otherwise, then both the new maketh a rent, and the piece that was taken out of the new agreeth not with the old. And no man putteth new wine into old bottles; else the new wine will burst the bottles, and be spilled, and the bottles shall perish. But new wine must be put into new bottles; and both are preserved.

In the first memorandum, the Acting General Counsel presented the NLRB’s pro-employee stance with regard to social media in the workplace. The memorandum “made clear that when analyzing whether an employee’s comments on social media are protected by the Act, it will apply current Board standards and consider whether: (1) the employee engaged in concerted activity; and (2) whether that activity was protected.”

The second memorandum “analyzes cases involving social media policies and disciplines and discharges due to conduct involving social media.” In analyzing these policies, the Division of Advice focused on the relative breadth of the policy language, possible examples that limited their application, and actual instances of application. The memorandum made clear that any ambiguity in the policy is to be construed against the employer, as the policy was written by the employer and it was the employer’s responsibility to clarify.

The third memorandum focused exclusively on employer social media policies. The memorandum examined seven social media policies, six of which contained at least some provisions that were unlawful, and one of which, the social media policy of Wal-Mart, was found by the Acting General Counsel to be lawful in its entirety. The memorandum “provide[s] the NLRB’s view or analysis of such policies in general,” and importantly, “outside of the context of specific discipline/discharge situations.”

The report made it clear that the NLRB is concerned with policies that it believes employees “would reasonably interpret” as infringing on section 7 activity. Further, it states that the NLRB would apply the Martin Luther Memorial Home/Lafayette Park test to social media policy cases. The memorandum also reveals that the focus is on the use of certain language, such as “offensive,” “demeaning,” and


110. MEMORANDUM OM 12-59, supra note 87, at 3.

111. Id.

112. Id. at 2.


114. Id.

115. MEMORANDUM OM 12-59, supra note 87, at 3.
“abusive.” 116 Read in its entirety, the Acting General Counsel’s memorandum shows that the NLRB “underestimates the ability of employees to reasonably understand employer policies, and purports to invalidate social media policies that employees could potentially interpret as infringing on Section 7, rather than merely policies that employees would reasonably interpret that way.”117

In its first case concerning a social media policy, the Board adopted the approach that was outlined in the Acting General Counsel’s third advisory memorandum. 118 On September 7, 2012, the Board issued its decision reviewing Costco’s social media policy, where it found that Costco’s policy violated section 8(a)(1).119 The Costco decision focused on the portion of the policy that prohibited employees from posting online statements that would “damage the Company, defame any individual or damage any person’s reputation, or violate the policies outlined in the Costco Employee Agreement.”120 The ALJ found the provision lawful on the ground that employees could not reasonably construe the provision as regulating section 7 conduct, but rather would reasonably understand that the purpose of this provision would ensure a “civil and decent workplace.”121 In reversing the ALJ and finding the provision in violation of section 8(a)(1), the Board applied the factors set forth in Lafayette Park. 122 The Board found that while the provision does not explicitly reference section 7 activities, the broad prohibitions in the provision would be interpreted by an employee as encompassing protected activities. 123 This decision was consistent with prior advice of the Acting General Counsel in his advisory memorandum regarding permissible social media policies and ALJ decisions. 124 As a remedy, the Board required Costco to post, in each of its stores in the United States where the invalid provision was in effect,125 a notice that included the statement: “WE WILL NOT maintain provisions in our Employee Agreement that may reasonably be interpreted as prohibiting you from discussing your wages and conditions of employment with other employees and third parties, including union representatives.”126

116. Id. at 8.
118. See MEMORANDUM OM 12-59, supra note 87, at 10.
119. The case concerned a group of Costco employees who were engaged in union-organizing discussions. It was alleged that the assistant general warehouse manager said, “I hear that you signed a paper for the Union,” which, according to prior cases decided by the Board, would likely be ruled coercive or unlawful. Costco Wholesale Corp., 358 N.L.R.B. No. 106, 5–6, 8–9 (2012).
120. Id. at 2.
121. Id.
122. Id.
123. Id.
124. MEMORANDUM OM 12-59, supra note 87, at 3.
126. Id. at 7.
Just two weeks after finding the Costco policy violative of the NLRA, the Board issued its second decision in the area of social media policies, where it found most sections of the employer’s social media policy to be overbroad. In the *EchoStar* decision, the Board found that “[t]he Respondent’s maintenance of the rule in question in the context and circumstances described chills employees’ Section 7 rights and therefore violates Section 8(a)(1) of the Act.” The Board recognized that while a company “has a legitimate interest in controlling the content and timing of the release of certain business information,” it must tailor its social media policy to meet that legitimate need and cannot make broad prohibitions restricting communications. The Board found EchoStar’s rule unlawful because it “broadly prohibits all disclosures about the Respondent ‘or its business activities’ without prior approval” of the company.

