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John R. Johnson

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# APPLICATION OF ANTITRUST LAWS TO THE SECURITIES INDUSTRY

by

John R. Johnson\*

WITHIN the last several years certain significant developments have called into question the basic theory of self-regulation of the securities industry with respect to pricing and entry mechanisms. The first of these was the realization after *Silver v. New York Stock Exch.*<sup>1</sup> that the securities industry is not immune from the application of antitrust laws and policy. The rash of private suits based upon antitrust grounds aimed at various industry practices that have followed the *Silver* decision and the spate of studies being undertaken by the Securities and Exchange Commission and the Justice Department bear witness to this awakening.<sup>2</sup> The second development that has brought the economic structure of the securities industry into question is the *Special Study*'s<sup>3</sup> searching analysis of pricing and exclusionary practices sponsored by the exchanges. The last factor is the realization that the SEC, either because of lack of statutory authority, or because of conscious restraint, has failed to delve very deeply into either the theory or the practical operation of regulatory activities concerning the economic structure of the securities industry.

The New York Stock Exchange<sup>4</sup> is the focal point of the controversy. The Exchange has created an institution which possesses certain near monopoly powers supported by three basic policies: the maintenance of a minimum commission schedule;<sup>5</sup> the imposition

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\* Attorney at Law, Dallas, Texas.

<sup>1</sup> 373 U.S. 341 (1963).

<sup>2</sup> See Wall Street Journal, April 26, 1965, p. 1, col. 6. The private suits that have been filed include an attack upon the NYSE members' refusal to share or negotiate for sharing of commissions as a concerted refusal to deal, *Thill Sec. Corp. v. New York Stock Exch.*, Civil No. 63-C-264, E.D. Wis., Oct., 1962; a charge that member firms have conspired to fix minimum commission rates, *Kaplan v. Lehman Bros.*, 250 F. Supp. 562 (N.D. Ill. 1966), see Wall Street Journal, March 25, 1965, p. 26, col. 2; charges that certain mutual funds paid excessive brokerage funds to "Exchange members rather than trading on the third market, *Ibid.* In addition, suits have been threatened which would challenge the Exchange rule prohibiting members from trading on the Third Market, see Wall Street Journal, March 15, 1965, p. 24, col. 1, and the Exchange's restrictive membership requirements. See Wall Street Journal, April 26, 1965, p. 6, col. 2. The SEC has commenced a study of the NYSE's curbing of member off-board trading in listed issues. The Justice Department has begun a study directed particularly toward discovering the effects of intra-industry competition resulting from commission rates, prohibitions against members sharing commissions with nonmember broker-dealers, and allegedly restrictive policies governing admission to membership. See Wall Street Journal, March 26, 1965, p. 3, col. 1.

<sup>3</sup> SEC, *Special Study of Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963) hereinafter cited as *Special Study*.

<sup>4</sup> Hereinafter cited NYSE.

<sup>5</sup> See NYSE Const. art. XV, in 2 CCH NYSE Guide ¶¶ 1701-12.

of various prohibitions designed to restrict multiple trading in listed securities;<sup>6</sup> and the utilization of a restrictive set of membership requirements, designed to control entry into the market.<sup>7</sup> The problem posed by this economic structure became even more critical as a result of the 1964 amendments to the securities acts.<sup>8</sup> In particular, two developments will tend to enhance the economic power of the NYSE. The extension of reporting requirements to a large segment of now unlisted securities<sup>9</sup> removes an impediment that has kept many companies from listing in the past.<sup>10</sup> Thus, the rush to list is likely to be extensive, with the consequence of further concentration of security business upon the NYSE.<sup>11</sup> Further, the provision requiring the publishing of wholesale quotations of over-the-counter securities<sup>12</sup> will tend to establish the NYSE commission schedule as the de facto commission schedule for the entire securities industry.<sup>13</sup>

Questions concerning the basic policy decisions which must be made with respect to this economic structure are two-fold. First, is this system necessary and appropriate for the attainment of goals (other than economic) sought under the securities acts? Then, if not, what is the proper means of improving the economic performance of the securities industry—direct rate and entry regulation by the SEC or the maintenance of competitive conditions through the antitrust laws?

## I. ECONOMIC STRUCTURE OF THE SECURITIES INDUSTRY

### A. NYSE Commission Rate Schedule

The NYSE was designed to provide a mechanism for the setting of

<sup>6</sup> See, e.g., NYSE Rule 394, in 2 CCH NYSE Guide ¶ 2394.

<sup>7</sup> See NYSE Const. art. IX, in CCH NYSE Guide ¶¶ 1401-15, and NYSE Rules 301-21, in CCH NYSE Guide ¶¶ 2301-21.

<sup>8</sup> Of the laws administered by the Securities and Exchange Commission, I shall refer to the following: Securities Act of 1933, 48 Stat. 74, as amended, 15 U.S.C. §§ 77a-aa (1958) [hereinafter cited as the 1933 Act]; Securities Exchange Act of 1934, 48 Stat. 881, as amended, 15 U.S.C. §§ 78a-jj (1958) [hereinafter cited as the 1934 Act]. The recent Securities Acts Amendments of 1964, Pub. L. 88-467, 78 Stat. 565 [hereinafter cited as the 1964 Amendments], amended the 1933 Act in one respect and significantly extended the 1934 Act.

Citations will not hereafter be given to references in text to §§ 1 and 2 of the Sherman Act, and §§ 3 and 7 of the Clayton Act. Sherman Act § 1, 26 Stat. 209, as amended, 15 U.S.C. § 1 (1958); Sherman Act § 2, 26 Stat. 209, as amended, 15 U.S.C. § 2 (1958); Clayton Act § 3, 38 Stat. 731, 15 U.S.C. § 14 (1958); Clayton Act § 7, 38 Stat. 731, as amended, 15 U.S.C. § 18 (1958).

<sup>9</sup> See 1964 Amendments, amending 1934 Act §§ 12(g)1 (registration statement), 13(a) and 15(d) (periodic reports), 14 (proxy solicitations), and 16 (insider trading).

<sup>10</sup> See Wall Street Journal, April 26, 1965, p. 6, col. 1; Wall Street Journal, March 17, 1965, p. 11, col. 1; Wall Street Journal, March 15, 1965, p. 24, col. 1.

<sup>11</sup> See Wall Street Journal, April 26, 1965, p. 6 col. 1; *Special Study*, pt. 2, at 947.

<sup>12</sup> 1964 Amendments, amending 1934 Act to add § 15A(b)(12). See NASD, REPORT ON PUBLICATION OF QUOTATIONS, CCH FED. SEC. L. REP. ¶ 77180.

<sup>13</sup> It will be very difficult for the over-the-counter dealers to charge more than the Exchange commission once wholesale prices, rather than marked-up prices, are published.

minimum commission rates and the establishment of a preference for members of the Exchange in their dealing with other members.<sup>14</sup> These objectives continue to be important today. Article XV of the Constitution of the NYSE provides that:

(a) Commissions must be charged on each transaction executed by members on behalf of others in securities admitted to dealings upon the Exchange;

(b) The commissions charged may not be less than the rates set forth in article XV of the constitution; *i.e.*, the commissions set forth are mandatory minimum commission rates;

(c) The commissions charged 'shall be net and free from any rebate, return, discount or allowance made in any shape or manner, or by any method or arrangement, direct or indirect;' and

(d) Nonmembers of the Exchange shall pay higher rates of commission than members.<sup>15</sup>

There are several significant points concerning the NYSE commission system that bear notice. First, the nonmember rates are minimum rates which apply uniformly to all nonmembers of the Exchange. They, coupled with the antirebate provisions, preclude direct price or rate competition. Second, there is no discount given for size or volume. Third, although the rates include ancillary services, there is no specification as to the types or extent of the services to be included. Moreover, there is no prohibition against making additional charges for such services; so competition, within limits, in respect of services is quite permissible. Fourth, with insignificant exceptions, the commission schedules of the other exchanges are identical to that of the NYSE.

The uniformity with which the rates are applied to nonmembers forces the nonmember broker to pay the full public commission even though he is unable to charge his customer any more than the rate charged him by the member. Thus, he is forced either to refuse business in listed securities and run the risk of losing the customer's entire business, or accept the business and sustain a loss equal to overhead costs. On the other hand, business channeled through a nonmember broker is important to the member broker; and, thus, the member seeks to make it attractive to the nonmember to channel business to him.

In order to attract such business, member brokers have instituted special devices—reciprocal business arrangements and special services—to evade the NYSE antirebate provision. The most common recip-

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<sup>14</sup> *Special Study*, pt. 2, at 295.

<sup>15</sup> *Special Study*, pt. 2, at 296.

rocal business arrangement is the return of commission business.<sup>16</sup> Although the Exchange specifically prohibits, by rule, a return of cash by a NYSE member to his reciprocal correspondent<sup>17</sup> (and ten other specific commission practices<sup>18</sup>), its rules are silent with respect to reciprocal arrangements with nonmember professionals.<sup>19</sup> A member also may reward a nonmember by furnishing him with special services: installation and maintenance of wire services,<sup>20</sup> clearance of non-Exchange transactions,<sup>21</sup> office space,<sup>22</sup> and special research and promotional materials and displays.<sup>23</sup>

The NYSE policy of charging the same commission rate, based on the value of the round lot, for each transaction, regardless of size, has also resulted in the institution of certain reciprocity relationships. Just as in the case of nonmember professionals, certain specialized services are extended to large volume buyers in exchange for their commission business.<sup>24</sup> Another practice designed to accomplish the same result is the give-up or directed split.<sup>25</sup> The NYSE commission rules allow a split of commission between members of the Exchange. Thus, a large volume buyer will direct the member with whom it transacts commission business to give-up a portion of the commission to another member who provides certain services for the buyer. In effect, this reduces the commission rate paid by the buyer because a part of it is used to pay for services other than the execution of the security transactions.

<sup>16</sup> In one variant of this practice, a member places business on a regional exchange with a nonmember who is a member of the regional exchange even though the member is also a member of that exchange or the security is traded on both exchanges. In another form, the member executes transactions in unlisted securities with the nonmember even though the member has its own over-the-counter trading department. *Special Study*, pt. 2, at 303. See *ibid.* for a discussion of the extent of such practices.

<sup>17</sup> NYSE Rule 369(1), in 2 CCH NYSE Guide ¶ 2369.

<sup>18</sup> NYSE Rule 369(2)-(7), in 2 CCH NYSE Guide ¶ 2369.

<sup>19</sup> The Exchange has taken the position that reciprocity arrangements representing "generated" or "allocated" business violate the antirebate rule, but that reciprocal business based on a member's "hope" that he can secure return business is legitimate. *Special Study*, pt. 2, at 305. The *Special Study* reports that:

The member normally directs business to his reciprocal correspondent with something more than 'hope' that his correspondent will reciprocate. Members' reports of such agreements filed with the Midwest Exchange under its commission rules indicate the firmness of the understanding on which they are founded. This general recognition of the existence of reciprocal ratios elevates the basis of these arrangements from the level of 'hope' to that of reasonable expectation based on informal agreement, often crystallized by years of business relationship and always subject to sanction of cancellation if the correspondent fails to maintain the agreed ratio.

*Ibid.* See *Special Study*, pt. 2, at 303.

<sup>20</sup> NYSE Rule 359, in 2 CCH NYSE Guide ¶ 2359.10.

<sup>21</sup> 2 CCH NYSE Guide ¶ 2381.18.

<sup>22</sup> NYSE Rule 344, in 2 CCH NYSE Guide ¶ 2343.11.

<sup>23</sup> 2 CCH NYSE Guide ¶ 2440A.

<sup>24</sup> *Special Study*, pt. 2, at 311-16.

<sup>25</sup> *Id.* at 316-18.

The practice of give-ups or directed splits is employed extensively with respect to mutual funds, especially with respect to the sale of the mutual fund shares by member organizations. The reciprocal give-up procedures tend to create a conflict of interest between the interest of mutual fund shareholders desiring lower commission charges and the interest of mutual fund advisers and underwriters attempting to stimulate the sale of additional shares by directing a split in commission charges.

