EXECUTIVE

April 21, 1971

MEMORANDUM FOR PETER FLANIGAN

FROM: GEORGE CRAWFORD

SUBJECT: SECURITIES INDUSTRY ANTITRUST LITIGATION

The New York Stock Exchange, and the other exchanges, have various rules and regulations which restrict the practices of their member firms, and which as "restraints of trade" violate section 1 of the Sherman Act or other parts of the antitrust laws. When the antitrust laws were passed, it was not specifically contemplated that they would apply to the securities industry, but they have since been found to do so. However, the Securities and Exchange legislation contemplates a system in which private exchanges are able to regulate their members, and the Supreme Court in 1963 held that even exchange rules not subject to SEC review under section 19(6) are exempted from the antitrust laws if the rules are necessary in order to make the Exchange Act work (Silver v. NYSE). Neither this nor other cases provide very clear criteria as to which rules fall within that category, nor is there any specific statutory mandate: the court reached its conclusion simply by reading together the antitrust laws on the one hand, the securities laws on the other.

Who determines which rules are exempted from the antitrust laws because they are necessary to make the Exchange Act work? The courts, unless the Congress should pass some specific legislative criteria. However, the SEC is in the best position to determine which rules are necessary to make the Exchange Act work, and so it arguably should be given the opportunity to make this determination in the first instance, subject to judicial review. The doctrine that the regulatory agency with particular expertise in a given subject should speak before the courts is a traditional one in administrative law (the "doctrine of primary jurisdiction") but there are many and complex exceptions. Antitrust cases are brought in the district courts, of course, and cannot be brought before the SEC. Some exchange rules are subject to SEC review under section 19 (b), but in the case of other exchange rules and practices there is no clear, simple, and speedy procedure to get an SEC determination whether a specific rule is necessary to make the Exchange Act work. Therefore, the courts may undertake to decide the question themselves. But were the SEC to lay down some standards, they would probably be respected by the courts. Moreover, the SEC is free to enter an appearance in any given case and state its position.

What specific exchange rules and industry practices have been challenged?

(1) Fixed commissions. Unless exempted from the antitrust laws, this would be straightforward price fixing and criminal penalties might even be applied. A 1967 case in the Seventh Circuit Court of Appeals (Chicago) established that this does not necessarily violate the antitrust laws, however (Kaplan v. Lehman Bros.). Nor is it automatically insulated: a District

Court (Illinois) dismissed on April 5, 1971, a suit seeking to compel fixed rates for large trades despite the SEC decision doing away with the practice. Thus, under the present cases, stock exchange establishment of fixed commissions appear to be protected from antitrust action unless disapproved by the SEC. However, on April 2 a $1.5 billion suit was filed charging the Exchange's failure to extend minimum commissions to small investors discriminates against them and violates the antitrust laws (Gordon v. NYSE). A similar suit, for $3 billion, but without the discrimination element, has been pending since October 1970 (Reinich v. NYSE). Also one was filed in Chicago on April 7 against the Board of Trade (Arenson v. Board of Trade).

(2) Exclusion of non-members from NYSE trading. In 1963 Thill Securities Corp. sued the NYSE in the federal district court in Milwaukee on grounds that excluding Thill (a non-member) from floor trading, and from using a member firm to place its trades at low rates, was in restraint of trade and violated the antitrust laws. The District Court dismissed the suit, but the Court of Appeals in Chicago reversed, 2-1, holding the plaintiff should have an opportunity to put forward its case. The Supreme Court declined to review the case and so it will go back for trial in Milwaukee. The Supreme Court's action means nothing at all; only rarely would the Court hear a case at such an early stage. The Court of Appeals' decision evidently means that Thill can present evidence to try to prove that the rule is in restraint of trade, and that the NYSE must thereupon prove the rule necessary to make the Exchange Act work. However, should the court determine that the SEC has primary jurisdiction, the case could be delayed until the SEC decides whether the rule is needed to make the Exchange Act work. SEC and Justice Department views will be filed on this point.

(3) Trading listed securities off the floor. The NASD was sued this year for omitting listed securities from its automated quotation system (NASDAQ). The NASD has since decided to list some such securities in its system, but should all listed securities be included in the NASDAQ system, I believe this suit would become moot. The NASD has under appeal in the Fifth Circuit (New Orleans) a case in which the NASD audits rules may be held totally exempt from the antitrust laws under its enabling legislation (the Maloney Act) which confers substantially more complete review authority in the SEC over the NASD than it has over the exchange under the Exchange Act (Harwell v. NASD). A suit has just been filed attacking the NYSE rule forbidding member firms from trading listed securities off the board except in certain circumstances (Schumate v. NYSE).

(4) Fixing differential and break point by odd lot dealers. In May of 1966 a treble damage action was brought on this price fixing change. Before 1966 the odd lot dealers did this without SEC or NYSE blessing; since that date they have had NYSE blessing on the practice. (Eisen v. NYSE)

(5) Registered representatives' commissions. This is a suit charging the NYSE and member firms with conspiring to keep registered representatives' commissions down by excluding them from sharing in the surcharge, inter alia. (Jacobs v. Bache & Co.)

There are a number of other lawsuits pending, but these are the most important issues.

Are all of these practices necessary to make the Exchange Act, and the self-regulation under the securities laws work? This question would seem best resolved by the SEC, and I would expect it to express its views in briefs before the relevant courts as these and other exchange rules are drawn into question. It is very unfair for treble damages to be imposed for behavior under traditional rules and practices of the exchanges and the industry; if these practices should be changed this should be brought about by SEC rule, without imposition of damages for past behavior. Of course, pendency of treble damage action may require the SEC to take stands more promptly and definitely on some of these issues than they otherwise would. I expect this litigation will lead to pressure on the SEC to determine what restraints of trade it believes necessary to make the exchange system work, but should not, and probably will not, lead to damages for traditional practices. To assure this result, we should encourage the Justice Department and SEC to express these views in court.

In addition, we might explore the introduction of legislation which would make clear the SEC power to review all Exchange and NASD rules and practices, in addition to those broad areas specified in Section 19 (b) of the Act, and at the same time would exempt the securities industry from the antitrust laws or (with comparable effect) make explicit the primary jurisdiction of the SEC, providing that no antitrust action would lie for a practice not disapproved by the SEC.

Should I explore these ideas further with the SEC and Justice Department?

GC:rjm