

1 UNITED STATES COURT OF APPEALS

2 FOR THE SECOND CIRCUIT

3 August Term, 2003

4 (Argued: March 18, 2004 Decided: August 16, 2004)

5 Docket No. 03-4883  
6  
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9 JOHN R. D'ALESSIO and D'ALESSIO SECURITIES, INC.,

10 Petitioners,

11 - v -

12 SECURITIES AND EXCHANGE COMMISSION,

13 Respondent.  
14 -----

15 Before: SACK and RAGGI, Circuit Judges, and TRAGER, District  
16 Judge.\*

17 Petition, pursuant to 15 U.S.C. § 78y(a)(1) and  
18 5 U.S.C. § 702, for review of an opinion and order of the  
19 Securities and Exchange Commission sustaining the New York Stock  
20 Exchange's termination of the petitioners' membership in the  
21 Exchange. The Commission rejected the petitioners' arguments  
22 that (1) the Exchange's partiality required its hearing officer  
23 to recuse himself from the disciplinary proceedings; (2) the  
24 partiality of the Commission required the Commission to recuse  
25 itself; and (3) the sanctions imposed by the Exchange were  
disproportionately harsh.

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\* The Honorable David G. Trager of the United States District Court for the Eastern District of New York, sitting by designation.



1 an independent floor broker<sup>1</sup> until his suspension by the Exchange  
2 in February 1998.

3 By February 1996, D'Alessio had become an Exchange  
4 floor official. As such, he was responsible for answering the  
5 questions of other floor brokers about Exchange rules and their  
6 interpretation. During the period relevant to this appeal,  
7 D'Alessio was an employee of petitioner D'Alessio Securities,  
8 Inc., an Exchange member-organization ("D'Alessio Securities" or  
9 D'Alessio's "firm"). D'Alessio was owner, president, and  
10 director of his firm, and acted as the firm's floor broker. On  
11 February 25, 1998, the Exchange summarily suspended D'Alessio and  
12 his firm from Exchange membership and from access to Exchange  
13 services. Those suspensions set in motion the series of events  
14 that ultimately led to the present petition.

15 The Exchange is a self-regulatory organization ("SRO")  
16 subject to Commission oversight pursuant to 15 U.S.C. §§ 78c,  
17 78f, 78s.<sup>2</sup> With exceptions not relevant here, a federal statute  
18 and a Commission regulation make it unlawful for an SRO floor  
19 broker to trade for an account in which the broker has an

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<sup>1</sup> Independent floor brokers are "agents who execute orders on the exchange floor typically for other members or other brokerage firms. For their services, Independent Floor Brokers receive a negotiated commission, which typically is based on the share volume of the trade." NYSE, Exchange Act Release No. 41574, 70 S.E.C. Docket 106, 1999 WL 430863, at \*2, 1999 SEC LEXIS 1290, at \*5-\*6 (June 29, 1999). There are some 500 Exchange members who act as independent floor brokers. Id.

<sup>2</sup> For a discussion of the NYSE's status and structure as an SRO, see Silver v. NYSE, 373 U.S. 341, 352-54 (1963); Barbara v. NYSE, 99 F.3d 49, 51 (2d Cir. 1996).

1 interest or over which the broker exercises discretion. 15  
2 U.S.C. § 78k(a)(1) ("Section 11(a)");<sup>3</sup> 17 C.F.R. § 240.11a-1  
3 ("Rule 11a-1").<sup>4</sup> These prohibitions are designed to prevent  
4 floor brokers from exploiting short-term market information and  
5 opportunities that are available to them but unavailable to other  
6 investors. See NYSE, Exchange Act Release No. 41574, 70 S.E.C.  
7 Docket 106, 1999 WL 430863, at \*1, 1999 SEC LEXIS 1290, at \*3  
8 (Jun. 29, 1999). The ban on proprietary or discretionary trading  
9 by floor brokers is further reflected in Exchange rules.  
10 See NYSE Rule 90(a), 95(a), & 111(a). D'Alessio and his firm --  
11 the petitioners -- argue that during the period prior to their  
12 suspension from Exchange membership, senior Exchange officials

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It shall be unlawful for any member of a national securities exchange to effect any transaction on such exchange for its own account, the account of an associated person, or an account with respect to which it or an associated person thereof exercises investment discretion . . . .

15 U.S.C. § 78k(a)(1).

4

No member of a national securities exchange, while on the floor of such exchange, shall initiate, directly or indirectly, any transaction in any security admitted to trading on such exchange, for any account in which such member has an interest, or for any such account with respect to which such member has discretion as to the time of execution, the choice of security to be bought or sold, the total amount of any security to be bought or sold, or whether any such transaction shall be one of purchase or sale.

17 C.F.R. § 240.11a-1(a).

1 were aware of violations of Section 11(a) and related rules, and  
2 yet tacitly encouraged floor brokers to engage in such activity.<sup>5</sup>

3 Exchange rules also prohibit floor brokers from  
4 "crossing trades" and "trading ahead," also called  
5 "frontrunning." See NYSE Rule 91 (crossing trades); NYSE Rule 92  
6 (trading ahead, frontrunning). A broker "crosses trades" when he  
7 or she fills a customer's order by buying or selling a security  
8 from an account in which the broker has an interest. A broker  
9 "trades ahead" or "frontruns" when he or she receives a large  
10 order for a particular security from an institutional client and,  
11 before executing the larger trade, first executes trades in that  
12 security for an account in which the broker has an interest so as  
13 to anticipate and exploit the movement in price the larger trade  
14 is likely to cause. In addition, NYSE Rules 123, 410, and 440,

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<sup>5</sup> During the early 1990s, while William Donaldson was Exchange Chairman, the Exchange was aware of certain profit-sharing arrangements between brokers and customers. The Exchange was also aware of stock "flipping," a related practice in which floor brokers rapidly buy and sell the same security in an effort to capture the spread between the stock's bid and ask prices. Profits made through flipping transactions are generally shared between the broker and the customer. See Letter from Richard A. Grasso, Chairman and Chief Executive Officer, NYSE, to Richard Walker, Director, SEC Division of Enforcement 2-3 (Oct. 7, 1998); see also MFS Sec. Corp. v. SEC, No. 03-4882, \_\_\_ F.3d \_\_\_, \_\_\_, slip. op. at [4] (2d Cir. 2004) (discussing "flipping"). The Exchange tacitly approved of at least some of these practices despite the potential conflict with Section 11(a) and Rule 11a-1. It determined that broker compensation based on profits did not invariably constitute an "interest" in an account. Rather, the Exchange concluded, whether a broker's interest in an account violated Section 11(a) turned on the subjective intent of the broker with respect to that account. See Letter from Richard A. Grasso, Chairman and Chief Executive Officer, NYSE, to Richard Walker, Director, SEC Division of Enforcement 2-3 (Oct. 7, 1998).

