

SECOND CIRCUIT REVIEW

Expert Analysis

## Court Declines to Extend Absolute Immunity In Claims Against Stock Exchanges

Stock exchanges are indispensable to the modern market economy. Holding powers derived from federal law, the exchanges regulate most aspects of the trading that occurs within their systems. They are expected to do so impartially—and, when acting in their regulatory capacity, are absolutely immune from suit. Yet, stock exchanges are also for-profit entities acting for their own economic benefit. While acting in this role, their actions are not immune from challenge. Naturally, a key question is how far the regulatory function of the exchanges extends.

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Second Circuit made clear that the absolute immunity stock exchanges enjoy does not extend to activities such as selling products like proprietary data feeds and co-location services to their members. In such situations, the exchanges

play the role of self-interested entities whose actions can be questioned in court. In *City of Providence*, the court halted its long-standing trend of reading the absolute immunity of stock exchanges expansively while defining the outer bounds of this immunity for future litigants.

### Background

As self-regulatory organizations (SROs) charged by Congress and the SEC with the responsibility of monitoring the activities of their members, stock exchanges like the New York Stock Exchange (NYSE) and the NASDAQ play a quasi-governmental role. Courts have agreed that when the exchanges “stand in the shoes” of the SEC, their actions are protected by the same absolute immunity that protects judges and prosecutors

acting in their official capacities. The scope of this immunity, however, has been a moving target, with *City of Providence* marking a departure by the Second Circuit from its approach to this question in a prior line of cases.

### Prior Second Circuit Litigation

The Second Circuit first considered the absolute immunity of stock exchanges in *Barbara v. New York Stock Exchange*, 99 F.3d 49 (2d Cir. 1996). There, a former NYSE floor clerk brought suit after the exchange disciplined him for misconduct by barring him from the exchange floor. The court, noting that the disciplinary role the NYSE had performed was essential to its quasi-governmental function, held that the NYSE's choice to discipline the plaintiff was absolutely immune from suit. In subsequent cases, the Second Circuit extended the absolute immunity of the exchanges to other scenarios, such as the NASDAQ's decision to announce the cancellation of a trade, *DL Capital Group v. NASDAQ Stock Market*, 409 F.3d 93 (2d Cir. 2005), and the NYSE's choice *not* to discipline certain

of its members for alleged misconduct, *In re NYSE Specialists Securities Litigation*, 503 F.3d 89 (2d Cir. 2007).

Most recently, the Second Circuit in *Standard Investment Chartered v. National Ass'n of Securities Dealers*, 637 F.3d 112 (2d Cir. 2011), held that absolute immunity barred a claim based on alleged misstatements in a proxy solicitation the National Association of Securities Dealers (NASD) issued in advance of a vote to change its bylaws. The change in bylaws was necessary to allow NASD to merge with the NYSE's regulatory arm, the result of which would be the creation of the Financial Industry Regulatory Authority (FINRA). The court recognized that the NASD's choice to consolidate with another SRO was an exercise of its regulatory function, but that the challenged proxy solicitation itself was not. Even so, the court extended absolute immunity to the proxy solicitation because it was "incident" to the NASD's regulatory function as a necessary step for the NASD to amend its bylaws and merge with another SRO. After *Standard Investment Chartered*,

the question was what stock exchange actions would the court find do *not* fall within the umbrella of absolute immunity, either as regulatory action or as action incident to it.

### 'City of Providence'

In *City of Providence*, the Second Circuit recognized, for the first time, a set of actions by stock exchanges that are not protected from suit by absolute immunity. The claims in the case challenged three activities in which the defendant exchanges engaged: selling proprietary data feeds that give members increased information about trades, selling co-location services through which members can place their computer servers closer to the exchanges' servers, and allowing members to use complex order types that increase the set of maneuvers they can use to compete with other traders on the exchanges. Plaintiffs, all institutional investors, argued that the exchanges prejudiced their ability to fairly compete by selling these services to high-frequency traders (HFTs). Though any exchange member could purchase the services, the plaintiffs

contended that the defendant exchanges committed securities fraud via manipulative conduct designed to favor HFTs, both because the services were cost prohibitive to other investors and because the defendant exchanges failed to reveal the significance of the advantages the services afforded the HFT firms that invested in them. At the trial court, the district judge dismissed the plaintiffs' claims, holding in the process that the bulk of the challenged actions was protected from suit by absolute immunity.

On appeal, Judge John Walker Jr., joined by Judge José Cabranes and Judge Raymond Lohier Jr., declined to extend absolute immunity to any of the challenged actions by the defendant exchanges. The panel considered but found unpersuasive the defendants' argument that the court had in previous cases already read the exchanges' absolute immunity to apply not only to the direct regulation of members but also to choices about how to operate the markets, such as the NASDAQ's decision to announce the cancellation of a trade in *DL Capital Group*. Even

in those cases, the panel noted, the challenged actions—such as informing the public of a decision to cancel a trade—were important aspects of the exchanges' regulatory function.

Conversely, the panel saw no regulatory function at play whatsoever in the defendants' decisions to offer proprietary data feeds, co-location services, and complex order types. By selling these products, the panel found, the defendants acted in a fashion “wholly

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divorced from [their] role as regulators.” *Id.* at 48. “When an exchange engages in conduct to operate its own market that is distinct from its oversight role,” the panel noted, “it is acting as a *regulated* entity—not a *regulator*.” *Id.* Because the court saw the actions at issue as simply those of exchanges acting in their capacity as for-profit entities, it reversed the trial court's absolute immunity holding and, after finding that

the plaintiffs had sufficiently stated their claims, revived the plaintiffs' case against the exchanges.

## Conclusion

In *City of Providence*, the Second Circuit clearly marked the boundaries of the absolute immunity stock exchanges enjoy throughout a broad swath of the actions they take. The court's holding represents an important shift in the trend of its decisions in this area of law. It also signals to stock exchanges and potential plaintiffs alike that there may be renewed life for claims alleging that exchanges have operated the markets in a fashion that favors some members over others, at least in situations where the exchanges act in a manner “wholly divorced” from their capacity as regulators.