In the third decision regarding an employer’s social media policy, the Board again affirmed the ALJ’s finding that the employer’s rule violated section 8(a)(1) but held that the Respondent lawfully terminated an employee for Facebook posts. The ALJ found, and the Board agreed, that the Respondent violated section 8(a)(1) by maintaining a rule in its handbook stating:

> Courtesy is the responsibility of every employee. Everyone is expected to be courteous, polite and friendly to our customers, vendors and suppliers, as well as to their fellow employees. No one should be disrespectful or use profanity or any other language which injures the image or reputation of the Dealership.

The Board majority reasoned that an employee would understand this “Courtesy” rule to encompass section 7 activity and that the broad prohibitions did not exclude any section 7-protected activity. The dissent,

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128. *Id.*
129. *Id.*
130. *Id.*
131. *Id.*
132. *Karl Knauz Motors, Inc.*, 358 N.L.R.B. No. 164, 1 (2012). In *Karl Knauz Motors, Inc.*, BMW held an event to promote its new car, where it planned on serving hot dogs, Doritos, cookies, and fruit. *Id.* at 11. An employee subsequently posted photographs of the event on his Facebook page, as well as photographs of a car accident at sister-dealership Land Rover. *Id.* Approximately one week later, that employee was fired. *Id.* at 13. The issues before the Board were whether the employee was fired for both postings or only the Land Rover photographs, and whether the postings were protected concerted activities. *Id.* at 16. The postings about the food at the event were deemed concerted activity and fell within section 7’s protection, but the Board found that the Land Rover photographs were neither protected nor concerted activities because there were no discussions, the picture was posted only by the one employee, and it did not concern terms and conditions of employment. *Id.* at 16–18.
133. *Id.* at 1.
134. *Id.*
on the other hand, found that the majority read the word “disrespectful” and the phrase “language which injures the image or reputation of the Dealership” in isolation and based its decision that an employee would reasonably believe it to infringe on section 7 on this isolated reading. The dissent criticized the Board for invalidating “any handbook policy that employees conceivably could construe to prohibit protected activity, regardless of whether they reasonably would do so.”

These three decisions shed light on the Board’s approach to social media policy cases but offer employers insufficient guidance on how to draft a lawful policy. Based on a review of the three decisions, it is clear that, in looking at how an employee would interpret a social media policy, the NLRB looks for language that is general (e.g., “demeaning,” or “disrespectful”). Unless there are specific examples that limit the meaning of these general words, the NLRB finds that these words are capable of being interpreted as applying to section 7 rights. In other words, the NLRB finds that an employee would think that the employer would claim that it is “disrespectful,” and therefore a violation of the social media policy, to talk about terms and conditions of employment online.

The NLRB construes general language against the employer since it is the employer who drafts the social media policy. The NLRB has frequently asserted that the words should be understood in the context of the entire social media policy, but in practice the NLRB appears to look at these general words in isolation rather than interpreting them in the context of the entire policy. Therefore, even a statement specifically stating that section 7-protected activities are not prohibited by the policy might not save an otherwise unlawful policy. The problem with this approach is that the NLRB finds social media policies unlawful based on hypothetical interpretations of language that might never either be interpreted by an actual employee as covering protected activity or used to discipline an employee.

135. Id. at 5.
136. Id.
137. “[T]he Board has found that an employer violates Section 8(a)(1) of the Act by maintaining rules that are so broad that they would reasonably be construed to limit protected criticism of the employer.” EchoStar Technologies, L.L.C., No. 27-CA-066726, 2012 WL 4321039 (NLRB Div. of Judges, Sept. 20, 2012).
138. Costco Wholesale Corp., 358 N.L.R.B. No. 106, 2 (2012) (“[T]here is nothing in the rule that even arguably suggests that protected communications are excluded from the broad parameters of the rule.”).
140. “Any ambiguity in a rule must be construed against the employer who promulgated the rule.” EchoStar, 2012 WL 4321039.
141. Id.
143. Memorandum OM 12-59, supra note 87 at 12.
An alternate approach to reviewing workplace rules was proposed by former Board member Peter Hurtgen in his dissent in Lafayette Park, and a recent note has argued that the approach urged by Hurtgen sets a more appropriate standard for the review of social media policies than the traditional approach taken by the Board. Under this approach (the Hurtgen approach), if a social media policy 1) does not explicitly target section 7 activities, 2) has not been used to punish section 7 activities, and 3) was not adopted in response to section 7 activities, the NLRB should not speculate that an employee might interpret the social media policy to cover section 7. Instead, under the Hurtgen approach, the NLRB should let the social media policy stand, and if it is used to discipline or terminate an employee, the employee has a remedy (i.e., the NLRB can review the disciplinary action to see if it violated section 7). The problem with the Hurtgen approach is that it potentially chills employee section 7 activity and forces an employee to litigate to vindicate those rights.

