

XII. NASDAQ and the Facebook IPO Settlement: Self-Regulatory Organizations and the Potential for Liability

A. Introduction

On Friday, May 18, 2012, Facebook held its initial public offering (IPO) on the NASDAQ exchange and offered 421 million shares to the public at \$38.00 per share.¹ However, technological errors delayed the initial opening and prevented investors from processing and confirming order requests.² Investors decided to assemble and launched a class action lawsuit against the exchange.³ The investors brought claims about the adequacy of pre-IPO and Class Period disclosures against NASDAQ for failures related to the offering.⁴ They alleged that the technological problems involved in the NASDAQ IPO Cross during the opening led to profit losses. Nearly three years later, on April 23, 2015, NASDAQ settled and agreed to pay \$26.5 million.⁵ Exchanges such as NASDAQ are “responsible for policing their own markets and therefore are legally immune from private liability for damages incurred when they are performing regulatory functions like conducting an IPO.”⁶ Accordingly, a settlement such as this is significant because it demonstrates a rare willingness of a court to sustain claims of investors against a self-regulatory organization (SRO).⁷

This article highlights the lawsuit and ensuing settlement between NASDAQ and those investors harmed as a result of the

¹ *In re Facebook, Inc., IPO Securities and Derivative Litig.*, 986 F. Supp. 2d 428 (S.D.N.Y. 2013).

² *See id.*

³ John McCrank, *Nasdaq to Settle Facebook IPO Lawsuit for \$26.5 Million*, REUTERS (Apr. 23, 2015), <http://www.reuters.com/article/2015/04/23/us-nasdaq-omx-facebook-litigation-idUSKBN0NE1FD20150423> [<http://perma.cc/ZJS5-34BL>] (“In a first for a U.S. stock exchange, Nasdaq OMX Group on Thursday agreed to pay \$26.5 million to settle a class-action lawsuit involving its bungling of Facebook Inc's [sic] \$16 billion initial public offering, the plaintiffs' lawyers said.”).

⁴ *Id.*

⁵ *Id.*

⁶ *Id.*

⁷ *Id.* (“The settlement is significant because exchanges are responsible for policing their own markets and therefore are legally immune from private liability for damages incurred when they are performing regulatory functions like conducting an IPO.”).

issues surrounding the Facebook IPO. Part B provides details about the lawsuit and allegations against NASDAQ. Part C goes into detail about the technological problems associated with the process used in the IPO. Next, Part D outlines the terms of the settlement agreement with investors and discusses prior compensation of brokers involved in the IPO. Part E describes the background behind the events, legislation leading up to the legal status of SROs, and the potential for SRO liability. Part F further explores the legal status of SROs in describing the quasi-governmental role of NASDAQ and distinguishes government functions from private entity functions. Part G then analyzes the application of SRO immunity to the facts of the Facebook IPO.

B. The Lawsuit Against NASDAQ

In 2003, a few college students at Harvard University created Facebook after experimenting with a facial recognition software program.⁸ Nine years later, that software developed into a massively popular social media platform and CEO Mark Zuckerberg decided to take Facebook public on the NASDAQ exchange.⁹ On the morning of the IPO launch, several technological problems caused order delays and profit losses for investors.¹⁰ As a result, on May 22, 2012, Facebook retail investors (Plaintiffs) sued NASDAQ, its parent, the NASDAQ OMX Group (NASDAQ OMX), and two top ranking technology officers of NASDAQ OMX.¹¹ The Plaintiffs brought both federal securities and negligence actions against NASDAQ.¹² They alleged that NASDAQ made material misrepresentations and omissions regarding the capabilities of its technology to be able to handle the massive volume involved in launching the Facebook IPO.¹³

C. IPO Cross Technology

⁸ See, e.g., DAVID KIRKPATRICK, *THE FACEBOOK EFFECT: THE INSIDE STORY OF THE COMPANY THAT IS CONNECTING THE WORLD* 23-25 (2010).

⁹ See Jaelyn Freeman, *Limiting SRO Immunity to Mitigate Risky Behavior*, 12 COLO. TECH. L.J. 193, 215 (2014).

¹⁰ *In re Facebook, Inc.*, 986 F. Supp. 2d 428, 438 (S.D.N.Y. 2013).

¹¹ *Id.*

¹² *Id.*

¹³ *Id.* at 440.