Since the commission rate schedule prohibits direct price competition among members of the Exchange, the most significant area of competition is in the field of ancillary services.<sup>26</sup> The failure of the Exchange to specify the types of services included within the commission charge has a salutary effect to the extent that the resulting competition tends to improve the scope, depth, and quality of services which are useful to the public.<sup>27</sup> Nevertheless, the lack of specificity has also led to the granting of special services to large buyers and professional nonmembers which are substantially more costly than the usual services extended to the public customers. In this sense the public customer subsidizes the large buyer in his dealings with the member. Inclusion of services in the commission rate also may have the effect of forcing many customers to pay for services that they receive but do not want.<sup>28</sup>

The final significant point concerning the NYSE minimum commission schedule is that the other exchanges tend to follow it almost completely. The nonmember commission rates on the American Stock Exchange and the six largest regional stock exchanges are identical to those of the NYSE, with the single important exception that three of these exchanges grant discounts to certain classes of nonmembers.<sup>29</sup> It is not surprising that the rates on the regional exchanges closely follow the pattern of the NYSE, for the bulk of the trading volume upon these exchanges consists of stocks traded both on the NYSE and the regional exchanges and is transacted largely by persons who are members of both the NYSE and the regional exchanges.<sup>30</sup>

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<sup>26</sup> *Id.* at 321.

<sup>27</sup> *Ibid.*

<sup>28</sup> *Ibid.*

<sup>29</sup> *Id.* at 299-300.

<sup>30</sup> "In total, 93% of the dollar volume of trading on the major regional exchanges is represented by stocks which have their primary markets on the NYSE or Amex." *Id.* at 930. With respect to the role of dual members on the regional exchanges, it is significant that such members account for 58% of all exchange income and 71% of gross commission income of the Midwest exchange. The corresponding percentages for the PCSE are 55% and 70%; for the Boston Stock Exchange, 74% and 74%; the PBWSE, 52% and 63%. *Id.* at 928-30. See also Table VIII-67, *id.* at 1078.

### B. Restrictions Placed Upon Competitive Markets

In order for a minimum commission rate schedule to be effective, there must be some means of concentrating the trading in securities which are listed on the NYSE on the Exchange or at least to assure that the rate schedule is followed in transactions which take place off the board.

The American Stock Exchange and the regional exchanges have found it advantageous to adhere to the NYSE commission schedule.<sup>31</sup> Thus, multiple exchange trading of listed securities does not introduce competition into commission rate setting with respect to the general public. It does, however, allow a segment of professionals, who are members of regional exchanges but not of the NYSE, access to markets that they would not otherwise have access to. In this manner the existence of the regional exchanges subjects the NYSE commission schedule to competitive pressures. Furthermore, the regional exchanges provide a mechanism through which the various reciprocal relationships designed to avoid the antirebate rule can be effected.<sup>32</sup> In this role they place further pressure upon the rate schedule.

An even more competitive force is the over-the-counter market in listed securities. Not only does it provide access to trading markets in listed securities to nonmember professionals, but also it provides direct competition in commission rates with respect to the general public. Because of the recent growth of this market and its importance as a competitive mechanism, it is useful to enter into a somewhat detailed discussion of the market's economic characteristics.

In recent years a great deal of attention has been directed toward developments in this rapidly expanding over-the-counter trading market in listed securities.<sup>33</sup> "For NYSE stocks alone, this market has grown from an estimated dollar volume of \$84 million in 1941 to an estimated \$2 billion twenty years later, a relatively greater expansion than that of the NYSE."<sup>34</sup> This represents about 3.8 per cent of the value of sales on the Exchange, as opposed to approximately 1 per cent in 1941. Dollar volume of such trading increased 185 per cent from 1955 to 1961, three times as much as the 60 per cent increase in volume for the same period on the Exchange.<sup>35</sup>

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<sup>31</sup> *Id.* at 299-300. It appears that something similar to the price leadership that has been exercised in certain manufacturing industries is also characteristic of the relationship between the NYSE and the other exchanges. No doubt the fact that the bulk of trading on the regional exchanges takes place in NYSE listed stocks and the high percentage of regional exchange business handled by dual members contributes to the similarity of commission policies.

<sup>32</sup> *Id.* at 305-06, 927.

<sup>33</sup> In this issue see Comment, *The Third Market*, 20 Sw. L.J. 640 (1966).

<sup>34</sup> *Special Study*, pt. 2, at 870.

<sup>35</sup> *Id.* at 873-74.

In 1961, 712 firms made markets in 270 common stocks. These stocks varied widely with respect to the type of issuer, activity on the Exchange, financial size of the issuer, and the breadth of stock distribution. Nevertheless, the market makers in this "Third Market" appeared to be attracted primarily to the widely held, financially large issuer.

The size of transactions in the Third Market tends to be either very large<sup>36</sup> or very small. The prevalence of large transactions reflects the Third Market's role in the handling of block transactions by institutions. The importance of institutional investors in the Third Market is highlighted by the result of a one-day study by the Securities and Exchange Commission. During the test day, public customers accounted for 62 per cent of the dollar volume in the Third Market but only 36 per cent of the dollar volume traded on the Exchange.<sup>37</sup> Moreover, institutional investors canvassed by the SEC questionnaire traded over-the-counter for 10.2 per cent of their dollar volume in one month and 9.5 per cent in another in NYSE securities.<sup>38</sup>

The Third Market also has a greater share of its volume in the smallest sized transactions than does the NYSE,<sup>39</sup> which leads one to believe that individuals do substantial trading on the Third Market. Individuals contributed 38 per cent of dollar value and 68 per cent of share volume on the test day.<sup>40</sup> Since institutions can deal directly with the market makers in the Third Market and do not require the services of an intermediary, some indication of the extent of use of the Third Market by individuals can be gleaned from an analysis of the customer records of the market makers. The records of the seven largest market makers showed that broker-dealers accounted for 76 per cent of the transactions and 60.8 per cent of the share volume,<sup>41</sup> of which a large part presumably was transactions for individuals.

The motivation for use of the Third Market seems relatively clear. It is provided by the capacity of the market to satisfy needs of various customers not met by the Exchange. In the case of institutions, it is primarily the objective of realizing the best possible net cost or pro-

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<sup>36</sup> In a three-week sample from 1961 covering the seven largest market makers in the Third Market, transactions of 500 shares or more represented 14% of transactions and 57% of share volume. In contrast, transactions of 500 shares or more represented only 4.5% of transactions and 21.8% of share volume on the NYSE. *Id.* at 878.

<sup>37</sup> *Id.* at 880.

<sup>38</sup> *Ibid.*

<sup>39</sup> Transactions of less than 100 shares represented 74% of transactions and 19% of share volume in the Third Market. The corresponding percentages for the NYSE were 48% and 9.1%. *Id.* at 879.

<sup>40</sup> *Id.* at 881-82.

<sup>41</sup> *Id.* at 882.



ceeds in each transaction which prompts the choice of effecting the transaction upon either the Third Market or the Exchange.<sup>42</sup> Under the terms of the NYSE commission schedule, institutions dealing in large blocks of stocks pay the same rate of commission as other public customers. No adjustment is made for volume of transaction. The minimum commissions paid on a transaction on the Exchange equal approximately 2 per cent on a \$40 stock. Thus, in the same stock, the area of competitive pricing equals something over  $\frac{3}{4}$  of a point on the Third Market. This is the area within which the buyer can negotiate with the market maker.<sup>43</sup> The second factor that influences the large volume purchasers' choice of market is the depth of the market.<sup>44</sup> In transacting business on the Exchange, the large volume purchaser may find that his own purchases substantially enhance the price of the security before his series of transactions is completed. Thus, the potential buyer must compare the net cost of the total volume of the shares purchased plus commission rates with the net price he can secure by direct negotiation with the off-board market makers.

The use of the Third Market by the small public investor can be explained almost exclusively in terms of price competition with the Exchange. The use of the market by this type of investor stems from the placement of orders for listed securities with nonmember broker-dealers. Such a dealer is faced with three choices: refuse to execute the order, execute the order on the Exchange through a member paying the full commission rate (either with or without reciprocal trading agreements or special service agreements),<sup>45</sup> or execute the order on the Third Market. Thus, a nonmember broker-dealer may effect such a transaction at a net cost to the customer that is equal to or less than the net price that would be exacted in an Exchange transaction and still realize a commission charge on the transaction.

The Third Market presents a definite threat to the commission structure devised by the NYSE. In order to protect that structure, the Exchange has adopted a rule prohibiting its members from trading in listed securities on the over-the-counter market.<sup>46</sup> Recently, at the insistence of the SEC, the Exchange has agreed to allow such trading in certain limited situations. In addition, there has been some specula-

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<sup>42</sup> *Id.* at 881.

<sup>43</sup> *Id.* at 897-98.

<sup>44</sup> The concept of depth refers to "the quantity of buying and selling interest and the potential activity on each side of the market." *Id.* at 17. See generally *id.* at 17-18. As used here the term refers to the quantity of buying or selling interest in a stock at particular price levels.

<sup>45</sup> See text accompanying notes 16-23 *supra*.

<sup>46</sup> NYSE Rule 394, in 2 CCH NYSE Guide ¶ 2394.

tion that the Exchange may adopt a rule prohibiting members from transacting business with and/or granting special services to non-members who trade in the Third Market.<sup>47</sup>

### C. *Restrictions On Membership*

The third protective device used by the Exchange is the imposition of various restrictions upon membership. Through its membership requirements, the Exchange controls entry into that segment of the securities industry which handles the overwhelming percentage of transactions in securities listed on the Exchange.

Article IX, section 3 of the NYSE constitution<sup>48</sup> requires that an applicant for membership receive a two-third vote of a quorum of the Board of Governors. To be eligible, an applicant must be twenty-one years of age and a citizen of the United States.<sup>49</sup> Partnerships formed between members and nonmembers, and corporations in which both members and nonmembers are shareholders must be approved by the Exchange.<sup>50</sup>

Special rules apply to the admission of a corporate applicant. First, every director of the corporation must be a holder of voting stock, and at least one director must be a member of the Exchange.<sup>51</sup> Second, every holder of voting stock must be a member or an allied member of the Exchange and an officer or employee of such corporation "who actively engages in its business and devotes the major portion of his time thereto . . ."<sup>52</sup> Third, every holder of any other class of stock must be approved by the Board of Governors.<sup>53</sup> Fourth, a primary purpose of the corporation must be the transaction of business as a broker or dealer in securities.<sup>54</sup> Fifth, such corporation must comply with such additional requirements as the Board of Governors may

<sup>47</sup> See Wall Street Journal, March 12, 1965, p. 6, col. 3; *Special Study*, pt. 2, at 955-56.

<sup>48</sup> NYSE Const. art. IX, § 3, in 2 CCH NYSE Guide ¶ 1403.

<sup>49</sup> NYSE Const. art. IX, § 2, in 2 CCH NYSE Guide ¶ 1402.

<sup>50</sup> NYSE Const. art. IX, § 7(a) (1), in 2 CCH NYSE Guide ¶ 1407.

<sup>51</sup> NYSE Rules 311-21, in 2 CCH NYSE Guide ¶¶ 2311-21.

<sup>52</sup> NYSE Const. art. IX, § 7(b) (2), in 2 CCH NYSE Guide ¶ 1407.

<sup>53</sup> NYSE Const. art. IX, § 7(b) (3), in 2 CCH NYSE Guide ¶ 1407.

A special Exchange committee to study the question of letting private investors acquire an interest in member concerns has recommended that members for the first time be allowed to raise capital by issuing debentures and other debt securities to the public. The committee rejected the proposal that the public be allowed to buy common stock, nonvoting stock and preferred stock. In addition, it recommended that the publicly held securities be limited to those which have a fixed rate of return, rather than permit participation in a firm's profit through income debentures. Wall Street Journal, April 14, 1965, p. 9, col. 2. Wall Street Journal, June 8, 1966, p. 5, col. 1.

The recommendations of the committee represent the first, small movement of the Exchange to relax entry requirements through distribution of members securities to the public, but the restrictiveness of the recommendation and the delay in instituting even this minor change gives little credibility to the thesis that the Exchange, of its own volition, will relax its stranglehold on access to Exchange markets.