Both the NLRB and Hurtgen approaches are seriously flawed. Neither sets forth principles or standards to guide in the drafting or interpretation of a social media policy. Rather, these two approaches are really just different ways to allocate risk. The NLRB approach puts the risk on the employer. If there is any uncertainty or ambiguity, the NLRB reasons that the uncertainty should be resolved against the employer who drafted the policy, and the policy is held to be unlawful. In contrast, the Hurtgen approach puts the risk on the employee. Under the Hurtgen approach, the NLRB would decline to rule on whether the policy could be read as covering section 7 activities; if the policy is in fact used to punish conduct that is arguably protected by section 7, the affected employee could seek review of that action.

IV. TOWARD A MORE BALANCED, PRINCIPLED APPROACH TO SOCIAL MEDIA POLICIES

What is needed is a more balanced approach—an approach that does not put either the employer or employee at risk; and a more principled approach—an approach that is based on standards of interpretation that will guide the employer in drafting a lawful social media policy and that will then guide the NLRB review of that social media policy. This Note proposes an approach that steers a middle course between Hurtgen’s “wait and see what happens” approach and the Board’s overly employee-
protective approach, under which policies are found unlawful if an employee “could” interpret some provision as applying to protected activities. Under the proposed approach, a policy would be found invalid on its face only if the Board determines that it is more likely than not that the policy, read as a whole, would be interpreted by employees as limiting or prohibiting activities protected by the Act.

In applying this standard, the Board should rely on the following traditional principles of interpretation:

- General words (e.g., “disrespectful,” or “demeaning”) should be read in light of and limited by the scope of specific examples that accompany the general words.\(^ {151} \)
- Each part of the policy should be read in the context of the entire document.\(^ {152} \)
- Words should be given their ordinary meaning, unless context clearly indicates a different meaning. (For example, a prohibition on being “disrespectful” should not be understood to prohibit employees from jointly discussing dangerous working conditions.)

This standard and these principles of interpretation will not only guide the Board in deciding facial challenges of social media policies, but will assist employers in drafting policies. The following are some additional recommendations to employers in drafting social media policies that protect employers’ interests while minimizing the risk that a policy will be found to violate the Act.

An introductory section to the policy is essential to set the context for the interpretation of the policy as a whole. This section must make clear what the purpose of the policy is—and what it is not.\(^ {153} \) There are a number of key components of such an introduction.

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151. This principle is based on the canon of construction known as *ejusdem generis*:

> Latin for “of the same kind,” used to interpret loosely written statutes. Where a law lists specific classes of persons or things and then refers to them in general, the general statements only apply to the same kind of persons or things specifically listed. Example: if a law refers to automobiles, trucks, tractors, motorcycles and other motor-powered vehicles, “vehicles” would not include airplanes, since the list was of land-based transportation.


152. This principle is based on the canon of construction known as *noscitur a sociis*: “[T]hat the meaning of an unclear word may be known from accompanying words.” *Noscitur a Sociis Legal Definition*, DUHAIME.ORG, http://www.duhaime.org/LegalDictionary/N/Nosciturasociis.aspx (last visited Nov. 17, 2013).

153. See Aroostook Cnty. Reg’l Ophthalmology Ctr. v. NLRB, 81 F.3d 209, 212–13 (D.C. Cir. 1996) (based on context of rule and its location in the manual, the court concluded that rule was not unlawful on its face).
First, the introduction should frame the policy in relation to core company values. Core company values might include integrity, respect, or honesty. Such a statement sets the context, within which the entire policy is to be read and understood.

Second, the introduction should state that the underlying purpose is to protect both the employer and the employees in light of some of the unique dangers of the Internet. In this regard it is appropriate, and lawful, to remind employees that once a message has been posted on a social media site, the sender may lose control of the distribution and that, due to archiving, the post might be available to a large audience for an indefinite period of time. A clause that cautions employees to think before posting, so long as it is not interpreted as a "veiled threat," will be lawful.