Implemented in 2006, the NASDAQ IPO Cross is an open auction process that enables investors to enter orders and participate in a price discovery.¹⁴ The essential purpose of an IPO Cross is to maximize transparency by determining a single price that accurately reflects supply and demand in the market.¹⁵ On the day of an IPO Cross, NASDAQ members place buy and sell orders in advance of the opening of trading and NASDAQ places these orders on a hold until a display period occurs.¹⁶ The display period lasts at least fifteen minutes and members may extend the period in five minute intervals.¹⁷ During that time, members can observe the auction price and participate in IPO price discovery.¹⁸ After this display period, the system checks, in a fraction of a second, whether any members cancelled orders and re-calculates the volume of the IPO Cross in order to validate the price and to ensure that it is accurate.¹⁹ Prior to the May 18 launch of the Facebook IPO, NASDAQ had tested this software and realized that it was susceptible to limitations that could affect the platform's ability to properly execute the offering.²⁰ Nonetheless, NASDAQ continued with the process and even promoted the capabilities of its technologies in order to attract companies like Facebook to the exchange.²¹ The Plaintiffs alleged that the extremely high volume of shares involved in the Facebook IPO caused the validation check between the display period and the

¹⁴ *Frequently Asked Question: The NASDAQ IPO Cross*, THE NASDAQ STOCK MARKET, INC. (June 2006), https://www.nasdaqtrader.com/content/ProductsServices/Trading/IPOHalt/iipo_faq.pdf [<https://perma.cc/ZK95-SMS7>].

¹⁵ *Id.* at 442.

¹⁶ *In re Facebook, Inc.*, 986 F. Supp. 2d at 440.

¹⁷ *Id.* (“During the Display Only Period, members can enter, modify, and cancel orders and ‘observe the evolution of the prospective auction price through NASDAQ’s dissemination of auction imbalance information, thereby enabling members (and their customers) to participate in IPO price discovery.’”).

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.* at 441 (“Defendants also made numerous statements prior to and after securing the Facebook IPO regarding the capability and reliability of NASDAQ’s technology and trading platform . . .”).

²¹ *Id.*

offering to continue in a feedback loop.²² This cycle forced NASDAQ to disable the system and caused investor losses.²³

D. Settlement Agreement

On May 22, 2015, the Plaintiffs and NASDAQ entered into a settlement agreement.²⁴ The lead plaintiffs to the agreement, on behalf of themselves and the class, were T3 Trading Group, LLC; Avatar Securities, LLC; Philip Goldberg; Steve Jarvis; Atish Gandhi; Colin Suzman; Meredith Bailey; and Faisal Sami.²⁵ NASDAQ denied any wrongdoing or liability, but concluded that “further litigation would be protracted and expensive, and they also have taken into account the uncertainty and risks inherent in any litigation, especially in complex cases such as this litigation.”²⁶ Both parties agreed to a settlement amount of \$26,500,000.²⁷ In reaching the terms of the settlement, Plaintiffs agreed to waive any unknown claims against NASDAQ and to allow Plaintiffs’ co-lead counsel to apply for an award of no more than one-third of the settlement fund amount.²⁸

A previous compensation package for brokers involved in the Facebook IPO may have influenced the final settlement agreement between NASDAQ and retail investors. In 2013, the SEC permitted NASDAQ to preemptively compensate brokers for the issues arising out of the Facebook IPO.²⁹ NASDAQ had submitted a proposal to the SEC for a rule change to amend Rule 4626 in order to be able to monetarily settle claims arising from the Facebook IPO.³⁰

²² *Id.* at 443.

²³ *Id.*

²⁴ *In re* Facebook, Inc., IPO Securities and Derivative Litig., 986 F. Supp. 2d 428 (S.D.N.Y. 2015) (No.12-2389).

²⁵ *Id.* at 1.

²⁶ *Id.* at 3.

²⁷ *Id.* at 11.

²⁸ *Id.* at 10-18.

²⁹ Nasdaq Stock Mkt. LLC, S.E.C. Release No. 34-69216 (2013) (“On July 23, 2012, The NASDAQ Stock Market LLC (‘Nasdaq’ or ‘Exchange’) filed with the Securities and Exchange Commission (‘Commission’), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (‘Act’) and Rule 19b-4 thereunder, a proposed rule change to amend Exchange Rule 4626—Limitation of Liability (‘accommodation proposal’).”).