1 which implement the record-keeping provisions for brokers and  
2 dealers contained in 17 C.F.R. §§ 240.17a-3 and 240.17a-4,  
3 require floor brokers to retain all of their trading orders for  
4 three years.

5 In 1994, the petitioners -- D'Alessio and his firm --  
6 entered into a business relationship with the Oakford  
7 Corporation. They concede that until February 25, 1998, they  
8 "flipped" stocks for, and had a profit-sharing arrangement with,  
9 Oakford. Under the agreement with Oakford, D'Alessio and his  
10 firm were to receive seventy percent of net profits from Oakford  
11 trades, and were to absorb seventy percent of the account's  
12 losses. D'Alessio concedes that he did not know directly of  
13 other brokers with this sort of arrangement, that he did not  
14 recall asking anyone at the Exchange whether it was permissible,  
15 and that he had only a "general sense" of the rules barring  
16 trading by a floor broker for an account in which the broker had  
17 an interest. NYSE Hearing of Mar. 28, 2000, at 120.

18 Along with petitioners' seventy percent interest in the  
19 Oakford account, D'Alessio also had discretion over trades for  
20 the account. He used this discretion to "cross trades" for  
21 Oakford's benefit. And D'Alessio was vested with discretion to  
22 decide how many shares of a particular security he would trade  
23 for Oakford. At least once, D'Alessio changed the number of  
24 shares in an existing Oakford order without first contacting  
25 Oakford. The petitioners gave the Oakford account preferential

1 treatment, "frontrunning" other customers for the benefit of the  
2 Oakford account.

3 Neither D'Alessio nor his firm complied with Commission  
4 regulations or Exchange Rules requiring brokers to maintain  
5 specified trading records. See 17 C.F.R. §§ 240.17a-3 & 240.17a-  
6 4; NYSE Rule 123, 410, & 440. Instead of keeping the records  
7 required by these detailed rules, see, e.g., NYSE Rule 410(a)  
8 (requiring Exchange members to "preserve for at least three  
9 years" all trading orders transmitted or carried to the Exchange  
10 floor), D'Alessio kept a box at his booth on the trading floor in  
11 which he put order tickets. As he himself described it, he threw  
12 away the contents "[w]henver the box got full." NYSE Hearing of  
13 Mar. 28, 2000, at 128. The amount contained in the box at any  
14 one time, he said, "could have been a year's worth, year and a  
15 half's worth, it could have been less." Id. The petitioners  
16 wisely do not seek to convince us that these record-keeping  
17 practices complied with Commission regulations or NYSE Rules.

#### 18 Criminal Proceedings

19 On February 25, 1998, federal law enforcement officials  
20 (it is difficult to determine from the record who) arrested  
21 D'Alessio on a charge of violating Section 11(a). On the same  
22 day, the Exchange summarily suspended D'Alessio and his firm from  
23 Exchange membership and access to Exchange services. The  
24 Exchange acted based upon D'Alessio's floor brokerage activities

1 involving Oakford.<sup>6</sup> Also on the same day, the Commission filed a  
2 civil action against, among others, D'Alessio and his firm. See  
3 Oakford Corp., Litigation Release No. 15653, 66 S.E.C. Docket  
4 1301, 1998 WL 75699, 1998 SEC LEXIS 311 (Feb. 25, 1998).<sup>7</sup>

5           Meanwhile, the government instituted criminal  
6 proceedings against Oakford, D'Alessio, and other floor brokers  
7 associated with Oakford in the United States District Court for  
8 the Southern District of New York. Defendants other than  
9 D'Alessio pleaded guilty, see United States v. Oakford Corp., 79  
10 F. Supp. 2d 357, 359 (S.D.N.Y. 1999), while the charges against  
11 D'Alessio were dismissed pursuant to a deferred prosecution  
12 agreement, D'Alessio v. NYSE, 258 F.3d 93, 97 (2d Cir. 2001).<sup>8</sup>

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<sup>6</sup> Under NYSE Rule 475, the petitioners had the right to request a hearing with respect to the summary suspension. On August 10, 1998, the petitioners requested such a hearing. On August 21, 1998, however, they withdrew the request. In early 1999, the petitioners again requested a hearing with respect to the suspension. In the course of the Exchange Division of Enforcement's investigation into D'Alessio's conduct, he failed to produce certain documents requested by the Exchange or to appear to testify at the time for which it was noticed. In response, an Exchange Hearing Panel censured D'Alessio and barred him from Exchange membership for one month. At this time, D'Alessio's summary suspension was apparently already in effect, so it is not clear what, if anything, this additional sanction accomplished. Ultimately, D'Alessio complied with both the Exchange requests for documents and for his testimony, permitting the Exchange hearing on the charges brought against D'Alessio to go forward on the merits.

<sup>7</sup> The Commission later moved to dismiss the civil complaint. The district court granted the motion, dismissing the action without prejudice. The Commission subsequently refiled the complaint. It settled with D'Alessio on May 2, 2001, in exchange for, inter alia, a payment by D'Alessio of \$200,000.

<sup>8</sup> D'Alessio suggests that the dismissal of criminal charges "exonerated" him with respect to the Exchange's disciplinary

1 But in an opinion and order in connection with the sentencing of  
2 defendants in the case, the district court (Jed S. Rakoff, Judge)  
3 observed that the Exchange's interpretation of Section 11(a)'s  
4 prohibition of "discretionary" trading by a floor broker, which  
5 deemed a trade chosen by a floor broker not "discretionary" so  
6 long as the broker notified the customer of the trade prior to  
7 making it, was "anemic" and made a "mockery" of the statutory  
8 language. Oakford Corp., 79 F. Supp. 2d at 362-63.