<sup>54</sup> NYSE Const. art. IX, § 7(b) (4), in 2 CCH NYSE Guide ¶ 1407.

from time to time prescribe.<sup>55</sup> Shareholders in the member corporations are restricted from transferring, selling, assigning or pledging their stock without prior written approval of the Exchange.<sup>56</sup> If the voting stock in such corporation is at any time acquired, held or owned by a person other than a member or allied member in good standing, or if any non-voting stock should at any time be held by a person not approved by the Exchange, the corporation may be deprived by the Exchange of all the privileges of a member corporation.

The Exchange also places restrictions on the type of business in which a member or allied member can engage. Rule 318 provides that every member organization shall engage primarily in the transaction of business as broker or dealer.<sup>57</sup> However, member organizations can engage in other activities with approval of the Exchange. Each individual member must be actively engaged in the securities business or devote a major portion of his time thereto, and every member or allied member in a member organization is required to be actively engaged in the business of his organization and to devote the major portion of his time thereto.

Several activities are specifically prohibited by the rule, in the absence of Exchange approval. Thus, no member shall become:

- (1) a partner in any non-member business organization;
- (2) an officer or employee of any non-member business corporation, firm or association;
- (3) an employee of any firm or individual engaged in business; or
- (4) associated with any outside securities, financial or kindred business.<sup>58</sup>

In sum, the Exchange maintains complete control of entry to membership. The acceptance of an individual members appears to be discretionary with the Board of Directors. In addition, entities formed by members—partnerships or corporations—are so regulated that complete control must be vested in Exchange members. In pursuit of this result, the Exchange must approve all partners; and it requires that nonmember partners agree to abide by the constitution and rules of the Exchange. Furthermore, the Exchange eliminates the danger that control of a corporate member might become lodged in persons unacceptable to the Exchange by prohibiting the sale of voting stock in a member corporation to anyone except a member.

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<sup>55</sup> NYSE Const. art. IX, § 7(b)(5), in 2 CCH NYSE Guide ¶ 1407. For the rules enacted pursuant to this section see NYSE Rules 311-21, in 2 CCH NYSE Guide ¶¶ 2311-21.

<sup>56</sup> NYSE Rule 315, in 2 CCH NYSE Guide ¶ 2315.

<sup>57</sup> NYSE Rule 318, in 2 CCH NYSE Guide ¶ 2318.

<sup>58</sup> *Ibid.*

## II. APPLICATION OF ANTITRUST LAWS TO REGULATED INDUSTRIES

A. *Basic Principles*

Through the practices discussed above, the NYSE has created an economic structure that well might be questioned upon antitrust grounds. It is quite clear that if this structure occurred within the context of an unregulated industry, at least some of the practices would run afoul of the antitrust laws.<sup>59</sup> The regulated character of the industry, however, severely complicates the question.

The first question that must be asked is whether the antitrust laws express a policy that can legitimately be applied to the operation of securities exchanges. The answer to this question lies in the nature of the complex set of objectives that this country seeks through its mixed private-governmental economic mechanism. The basic problem is to determine to what extent the imposition of a regulating mechanism upon a segment of the economy exempts the activities of the members of that sector from the antitrust laws. Generally, the express policy of promotion of free and open competition, as illustrated by the antitrust laws, is the basic premise underlying the whole economy, including the regulated sectors.<sup>60</sup> This basic policy, however, has been supplemented in two ways. In those areas in which the competitive system breaks down and fails to achieve desired economic goals, avenues other than unrestrained competition have been selected.<sup>61</sup> In other areas desired non-economic objectives that conflict with the mechanism of unrestrained competition have been given priority, with the result that antitrust policies have played a subordinate role.<sup>62</sup> The various regulatory statutes seek to promote policies thought appropriate to particular sectors of the economy. The objectives of the regulatory statute may or may not be consistent with the objectives of the antitrust laws, depending upon the type of problem sought to be solved by, and the method of solution deemed appropriate under, the particular regulatory statute.

In certain areas of regulatory control, Congress has recognized a conflict and has provided for it by specific exemptions from the antitrust laws in the regulatory statute.<sup>63</sup> Presumably, the decision to

<sup>59</sup> See text accompanying notes 160-61 and 187-91 *infra*.

<sup>60</sup> ATT'Y GEN. NAT'L COMM. ANTITRUST REP. I (1955).

<sup>61</sup> The so-called public utilities are the classic example of such areas of the economy. The telephone and electric industries can be classified in this category. Each is heavily regulated on the state and/or municipal level and also on the federal level. See Communications Act of 1934, 48 Stat. 1070, as amended, 47 U.S.C. §§ 201-22 (1958) (telephone); Federal Power Act, 49 Stat. 847 (1935), as amended, 16 U.S.C. §§ 824-24h (electric utility companies).

<sup>62</sup> Federal Aviation Act, 72 Stat. 737, 49 U.S.C. §§ 1301-1542.

<sup>63</sup> *E.g.*, Reed-Bulwinkle Act, 62 Stat. 472 (1948), 49 U.S.C. § 5b(9) (1958) (railroads); 59 Stat. 34 (1945), as amended, 15 U.S.C. § 1012(b) (1958) (insurance).

include a specific exemption rests upon two factors: the inherent conflict in purpose between the regulatory statute and the antitrust laws, and a conscious choice of one overriding set of objectives through a balancing of policies. In other areas of regulatory activity, Congress has not seen fit to insert specific exemptions into the regulatory statute.<sup>64</sup> In at least some of these areas, however, the operation of the statute will conflict with certain policies of the antitrust laws. In such a situation, the courts are called upon to accommodate the statutes, determining whether Congress intended an implied exemption from the antitrust laws, whether the antitrust laws are to apply with their full force and vigor, or whether some intermediate solution between these two is appropriate. The guiding principle should be that the basic policy expressed by the antitrust laws should continue to be an important consideration in policy formulation in the regulated industries insofar as it does not conflict with other goals of higher priority.

The infusion of antitrust considerations into the regulated industries can take place in either of two ways: a statutory command and authority to the agency to consider antitrust policies in the formation of its policies,<sup>65</sup> or final authority in the courts to apply the antitrust laws to the industry. With respect to the securities industry, it may be asked whether, given the regulatory statutes as they presently read and the history of SEC activities in areas which have antitrust implications, the SEC or the courts are the proper instrument to determine the extent and manner of application of the antitrust laws to the securities industry. It may also be asked whether statutory directives could be added to the securities acts that would obviate any need for the courts to interfere. An attempt will be made to partially answer these questions in the last section of the Article. In addition, an evaluation will be made of the extent to which the practices outlined in section 2 conflict with antitrust policy and the extent to which they are necessary for the achievement of the goals of the securities acts.

### B. *Analysis Of Recent Supreme Court Cases*

An analysis of certain recent Supreme Court cases is helpful for understanding the development of standards exempting certain regulated industries from the antitrust laws. In each case the Supreme

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<sup>64</sup> *E.g.*, Natural Gas Act, 52 Stat. 821-33 (1938), as amended, 15 U.S.C. §§ 717-17w (1948), as amended, 15 U.S.C. § 717 (Supp. IV 1957).

<sup>65</sup> *E.g.*, Federal Aviation Act, 72 Stat. 737 (1958), 49 U.S.C. §§ 1301-1542 (1958) (air carriers). The provision directing the board to consider antitrust policies is found in 72 Stat. 740 (1958), 49 U.S.C. § 1302(d) (1958).

Court faced the task of accommodating a regulatory statute with the antitrust laws.

The first case to be considered, *United States v. Borden Co.*,<sup>66</sup> concerned the attack through the Sherman Act upon an agreement between dairymen and others to fix milk prices. The Court held that the Agricultural Marketing Act,<sup>67</sup> which gave the Secretary of Agriculture the power to approve certain marketing agreements, did not exempt from the operation of the antitrust laws agreements that had not been validly approved by the Secretary. The act set up a well-defined procedure by which a marketing agreement was to be approved by the Secretary and thus afforded specific antitrust exemption. In absence of such approval, an agreement was not so protected.<sup>68</sup> In addition, the Court held that the Clopper-Volstead Act,<sup>69</sup> which authorized the formation of certain agricultural cooperatives<sup>70</sup> and exempted them from the antitrust laws with respect to the lawful carrying out of the legitimate objects thereof, did not exempt the agreement here complained of because it included persons other than members of the cooperatives.<sup>71</sup> The Court reached this result even though the Secretary of Agriculture was given the power to issue cease and desist orders if after a hearing he determined that a cooperative monopolized or restrained trade to such an extent that the price of any agricultural product was unduly enhanced.<sup>72</sup> The Court reasoned that the limited provision was not a substitute for the provisions of the Sherman Act.<sup>73</sup>

In *Georgia v. Pennsylvania R. R.*,<sup>74</sup> the state of Georgia, in an original action in the Supreme Court, alleged that defendant railroads had conspired to fix rates so as to discriminate against Georgia.<sup>75</sup> The Court held that the Sherman Act could not be used to collect damages because of alleged violations with respect to rates because this was within the primary jurisdiction of the Interstate Commerce Commission and because such rates had been found to be reasonable and nondiscriminatory by the Commission. That remedy would defeat

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<sup>66</sup> 308 U.S. 188 (1939).

<sup>67</sup> 50 Stat. 246 (1937), as amended, 7 U.S.C. §§ 601-59 (1958).

<sup>68</sup> 308 U.S. at 200-01. See 50 Stat. 246 (1937), as amended, 7 U.S.C. § 608b (1958).

<sup>69</sup> 42 Stat. 388 (1922), 7 U.S.C. §§ 291, 292 (1958).

<sup>70</sup> 308 U.S. at 204.

<sup>71</sup> *Id.* at 205.

<sup>72</sup> 42 Stat. 388 (1922), 7 U.S.C. § 292 (1958).

<sup>73</sup> 308 U.S. at 206. The provision failed to provide certain remedies that were available under the Sherman Act (criminal penalties). Moreover, the Sherman Act covered attempts to monopolize as well as actual monopolization.

<sup>74</sup> 324 U.S. 439 (1945).

<sup>75</sup> *Id.* at 445.

the purpose of the Interstate Commerce Act.<sup>76</sup> Nevertheless, the Court reaffirmed the principle stated in *Keogh v. Chicago & N.W.R.R.*<sup>77</sup> that approval by the Commission did not bar the United States from enforcing the provisions of the Sherman Act with respect to such approved rates.<sup>78</sup> Although the Clayton Act specifically limited the power to institute such suits, it nevertheless allowed injunctive relief "when and under the same condition and principles as injunctive relief against threatened conduct—is granted by courts of equity."<sup>79</sup> The Court, therefore, allowed the action by Georgia attacking the rate-fixing *combination* as such because the Commission had no supervisory authority over such a combination.<sup>80</sup>

The Court felt it irrelevant that the Commission had the statutory power to remove discriminatory rates of the character alleged to exist<sup>81</sup> since the suit was designed to eliminate the *conspiracy* to fix rates, not simply to abrogate one particular set of discriminatory rates. Even though the Commission was empowered to set minimum and maximum rates, there still existed a middle zone within which the Sherman Act demanded that prices be competitively set.

In *United States v. R.C.A.*,<sup>82</sup> the government attacked an exchange of television stations as being part of a conspiracy in violation of section 1 of the Sherman Act, even though the exchange had been approved by the Federal Communications Commission.<sup>83</sup> It was asserted that the FCC had authority to pass on the antitrust aspects of the exchange and that the regulatory scheme of the Communications Act exempted the exchange from operation of the antitrust laws.<sup>84</sup> The Court rejected both these contentions. Considered controlling was the fact that section 313 of the Communications Act<sup>85</sup> specifically declared that the antitrust laws were to remain applicable to the industry and that the Commission was given no power to decide antitrust questions.<sup>86</sup> The Court then turned to the problem of whether the overall regulatory scheme of the act required invocation of the primary jurisdiction doctrine.<sup>87</sup> The Court concluded that in

<sup>76</sup> *Id.* at 453. Interstate Commerce Act, 24 Stat. 379 (1887), as amended, 49 U.S.C. §§ 1-10 (1958).

<sup>77</sup> 260 U.S. 156 (1922).

<sup>78</sup> 324 U.S. at 453.