Third, the introduction should state, in simple, plain language, that the policy is not intended to restrict in any way employee engagement in activities that are protected by section 7. The NLRB in Costco stated that there should be a provision "which clarifies the intent of the rule and makes clear to employees that they are free to discuss their terms and conditions of employment with others." In some cases the Board has criticized the absence of such a disclaimer, while in others the Board has found that the disclaimer is too technical and would not be understood by a typical employee. Therefore, the key is to include a disclaimer that is easily understood by a layperson yet does not undermine the purpose of the policy.

In addition, the policy should include concrete examples to clarify the scope and meaning of general statements. While a social media policy, like any policy that is intended to be distributed to and understood by all company employees, should be as short and simple as possible, the NLRB’s approach to social media cases makes that objective virtually impossible. The Board has consistently interpreted simple, broad statements against the employer, finding that, in the absence of clarifying examples, employees

155. Id. at 11–12.
156. Id. at 3 (citation omitted) ("Rules that are ambiguous as to their application to Section 7 activity, and contain no limiting language or context that would clarify to employees that the rule does not restrict Section 7 rights, are unlawful. . . . In contrast, rules that clarify and restrict their scope by including examples of clearly illegal or unprotected conduct, such that they would not reasonably be construed to cover protected activity, are not unlawful.").
159. See, e.g., EchoStar Technologies, L.L.C., No. 27-CA-066726, 2012 WL 4321039 (NLRB Div. of Judges, Sept. 20, 2012) ("Should a conflict arise between an EchoStar policy and the law, the appropriate law shall be applied and interpreted so as to make the policy lawful in that particular jurisdiction" was held by the Board to be too technical and did not clarify the intent of the rule.)
would construe the language as prohibiting protected section 7 conduct.\textsuperscript{160} Therefore, in drafting the body of the policy it is critical that there is a careful use of examples to provide context for the interpretation of all general or vague terms, such as “confidential information” or “disrespectful.”\textsuperscript{161}

Moreover, there are a number of topics and words that should not be included in the policy. Perhaps most obviously (although some social media policies have violated this rule), the policy should not mention the discussion of wages or working conditions.\textsuperscript{162} Second, the policy should not state that an employee must obtain prior approval before mentioning the workplace in a social media post.\textsuperscript{163} Third, the policy should not require that employees report “unusual” social media activity to management.\textsuperscript{164} Finally, any statements regarding the law, or the possible legal consequences of online activity, should be accurate and objective.\textsuperscript{165}

\section*{V. PROPOSED SOCIAL MEDIA POLICY}

As discussed above, the Board should take a more balanced, less rigid approach to social media policies—an approach that reflects a careful consideration of the unique characteristics of social media. At the same time, employers must take great care in drafting their social media policy so as not to infringe upon their employees’ section 7 rights.

The annotated Model Social Media Policy set forth below, read as a whole, should achieve the typical employer’s objectives in adopting the policy while also minimizing the risk that any provisions will be found unlawful under the NLRA. The policy is based on the principles set forth

\textsuperscript{160} See, e.g., \textit{Karl Knauz Motors}, 358 N.L.R.B. No. 164 at 1; \textit{EchoStar}, 2012 WL 4321039.
\textsuperscript{161} MEMORANDUM OM 12-59, \textit{supra} note 87, at 6–7 (“The term ‘completely accurate and not misleading’ is overbroad because it would reasonably be interpreted to apply to discussions about, or criticism of, the Employer’s labor policies and its treatment of employees that would be protected by the Act so long as they are not maliciously false. Moreover, the policy does not provide any guidance as to the meaning of this term by specific examples or limit the term in any way that would exclude Section 7 activity.”).
\textsuperscript{162} See \textit{id.} at 7. “Sensitive information such as membership, payroll, confidential financial, credit card numbers, social security number or employee personal health information may not be shared, transmitted, or stored for personal or public use without prior management approval.” \textit{Costco Wholesale Corp.}, 358 N.L.R.B. No. 106 at 1.
\textsuperscript{163} MEMORANDUM OM 12-59, \textit{supra} note 87, at 7; see also \textit{EchoStar}, 2012 WL 4321039 (“The Handbook’s broad prohibition of all public, private, and media communications about the Respondent without the company’s prior approval clearly runs afoul of these rights.”).
\textsuperscript{164} MEMORANDUM OM 12-59, \textit{supra} note 87, at 9 (“We . . . found unlawful the policy’s instruction that employees ‘[r]eport any unusual or inappropriate internal social media activity.’ An employer violates the Act by encouraging employees to report to management the union activities of other employees.”).
\textsuperscript{165} The Board found the following clause to be unlawful: “Should a conflict arise between an EchoStar policy and the law, the appropriate law shall be applied and interpreted so as to make the policy lawful in that particular jurisdiction.” \textit{EchoStar}, 2012 WL 4321039. It reasoned that “a general clause or other language asserting that a document should be applied and interpreted in such a manner that it is legal proper does not save an otherwise invalid rule under the Act.” \textit{id.}
above. Except as noted and explained in footnotes, this policy is based on the social media policy of Wal-Mart, which was determined to be lawful by the Acting General Counsel of the NLRB in his third report on social media policies.