9 SEC Proceedings Against the Exchange

10 At about the time the criminal proceedings against the  
11 Oakford-related defendants were underway, the Commission launched  
12 an investigation into trading practices on the Exchange floor.  
13 It concluded that as a result of, among other things, "improperly  
14 restrictive rule interpretations," the Exchange had allowed  
15 independent floor brokers to disregard securities laws and  
16 Exchange rules. Letter from Lori A. Richards, Director, SEC  
17 Office of Compliance Inspections and Examinations, to Richard A.  
18 Grasso, Chairman and Chief Executive Officer, NYSE 1 (Sept. 14,  
19 1998). On June 29, 1999, pursuant to a settlement agreement with

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proceeding. Petitioners' Br. at 37. According to D'Alessio,  
"[p]etitioners . . . sincerely believed that when they entered  
into a profit sharing arrangement it was proper to do so, which  
good faith was accepted by the United States Attorney's Office  
when it dismissed the criminal case against Petitioner D'Alessio  
in 1999. All of this proof was denied to Petitioners by the  
hearing officer." Petitioners' Reply Br. at 15. However, the  
United States Attorney's Office's decision to exercise its  
prosecutorial discretion and drop the charge against D'Alessio  
has little bearing, if any, on this court's review of the SEC's  
review of the Exchange's disciplinary action.

1 the Exchange, the Commission issued an order concluding that the  
2 Exchange had been lax in policing trading by independent floor-  
3 brokers for trading involving accounts in which the brokers had  
4 an interest. The order instructed the Exchange to enforce the  
5 relevant rules. NYSE, Exchange Act Release No. 41574, 70 S.E.C.  
6 Docket 106, 1999 WL 430863, at \*7-\*10, 1999 SEC LEXIS 1290, at  
7 \*21-\*31 (June 29, 1999).

#### 8 The Petitioners' Lawsuit

9 On December 14, 1999, D'Alessio and his firm instituted  
10 a lawsuit in the Supreme Court of New York, New York County,  
11 against the Exchange and three Exchange officials: Chairman  
12 Richard Grasso, Group Executive Vice-President for Market  
13 Surveillance Edward Kwalwasser, and Senior Vice-President for  
14 Market Surveillance Robert McSweeney. The complaint, which  
15 sought \$25 million in damages, alleged state-law tort and breach-  
16 of-contract claims based on alleged misconduct by the Exchange  
17 and its officials. Drawing on the Commission's investigation and  
18 criticism of Exchange enforcement of Section 11(a) and related  
19 regulations, as well as on Judge Rakoff's prior criticism of the  
20 Exchange's interpretation of "discretion," Oakford Corp., 79 F.  
21 Supp. 2d at 362-63, D'Alessio and his firm alleged that their  
22 unlawful trading was a byproduct of the actions of the Exchange  
23 and its officers in disseminating a knowingly incorrect  
24 interpretation of the relevant statutes and Exchange rules and in  
25 concealing that fact from the office of the United States  
26 Attorney for the Southern District of New York. The defendants

1 removed the action to the United States District Court for the  
2 Southern District of New York. Although the complaint alleged  
3 only state-law claims, the district court concluded that it had  
4 removal jurisdiction under Franchise Tax Board v. Construction  
5 Laborers Vacation Trust, 463 U.S. 1, 28 (1983), and Smith v.  
6 Kansas City Title & Trust Co., 255 U.S. 180, 199-202 (1921),  
7 because D'Alessio and his firm's right to relief under state law  
8 necessarily depended on resolution of a substantial question of  
9 federal law, namely, the construction of Section 11(a) and  
10 related SEC regulations. See Frayler v. NYSE, 118 F. Supp. 2d  
11 448, 450 (S.D.N.Y. 2000) (asserting removal jurisdiction over  
12 similar tort suit against the Exchange by an independent floor  
13 broker); id. at 451 n.4 (applying analysis from Frayler to sua  
14 sponte review of the removability of D'Alessio and his firm's  
15 state-court suit). The district court ultimately dismissed the  
16 action on the grounds that, having been sued in their regulatory  
17 capacities, the defendants enjoyed absolute immunity. D'Alessio  
18 v. NYSE, 125 F. Supp. 2d 656, 657-59 (S.D.N.Y. 2000), aff'd, 258  
19 F.3d 93 (2d Cir. 2001).

#### 20 The Exchange's Charges against the Petitioners

21 In the meantime, on December 27, 1999, almost two weeks  
22 after D'Alessio and his firm filed their complaint in New York  
23 State Supreme Court, the Exchange formally charged them with  
24 disciplinary violations, including violations of Section 11(a),  
25 Rule 11a-1, and NYSE Rules 90(a), 95(a), and 111(a) (prohibiting  
26 floor brokers from engaging in proprietary and discretionary

1 trading); NYSE Rule 91 (crossing trades); NYSE Rule 92  
2 (frontrunning); and NYSE Rule 440 and Exchange Act Rules 17a-3  
3 and 17a-4 (record-keeping requirements). The first step in the  
4 Exchange disciplinary process is a proceeding before a Hearing  
5 Panel consisting of one hearing officer employed by the Exchange  
6 and two members of the Exchange. See NYSE Const. art. IX, §§ 2,  
7 4, available at <http://www.nyse.com/pdfs/constitution.pdf> (last  
8 visited Aug. 9, 2004). In petitioners' case, the Hearing Panel  
9 Exchange members -- i.e., the panel members other than the  
10 hearing officer -- were floor brokers like D'Alessio; they were  
11 not Exchange employees.

12 The petitioners made a motion before the Hearing Panel  
13 arguing that "the NYSE and its employees must disqualify itself  
14 [sic] from this entire matter. The matter should be immediately  
15 referred to an outside arbitrator." Letter from Dominic F.  
16 Amorosa, Atty. for Petitioners, to Rosetta L. Alter, Hearing  
17 Board Manager, NYSE 1 (Feb. 7, 2000). The petitioners argued  
18 that because their concurrent lawsuit against the NYSE was  
19 adverse to both the Exchange and its highest officers, all  
20 Exchange employees suffered from a conflict of interest with  
21 respect to the petitioners. The Exchange hearing officer -- the  
22 only Exchange employee on the Hearing Panel -- denied the motion  
23 and declined to recuse himself.

