

September 3, 2022

Via Electronic Submission

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Exemption for Certain Exchange Members, Release No. 34-95388; File No. S7-05-15

To the Chairman and Commissioners:

I submit this comment letter on the Commission's above-referenced proposal to require certain broker-dealers to join FINRA, the sole national securities association recognized by the SEC. I am a partner at a large international law firm that represents many FINRA members (of all sizes and business models) and practice before FINRA and the SEC. Previously (among other positions) I have served as the SEC's Assistant General Counsel for Market Regulation, the General Counsel of a large national broker-dealer, and as Chair of the ABA Subcommittee on Trading and Markets in the Federal Regulation of Securities Committee of the ABA Business Law Section. I write solely on my own behalf, not on behalf of my law firm, my colleagues within the law firm, or on behalf of any clients of the law firm.

My point in writing this comment letter is to explain that by adopting a Commission rule requiring certain broker-dealers to register with FINRA, FINRA will become, at least as to those broker-dealers, a "part of the Government" under the standard set forth by the U.S. Supreme Court in *Free Enterprise Fund v. Public Company Accounting Board*, 561 U.S. 477 (2010) ("*PCAOB*"). Because FINRA is not currently structured in a way that comports with state actor status, the Commission must amend FINRA's rules in order to adopt the rule proposal at issue here.

The *PCAOB* case established a clear standard that an entity is "part of the Government" if it is created by the government, with expansive powers to regulate an entire industry, if members of that industry are compelled by statute or regulation to join that entity, pay its fees and comply with its rules and standards, and if that entity can sanction the member firms and their associated persons with the force of federal law. As to the broker-dealers which the proposal will require to join FINRA (as well as FINRA's other members), all of these facts will be true. Indeed, as the *PCAOB* case recognized, the *PCAOB* "was modeled on private self-regulatory organizations in the securities industry—such as the New York Stock Exchange—that investigate and discipline their own members subject to Commission oversight." The *PCAOB* case compels the conclusion that FINRA, at least as to the broker-dealers that will be required by the proposed rule to join FINRA, is a "part of the Government" and thus is subject to the constitutional principles and laws that apply to state actors. There is no meaningful way to distinguish broker-dealers required by SEC rule to join FINRA as a condition of doing business from accounting and auditing firms required by federal law to join the *PCAOB* as a condition of doing business.

I recognize that there are some older court decisions that have found that FINRA (or its predecessor, the NASD) are not state actors. See *D.L. Cromwell Invests., Inc. v. NASD Regulation, Inc.*, 279 F.3d 155 (2d Cir. 2002); *Desiderio v. NASD, Inc.*, 191 F.3d 198 (2d Cir. 1999). Those decisions in turn relied on earlier precedents from a time when joining the NASD truly was discretionary, without any consideration of the effect of Congress' intervening 1983 decision to adopt Section 15(b)(8) of Exchange

Act, which requires virtually all broker-dealers to become members of the NASD. The current rule proposal would limit the regulatory exception to Section 15(b)(8) for proprietary trading firms contained in Rule 15b9-1. But in any event, those decisions clearly are superseded by the Supreme Court's subsequent decision in *PCAOB*. When the SEC compels broker-dealers to become a member of what is now FINRA as a condition of doing business, then under the *PCAOB* decision, FINRA becomes a "part of the Government" and must comply with the relevant constitutional and statutory results of that status.

The steps which the SEC must take for FINRA to serve as a state actor are straight-forward and will not be fatal to FINRA – they are all steps that already apply (or should apply) to the PCAOB.

- FINRA's disciplinary decision-makers (its Board, its National Adjudicatory Committee and its hearing examiners) must be appointed by and be removable by Officers of the United States (specifically, by the SEC Commissioners)
- FINRA must comply with the Freedom of Information Act and make documents available to members of the public upon request
- FINRA must comply with the Government in the Sunshine Act, give advance notice and allow public attendance when its board meets
- FINRA must comply with the Paperwork Reduction Act and seek OMB approval when it adopts collections of information
- FINRA must comply with the Paperwork Reduction Act and the Regulatory Flexibility Act when it proposes new or amended rules
- FINRA must not sanction individuals under Rule 8210 for asserting their constitutional rights not to testify under the Fifth Amendment
- FINRA must comply with First Amendment principles relating to commercial speech when it regulates communications with the public under Rule 2210 and related rules
- FINRA must comply with the general federal statute of limitations for civil actions seeking penalties in 28 U.S.C. § 2462

The constitutional status of FINRA as a state actor has long vexed commentators. *See, e.g.,* Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?* 14 *Stanford J. Law, Business and Finance* 151 (2008); Note, *Is FINRA a State Actor: A Question that Exposes the Flaws of the State Actor Doctrine and Suggests a Way to Redeem It*, 67 *Vanderbilt L. Rev.* 1173 (2014), *Developments in the Law – State Action and the Public/Private Distinction*, 123 *Harv. L. Rev.* 148 (2010), McLaughlin, *Is FINRA Constitutional?* 43 *Securities Regulation & Law Report* 681 (Mar. 28, 2011). The SEC faced this issue but dodged having to decide it in *Frank P. Quattrone*, Exch. Act Rel. No. 53547 (2006). It can no longer do so today. If the SEC is going to require additional broker-dealers to register with FINRA as a matter of Commission regulation, then the SEC must comply with the Supreme Court precedent directly on point. The SEC must accept that FINRA has become a state actor, and take the appropriate steps to conform FINRA's structure and rule to reflect that state actor status.

Very truly yours,

s/ W. Hardy Callcott

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