<sup>79</sup> Clayton Act, 38 Stat. 737 (1914), 15 U.S.C. § 26 (1958); 324 U.S. at 460.

<sup>80</sup> 324 U.S. at 455.

<sup>81</sup> *Id.* at 459.

<sup>82</sup> 358 U.S. 334 (1959).

<sup>83</sup> Federal Communications Act, 48 Stat. 1086 (1934), as amended, 47 U.S.C. §§ 310b (1958).

<sup>84</sup> 358 U.S. at 338.

<sup>85</sup> 48 Stat. 1087 (1934), as amended, 47 U.S.C. § 313 (Supp. V, 1963).

<sup>86</sup> 358 U.S. at 339-46.

<sup>87</sup> *Id.* at 346.

the absence of a pervasive regulatory scheme and in the absence of rate structures, no justification for application of the primary jurisdiction doctrine existed.<sup>88</sup>

In *Milk Producers Ass'n. v. United States*,<sup>89</sup> the United States attacked an agricultural cooperative (1) for attempting to monopolize trade in fluid milk in Maryland, Virginia, and the District of Columbia; (2) for combining and conspiring with a dairy to eliminate competition in the same area; and (3) for violating section 7 of the Clayton Act<sup>90</sup> in the acquisition of a competitor. The defendant argued that section 6 of the Clayton Act,<sup>91</sup> and sections 1 and 2 of the Clopper-Volstead Act,<sup>92</sup> completely immunized cooperatives from the antitrust laws. The lower court held that cooperatives were exempt provided that they did not enter into conspiracies or combinations with persons who are not producers of agricultural commodities.<sup>93</sup> On this basis it held the cooperative exempt from the Sherman Act section 2 charge but not exempt from the Sherman Act section 1 or the Clayton Act section 7 charges. The Supreme Court disposed of the association's contention on the basis of sections 1 and 2 of the Clopper-Volstead Act in the same manner it had in *United States v. Borden Co.*<sup>94</sup> In regard to the Sherman Act section 2 charge, the Court held that even activities engaged in solely by cooperative members could violate the antitrust laws if outside the lawful objectives of the cooperative as defined in the statute authorizing its creation.<sup>95</sup>

In *California v. FPC*,<sup>96</sup> in which the Government attacked a merger between two pipeline companies after the merger had been approved by the Federal Power Commission,<sup>97</sup> the Court found that there was no pervasive regulatory scheme in the industry which entrusted administration of antitrust policy to the Commission.<sup>98</sup> Considered controlling was the fact that the Natural Gas Act did not specifically confer immunity from antitrust laws upon mergers approved by the FPC as the Interstate Commerce Act did in the case of mergers of carriers approved by the ICC.<sup>99</sup> Also controlling was

<sup>88</sup> *Id.* at 350.

<sup>89</sup> 362 U.S. 458 (1960).

<sup>90</sup> 38 Stat. 731, as amended, 15 U.S.C. § 18 (1958).

<sup>91</sup> 38 Stat. 731 (1914), 15 U.S.C. § 17 (1958).

<sup>92</sup> 42 Stat. 388 (1922), 7 U.S.C. §§ 291, 292 (1958).

<sup>93</sup> *United States v. Virginia Milk Prod. Assn., Inc.*, 167 F. Supp. 45 (1958).

<sup>94</sup> 308 U.S. 188 (1939).

<sup>95</sup> 362 U.S. at 468.

<sup>96</sup> 369 U.S. 482 (1962).

<sup>97</sup> *Pacific Northwest Pipeline Corp.*, 22 F.P.C. 1091 and 23 F.P.C. 350.

<sup>98</sup> 369 U.S. at 485.

<sup>99</sup> Interstate Commerce Act, 24 Stat. 380 (1897), as amended, 49 U.S.C. § 5(11) (1958).



the fact that the proviso of the Clayton Act stating that it did not apply to transactions duly consummated pursuant to authority given the Commission under any statutory provision<sup>100</sup> was inapplicable because the Commission itself was never given the power to adjudicate antitrust issues.<sup>101</sup> The Court held that the FPC must stay its proceedings until a court determination of the antitrust issue was effected.

In *Pan Am. World Airways, Inc. v. United States*,<sup>102</sup> the Government alleged that Pan American and W. R. Grace & Co. had entered into an illegal agreement to divide markets. The Court noted that the scheme of the Federal Aviation Act,<sup>103</sup> extensive as it was, did not grant complete immunity from the antitrust laws.<sup>104</sup> The Court stated, however, that limitations of routes and divisions of territories and the relation of surface carriers to air carriers were basic in that regulatory scheme.

The acts charged in this civil suit as antitrust violations are precise ingredients of the Board's authority in granting, qualifying, or denying certificates to aid carriers, in modifying, suspending, or revoking them, and in allowing or disallowing affiliations between common carriers and air carriers.<sup>105</sup>

Moreover, the regulatory statute, in a provision similar to section 5 of the Federal Trade Commission Act,<sup>106</sup> specifically gave the Board the authority to review unfair trade practices. Therefore, the case was held to be distinguishable from the *Georgia* case because the Civil Aeronautics Board had primary jurisdiction in this area.

In *United States v. Philadelphia Nat'l. Bank*,<sup>107</sup> the Government attacked the merger of two banks under section 7 of the Clayton Act even though the merger had been approved by the Comptroller of the Currency under the provisions of the Bank Merger Act of 1960.<sup>108</sup> Under that statute, the Comptroller was directed to consider competitive factors before approving mergers<sup>109</sup> and was denied the power to approve until he had received reports from the other two banking agencies and the Attorney General on the probable effects of the pro-

<sup>100</sup> Clayton Act, 38 Stat. 731 (1914), as amended, 15 U.S.C. § 7 (1958).

<sup>101</sup> 369 U.S. at 486.

<sup>102</sup> 371 U.S. 296 (1963).

<sup>103</sup> 72 Stat. 737 (1958), 49 U.S.C. §§ 1301-1542 (1958).

<sup>104</sup> 371 U.S. at 304-05.

<sup>105</sup> *Id.* at 305.

<sup>106</sup> 38 Stat. 719 (1914), as amended, 15 U.S.C. § 45 (1958).

<sup>107</sup> 374 U.S. 321 (1963).

<sup>108</sup> 74 Stat. 129, as amended, 12 U.S.C. § 1828(c) (Supp. IV, 1962). As a result of the *Philadelphia Bank* case, Congress passed the Bank Merger Act Amendment of 1966, altering the procedure for antitrust attack upon bank mergers.

<sup>109</sup> *Ibid.*

posed transaction upon competition. Although the three reports advised that the merger would have substantial anticompetitive effects in the Philadelphia area, the Comptroller approved the merger, making a specific finding upon the competition issue.<sup>110</sup> In the antitrust case that ensued, the Supreme Court rejected the contention that the Bank Merger Act immunized the merger from the antitrust laws. The Court based its opinion on several factors: the Comptroller was not required to give the effect upon competition any particular weight in passing on the merger and was not even required to hold a hearing; there was no specific provision for judicial review of his decision; the legislative history of the act and an examination of bank regulation indicated that the regulation was not so comprehensive that enforcement of the antitrust laws would either be unnecessary or disruptive to that structure.<sup>111</sup> This last factor was held to be true even though the rate regulation was limited and largely indirect, that banks could do business where they pleased, and that they were not under a duty not to discriminate in their services.<sup>112</sup> Thus, a large area was left for the operation of competitive forces. This was deemed to be an area in which competition needed the protection of the antitrust laws.

In *Carnation Co. v. Pacific Westbound Conference*,<sup>113</sup> it was alleged that Pacific Westbound, which was comprised of associations of shipping companies, had initiated and maintained a rate increase in order to implement certain rate-making agreements between the conferences which had never been approved by the Maritime Commission.

The Shipping Act contains an explicit provision exempting from the antitrust laws activities which are lawful under section 15 of the act.<sup>114</sup> The provision covers agreements approved by the Maritime Commission and implements to approved agreements. The Court held, however, that rate-making agreements and implements thereto which had not been approved by the Commission were subject to the antitrust laws. In reaching this decision, the Court rejected the contention that the remaining provisions of the act constituted or implied an exemption from the antitrust laws.<sup>115</sup>

The Court held that in the area in which the Commission had jurisdiction, the courts should not take action which might interfere

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<sup>110</sup> 374 U.S. at 332-33.

<sup>111</sup> 374 U.S. at 351-52.

<sup>112</sup> *Ibid.*

<sup>113</sup> 86 S. Ct. 781 (1966).

<sup>114</sup> Shipping Act of 1916, 39 Stat. 733, as amended, 46 U.S.C. §§ 801-842; Section 15, 46 U.S.C. § 814.

<sup>115</sup> 86 S. Ct. at 785-86.

with the Commission's exercise of its lawful powers.<sup>116</sup> Thus, until the Commission had ruled on the lawfulness of the agreement, the Court should not enter an injunction which would prohibit implementation of the agreement even after a possible Commission approval.

However, since the Commission had no power to *retrospectively* approve rate agreements, the award of damages by a court for past and completed conduct which clearly violated the Shipping Act was held not to interfere with the authority of the Commission.

A study of these cases indicates that the Court has chosen to apply the so-called repugnancy test. The Court first determines whether the statutory regulatory scheme is so pervasive that it leaves no scope of operation for the antitrust law. In practice, it is doubtful that such an area can be found,<sup>117</sup> for the Court has held that even in the very heavily regulated air carrier industry the antitrust laws may be applicable to certain activities.<sup>118</sup> The Court then determines whether the specific factor questioned by the antitrust suit is exempt from the antitrust laws. It is so only if its inclusion within the scope of antitrust attack will frustrate the policy goals of the regulatory statute—*i.e.*, the activity is exempt from the antitrust laws only to the minimum extent necessary for the proper functioning of the regulatory act.<sup>119</sup>

Whether application of the antitrust laws will frustrate the purposes of the regulatory statute is tested in two ways: would it render procedural provisions in the act meaningless,<sup>120</sup> and would it render ineffective substantive results achieved under the statute.<sup>121</sup> Two questions need to be asked. First, once the necessities of regulatory policy

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<sup>116</sup> 86 S. Ct. at 786-87.

<sup>117</sup> Two writers have concluded that even in the extremely heavily regulated electric utility area some scanty scope for application of the antitrust laws still exists. Hale & Hale, *Competition or Control V: Production and Distribution of Electric Energy*, 110 U. PENN. L. REV. 57, 75; cf. Tampa Electric Co. v. Nashville Coal Co., 365 U.S. 320, 334-35 (1961).

<sup>118</sup> United States v. R.C.A., 358 U.S. 334 (1959). See Hale & Hale, *Competition or Control II: Radio and Television Broadcasting*, 107 U. PA. L. REV. 585 (1959).

<sup>119</sup> Silver v. New York Stock Exch., 373 U.S. 341 (1963).

<sup>120</sup> United States v. Philadelphia Nat'l Bank, 374 U.S. 321 (1963); California v. FPC, 369 U.S. 482 (1962); United States v. Borden Co., U.S. 188 (1939). In Pan Am. World Airways, Inc. v. United States, 371 U.S. 296 (1963), one factor which influenced the Court's decision that the antitrust laws did not apply to the practice under discussion was that the regulatory statute specifically gave the Commission the authority to review such practices and to judge them on standards virtually equivalent to those of the antitrust laws.

<sup>121</sup> Milk Producers Assn. v. United States, 362 U.S. 458 (1960); United States v. R.C.A., 358 U.S. 334 (1959); Georgia v. Pennsylvania R.R., 324 U.S. 439 (1945). For a case in which the Court found that application of the antitrust laws would have rendered ineffective the substantive policies of the regulatory statute, see Pan Am. World Airways, Inc. v. United States, 371 U.S. 296 (1963).

are satisfied, what range is left for competitive influences?<sup>122</sup> If the area of private discretion and for the free play of competitive forces left by the regulatory act is broad, the tendency is to hold the antitrust laws generally applicable to industry economic practices, especially those practices centered in the free area. Secondly, it is asked, under the statutory standards, into what area and for what purposes can the regulatory body insert itself? If the regulatory body is given no power to govern practices of the type sought to be attacked under the antitrust laws, then those laws will be applied to police the area. Even if some authority to regulate the practices has been given to the agency and exercised by it, the antitrust laws are still applicable unless the standards applied by the agency are either virtually the same as those applied under the antitrust laws or are different from those standards only because of a basic overriding policy of the regulatory statute. Moreover, the problem of unexercised agency power dictates that even in situations in which the agency has power to affirmatively act, the jurisdiction of the antitrust court is preserved<sup>123</sup> as long as the agency does not see fit to do so.