24 In an effort to establish that the kind of "profit  
25 sharing" arrangement between the petitioners and Oakford had been

1 sanctioned by the Exchange,<sup>9</sup> D'Alessio and his firm sought to  
2 call Grasso, Kwalwasser, and McSweeney as witnesses. The hearing  
3 officer denied this request, ruling that their testimony would be  
4 repetitive and cumulative because other Exchange employees had  
5 testified that the trading practices in which D'Alessio and his  
6 firm had engaged were prohibited.

7 In a decision dated November 14, 2000, the panel  
8 concluded that D'Alessio and his firm had knowingly violated the  
9 law by, among other things, having an interest in the Oakford  
10 account, giving the Oakford account preferential treatment, and  
11 engaging in discretionary trading on behalf of the account. NYSE  
12 Exchange Hearing Panel Decision Nos. 00-195, 00-196, at 8 (Nov.  
13 14, 2000). It censured both D'Alessio and his firm. Id. at 9.  
14 It barred them from "allied membership, approved person status,  
15 and from employment or association in any capacity with any  
16 member or member organization for a period of seven years." Id.  
17 The petitioners were also "permanently barred from membership  
18 and/or employment on the Floor of the Exchange in any capacity."  
19 Id.

20 Two weeks later, the petitioners appealed the panel's  
21 decision to the NYSE Board of Directors. During the pendency of  
22 the appeal, the petitioners again insisted that "the NYSE must  
23 disqualify itself from these proceedings and the matter [must be]

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<sup>9</sup> The petitioners do not address the other Exchange Rule violations of which the Hearing Panel found them guilty, including loss sharing, "crossing trades," "frontrunning," and failure to keep specified trading records for three years.

1 referred to an independent arbiter at once." Letter from Dominic  
2 F. Amorosa, Atty. for Petitioners, to Karalene J. Gayle,  
3 Assistant General Counsel, NYSE 4 (Feb. 13, 2001). The Board  
4 declined to do so. The two management directors on the Board,  
5 one of whom was Richard Grasso, did, however, recuse  
6 themselves.<sup>10</sup> The Board then affirmed the decision of the  
7 Hearing Panel.

#### 8 SEC Review

9 On April 11, 2001, the petitioners sought Commission  
10 review of the Board's ruling pursuant to 15 U.S.C. § 78s(d)(2),  
11 (e)(1). On August 3, 2001, during the pendency of the appeal,  
12 Harvey Pitt was appointed Chairman of the Commission. Pitt, as a  
13 lawyer in private practice, had represented the Exchange in  
14 petitioners' state-law action. On May 7, 2002, counsel for  
15 D'Alessio and his firm wrote to the Commission to inquire whether  
16 Pitt had any responsibility with respect to his appeal. Two days  
17 later, Pitt recused himself.

18 Six months later, Pitt resigned as SEC Chairman. But  
19 on December 13, 2002, the petitioners moved to disqualify the  
20 entire Commission based on the then-pending nomination of former

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<sup>10</sup> The Exchange Board is comprised of two "management directors" and twenty-four "non-management directors," twelve of whom are "public directors." These twelve "public directors" are "non-industry" directors "representing the investing public." See Governance of the New York Stock Exchange, Inc. 3 (2003), <http://www.nyse.com/pdfs/governancewhitepaper.pdf> (last visited July 23, 2004). The two management directors are the Chairman and the Chief Executive Officer ("CEO") of the Exchange (if the CEO is not also the Chairman). See NYSE Const. art. IV, § 2, available at <http://www.nyse.com/pdfs/constitution.pdf>.

1 Exchange Chairman William Donaldson to be Chairman of the  
2 Commission. Donaldson also eventually recused himself, so  
3 notifying the petitioners on March 27, 2003. The Commission did  
4 not, however, recuse itself as an agency with respect to the  
5 petitioners' appeal.

6 On April 3, 2003, the Commission issued an order  
7 sustaining the decision of the Exchange Board affirming the  
8 ruling of the Hearing Panel. In an opinion accompanying the  
9 order, the Commission said that it was "bas[ing its] findings  
10 upon an independent review of the record." John R. D'Alessio,  
11 Exchange Act Release No. 47627, 79 S.E.C. Docket 2786, 2003 WL  
12 1787291, at \*2, 2003 SEC LEXIS 806, at \*6 (April 3, 2003). After  
13 a lengthy discussion of the facts underlying the case, the  
14 Commission concluded that D'Alessio and his firm had committed  
15 the violations of which they had been found guilty by the  
16 Exchange. Id., 2003 WL 1787291, at \*9, 2003 SEC LEXIS 806, at  
17 \*31-\*32. The Commission also concluded that the petitioners'  
18 allegations that the Exchange tacitly encouraged the kind of  
19 relationship D'Alessio and his firm had had with Oakford were not  
20 substantiated by the record. Id., 2003 WL 1787291, at \*9-\*10,  
21 2003 SEC LEXIS 806, at \*33-\*39. The Commission then considered  
22 and rejected the petitioners' argument that the Exchange  
23 proceedings were fundamentally unfair because of the Exchange's  
24 alleged partiality. Id., 2003 WL 1787291, at \*10-\*13, 2003 SEC  
25 LEXIS 806, at \*40-\*51. First, the Commission rejected the  
26 petitioners' argument that the Exchange disciplinary proceedings