³⁰ *Id.* (“Nasdaq proposes to add subsection (3) to Nasdaq Rule 4626(b) to establish a voluntary accommodation program for certain claims arising

The unamended NASDAQ Rule 4626(a) stated “Nasdaq and its affiliates are not liable for any losses, damages, or other claims arising out of the Nasdaq Market Center or its use.”³¹ However, under NASDAQ Rule 4626(b), the exchange could compensate users for “losses directly resulting from the systems' actual failure to correctly process an order, Quote/Order, message, or other data [D]uring a single calendar month [but] shall not exceed the larger of \$500,000 or the amount of the recovery obtained by Nasdaq under any applicable insurance policy.”³² NASDAQ proposed to compensate those affected by technological system failures in the Facebook IPO by increasing the payout amount of \$500,000 to \$62 million.³³ The SEC found the Commission’s acceptance of this proposal to amend Rule 4626 consistent with Section 6(b)(5) of the Securities Exchange Act of 1934 (the Act), which requires:

[T]he rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest, and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.³⁴

E. Self-Regulatory Organizations and Exchange Immunity

In the years following the stock market crash of 1929, legislators passed the Securities Act of 1933 and the Securities

from the initial public offering (‘IPO’) of Facebook, Inc. (‘Facebook’) on May 18, 2012 (collectively ‘Facebook IPO’).”).

³¹ *Id.*

³² *Id.*

³³ *Id.*

³⁴ *Id.* at 6.

Exchange Act of 1934.³⁵ Legislators designed these statutes to restore confidence in capital markets and heighten regulation on a “failed” laissez faire approach to Wall Street.³⁶ In turn, this legislation created the Securities and Exchange Commission (SEC) with the purpose of granting the commission the authority to regulate the securities industry and to protect investors.³⁷

Under the Securities Exchange Act of 1934, Congress established a regulatory system that relied on the SEC to oversee SROs that regulate the securities market.³⁸ The SEC authorized the Financial Industry Regulatory Authority (FINRA) to delegate SRO functions to NASDAQ.³⁹ As an SRO, NASDAQ assumes the dual role of being both a regulator that engages in government activities and functions, as well as a private corporation that engages in activities that may further private business interests.⁴⁰ The SEC has acknowledged this hybrid role that NASDAQ and other SROs assume due to business pressures in the financial market industry.⁴¹

F. NASDAQ’s Quasi-Governmental Functions

Quasi-governmental functions are actions a private entity takes that a government agency legally supports.⁴² When an SRO performs quasi-governmental actions including adjudicatory,

³⁵ Elisabeth Keller & Gregory Gehlmann, Comment, *A Historical Introduction to the Securities Act of 1933 and The Securities Exchange Act of 1934*, 39 Ohio St. L.J. 329, 329 (1988).

³⁶ *Id.*

³⁷ See generally Freeman, *supra* note 9, at 197 (“Under the Act, the SEC oversees SROs, defined broadly to include ‘any national securities exchange, registered securities association, or registered clearing agency.’”).

³⁸ Securities Act of 1934, 15 U.S.C. §§ 78f–78c(a)(26).

³⁹ Order Approving the Plan of Allocation and Delegation of Functions by NASD to Subsidiaries, Exchange Act, 62 Fed. Reg. 62,385 (Nov. 21, 1997).

⁴⁰ Weissman v. NASD, Inc., 500 F.3d 1293, 1296 (11th Cir. 2007) (“Indeed, even though the SEC has explicitly delegated regulatory functions to SROs, the SEC itself is mindful that SROs have dual status as both quasi-regulators and private businesses.”).

⁴¹ Concept Release Concerning Self-Regulation, Exchange Act, 69 Fed. Reg. 71,256 (Dec. 8, 2004).

⁴² See *Quasi-Public Corporation*, INVESTOPEDIA, http://www.investopedia.com/terms/q/quasi_public_corporation.asp [perma.cc/6BNH-QWGWZ].

regulatory, and prosecutorial functions, it has absolute immunity.⁴³ For example, such functions include deciding to suspend or cancel trades, disciplining members and associates of an exchange, and performing other similar functions that fall under the umbrella of the Act.⁴⁴ However, an SRO loses absolute immunity if it operates as a private entity would, outside of the delegated authority of the Act.⁴⁵ For instance, in 2007, the Eleventh Circuit in *Weissman v. National Ass'n of Securities Dealers* found that advertising and representing the financial health of companies conducting fraudulent activity was a private activity not protected by absolute immunity.⁴⁶ The Eleventh Circuit developed an objective test for whether a function was quasi-governmental or not and determined that courts must look at the underlying nature and function of the activity, rather than the SRO's subjective intent or motivation.⁴⁷