### III. APPLICATION OF THE ANTITRUST LAWS TO THE SECURITIES INDUSTRY—GENERAL

#### A. *The Special Problem Of The Self-Regulation Concept*

The problem encountered in applying the antitrust laws to the securities industry is further complicated by the philosophy of the Securities Exchange Act<sup>124</sup>—a policy of governmental supervision of a basically self-regulated industry.<sup>125</sup> The very concept of government sponsored self-regulation implies the existence of organizations and practices that will conflict with the premises of the antitrust laws.<sup>126</sup> It also means that no pervasive regulatory system was

<sup>122</sup> See *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321 (1963), in which this factor was indicated as being important.

<sup>123</sup> Cf. *Silver v. New York Stock Exch.*, 373 U.S. 341, 364 n.16 (1963).

<sup>124</sup> 1934 Act.

<sup>125</sup> "The Commission's relationship to the business it regulates is fundamentally different from that of other Federal independent administrative agencies; it is not only regulator, but also supervisor of 'self'-regulators. . . . [S]ecurities regulation is unique in featuring self-regulation as an essential and officially sanctioned part of the regulatory pattern." *Special Study*, pt. 4, at 501. See Cory, *Self Regulation in the Securities Industry*, 49 A.B.A.J. 244 (1963), for a discussion of the concept of self-regulation.

<sup>126</sup> See *Special Study*, pt. 4, at 502. The *Study* carefully points out that a three-fold need for government supervision of self-regulation exists. The first is to assure that the self-regulatory agencies "actually assume responsibility for and effectively discharge those functions assigned to them. . . ." *Ibid.* Secondly, since "self-regulation by a member organization involves some degree of impairment of competition, public supervision is necessary to insure that such impairment, where necessary, is compensated for by effective regulation and that the kinds and extent of impairment are only such and no greater than required

intended to be or was imposed upon this section of the economy. Quite to the contrary, the Securities Exchange Act leaves a large area to private discretion. Although the act sanctions the exchange type of organization, it makes no attempt to legalize every type of activity which could be fostered through joint action. Indeed, certain powers are given the SEC to interfere directly and indirectly into matters of exchange policy when it becomes necessary to carry out the statutory duties imposed by the Exchange Act. It is submitted, however, that the powers lodged in the SEC are designed to effectuate only the policies of the regulatory statute and not the policies expressed in the antitrust laws. Among other things, the noninclusion of rights and remedies under the Exchange Act<sup>127</sup> suggests that the continued applicability of the rights and remedies of the antitrust and other laws was intended. Thus, the applicability of the antitrust laws to various practices entered into under the self-regulatory system must be judged by the standard of repugnancy discussed above.

The conflict between the philosophy of self-regulation of the exchange markets and the antitrust laws can arise in two ways: first, an exchange rule or activity by its very nature violates the antitrust laws because of its anticompetitive consequences; second, an otherwise unobjectionable rule or activity can have anticompetitive effects because of the manner in which it is implemented.<sup>128</sup> In either of these cases the applicability of the antitrust laws can be determined only after a meticulous appraisal of the SEC's role in sanctioning the rule or activity and of the statutory standards allegedly authorizing such sanction. The relationship here between the regulatory body and the industry differs from the ordinary relationship in a regulated industry. In general, the power is one of limited oversight rather than direct involvement. An analysis of antitrust implications of exchange practices entails a close examination of the nature and the extent of the regulatory body's supervisory powers.

### B. *The Statutory Context*

The appraisal necessarily must begin with an examination of the statutory provisions defining the relationship between the governmental supervisory power and the self-regulatory body. The Securities Exchange Act requires all securities exchanges, with an exception because of small size, to register with the Commission.<sup>129</sup> Each ex-

by the exigencies of regulation." *Ibid.* Third, in some respects the self-regulatory activities operate as quasi-public utility institutions. Insofar as they so operate, public supervision is required for much the same reasons that the traditional public utilities are regulated.

<sup>127</sup> 1934 Act § 28 (a).

<sup>128</sup> See, e.g., *Silver v. New York Stock Exch.*, 373 U.S. 341 (1963).

<sup>129</sup> 1934 Act § 5.

change must file copies of its rules,<sup>130</sup> satisfy the Commission that the rules "are just and adequate to insure fair dealing and to protect investors,"<sup>131</sup> and provide sanctions against conduct inconsistent with just and equitable principles of trade, including violation of the act or rules thereunder.<sup>132</sup> Furthermore, it must "agree to comply with the act and rules thereunder and, within the limits of its ability, to enforce compliance by its members."<sup>133</sup> Once an exchange is registered, it can, without Commission approval, adopt any rule not inconsistent with the act or a Commission rule.<sup>134</sup> However, it must agree to furnish the Commission with copies of any rule amendments "forthwith upon their adoption."<sup>135</sup>

The Commission is authorized to alter or to supplement exchange rules in twelve specified areas of exchange operations and in similar matters.<sup>136</sup> It also may withdraw the registration of an exchange because of a violation of the act or rules thereunder or failure to enforce member compliance with respect thereto.<sup>137</sup> The statute does not require that the exchange file new rules or amendments before they become effective; nor does it expressly authorize the Commission to prevent a new rule or amendment from becoming effective. Moreover, the Commission is not empowered to take action against a member for violation of exchange rules as such. No provisions appear in the statute with respect to an exchange's procedure in disciplinary matters or for Commission review, on its own motion or application of an aggrieved person, of an exchange's enforcement actions.<sup>138</sup>

There are certain areas in which the exchange may directly regulate under its rulemaking authority. These include the categories of floor trading,<sup>139</sup> off-floor trading by members,<sup>140</sup> operations of specialists and odd-lot dealers,<sup>141</sup> short sales,<sup>142</sup> stop-loss orders,<sup>143</sup> and manipulative or deceptive devices.<sup>144</sup>

<sup>130</sup> 1934 Act § 6(a)(2), (3).

<sup>131</sup> 1934 Act § 6(d).

<sup>132</sup> 1934 Act § 6(b).

<sup>133</sup> 1934 Act § 6(a)(1).

<sup>134</sup> 1934 Act § 6(c).

<sup>135</sup> 1934 Act § 6a(4).

<sup>136</sup> 1934 Act § 19(b).

<sup>137</sup> 1934 Act § 19(a)(1).

<sup>138</sup> See *Silver v. New York Stock Exch.*, 373 U.S. 341, 357 (1963) and 2 LOSS, SECURITIES REGULATION 1178, (2d ed. 1961). In contrast, the 1938 Maloney Act amendments to the Exchange Act give the SEC the power to examine disciplinary action by a registered securities association. 1934 Act § 15 3(g) and (h).

<sup>139</sup> 1934 Act § 11(a).

<sup>140</sup> *Ibid.*

<sup>141</sup> 1934 Act § 11(b).

<sup>142</sup> 1934 Act § 10(a).

<sup>143</sup> *Ibid.*

<sup>144</sup> 1934 Act § 10(b).

### C. *No Blanket Exemption*

In light of this regulatory background, it is clear that the securities industry is afforded no blanket exemption from the antitrust laws. In *Silver v. New York Stock Exch.*,<sup>145</sup> Justice Goldberg stated that:

The Securities Exchange Act contains no express exemption from the antitrust laws or, for that matter, from any other statute. This means that any repealer of the antitrust laws must be discerned as a matter of implication, and '[i]t is a cardinal principle of construction that repeals by implication are not favored.' . . . *Repeal is to be regarded as implied only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary.* This is the guiding principle to reconciliation of the two statutory schemes.<sup>146</sup>

The *Silver* case, besides holding against a blanket exemption, also ruled out enforcement of antitrust provisions without consideration of policies sought to be achieved by the securities acts. In *Silver*, the Court, after stating that "under the aegis of the rule of reason, traditional antitrust concepts are flexible enough to permit the Exchange sufficient breathing space within which to carry out the mandate of the Securities Exchange Act,"<sup>147</sup> indicated that conduct that would be a per se violation of the antitrust laws in the absence of statutory regulation, must be judged under a rule of reason standard when a regulatory statute is present.

## IV. APPLICATION OF THE ANTITRUST LAWS TO SPECIFIC EXCHANGE PRACTICES

### A. *General Principles*

The illegality of any specific practice of a securities exchange hinges upon a three-fold inquiry. First, does the Securities Exchange Act give an implied exemption from the antitrust laws with respect to the area in which that particular practice occurs. Second, even if no such exemption is available, does protection of the objectives of the Securities Exchange Act require that the practice be judged by a "reasonableness" rather than a per se standard? If so, is the practice a reasonable restraint of trade which does not violate the antitrust laws?

With respect to the question of whether the Securities Exchange Act contains an implied exemption from the antitrust laws for an agreement to fix minimum commission rates, and the attendant prac-

<sup>145</sup> 373 U.S. 341 (1963).

<sup>146</sup> *Id.* at 357 (Emphasis added.)

<sup>147</sup> *Id.* at 360.

tices outlined above, the reasoning of the *Silver*<sup>148</sup> case is helpful. In that case the Court held that no implied exemption existed with respect to the application of a rule authorizing the Exchange to order its members to refuse private wire connections to nonmembers.<sup>149</sup> The rule itself had the quasi-approval of the Commission because of its actions under sections 6(a) and (d) of the Securities Exchange Act.<sup>150</sup> Furthermore, the Court assumed that section 19(b) of the act gave the Commission power to disapprove the rule presented in the case.<sup>151</sup> On the other hand, it emphasized the fact that the Commission was given no jurisdiction to review particular instances of enforcement of exchange rules.<sup>152</sup> The Court left open the question of whether the power given the Commission under section 19(b) creates an implied exemption as to those matters the Commission is authorized to review.<sup>153</sup>

In *Kaplan v. Lehman Bros.*, a recent district court decision,<sup>154</sup> the question of whether the Securities Exchange Act contained an implied exemption for an agreement to fix minimum commission rates was squarely presented. The plaintiff alleged that the fixing of minimum commission rates through the collective action of a stock exchange was illegal per se under the Sherman Act. The court reasoned that the adoption by the Exchange of a rule setting commission rates was not per se illegal because the Exchange Act gave the Exchange the authority to institute such a rule and authorized the SEC to review any such rule making any alteration or amendment it deemed advisable.<sup>155</sup> The only attack that could be made on such a rule was that the rates were not uniformly applied or that the rates schedules were discriminatory.

In *Kaplan*, then, *Silver* was read to allow court review only of specific application of exchange rules and only then if the Commission has no review power itself. Under this approach, the very existence of an exchange rule with anticompetitive implications could not be attacked, at least if it involved an area within which the Commission had the power to supplement or alter exchange rules. Thus, section 19(b) would provide an implied exemption from attack upon the rule qua rule under the antitrust laws. A statement in the *Silver*

<sup>148</sup> *Silver v. New York Stock Exch.*, 373 U.S. 341 (1963).

<sup>149</sup> The decision that the particular application violated the Sherman Act turned not on the substantive standards applied by the Exchange but rather upon its failure to provide the nonmember an appropriate opportunity to explain or refute the charges against him.

<sup>150</sup> 1934 Act §§ 6(a), (d). See text accompanying notes 129-44 *supra*.

<sup>151</sup> *Silver v. New York Stock Exch.*, 373 U.S. 341, 357 (1963).

<sup>152</sup> *Ibid.*

<sup>153</sup> *Id.* at 358 n.12, 360.

<sup>154</sup> 250 F. Supp. 562 (N.D. Ill. 1966).