1 were in retaliation for the petitioners' bringing suit against  
2 the Exchange. Id., 2003 WL 1787291, at \*10, 2003 SEC LEXIS 806,  
3 at \*40-\*41. The Commission noted that although the Exchange  
4 initiated the proceedings two weeks after the petitioners filed  
5 their suit against it, the Exchange had also, during the period  
6 prior to the petitioners' filing in state court, "engaged in a  
7 wide range of acts preparatory to its filing of charges against  
8 [D'Alessio and his firm]." Id., 2003 WL 1787291, at \*10, 2003  
9 SEC LEXIS 806, at \*41. Second, the Commission, relying on Sloan  
10 v. NYSE, 489 F.2d 1, 3 (2d Cir. 1973), concluded that the fact  
11 that the petitioners had brought suit against the Exchange did  
12 not preclude the Exchange from instituting disciplinary  
13 proceedings against them. D'Alessio, 2003 WL 1787291, at \*11,  
14 2003 SEC LEXIS 806, at \*42-\*43. The Commission also found that  
15 the petitioners had offered no evidence of the Exchange Board's  
16 partiality. In any event, the Commission reasoned, its de novo  
17 review provided "ample protection from any claimed partiality or  
18 bias" on the part of the Exchange. Id., 2003 WL 1787291, at \*12,  
19 2003 SEC LEXIS 806, at \*46. The Commission also rejected the  
20 petitioners' insistence that the SEC was required to recuse  
21 itself in favor of an independent arbiter. Id., 2003 WL 1787291,  
22 at \*12-\*13, 2003 SEC LEXIS 806, at \*47-\*51.

23 As for the petitioners' claim that they were victims of  
24 selective prosecution by the Exchange and that they had received  
25 disproportionately harsh sanctions, the Commission noted that it

1 has consistently held that the propriety of an SRO-imposed  
2 sanction is highly fact-dependent and "cannot be determined by  
3 comparison with action taken in other cases." Id., 2003 WL  
4 1787291, at \*13, 2003 SEC LEXIS 806, at \*52. The Commission  
5 decided that, on the particular facts of this case, the  
6 petitioners had "violated the principles of commercial honor and  
7 trust that are the hallmark of the exchange auction market  
8 system. Their violations go to the heart of the duties a floor  
9 broker owes a customer." Id., 2003 WL 1787291, at \*13, 2003 SEC  
10 LEXIS 806, at \*54. The Commission concluded that the Exchange's  
11 sanctions imposed against the petitioners were "fully warranted."  
12 Id., 2003 WL 1787291, at \*14, 2003 SEC LEXIS 806, at \*56.

13 On May 6, 2003, D'Alessio and his firm filed a petition  
14 in this Court pursuant to 15 U.S.C. §§ 78y(a)(1) and 5 U.S.C.  
15 § 702 for review of the Commission's order. They argue that the  
16 order should be vacated on the grounds that (1) the Exchange  
17 hearing officer who presided over the petitioners' disciplinary  
18 hearing suffered from a conflict of interest with respect to the  
19 petitioners and therefore should have recused himself; (2) the  
20 SEC Commissioners were barred by their conflict of interest from  
21 hearing the case; and (3) the disciplinary sanctions imposed on  
22 D'Alessio and his firm by the Exchange were disproportionately  
23 harsh in comparison to the sanctions imposed in similar cases.

## 24 **DISCUSSION**

### 25 I. Standard of Review

1 "In reviewing the SEC's opinion and order, we must  
2 affirm '[t]he findings of the Commission as to the facts, if  
3 supported by substantial evidence.'" Valicenti Advisory Servs.,  
4 Inc. v. SEC, 198 F.3d 62, 64 (2d Cir. 1999) (quoting 15 U.S.C.  
5 § 80b-13(a) (alteration in original)), cert. denied, 530 U.S.  
6 1276 (2000); 15 U.S.C. § 78y(a)(4). The Administrative Procedure  
7 Act, which applies to our review of Commission orders, see, e.g.,  
8 Domestic Sec., Inc. v. SEC, 333 F.3d 239, 248 (D.C. Cir. 2003),  
9 provides that a reviewing court shall "hold unlawful and set  
10 aside agency action, findings, and conclusions found to be . . .  
11 arbitrary, capricious, an abuse of discretion, or otherwise not  
12 in accordance with law," 5 U.S.C. § 706(2).

## 13 II. Alleged Conflicts of Interest

### 14 A. The Exchange

15 The petitioners argue that due process required that  
16 the hearing officer on the Hearing Panel that conducted their  
17 disciplinary hearings recuse himself. Because D'Alessio and his  
18 firm had previously filed suit in state court against the  
19 Exchange, the petitioners argue, all Exchange employees,  
20 including the hearing officer, were biased against the  
21 petitioners and incapable of giving them a fair hearing.<sup>11</sup> We

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<sup>11</sup> Although the petitioners asserted only the alleged partiality of the hearing officer in their initial brief to us, in their reply brief they extend the bias argument to the NYSE Board as a whole, as they did in the course of the proceedings before the Board. "[A]rguments raised for the first time in an appellate reply brief are not properly before the court." United States v. Hernandez-Fundora, 58 F.3d 802, 811 n.3 (2d Cir.), cert. denied, 515 U.S. 1127 (1995). We therefore do not consider

1 conclude that the argument is ill conceived and that the Exchange  
2 was not in error in concluding that such alleged partiality on  
3 the part of the hearing officer did not render the Exchange  
4 disciplinary proceedings against D'Alessio and his firm unfair or  
5 invalid.

6 As we observe in MFS Securities Corp. v. SEC, No. 03-  
7 4882, \_\_\_ F.3d \_\_\_ (2d Cir. 2004), decided today:

8 Under the due process clauses of the Fifth  
9 and Fourteenth Amendments, parties and the  
10 public are entitled to tribunals free of  
11 personal bias. In re Murchison, 349 U.S.  
12 133, 136 (1955); see also Chew v. Dietrich,  
13 143 F.3d 24, 28 n.4 (2d Cir.) (observing that  
14 the due process clauses of the Fifth and  
15 Fourteenth Amendments create equivalent  
16 requirements for most purposes), cert.  
17 denied, 525 U.S. 948 (1998). This requirement  
18 is applicable to administrative agencies such  
19 as the Commission in much the same way as it  
20 is applicable to courts. See Gibson v.  
21 Berryhill, 411 U.S. 564, 579 (1973).

22 Id. at \_\_\_, slip op. at [ ].

23 The petitioners assume, without elaboration, that such  
24 a due-process requirement applies to Exchange disciplinary  
25 proceedings. That is, however, not self evident.<sup>12</sup>

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that argument here.