While the following model policy is a good template, each company should carefully craft its own policy in light of the nature of the business and its particular needs. An online retailer, for example, will need a social media policy that is substantially different from that of a manufacturing plant.

**MODEL SOCIAL MEDIA POLICY**

At [Employer], we understand that social media can be a fun and rewarding way to share your life and opinions with family, friends, and co-workers around the world. However, use of social media also presents certain risks and carries with it certain responsibilities. To assist you in making responsible social media decisions, we have established these guidelines for the appropriate use of social media, which are based on our company’s core values—Integrity, Accountability and Respect.

166. The involvement of Lafe Solomon, the NLRB’s Acting General Counsel, in the Wal-Mart social policy matter gave rise to an investigation into a violation of the NLRB’s ethics rules. Memorandum from David P. Berry, Inspector Gen., NLRB, Investigation No. OIG-I-475 (Sept. 13, 2012) [hereinafter Inspector Gen. Memorandum], available at http://edworkforce.house.gov/uploadedfiles/09-13-12_report_of_investigation_-_oig-i-475.pdf. In January 2012, Mr. Solomon was informed that the Division of Advice had decided to issue an Advice Memorandum finding that Wal-Mart’s social media policy violated section 8(a)(1). Id. at 2. Although he agreed that the Wal-Mart policy was overly broad and therefore unlawful, Mr. Solomon directed that the Division of Advice reach out to Wal-Mart to encourage them to amend the policy, which they did. Id. at 3–4. At the time of that meeting, Mr. Solomon owned more than $15,000 of Wal-Mart stock. Id. at 3, 7. Shortly thereafter, Mr. Solomon sought a waiver of the NLRB ethics rule that prohibits an NLRB employee from having “personal and substantial participation” in a matter in which he or she has a financial interest. Id. at 3, 8; see 5 C.F.R. § 2640.103(a)(3) (2013). The waiver was never issued. Inspector Gen. Memorandum, supra note 166, at 7. In February 2012, Mr. Solomon sold his Wal-Mart stock. Id. Mr. Solomon thereafter featured the revised Wal-Mart social media policy in his third memorandum as an example of a lawful policy. MEMORANDUM OM 12-59, supra note 87, at 19–24. A subsequent investigation by the NLRB Inspector General concluded that Mr. Solomon had violated the NLRB ethics rules by participating in the meeting regarding an attempt to convince Wal-Mart to amend its policy. See Inspector Gen. Memorandum, supra note 166, at 9. See also Ashley Post, Lafe Solomon Accused of Violating NLRB Ethics Standards, INSIDE COUNS. (Sept. 17, 2012), http://www.insidecounsel.com/2012/09/17/lafe-solomon-accused-of-violating-nlrb-ethics-stan. While this episode was undoubtedly embarrassing for Mr. Solomon, there is nothing in the Report of the Inspector General that in any way compromises the conclusion that the Wal-Mart social media policy, as revised, is lawful, and that it is a good model for other employers. Inspector Gen. Memorandum, supra note 166, at 11.


168. The first paragraph sets the context of the policy by introducing the theme of personal responsibility in the face of the risks posed by social media. See Aroostook Cnty. Reg’l
In the rapidly expanding world of electronic communication, social media can mean many things. Social media includes all means of communicating or posting information or content of any sort on the Internet, including to your own or someone else’s web log or blog, journal or diary, personal web site, social networking or affinity web site, web bulletin board or a chat room, whether or not associated or affiliated with [Employer], as well as any other form of electronic communication.170

Ultimately, you are solely responsible for what you post online. Before creating online content, consider some of the risks and rewards that are involved. Keep in mind that any of your conduct that adversely affects your job performance, the performance of fellow associates, or otherwise adversely affects members, customers, suppliers, people who work on behalf of [Employer], or [Employer’s] legitimate business interests may result in disciplinary action up to and including termination.