<sup>155</sup> *Id.* at 564-65.



decision, however, seems to indicate that such an exemption would not follow as a matter of course. In a footnote,<sup>156</sup> the Court pointed out that even if it were assumed that the Commission possessed the power, under section 19(b), to require that the Exchange adopt a general rule providing a hearing and attendant procedures to nonmembers, any such rule itself must be consistent with the antitrust laws. Furthermore, in the absence of Commission adoption of such a rule, it is not incompatible with the Commission's power for an antitrust court to announce the rule. Thus it still appears to be true that neither the mere availability of remedy by Commission action nor, at least in certain areas, actual favorable Commission action, will immunize an Exchange rule from attack under antitrust principles. Under this rationale, the provisions of sections 6(a), 6(d), and 19(b) of the Securities Exchange Act do not automatically immunize the Exchange practice from attack.

The next question that arises concerns the standards by which the practice should be judged under the antitrust laws. The Court in *Silver* stated that because of the posture in which the case arose, "there was no need for us to define further whether the interposing of a substantive justification in an antitrust suit . . . is to be governed by a standard of arbitrariness, good faith, reasonableness, or some other measure."<sup>157</sup> The Court did point out, however, that the interrelations between the securities acts and the antitrust laws made it necessary to apply some standard other than that of per se violation. The Court indicated that "under the aegis of the rule of reason, traditional antitrust concepts are flexible enough to permit the Exchange sufficient breathing space within which to carry out the mandate of the Securities Exchange Act."<sup>158</sup>

The plaintiffs in the *Kaplan*<sup>159</sup> case took the position that maintenance of a fixed commission schedule was illegal merely because it was the product of joint action of the Exchange members. The Court correctly held that under the *Silver* decision the legality of such action could not be judged on a per se standard. The Court seemed to indicate, however, that the inquiry ends there. The *Silver* rationale, though, would seem to demand that the practice of maintaining fixed commission schedules be tested by a reasonableness standard.

Finally, then, it must be asked whether the NYSE minimum commission scale and the attendant practices constitute unreasonable restraints of trade. Each of the three practices will be treated in turn.

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<sup>156</sup> 373 U.S. at 364 n.16.

<sup>157</sup> *Id.* at 365-66.

<sup>158</sup> *Id.* at 360; see note 47 *supra*.

<sup>159</sup> *Kaplan v. Lehman Bros.*, 250 F. Supp. 562 (N.D. Ill. 1966).

### B. NYSE Commission Schedule

The very existence of a minimum commission schedule and anti-rebate provisions raises a question of illegality under the antitrust laws. Agreements by competing concerns fixing the price at which they will sell their products or services<sup>160</sup> are illegal per se under the Sherman Act. Thus, such agreements are illegal regardless of the reasons advanced to justify them.<sup>161</sup> In the absence of any government regulation of this aspect of the securities industry, it is clear that the practice of the NYSE membership in fixing minimum commission rates would be an agreement in restraint of trade constituting a per se violation of the Sherman Act.

Whether it constitutes an unreasonable restraint of trade within the context of the securities industry must be determined by balancing the injury sustained by the public because of the absence of competitive rate setting against advantageous promotion of Securities Exchange Act objectives by the fixed rates.

The situation with respect to SEC power over pricing activities is somewhat anomalous among regulatory bodies. Whereas the SEC is given power to review general exchange policies with respect to rate setting, it is not given the power to review particular instances of application of general standards expressed in the rule. This is in direct contrast to a number of other agencies which have the power to review individual rates and to prohibit discriminatory practices but which do not have the power to enjoin conspiracies or combinations designed to implement anticompetitive practices.

In the *Georgia* case,<sup>162</sup> the Court found that in the absence of agency jurisdiction to enjoin such combinations, there existed a sufficient reason for allowing the application of the antitrust laws to provide such remedy. However, it noted that the antitrust laws could not be used to review any particular rate or alleged discriminatory practice which had been approved by the Commission. By way of analogy, it could be argued that the antitrust laws are applicable to particular actions taken pursuant to general Exchange rules, but that they cannot be used to challenge Exchange rules themselves. The *Kaplan*<sup>163</sup> case adopted this approach. The fallacy in the *Kaplan* argument is pointed out in the *PNB*<sup>164</sup> and *California*<sup>165</sup> cases. There

<sup>160</sup> See *United States v. Nat'l Assn. of Real Estate Bds.*, 339 U.S. 485 (1950).

<sup>161</sup> *United States v. Socony-Vacuum Oil Co., Inc.*, 310 U.S. 150 (1940); *Morton Salt Co. v. United States*, 235 F.2d 573 (10th Cir. 1956).

<sup>162</sup> *Georgia v. Pennsylvania R.R.*, 324 U.S. 439 (1945).

<sup>163</sup> *Kaplan v. Lehman Bros.*, 250 F. Supp. 562 (N.D. Ill. 1966).

<sup>164</sup> *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321 (1963).

<sup>165</sup> *California v. FPC*, 369 U.S. 482 (1962).

it was made clear that the presence of review power or approval power of one sort or another is not sufficient justification for exemption from the antitrust laws. As pointed out in *Pan Am.*,<sup>166</sup> in order to justify such exemption, enforcement of the antitrust laws in that particular area must actually interfere with the essential operation of the regulatory statute either by making it procedurally useless or substantively ineffective.

Application of the Sherman Act to the Commission schedule does neither of these. Application of the antitrust laws to determine the legality of Exchange rules does not make the provisions of section 19(b) with respect to commissions useless. The SEC is directed to apply a very different standard than that applied under the antitrust laws. The SEC is directed to alter or suspend an exchange's rules with respect to fixing reasonable rates if such change is necessary for the protection of investors, to insure fair dealing, or to insure fair administration of the exchange. The statutory criteria must be interpreted in light of the basic purpose of the Securities Exchange Act,<sup>167</sup> not by an appeal to antitrust precedent.

Neither does application of the Sherman Act to commission schedules render the Securities Exchange Act substantively ineffective. The *Kaplan* rationale that the Securities Exchange Act contemplated Commission review of rate setting activities<sup>168</sup> implies that Congress intended that the Exchange fix rates. This theory immediately meets several difficulties.

First, early drafts of the bill which became the Securities Exchange Act would have empowered the Commission to fix rates of commission directly.<sup>169</sup> Under the act as passed, the Commission's authority is confined to alteration or supplementation of Exchange rules in respect to the fixing of *reasonable* rates of commission. Early drafts of the bill also referred to *uniform* rates of commission,<sup>170</sup> but without explanation the language was altered to rely solely on the standard of reasonable rates. This term must be interpreted in light of the criteria of "protection of investors or to insure fair dealing in securities traded upon such Exchange or to insure fair administration of such Exchange."<sup>171</sup> Thus, it appears that although Congress recognized the existence of such pricing practices prior to enactment of the

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<sup>166</sup> *Pan Am. World Airways, Inc. v. United States*, 371 U.S. 296 (1963).

<sup>167</sup> See 1934 Act §§ 2, 6, 19.

<sup>168</sup> See 1934 Act § 19(b).

<sup>169</sup> Section 2683, 73d Cong., 2d Sess. § 18(c) 1934; see *Special Study*, pt. 2, at 301.

<sup>170</sup> *Hearings on Stock Exchange Practices Before Senate Committee on Banking and Currency*, 73d Cong., 2d Sess. 7705 (1934).

<sup>171</sup> 1934 Act § 19(b).

Securities Exchange Act, it did not necessarily authorize such schedules for antitrust purposes.

Second, although there are no provisions applicable to an exchange such as those contained in section 15, which affirmatively prohibits fixing minimum profits or imposing schedules of prices or minimum rates of commissions, allowances, discounts or other changes<sup>172</sup> with respect to over-the-counter securities markets neither are there any provisions authorizing or protecting from the antitrust laws specified commission practices as is done under section 15.<sup>173</sup> This absolute neglect of Congress either to declare affirmatively a policy of competition with respect to commission rates or to exempt anticompetitive commission practices indicates that Congress never intended to express any policy with respect to the applicability of the antitrust laws.

Turning to the actual language of the act, section 19 (b) authorizes the SEC to require changes in Exchange rules if

such changes are necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange . . . in respect of . . . (9) the fixing of reasonable rates of commission . . . and (13) similar matters.<sup>174</sup>

Thus, the statute directs the Commission to assure that Exchange commission policy does not adversely affect the investor and that it insure fair dealing both with respect to transactions between members and nonmembers (including the public).

It is difficult to see how either of these aims is promoted by the establishment of a minimum commission schedule. In ordinary competitive circumstances, the absence of price fixing devices tends to assure the establishment of prices beneficial to the consumer. In the various regulated industries in which rates are fixed, the decision not to rely on the competitive forces of the marketplace rests on one of two grounds: the industry is so constructed that either monopoly power is necessarily conferred upon its constituents<sup>175</sup> or unrestrained competition would result in the financial maladjustment of the industry.<sup>176</sup> In the former situation, the emphasis is upon the setting of maximum, not minimum rates. The very possibility of the existence of the latter type of situation can be seriously questioned.<sup>177</sup>

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<sup>172</sup> 1934 Act § 15A(b)(7).

<sup>173</sup> 1934 Act § 15A(n).

<sup>174</sup> 134 Act § 19(b).

<sup>175</sup> See note 60 *supra*.

<sup>176</sup> This has been stated as a basis for regulation of motor carriers, air carriers, marketing of certain agricultural products and many other activities.

<sup>177</sup> In most of the areas in which regulation is imposed ostensibly to avoid harmful effects of unrestrained competition, the real thrust of regulation is to protect existing entities in the industry from competition of new entrants.

The only possible economic rationale that can be advanced in favor of a minimum commission schedule for listed securities is the proposition that the quality of service provided to the investor by the members of the Exchange would necessarily be dissipated by the ruinous competition that would follow the abrogation of the schedule. The abandonment of the Commission schedule would undoubtedly have the effect of lowering Commission rates to the point at which the Exchange members could meet effectively the competition from the third market.<sup>178</sup> Moreover, the members would begin to compete for business among themselves with respect to price. No doubt there would be a tendency to price the essential brokerage service separately from the various ancillary services.<sup>179</sup> This would allow the customer to choose the ancillary services he had need of or desired.<sup>180</sup> It can be argued that this would interfere with the statutory criterion of protection of the investor in that the customer might unwittingly refuse ancillary services which might otherwise inure to his benefit. Furthermore, at least some member firms might drop ancillary services entirely in an effort to reduce large fixed costs involved in providing many of them.

These and other similarly undesirable results could be avoided in a rather simple manner—the SEC could specify the various services that members must make available in order to protect the investor and the minimum requirements of member firms necessary to promote that end.<sup>181</sup> The cost of meeting such requirements would be imposed upon each member, setting a minimum level to which Commission rates could be driven by competition. In this manner the investor would be provided the safeguards deemed necessary under the Securities Act and yet would also be provided the benefit of competition in rate setting to the extent it is compatible with provisions for such safeguards.

### C. Reciprocal Relationships And Special Services

The prevalence of the various reciprocal relationships<sup>182</sup> employed by members in conjunction with nonmember broker-dealers and large volume customers raises a question of whether they constitute arrangements which violate the Sherman Act's prohibition of various business relationships that tend to restrain trade. Agreements to re-

<sup>178</sup> See text accompanying notes 33-47 *supra*.

<sup>179</sup> See text accompanying notes 26-30 *supra*.

<sup>180</sup> *Ibid.*

<sup>181</sup> In all likelihood, this could be done under the § 19(b) powers to supplement exchange rules. In any event, an amendment to the Exchange Act giving the SEC direct rulemaking power with respect to these items would seem in order.

<sup>182</sup> See text accompanying notes 16-25 *supra*.

turn commission business give rise to possible conflicts of interest in that a member's commitment to return business may conflict with his duty to transact his business in the best available market.<sup>183</sup> Such a result is particularly likely to occur when over-the-counter business is directed to the correspondent instead of to the dealer offering the best price.<sup>184</sup> Under these conditions, it appears that such agreements might well be found to be unreasonable restraints of trade under the Sherman Act.<sup>185</sup>

#### D. *Prohibition On Members Trading In The Third Market*

Rule 394 of the NYSE prohibits over-the-counter dealing in listed securities by Exchange members, except in certain highly restrictive situations.<sup>186</sup> In addition, there has been speculation that the Exchange might institute a rule prohibiting members from dealing with or providing various services to nonmembers who trade in the Third Market or who use an existing discretionary rule to achieve the same result.<sup>187</sup>

In the absence of the securities laws, the prohibition of members trading in the Third Market would be in effect an exclusive dealing arrangement in violation of the Sherman Act.<sup>188</sup> The prohibition imposed by rule 394 also seems to be a type of concerted refusal to deal or a boycott which may violate the Sherman Act. The general rule is that a combination or conspiracy between sellers to refuse to sell to a person or between buyers to refuse to buy from a person is unlawful.<sup>189</sup> Concerted refusals to deal ordinarily are per se illegal

<sup>183</sup> *Special Study*, pt. 2, at 309-10.