G. NASDAQ's Immunity from the Facebook IPO

The district court of the Southern District of New York (SDNY) found that only certain actions NASDAQ took involving the Facebook IPO qualified for absolute immunity.⁴⁸ Actions with absolute immunity included NASDAQ's decision not to stop trading and NASDAQ's Class Period announcements during the IPO on whether to suspend trading.⁴⁹ Plaintiff investors argued that NASDAQ acted as a private entity and did not halt trading or announce such decisions because NASDAQ was trying to promote

⁴³ *Weissman*, 500 F.3d at 1296 (“Because they perform a variety of vital governmental functions, but lack the sovereign immunity that governmental agencies enjoy, SROs are protected by absolute immunity when they perform their statutorily delegated adjudicatory, regulatory, and prosecutorial functions.”).

⁴⁴ See *Sparta Surgical Corp. v. Nat'l Ass'n of Sec. Dealers, Inc.*, 159 F.3d 1209, 1213–15 (9th Cir. 1998).

⁴⁵ *Weissman*, 500 F.3d at 1297 (“When an SRO is not performing a purely regulatory, adjudicatory, or prosecutorial function, but rather acting in its own interest as a private entity, absolute immunity from suit ceases to obtain.”).

⁴⁶ *Id.* at 1298.

⁴⁷ *Id.* at 1297.

⁴⁸ *In re Facebook, Inc., IPO Securities and Derivative Litig.*, 986 F. Supp. 2d 428 (S.D.N.Y. 2013).

⁴⁹ *Id.* at 450-459.

volume and profits.⁵⁰ The court rejected this argument and reasoned that the ability to suspend trading and the announcement of such a decision were regulatory functions.⁵¹ The court concluded that the non-exercise of the power to halt trading was equally entitled to immunity.⁵²

Conversely, the SDNY determined the Plaintiff's negligence claims against NASDAQ did not qualify for absolute immunity.⁵³ These negligence claims included the inadequate designs, testing procedures, and advertisements of NASDAQ's software.⁵⁴ The court reasoned that NASDAQ's actions in promoting technology to companies, including Facebook, were for the sole purpose of increasing trading volume and profits for the companies.⁵⁵ In other words, NASDAQ took the sort of action that private entities would employ. The court also concluded that since NASDAQ had discovered certain flaws in the IPO Cross technology prior to the Facebook IPO, the failure to correct the promotion of technology capabilities was not immune to liability; NASDAQ had engaged in advertising activities tailored to serve its own interests as a private entity.⁵⁶

H. Conclusion

As financial markets become more competitive and legislation adapts to reflect changes resulting from the 2008 recession, courts will likely continue to scrutinize the role that financial exchanges such as the NASDAQ assume. NASDAQ has an incentive to categorize more of its activity as serving a regulatory function rather than a private function.⁵⁷ Attempts to increase profits

⁵⁰ *Id.*

⁵¹ *Id.* (“The capacity to suspend trading, irrespective of the identity of the decision-maker or the presence of an official SEC rule, is a quintessentially regulatory function.”).

⁵² *Id.* at 455.

⁵³ *Id.* at 450-454.

⁵⁴ *Id.*

⁵⁵ *Id.* at 452.

⁵⁶ *Id.* (“There are no immunized or statutorily delegated government powers to design exchange computer software, to appropriately test computer software, or to fix computer software when it is malfunctioning before executing an Offering after touting its competence.”).

⁵⁷ See Craig Springer, *Weissman v. NASD: Piercing the Veil of Absolute Immunity of an SRO Under the Securities Exchange Act of 1934*, 33 DEL. J.

as a private entity may be tempting, but could result in liability.⁵⁸ The settlement between the retail investors and NASDAQ over the Facebook IPO illustrates a gray area between balancing the responsibilities of SROs with the interest of participants in the financial markets. It is unclear whether the Facebook IPO settlement demonstrates a pervasive willingness for courts to scrutinize the actions of SROs such as NASDAQ. However, it appears that for now, courts are placing a high priority on the protection of investors.

Frank Pustorino⁵⁹

CORP. L. 451–469, 468 (2008) (“Lawsuits like Weissman’s will simply cause SROs, like Nasdaq, to be more cautious about how they portray themselves to the public.”).

⁵⁸ *Id.* at 465.

⁵⁹ Student, Boston University School of Law (J.D. 2017).