<sup>12</sup> "Because the United States Constitution regulates only the Government, not private parties, a litigant claiming that his constitutional rights have been violated must first establish that the challenged conduct constitutes 'state action.'" United States v. Int'l Bhd. of Teamsters, 941 F.2d 1292, 1295 (2d Cir. 1991), cert. denied, 502 U.S. 1091 (1992). The Exchange, a nonprofit New York corporation, is a private entity. But the Exchange is required as a condition of its status as a registered national securities exchange to carry out a self-regulatory function defined by federal statute and subject to SEC oversight. See Barbara, 99 F.3d at 51. We have held in other contexts that

1           But whatever the merits of the constitutional argument,  
2 we need not reach it today. Federal statute requires, as a  
3 condition of registration as a national securities exchange, that  
4 the rules of the exchange "in general, provide a fair procedure  
5 for the disciplining of members and persons associated with  
6 members." 15 U.S.C. § 78f(b)(7); see also Silver v. NYSE, 373  
7 U.S. 341, 364-65 (1963) ("Congress in effecting a scheme of self-  
8 regulation designed to insure fair dealing cannot be thought to  
9 have sanctioned and protected a self-regulative activity when  
10 carried out in a fundamentally unfair manner."). Whatever else

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the National Association of Securities Dealers ("NASD"), a private SRO that is for present purposes analogous to the Exchange, is not a state actor subject to due process requirements. Perpetual Sec., Inc. v. Tang, 290 F.3d 132, 137-39 (2d Cir. 2002), cert. denied, 531 U.S. 1069 (2001); Desiderio v. NASD, 191 F.3d 198, 206-07 (2d Cir. 1999). In Gold v. SEC, 48 F.3d 987 (7th Cir. 1995), the Seventh Circuit, although ultimately considering the issue waived, recognized that it had "expressed doubt . . . that the comprehensive regulation of securities exchanges by the federal government would turn those exchanges into government actors." Id. at 991.

Moreover, "the fact that a business entity is subject to 'extensive and detailed' state regulation does not convert that organization's actions into those of the state." Desiderio, 191 F.3d at 206 (quoting Jackson v. Metro. Edison Co., 419 U.S. 345, 350 (1974)).

At the same time, however, "we recognize that private entities may be held to constitutional standards if their actions are 'fairly attributable' to the state." Id. (citation omitted). In considering an Exchange disciplinary proceeding, such as the present one, in which the disciplinary violations alleged include violations of federal securities laws and SEC regulations, the argument that the nexus between the State and the challenged proceeding is sufficiently close that the Exchange's behavior may be fairly attributable the State may not be trivial. However, we need not, and do not, address this issue here.

1 section 78f(b) (7)'s requirement of "a fair procedure" means, and  
2 whether or not it incorporates all due process requirements that  
3 would bind an agency of the federal government, we think that  
4 provision of "a fair procedure" in SRO disciplinary proceedings  
5 gives rise to a due-process-like requirement that the decision-  
6 maker be impartial. Thus, whether the norm arises out of the  
7 statute or the constitution, we conclude that impartial  
8 adjudicators are required. The analysis we make when the  
9 impartiality of the Exchange is challenged is thus similar to  
10 that which we employ when the impartiality of the Commission is  
11 challenged, as it is both here and in MFS Securities, \_\_\_ F.3d at  
12 \_\_\_, slip op. at [ ], decided today.

13 We conclude that the hearing officer's participation in  
14 the petitioners' disciplinary proceeding did not render the  
15 proceeding unfair. The petitioners' theory is that because they  
16 were concurrently suing the Exchange and senior Exchange  
17 officials, and because their allegations in that suit had the  
18 potential to embarrass the Exchange and those officials, the  
19 hearing officer was biased against the petitioners: The hearing  
20 officer would not want to incur the disfavor of his superiors by  
21 finding for parties who were directly adverse to them in  
22 litigation charging the superiors with misbehavior. We think  
23 that to be insufficient to establish bias.

24 We assume that if an Exchange official is the specific  
25 target of a civil lawsuit brought by an Exchange member, that  
26 official should not participate as a hearing officer in Exchange

1 disciplinary proceedings against the member. The official's  
2 interests would in such a case likely be directly adverse to the  
3 Exchange member's. But the petitioners do not allege that the  
4 hearing officer here bore any personal animus toward them, nor do  
5 they allege that he had anything even resembling a direct  
6 financial stake in the outcome of the disciplinary proceeding.  
7 They have adduced no evidence tending to show that the interests  
8 of the hearing officer himself were directly adverse to the  
9 petitioners or amounted to a personal stake in the outcome of the  
10 civil suit. Of course an Exchange employee who acts as a hearing  
11 officer may want to please his or her superiors who are  
12 themselves embroiled in litigation. But we think that that alone  
13 is far too attenuated an interest to cast a shadow on the  
14 employee's impartiality. As we observe today in MFS Securities,  
15 \_\_\_ F.3d at \_\_\_, slip. op. at [16], the bias of one member of a  
16 regulatory agency generally does not spread "contagion-like"  
17 throughout the agency. Id. We similarly conclude that the bias  
18 or attitude of senior Exchange officials does not invariably  
19 trickle down to all employees at all levels of the Exchange.

20 Our conclusion in this regard is consistent with our  
21 decision in Sloan v. NYSE, 489 F.2d 1 (2d Cir. 1973). There, the  
22 Exchange had brought a civil action against several of its  
23 members. The members had asserted counterclaims. The Exchange  
24 concurrently instituted an internal disciplinary proceeding  
25 against the members. The members sought to enjoin the proceeding  
26 on the ground that the Exchange hearing officer was not impartial

1 because "the Exchange and [the members] oppose one another in a  
2 separate civil action in which the charges brought in the  
3 disciplinary proceeding are material." Id. at 3. We affirmed  
4 the district court's denial of preliminary injunctive relief,  
5 noting that "the interests of the [Hearing] [P]anel members are  
6 sufficiently attenuated from the outcome of the proceeding to  
7 make the possibility of partiality quite remote." Id. at 4.