<sup>184</sup> See text accompanying notes 16-23 *supra*.

<sup>185</sup> One writer has suggested that because of limited access to Exchange membership, the antirebate rule and the reciprocal dealing arrangements may be a form of group boycott. Nerenberg, *Applicability of the Antitrust Laws to the Securities Field*, 16 W. RES. L. REV. 131, 149 (1964). In *Thrill Sec. Corp. v. New York Stock Exch.*, Civil No. 63-c-264, E.D. Wis., Oct., 1962, a nonmember broker-dealer filed an action on behalf of himself and all other nonmember broker-dealers, alleging a conspiracy to restrain trade by the Exchange and its members in refusing to share or negotiate for sharing of commissions. The various reciprocal relationships and special service arrangements also could be attacked as a type of exclusive dealing. Nerenberg, *supra* at 150 n.89.

<sup>186</sup> NYSE Rule 394, in 2 NYSE Guide ¶ 2394. For the exceptions see 2 NYSE Guide ¶ 2394.10. In recent months, the SEC has been pressuring the Exchange to soften the requirements of Rule 394, see *Wall Street Journal*, March 17, 1966, p. 4, col. 1; *Wall Street Journal*, Feb. 18, 1966, p. 4, col. 3; *Wall Street Journal*, July 11, 1966, p. 22, col. 1; *Wall Street Journal*, July 22, 1966, p. 3, col. 2; *Wall Street Journal* Aug. 5, 1966, p. 2, col. 3. In September 1966, the Exchange agreed in principle to the adoption of rule 394(b) authorizing limited trading by the Third Market. See SEC Securities Exchange Act Release No. 7954, Sept. 16, 1966.

<sup>187</sup> See note 46 *supra*.

<sup>188</sup> See 1 TRADE REG. REP. ¶ 3010 for a discussion of the illegality under the Sherman Act of exclusive dealing arrangements.

<sup>189</sup> *Klor's, Inc. v. Broadway-Hale Stores, Inc.*, 359 U.S. 207 (1959).

under the act.<sup>190</sup> Nevertheless, in certain situations the courts have applied the reasonableness test to such a refusal.<sup>191</sup> The adoption of a rule prohibiting members from transacting business with, or providing services to, nonmembers who participate in the Third Market would raise an even clearer question of legality under the theory of concerted refusal to deal.

Rule 394 and the hypothetical rule suggested above raise the same question concerning the interrelationship of the Securities Exchange Act and the antitrust laws that the NYSE Commission schedule did: Do these practices violate the antitrust laws when judged by the reasonableness standard? The rationale of the *Silver* case<sup>192</sup> is even more closely in point with respect to these restrictive rules than it was to the rule establishing a commission schedule. A case which squarely presented the question of the legality of rule 394 would allow the Court to reach the question it failed to answer in *Silver*—under what circumstances and to protect what interests is the NYSE justified in engaging in practices that ordinarily would amount to exclusive dealing arrangements and concerted refusals to deal.

The Court in the *Silver* case pointed out that in order to carry out its statutory duty as set forth in the Securities Exchange Act, the Exchange must govern by rule certain aspects of its members' relationship with nonmembers, including nonmember broker-dealers.<sup>193</sup> Certain of these relationships are "inconsistent with just and equitable principles of trade, and rules regulating such dealings are indeed 'just and adequate to insure fair dealing and to protect investors.'"<sup>194</sup> The Court noted<sup>195</sup> that rules prohibiting dealings with boiler shop operations<sup>196</sup> or bucket shops<sup>197</sup> would fall into this category. The Court

<sup>190</sup> *Klor's, Inc. v. Broadway Stores, Inc.*, *supra* note 129; *Evening News Publishing Co. v. Allied Newspaper Carriers*, 263 F.2d 715 (3d Cir. 1959).

<sup>191</sup> It has been held that a group refusal to deal motivated by legitimate business reasons, exerting no coercion upon outsiders, and resulting in no unreasonable restraint of trade is not illegal per se. *United States v. Insurance Bd. of Cleveland*, 144 F. Supp. 684 (N.D. Ohio 1956). Similarly, the rule of reason has been held applicable to concerted refusals to deal that do not involve economic pressure, or coercion to induce or compel compliance. *United States v. Bakersfield Associated Plumbing Contractors, Inc.*, 1958 Trade Cases ¶ 69087 (S.D. Cal. 1958). Thus, in one case an association's rules and regulations, in so far as they constituted concerted refusals to deal, were not "commercial" boycotts deemed illegal per se. *United States v. United States Trotting Ass'n*, 1960 Trade Cases ¶ 69761 (S.D. Ohio 1960).

<sup>192</sup> *Silver v. New York Stock Exch.*, 373 U.S. 341 (1963).

<sup>193</sup> *Id.* at 349-57.

<sup>194</sup> *Id.* at 355.

<sup>195</sup> *Id.* at 354-55.

<sup>196</sup> A boiler-shop is defined as "a physically small operation which employs high pressure telephone salesmanship to oversell to the public by quantity, and in many cases by quality." *Id.* at 354 n.10.

<sup>197</sup> "A sham brokerage establishment in which patrons were led to believe that their orders were being properly executed when in fact they were only wagering on a price fluctuation. These gambling operations were outlawed by state statutes and virtually made

went on to say that the rule involved in that case—regulation of maintenance of private wire connections with nonmembers—operated in an area appropriate for exchange regulation.<sup>198</sup> Thus, the rule itself did not violate the antitrust laws because it properly sought to effectuate the policies expressed in the Exchange Act and was necessary incident to the proper functioning of the securities acts. The outcome of the case, however, turned on the particular application of the rule there involved.

Rule 394 and the hypothetical rule outlined above must be subjected to the same kind of analysis as was rule 355 in the *Silver* case. Aside from the possibility of particular application which would violate antitrust principles, there is an even more fundamental question concerning the legitimacy of the two rules themselves.

The Securities Exchange Commission's action in proposing rule 394(b) for Exchange adoption and rule 19b-1 of the Exchange Act for Commission adoption indicates that the Commission feels that this area of Exchange activity is subject to direct Commission regulation under sections 19(b), 17(a) and 23(a) of the Exchange Act. On its face, section 19(b) does not seem to contemplate Commission interference in the area of members' activities outside the Exchange market, and if included in section 19(b), must come within the catchall of similar matters. Even if it be assumed that section 19(b) authorizes Commission regulation in this area, the observations made with respect to section 19(b) and the minimum commission schedule are equally applicable here.

The answer concerning the legality of the rules, as in *Silver*, turns upon an analysis of the effects of the practices judged against the objectives sought to be promoted both by the Exchange Act and by the antitrust laws. Proponents of the restrictive rules argue that they are necessary for the orderly functioning of the exchange market and for the protection of investors.<sup>199</sup> The Exchange argues that for the auction market to function properly it needs "depth" that can be supplied only if rule 394 remains in effect.<sup>200</sup>

It is true that to the extent the Third Market involves trading that would otherwise take place on the Exchange, it affects the depth of

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extinct by the Securities Exchange Act. . . ." PRENTICE-HALL, ENCYCLOPEDIA OF BUSINESS LAW 101 (1961). The term has also been defined as: "A broker's office where the 'house' takes the side opposite that taken by the customer. Since most people 'go long' on stocks, the house, in taking the opposite side, agrees to deliver, at a later date. In a bull market this means loss, on the average to the bucket shop. In a declining market, bucket shops prosper." COLLAGHAN & Co., ENCYCLOPEDIA OF LAW 132.

<sup>198</sup> 89 U.S. 353, 355-56.

<sup>199</sup> See *Special Study*, pt. 2, at 955-56.

<sup>200</sup> *Ibid.* See also Wall Street Journal, March 12, 1965, p. 6, col. 3; Wall Street Journal, March 3, 1965, p. 9, col. 1.



the Exchange market. The crucial question, however, is whether the depth would be so adversely affected that it would be extremely harmful to the operation of the auction market. In 1961, out of the 270 NYSE common stocks for which off-board markets were made, the off-board sales of 119 (44 per cent) were only 3.5 per cent or less of sales on the Exchange. The off-board sales of the 50 stocks with the largest off-board sales averaged 6.4 per cent of Exchange sales. 43 of the 170 stocks amounted to more than 10 per cent of Exchange sales.<sup>201</sup> Thus, the indications are that, generally, the Third Market in the past has not constituted a great threat to the depth of the Exchange market. This conclusion is reinforced by the fact that most of the stocks traded on the Third Market enjoy substantial activity on the NYSE.<sup>202</sup> In addition, the substantial growth in Exchange volume over the period of development of the Third Market indicates that, even if some diversion has occurred, the depth of the Exchange markets is substantially greater today than it was at the beginning of the period.<sup>203</sup>

Additional factors that tend to minimize the Third Market's present effect on depth of Exchange markets are that (1) some portion of the Third Market volume consists of an addition to total trading rather than a diversion from the Exchange, and (2) Third Market market-makers do substantial trading on the Exchange. Moreover, whatever its effect on the depth of the primary market, "the third market provides the public customer with overall markets of greater depth."<sup>204</sup> Thus, it must be concluded that at least at the present level of Third Market activity, assertions that the depth of the primary market has been severely injured must be rejected.

Proposed rule 394(b) would allow an Exchange member holding a customer's round-lot order for a listed stock to solicit a qualified non-member market-maker to participate in the execution of the order if, among other things: (a) the feasibility of obtaining a satisfactory execution of the order on the floor of the Exchange has been made during that market session, (b) the floor governor of the Exchange has been provided with certain specified information and (c) members on the floor or the Exchange specialist do not displace the non-member market-maker's bid by offering to handle the trade or a part thereof at such price.

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<sup>201</sup> *Special Study*, pt. 2, at 902.

<sup>202</sup> 207 of the 270 stocks for which markets were made in 1961 (77%) traded over 600,000 shares on the Exchange that year. *Ibid.*

<sup>203</sup> *Ibid.*

<sup>204</sup> *Id.* at 903. For example, the Third Market provides an alternative to the institutional investor whose order may be too large to fill on the auction market without affecting price and too large to be handled on its entirety by the specialist.

With respect to proposed rule 394(b) it is significant to know the following:

1. Participation by non-members is limited to special categories of non-member broker dealers who meet certain Commission and exchange requirements. It does not include customers of any type.
2. Under the provisions of rule 394(b), the customer is still charged the full Exchange commission rate on the transaction.
3. The offer to a non-member to participate in the trade can be initiated only by the member.

It is evident that the proposed rule is designed to allow the Exchange member receiving a large order for a purchase or sale of stock to take advantage of the depth of the Third Market. It does not, however, allow the customer any freedom to negotiate the commission rate, a freedom which is allowed to the customer when dealing directly on the Third Market. Thus, the effect of rule 394 will not be significantly changed by adoption of proposed rule 394(b).<sup>205</sup>

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<sup>205</sup> Securities Exchange Act Release No. 7954 provides a background discussion and the texts of proposed Exchange Rule 394 and Exchange Act Rule 19b-1.

Rule 394(b)—*Solicitation of Non-Member Market-Makers to Participate in Transactions Off-the-Floor of the Exchange.*

(1) A member or member organization holding a customer's round-lot order for the purchase or sale of stock may, if he so desires, solicit a qualified non-member market-maker to participate in the execution of the order for the non-member's own account, off-the-floor of the Exchange, provided he has reported to a floor governor, other than the specialist in the stock, that all of the following conditions have been met:

- (A) A diligent effort to explore the feasibility of obtaining a satisfactory execution of the order on the floor has been made during that market session.
- (B) The member or member organization has provided the floor governor with the following information:
  - (i) the name of the stock and size of the order;
  - (ii) details of the effort made to explore the feasibility of obtaining a satisfactory execution of the order on the floor;
  - (iii) the number of shares, if any, he is taking or supplying for his own account, and
  - (iv) the extent, if any, of the interest the specialist has indicated in participating at an indicated price or prices.