Also, keep in mind that once you have posted something on social media, it may not be possible to retract the message, and it may be available on the Internet for a long period of time.171 The intent of this Policy is not to restrict the flow of useful and appropriate information but to minimize the risk to the Company and its associates.172

The National Labor Relations Act and other laws protect the rights of employees to engage in certain activities, including the right to talk about and work together on issues such as wages and other terms and conditions of employment. This policy is not intended to

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169. This statement of values is based on the Wal-Mart policy, but the statement has been moved to the beginning of the policy, where it helps set the context within which the policy is to be interpreted. MEMORANDUM OM 12-59, supra note 87, at 19–24. Each company must, of course, tailor such a statement to reflect its own values.

170. Even in the age of Facebook and Twitter, one should not assume that every employee will understand the reach of the policy without a brief statement about the meaning of social media.

171. It is permissible to caution employees that postings on the Internet may be archived and available indefinitely, MEMORANDUM OM 12-59, supra note 87, at 23, but the policy should not suggest that the employer will be conducting surveillance to see what employees have posted online. See Cowan Hamada, supra note 47, at 18.

interfere with or limit the exercise of any such legal rights of employees.173

GUIDELINES

1. Know and follow the rules

Carefully read these guidelines, the [Employer] Statement of Ethics Policy, the [Employer] Information Policy and the Discrimination & Harassment Prevention Policy, and ensure your postings are consistent with these policies. Inappropriate postings that may include discriminatory remarks, harassment, and threats of violence or similar inappropriate or unlawful conduct will not be tolerated and may subject you to disciplinary action up to and including termination.174

2. Be responsible

Use your best judgment and exercise personal responsibility. Take your responsibility as stewards of personal information to heart. As a company, [Employer]

173. Social media policies often include savings clauses, or disclaimers, stating that the policy is not intended to interfere with rights protected by the NLRA. The Board has frequently held that, where the policy includes “overbroad prohibitions that reasonably would be interpreted to prohibit protected activities, a general disclaimer is insufficient where employees would not understand from the disclaimer that protected activities are in fact permitted.” Advice Memorandum from Barry J. Kearney, Assoc. Gen. Counsel, Div. of Advice, NLRB, to Wayne Gold, Reg’l Dir., NLRB, Nos. 05-CA-064793, 05-CA-065187, 05-CA-064795 (Mar. 21, 2012) [hereinafter Giant Food Advice Memorandum], available at http://mynlrb.nlrb.gov/link/document.aspx/09031d458132b26a. On the other hand, the absence of such a disclaimer is not fatal; in fact, Wal-Mart’s social media policy was found to be fully consistent with section 7 in the absence of any disclaimer. MEMORANDUM OM 12-59, supra note 87, at 22–24. Nonetheless, it is advised that a social media policy include a disclaimer. The key is not to use legalese; references to “concerted activities” or to “rights under the NLRA,” without further explanation, have been found to be insufficient because they would not be understood by a “layperson.” Id. at 14. For instance, the Board in EchoStar examined the following clause in the company’s employee handbook:

One or more of the policies set forth in this Handbook may be affected by the application of law. Should a conflict arise between a [sic] EchoStar policy and the law, the appropriate law shall be applied and interpreted so as to make the policy lawful in that particular jurisdiction]

EchoStar Technologies, L.L.C., No. 27-CA-066726, 2012 WL 4321039 (NLRB Div. of Judges, Sept. 20, 2012). The Board found that the clause did not save an otherwise invalid rule under the NLRA because “a general clause or other language asserting that a document should be applied and interpreted in such a manner that it is legal proper does not save an otherwise invalid rule under the Act.” Id. 174. “[R]ules that clarify and restrict their scope by including examples of clearly illegal or unprotected conduct, such that they would not reasonably be construed to cover protected activity, are not unlawful.” MEMORANDUM OM 12-59, supra note 87, at 3 (quoting Tradesmen Int’l, Inc., 338 N.L.R.B. 460, 460–62 (2002)).
trusts—and expects—you to exercise personal responsibility whenever you participate in social media or other online activities. Remember that there can be consequences to your actions in the social media world—both internally, if your comments violate [Employer] policies, and with outside individuals and entities. If you’re about to publish, respond, or engage in something that makes you even the slightest bit uncomfortable, don’t do it.175

3. Be respectful

Always be fair and courteous to fellow associates, customers, members, suppliers, or people who work on behalf of [Employer]. Also, keep in mind that you are more likely to resolve work-related complaints by speaking directly with your co-workers or utilizing our Open Door Policy than by posting complaints to a social media outlet.176 Nevertheless, if you decide to post complaints or criticism, avoid using statements, photographs, video, or audio that reasonably could be viewed as malicious, obscene, threatening, or intimidating, that disparage customers, members, associates, or suppliers, or that might constitute harassment or bullying. Examples of such conduct might include offensive posts meant to intentionally harm someone’s reputation or posts that could contribute to a hostile work environment on the basis of race, sex, disability, religion, or any other status protected by law or company policy.177


176. The rule that employees “are encouraged to resolve concerns about work by speaking with co-workers, supervisors, or managers” is unlawful.