8 "If disciplinary proceedings were to come to a halt  
9 whenever an exchange sought relief in a civil suit and the  
10 defendant counterclaimed, th[e] regulatory framework would be  
11 undermined." Id.; cf. MFS Securities, \_\_\_ F.3d at \_\_\_, slip op.  
12 at [ ] ("We cannot require, as a matter of constitutional law,  
13 that administrative tribunals disqualify themselves for the most  
14 theoretical and remote of reasons. To do so might well impair  
15 their ability to fulfill their congressionally imposed  
16 adjudicative functions.").

17 Finally, acceptance of the petitioners' theory would  
18 give rise to a perverse incentive for Exchange members, when  
19 fearing possible Exchange disciplinary proceedings and desiring  
20 to disqualify Exchange members in any such adjudication, to  
21 strike preemptively in the courtroom against the Exchange. We  
22 can discern no legitimate goal to be served by encouraging such  
23 litigation.

24 The Commission did not abuse its discretion in  
25 affirming the order of the Exchange in this regard.

26 B. The Commission

1           The petitioners further argue that even though Chairmen  
2 Pitt and Donaldson recused themselves from personal involvement  
3 in the petitioners' appeal to the Commission, because Pitt had  
4 represented the Exchange in the civil lawsuit brought by the  
5 petitioners against the Commission, and because Donaldson was a  
6 former Chairman of the Exchange, the Commission as an institution  
7 could not be impartial with respect to the petitioners' appeal.  
8 The petitioners therefore insist that the Commission was required  
9 to disqualify itself in this matter in favor of an independent  
10 arbitrator. Today, in MFS Securities, we denied a virtually  
11 identical claim. MFS Sec., No. 03-4882, \_\_\_ F.3d at \_\_\_, slip  
12 op. at [ ]. For the reasons stated there, we reject the  
13 petitioner's argument here.

14           To be sure, the petitioners have raised a question of  
15 the timing of Chairman Pitt's recusal that was not present in MFS  
16 Securities. They did so for the first time, however, in their  
17 reply brief. "[A]rguments raised for the first time in an  
18 appellate reply brief are not properly before the court." United  
19 States v. Hernandez-Fundora, 58 F.3d 802, 811 n.3 (2d Cir.),  
20 cert. denied, 515 U.S. 1127 (1995). We therefore do not consider  
21 the argument here.

### 22           III. Sanctions

23           Finally, D'Alessio and his firm argue that the  
24 sanctions that the Hearing Panel imposed on them were so  
25 disproportionately severe, and so manifestly the product of  
26 selective prosecution by the Exchange, that the Commission abused

1 its discretion in sustaining the sanctions. Cf. Stoiber v. SEC,  
2 161 F.3d 745, 753 (D.C. Cir. 1998) ("We review an SEC decision  
3 affirming sanctions imposed by the NASD against a broker for an  
4 abuse of discretion."), cert. denied, 526 U.S. 1069 (1999).  
5 After reviewing the sanctions imposed and the reasoning of the  
6 Commission, we conclude that the Commission did not abuse its  
7 discretion on this score.

8 D'Alessio, by becoming an Exchange member, "voluntarily  
9 submitted himself to the discipline of what is largely a self-  
10 regulating association." Markowski v. SEC, 34 F.3d 99, 105 (2d  
11 Cir. 1994); see also Sloan, 489 F.2d at 4 ("[W]hen appellants  
12 became members of the Exchange they consented, quite knowingly  
13 and intelligently to [its] disciplinary procedures."). It does  
14 not follow that the Exchange's discretion in sanctioning its  
15 members for disciplinary violations is boundless. We have  
16 suggested, with respect to the Commission's confirmation of NASD  
17 sanctions, that we would overturn them if they were "unwarranted  
18 in law . . . or without justification in fact." Markowski, 34  
19 F.3d at 105 (ellipses in original; citation and quotation marks  
20 omitted).

21 In the analogous context of our review of SEC-imposed  
22 sanctions, we have refused, on due process grounds, to defer to  
23 the Commission's imposition of sanctions where "doing so would  
24 penalize an individual who has not received fair notice of a  
25 regulatory violation." Upton v. SEC, 75 F.3d 92, 98 (2d Cir.  
26 1996); see also Arthur Lipper Corp. v. SEC, 547 F.2d 171, 184 (2d

1 Cir. 1976) (revising and limiting SEC sanctions where the  
2 violations occurred during "years of considerable uncertainty as  
3 to the regulatory climate concerning [the violation]"), cert.  
4 denied, 434 U.S. 1009 (1978). Whether due process applies in the  
5 same way in the present context, we think it likely that  
6 provision of "a fair procedure," 15 U.S.C. § 78f(b)(7); see  
7 Silver, 373 U.S. at 364-65, permits the Exchange to discipline a  
8 member only after the disciplined member has received fair notice  
9 that the conduct in question violated Exchange Rules or the  
10 securities laws or was otherwise grounds for the imposition of  
11 sanctions. In the case before us, the petitioners had ample  
12 notice that the totality of their conduct -- sharing of profits  
13 and losses with Oakford, exercising discretion with respect to  
14 Oakford trades, giving preferential treatment to Oakford's  
15 account over other customers by crossing trades and frontrunning,  
16 and failing to adhere to the Exchange's record-keeping  
17 requirements -- violated Exchange rules and securities  
18 regulations.

19 To be sure, there appears to have been some uncertainty  
20 at the Exchange during the relevant period with respect to the  
21 extent to which profit-sharing arrangements violated Section  
22 11(a) or Exchange rules. The petitioners' relationship with  
23 Oakford and their record-keeping violations, however, went far  
24 beyond the sharing of profits. Although Exchange guidance on the  
25 meaning of "interest in an account" may have been wanting, there  
26 could have been no question at the time of the petitioners'

1 relationship with Oakford that the petitioners' trading and  
2 record-keeping practices as a whole violated Exchange rules and  
3 securities regulations. The Commission did not abuse its  
4 discretion when it concluded that

5 [e]ven assuming . . . that the Exchange  
6 failed to disseminate a clear standard with  
7 respect to whether sharing in the profits and  
8 losses of an account makes that account a  
9 member's own account, [D'Alessio and his  
10 firm's] other violations -- trading for an  
11 account over which [D'Alessio and his firm]  
12 exercised discretion, according that account  
13 preferential treatment and failing to make  
14 and preserve required records -- fully  
15 warrant the sanctions imposed by the NYSE.

16 John R. D'Alessio, Exchange Act Release No. 34-47627, 79 S.E.C.  
17 Docket 2786, 2003 WL 1787291, at \*14 n.70, 2003 SEC LEXIS 806, at  
18 \*56 n.70.

19 The petitioners also argue that the sanctions imposed  
20 by the Exchange were so disproportionately severe in relation to  
21 sanctions imposed in similar cases that they demonstrate that the  
22 petitioners were the target of selective prosecution by the  
23 Exchange. We have indeed shown our willingness to overturn  
24 Commission penalties that we concluded were draconian. In Arthur  
25 Lipper, 547 F.2d at 184-85, for example, we reduced Commission-  
26 imposed permanent suspension from the securities industry to a  
27 twelve-month suspension, in part because the sanctioned firm had  
28 confronted an unclear regulatory environment and had relied on  
29 advice of counsel that ultimately proved to be wrong. Similarly,  
30 in Blinder, Robinson & Co. v. SEC, 837 F.2d 1099 (D.C. Cir.),  
31 cert. denied, 488 U.S. 869 (1988), the District of Columbia

1 Circuit vacated and remanded Commission-imposed sanctions that  
2 the court concluded might be too severe. Id. at 1112-14. It so  
3 decided, however, because petitioners in that case had "mounted a  
4 non-frivolous claim" that "the SEC's hand comes down more heavily  
5 on smaller, newer firms than it does on old-line, or at least  
6 more established, houses with the 'right sort' of exchange  
7 memberships." Id. at 1112. The court noted that "[w]hat is  
8 alleged here was not mere disparities, but rather an asserted  
9 systematic pattern of disparate treatment, resulting in  
10 predictably, disproportionately harsh sanctions." Id. (citation  
11 omitted; emphasis in original).

12 "The allegation [was] thus not simply that  
13 penalties have differed from case to  
14 case. . . . [E]ach case in securities  
15 regulation, as elsewhere, is different.  
16 Those inevitable differences and gradations  
17 in fact can best be discerned and articulated  
18 by the Commissioners whose job it is to come  
19 to these sorts of judgments."

20 Id.

21 The allegations made by petitioners here stand in stark  
22 contrast to those made in Lipper or Blinder, Robinson. There is  
23 no suggestion of mistaken reliance on counsel or systematic bias.  
24 The petitioners allege "mere disparities," id., between the  
25 sanctions imposed in their case and those imposed in cases they  
26 assert are similar. Such disparities alone are not without more  
27 sufficient to establish improper selective prosecution by the  
28 Exchange.

29 Perhaps gross disparities in sanctions for similar  
30 behavior would at least suggest underlying bias. Our examination

1 of the sanctions imposed in similar Exchange disciplinary cases<sup>13</sup>  
2 that are in the record, however, does not confirm such  
3 disproportionality. The petitioners cite Hearing Panel decisions  
4 in which Exchange members and their firms were disciplined for  
5 violating Section 11(a), giving preferential treatment to an  
6 account in which they had an interest, making material  
7 misstatements to the Exchange, and failing to adhere to Exchange  
8 record-keeping requirements. See Gary John Hemmingstad, NYSE  
9 Hearing Panel Decision No. 02-151 (July 18, 2002) (imposing  
10 sanctions of censure, a three-year plenary bar,<sup>14</sup> and a five-year  
11 bar from the Exchange floor); AFC Partners, LLC, NYSE Hearing  
12 Panel Decision Nos. 02-12, 02-13, 02-14 (Jan. 14, 2002) (censure  
13 and \$75,000 fine for the firm; censure, eighteen-month plenary  
14 suspension, and \$200,000 fine for one violator; censure and six-  
15 month plenary suspension for another); Richard Kwiatkowski, NYSE  
16 Hearing Panel Decision No. 01-100 (Nov. 2, 2001) (censure,  
17 permanent bar from employment on the trading floor, and five-year  
18 plenary bar). Although the Exchange Rules and securities

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<sup>13</sup> To the extent petitioners contend that they were somehow prejudiced by the Commission's failure to direct that the Exchange provide them with decisions disciplining other Exchange members and their firms for similar violations of Exchange rules and securities regulations, we note that such decisions are matters of public record. Indeed, petitioners' counsel acknowledged this fact at oral argument; thus, petitioners could have obtained these materials without the Exchange's disclosure.

<sup>14</sup> A "plenary" bar or suspension, as the Exchange Hearing Panel uses the term, appears to refer to a bar from "allied membership, approved person status, and from employment or association in any capacity with any member or member organization."

1 regulations that the members were found to have violated in those  
2 cases are largely the same as those violated by the petitioners,  
3 each of these cases involved facts dissimilar from those before  
4 the Exchange in this case. That those dissimilar facts resulted  
5 in dissimilar sanctions does not, of course, tend to establish  
6 bias or selective prosecution, nor does it show that the sanction  
7 imposed was impermissibly disproportionate.<sup>15</sup>

8 The Commission did not abuse its discretion in  
9 affirming the order of the Exchange in this regard.

10 **CONCLUSION**

11 For the foregoing reasons, the petition for review is  
12 denied and the order of the Commission is affirmed.

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<sup>15</sup> In the decision bearing the greatest factual similarity to D'Alessio and his firm's, Kwiatkowski, the Exchange Hearing Panel permanently barred Kwiatkowski from the Exchange floor and imposed on him a five-year plenary bar. But there were factual distinctions between the two cases. Here, the Hearing Panel found that the petitioners had received more than \$450,000 of the Oakford account's net profits, compared to the slightly more than \$175,000 that Kwiatkowski's firm received. And D'Alessio was a floor official -- a position of trust; Kwiatkowski, apparently, was not. Especially in light of these differences between the cases, we cannot conclude that the relatively modest difference in the sanctions imposed indicates a lack of fairness on the part of the Exchange or error on the part of the Commission in affirming the Exchange's order.