An employer may reasonably suggest that employees try to work out concerns over working conditions through internal procedures. However, by telling employees that they should use internal resources rather than airing their grievances online, we found that this rule would have the probable effect of precluding or inhibiting employees from the protected activity of seeking redress through alternative forums.

MEMORANDUM OM 12-59, supra note 87, at 11.

177. Employers should pay particular attention to drafting provisions that caution against the making of disparaging or disrespectful comments because the Board has frequently found such provisions to be vague and likely to be interpreted by employees as applying to comments about
4. Be honest and accurate

Make sure you are always honest and accurate when posting information or news, and if you make a mistake, correct it quickly. Be open about any previous posts you have altered. Remember that the Internet archives almost everything; therefore, even deleted postings can be searched. Never post any information or rumors that you know to be false about [Employer], fellow associates, members, customers, suppliers, people working on behalf of [Employer], or competitors.

5. Post only appropriate and respectful content

Maintain the confidentiality of [Employer’s] trade secrets and private or confidential information. Trade secrets may include information regarding the development of systems, processes, products, know-how, and technology. Do not post internal reports, policies, procedures, or other internal business-related confidential communications.

Respect financial disclosure laws. It is illegal to communicate or give a “tip” on inside information to others so that they may buy or sell stocks or securities. Such online conduct may also violate the Insider Trading Policy.

wages and working conditions. EchoStar Technologies, L.L.C., No. 27-CA-066726, 2012 WL 4321039 (NLRB Div. of Judges, Sept. 20, 2012). A provision that advises that employees “may not make disparaging or defamatory comments” about the employer or its “employees, officers, directors, vendors, customers, partners, affiliates, or our, or their product/services” has been found to violate section 7 because employees “would reasonably construe this prohibition to apply to protected criticism of the Employer’s labor policies or treatment of employees.” MEMORANDUM OM 12-59, supra note 87, at 16–17. In contrast, it is permissible to caution that employees may not “defame or otherwise discredit the Employer’s products or services.” Giant Food Advice Memorandum, supra note 173, at 13.

178. The Third Advice Memorandum explains:

Employees have no protected right to disclose trade secrets. Moreover, the Employer’s rule provides sufficient examples of prohibited disclosures (i.e., information regarding the development of systems, processes, products, know-how, technology, internal reports, procedures, or other internal business-related communications) for employees to understand that it does not reach protected communications about working conditions.

MEMORANDUM OM 12-59, supra note 87, at 20.

179. This clause provides sufficient examples of prohibited disclosures so that it would not reasonably be interpreted by an employee that disclosure of financial information includes terms of employment. See id. at 6–7 (employer’s social media policy that defined non-public information as “[a]ny topic related to the financial performance of the company” is unlawful because it encompasses section 7-protected activity).
Do not create a link from your blog, website, or other social networking site to an [Employer] website without identifying yourself as an [Employer] associate.

Express only your personal opinions. Never represent yourself as a spokesperson for [Employer]. If [Employer] is a subject of the content you are creating, be clear and open about the fact that you are an associate, and make it clear that your views do not represent those of [Employer], fellow associates, members, customers, suppliers, or people working on behalf of [Employer]. If you do publish a blog or post online related to the work you do or subjects associated with [Employer], make it clear that you are not speaking on behalf of [Employer]. It is best to include a disclaimer such as “The postings on this site are my own and do not necessarily reflect the views of [Employer].”

Do not post anything on the Internet in the name of [Employer] or in a manner that could reasonably be attributed to [Employer] without prior written authorization from the President or the President’s designated agent.

6. Respect other’s intellectual property

Respect all copyright and other intellectual property laws. For [Employer’s] protection as well as your own, it is critical that you show proper respect for the law governing copyrights, fair use of copyrighted materials owned by others, trademarks, and other intellectual property,

180. The Third Advice Memorandum provides further guidance with regard to acting as a spokesperson for an employer:

A rule that requires an employee to receive prior authorization before posting a message that is either in the Employer’s name or could reasonably be attributed to the Employer cannot reasonably be construed to restrict employees’ exercise of their Section 7 right to communicate about working conditions among themselves and with third parties.

MEMORANDUM OM 12-59, supra note 87, at 15.

181. The Acting General Counsel’s guidance continues:

We did not find unlawful, however, the prohibition on representing “any opinion or statement as the policy or view of the [Employer] or of any individual in their capacity as an employee or otherwise on behalf of [Employer].” Employees would not reasonably construe this rule to prohibit them from speaking about their terms and conditions of employment. Instead, this rule is more reasonably construed to prohibit comments that are represented to be made by or on behalf of the Employer.

Id. at 17.

182. This paragraph is based on the social media policy of Us Helping Us cited in the NLRB’s Third Advice Memorandum. Id. at 15.
including [Employer’s] own copyrights, trademarks, and brands. Get permission before reusing [Employer’s] content or images.\textsuperscript{183}

7. Using social media at work

Do not use social media on equipment we provide unless it is work-related as authorized by your manager or consistent with the Company Equipment Policy.

Do not use social media while on duty. For purposes of these guidelines, “on duty” does not include meal or other break times.\textsuperscript{184}

Do not use [Employer] email addresses to register on social networks, blogs, or other online tools utilized for personal use.

8. Retaliation is prohibited

[Employer] prohibits taking negative action against any associate for reporting a possible deviation from this policy or for cooperating in an investigation. Any associate who retaliates against another associate for reporting a possible deviation from this policy or for cooperating in an investigation will be subject to disciplinary action, up to and including termination.

9. Media contacts

Associates should not speak to the media on [Employer’s] behalf without contacting the Corporate Affairs Department. All media inquiries should be directed to them.

10. For more information

If you have questions or need further guidance, please contact your HR representative.\textsuperscript{185}

\textsuperscript{183} This paragraph is based on the social media policy of the McKesson Corporation cited in the NLRB’s Third Advice Memorandum. \textit{id.} at 11 (citing McKesson Corp. Advice Memorandum, \textit{supra} note 175).

\textsuperscript{184} “[W]e concluded that the prohibition on participating in these activities on Company time is unlawfully overbroad because employees have the right to engage in Section 7 activities on the Employer’s premises during non-work time and in non-work areas.” \textit{MEMORANDUM OM 12-59, supra} note 87, at 17 (quoting \textit{Republic Aviation Corp. v. NLRB}, 324 U.S. 793, 803 n.10 (1945)). Accordingly, it is important to make clear that any such restriction does not apply during lunch or break time.

\textsuperscript{185} “[A] general admonition that if an employee has questions to talk to human resources does not create a legal loop that an employee must jump through before the force of the rules may be
CONCLUSION

Gone are the days of having to read the latest headlines in a newspaper. Information, gossip, even photographs are shared at lightning speed, and the Internet and the way in which information spreads is only going to get faster and more efficient. Sixty years ago, it took a month for a movement to catch its stride, and four years to pass legislation; with the assistance of the Internet, a country's president of three decades stepped down in just eighteen days.

In light of the significant potential consequences of online speech, both to employers and employees, it is imperative that employers be able to set forth guidelines for appropriate employee conduct with respect to social media. The current approach of the NLRB to social media policy cases does not take into account the risks employers and employees face when it comes to employee postings. Employers are left in a very difficult position, in which facially neutral policies are held unlawful on the ground that an employee will interpret a policy that urges employees to be “courteous” in their online communications concerning the workplace as prohibiting any discussion of wages and working conditions.186

While the Board claims that it reads these policies in context and in their entirety, in fact the Board focuses on words in isolation and utilizes a bright-line test under which policies are found unlawful if they use words such as “disrespect” and “demeaning.” The NLRB should adopt a more balanced and principled approach—an approach that is based on standards of interpretation that will guide the employer in drafting a lawful social media policy and that will then guide the NLRB review of that social media policy.

The approach must be workable in the twenty-first century in order to properly protect both employers and employees. The suggested approach will allow those employers who choose to abide by the law in drafting social media policies to do so and allow those employees who choose to abide by the social media policies to do so as well. Given the high stakes in the online world, there should be no uncertainty when it comes to what is acceptable and what is not.

Lauren R. Younkins*

186. For example, the NLRB has found unlawful a social media policy that states employees should be “courteous” because employees will reasonably believe it means they cannot talk about terms and conditions of employment. See Karl Knauz Motors, Inc., 358 N.L.R.B. No. 164, 1 (2012).

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