(2) A qualified non-member market-maker in a stock is a broker-dealer registered with the Securities and Exchange Commission as a broker-dealer, who meets the capital and other applicable requirements and who has notified the Exchange that he is available to be solicited for his own account by members and member organizations pursuant to this rule for bids and offers in that stock.

(3) The member or member organization must file a report promptly after the completion of a transaction made pursuant to this rule listing all parties to the transaction; the amount of participation of each, the price; the time of receipt of the order, the time of the off-floor execution and the name of the governor to whom he reported.

(4) Notwithstanding the provisions of Rule 104, the specialist may buy on a plus or zero plus tick or sell on a minus or zero minus tick, any or all of the stock with respect to which a third market-maker is to be asked to participate.

(5) Under the provision of this rule, a member must ask other members in

On the other hand, allowing members complete freedom to trade in the Third Market likely would have dramatic effects in the Exchange market. It would allow circumvention of the NYSE's commission-rate schedule because a member could effect a transaction with a nonmember at something less than the commission specified in the schedule. Thus, a great deal of the trading now done on the Exchange for nonmember broker-dealers and institutions might be

the crowd immediately prior to the off-floor trade if they have orders to execute at the same price and on the same side of the market. If such be the case, the non-member market-maker's bid or offer may be displaced in whole or in part by:

- (i) any or all bids or offers at that price on the specialist's book and any or all bids or offers made by other brokers acting as agents for other than registered traders, registered odd-lot dealers or members or member organizations known by the broker to be acting for their own account; or
- (ii) the specialist in the stock, acting as a dealer, if the specialist before the third market-maker was solicited, advised the member or member organization of the extent of his interest at an indicated price or prices at which the transaction is to be made.

Exchange Act Rule 19b-1:

For the purposes of any rule of a national securities exchange which the Commission shall have requested an exchange to adopt pursuant to the provisions of Section 19(b) of the Act and which rule prescribes the conditions under which exchange members may deal with a "qualified non-member market-maker," any broker-dealer may become and remain qualified as to one or more specified securities registered for trading on a national securities exchange by:

- (1) Maintaining (A) a net worth of not less than \$1,500,000; or (B) a minimum net capital of \$250,000 (computed as provided in Rule 15c3-1) for each security as to which it is so qualified; and
- (2) Making a market in each such security including regularly making bona fide bids and offers for such securities for its own account; and
- (3) Filing with the Commission and the Exchange an "Initial Statement under Rule 19b-1" showing net worth or net capital required to qualify and the name of each security as to which it is qualified; and
- (4) Promptly notifying the Commission and the Exchange whenever a change occurs in net worth or net capital which would make him ineligible as a qualified non-member market-maker under (1) above; and
- (5) Filing a report with the Commission and the Exchange whenever he thereafter commences or ceases making a market for purposes of this Rule in any security registered for trading on a national securities exchange, containing the dates of such commencement or cessation forthwith after such action takes place. [For purposes of this paragraph, a non-member market-maker may report on Form X-17A-9(1) and such report will be deemed to also be a filing in compliance with Rule 17a-9(b) unless the broker-dealer specifies that such commencement or cessation is for purposes of Rule 19b-1 only.]

The new rule may result in a certain amount of additional competitive pressure from the Third Market on the Exchange commission rate schedule. Suppose a qualified non-member market-maker maintains a market in stock X. Further suppose that the Exchange price at a given moment is \$40 per share. On the Exchange, a customer would pay approximately \$41 per share including commissions on a purchase and would receive approximately \$39 per share net of commission on a sale. Thus, a qualified non-member could, upon solicitation from a member, participate in a sale at a price of, say, \$39.75 a share (\$.25 less than the Exchange price) and still be able to purchase an equal number of shares of stock X from a customer at something between \$39 and \$39.75 per share. The first customer's net cost of the purchase would be \$40.75 per share, including commission, \$.25 less than if the member had purchased on the exchange to satisfy the customer's order.

channeled into the Third Market. Although the commission received by the member in each such transaction would likely be less than the full commission rate, the incentive of increased volume would stimulate the member to engage in such transactions. Each member would be forced to deal in this manner because of fear of loss of volume to other members who were willing to so deal. In the extreme case, one might expect this competitive action to draw all sales from members to nonmembers into the Third Market and thus effectively destroy the commission schedule. If this were the result, the Exchange's only alternative would be to reduce commission rates to the point at which it would become economically feasible to trade only, or equally so, on the Exchange market.

In evaluating the propriety of this restrictive practice, it must be kept in mind that the prohibition of member trading on the Third Market is designed to protect the commission rate schedule. Arguments based on the promotion of Exchange trading in order to protect investors and provide a continuous auction market are totally irrelevant if the Exchange could function adequately with a competitive commission rate schedule. Thus, in the final analysis, the argument concerning depth is valid only if the Exchange market could not function properly in the context of competitively derived commission rates. Thus, antitrust rational in this area rests upon the same considerations that were analyzed in the treatment of the alleged price-fixing activities of the Exchange.<sup>206</sup>

Even assuming that the prohibition concerning member trading in the Third Market is continued without attack, the Exchange may find it necessary to proscribe sanctions against nonmembers who trade in the Third Market in order to protect Exchange business. Such sanctions could take various forms but the two most effective would appear to be a prohibition against dealing with or a prohibition against extending services (such as wire connections) to such nonmembers.

Even assuming that a fixed commission schedule at some level is necessary to accomplish the purposes of the securities acts and that the prohibition of member trading upon the Third Market is a legitimate tool to effect the maintenance of such rates, the further measures discussed above present a slightly different situation. In what ways might the continued growth in the Third Market affect the operation of the exchange system?

Competition between the Exchange market and the Third Market varies with the size of transaction and the nature of the customer. "There is little price competition in the smaller sized transactions

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<sup>206</sup> See text accompanying notes 160-81 *supra*.

effected by broker-dealer intermediaries."<sup>207</sup> Thus, it is unlikely that the small transactions with public customers on the Third Market will place great stress on the present level of NYSE commission rates. The nature of the competition with respect to institutional buyers and nonmember broker-dealers is quite different. The impetus for competition here is primarily relative prices. The market makers of the Third Market can compete with Exchange members by shaving commission rates below the level set by the NYSE commission rate and also by not providing services which are included within the Exchange commission rate but which are of little value to the institutional investor or to the nonmember professional.<sup>208</sup> The effect of such competition is ameliorated to some extent by the various reciprocal relations and special service agreements entered into by the Exchange members,<sup>209</sup> but nevertheless it appears to be substantial.<sup>210</sup> Moreover, the very character of the Third Market as a negotiated market implies competition of a different sort. The inherent qualities of speedier transactions and more secrecy appeal to certain categories of buyers.<sup>211</sup>

In light of these elements of competition, it appears that in absence of the Exchange's adoption of the proposed rule prohibiting members from transacting business with, and/or granting special services to, nonmembers who trade in the Third Market, the Third Market will force adjustment of the NYSE commission rate in two areas. Some sort of quantity discount mechanism will be devised to service the needs of institutional investors. At the same time, some tightening of the antirebate rule will be made to prohibit the various give-up and directed-split practices and the special service agreements.<sup>212</sup> Special services still could be provided to those buyers who requested them, with the buyer charged accordingly. Secondly, some sort of special commission rate, competitive with the result achieved on the Third Market, will be provided for nonmember professionals. Here too, a tightening up of policies with respect to reciprocal commission agreements and special service arrangements is likely to take place.<sup>213</sup>

These competitive results seem to be salutary on balance. It appears unlikely that such a modification of NYSE commission practices would so seriously affect the profit ratios of member firms that the service to the various classes of buyers would deteriorate. The tentative conclusion can be drawn that the enactment of the hypothet-

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<sup>207</sup> *Special Study*, pt. 2, at 904.

<sup>208</sup> *Id.* at 904-05.

<sup>209</sup> See text accompanying notes 16-25 *supra*.

<sup>210</sup> See *Wall Street Journal*, March 12, 1965, p. 6, col. 3.

<sup>211</sup> *Special Study*, pt. 2, at 905-06.

<sup>212</sup> See text accompanying notes 24-25 *supra*.

<sup>213</sup> See text accompanying notes 16-23 *supra*.

ical restrictive Exchange rule is not necessary for the protection of investors or for the maintenance of fair dealing in the securities industry. Thus, the hypothetical rule appears to violate the anti-trust laws prohibition against concerted refusals to deal.

#### E. Restrictive Membership Requirements

The question of the restrictive membership requirements poses a slightly different problem with respect to the antitrust laws. It does not appear that application of the antitrust laws to this phase of Exchange operation would render the Securities Exchange Act procedurally useless. Although section 6(d) of the act apparently impliedly gives the Commission the power to deny registration to an applicant exchange whose rules are not just and adequate to insure fair dealing and to protect investors,<sup>214</sup> it is questionable whether the Commission could deny registration to an exchange merely because admittance to membership was entirely a discretionary matter with the exchange or the matter was left to further rulemaking. Moreover, section 19(b) of the act gives no power to the SEC to amend or supplement exchange rules with respect to membership requirements except to assure that the exchange supplies "safeguards in respect of the financial responsibility of members and adequate provision against the evasion of financial responsibility through the use of corporate forms or special partnerships."<sup>215</sup>

In certain cases, application of the antitrust laws to membership requirements might render ineffective the substantive provisions and policies of the Securities Exchange Act. The exclusion of competitors from membership in trade associations has been held illegal under the Sherman Act; associations have been ordered to admit to membership qualified applicants upon nondiscriminatory terms and conditions.<sup>216</sup> On the other hand, the basic policy of the Securities Exchange Act requires that exchanges set some minimum admission standards.<sup>217</sup> Thus, the membership provisions can be attacked through the antitrust laws only if they are used to help achieve some illegal result such as a price fixing scheme or a concerted refusal to deal. Thus, if admission standards were designed and employed to reinforce agreements among members to fix commission rates or to deny membership to those with whom the members had refused to deal, they might be illegal as devices essential to the furtherance of a price-fixing plan or a concerted refusal to deal to the extent they are not necessary

<sup>214</sup> Cf. *Silver v. New York Stock Exch.*, 373 U.S. 341, 357 (1963).

<sup>215</sup> 1934 Act § 19(b)(1). See *Wall Street Journal*, Feb. 19, 1965, p. 5, col. 2.

<sup>216</sup> *Associated Press v. United States*, 326 U.S. 1 (1945).

<sup>217</sup> See 1934 Act §§ 6(b) and 19(b)(1). See also *Special Study*, pt. 1, at 150-52.

to accomplish the policies of the securities acts. Requirements barring persons who have violated the securities acts and other statutes, setting levels of competency and experience, and requiring fiscal responsibility are entirely consistent with, and, in fact, may even be required by, the standards of protection of the investor and promotion of fair dealing in the industry which are set forth in the Exchange Act. On the other hand, certain of the membership requirements of the Exchange seem designed to limit entry for the purpose of protecting present members from competition in the sale of securities.<sup>218</sup>

The *Silver* case suggests another possible application of the antitrust laws to the admission requirements. *Silver* made it clear that the antitrust laws require that certain procedural safeguards be offered to a person adversely affected by an Exchange determination.<sup>219</sup> Thus, the courts could cite *Silver* for the proposition that denial of membership without an opportunity to present one's qualifications illegally restrains trade in violation of the Sherman Act.

## V. REMEDIES SHORT OF APPLYING THE ANTITRUST LAWS

### A. Under The Present Statute

Although the antitrust laws do have application to Exchange activities when such activities are inconsistent with the antitrust laws and are not required by the policies of the Securities Exchange Act, the SEC can do much to obviate the necessity for antitrust enforcement, even without amendment of the Exchange Act. Most important, the SEC could encourage development of dual markets to provide a

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<sup>218</sup> The recent admission to membership on the Pacific Coast Exchange of Kansas City Securities Corporation, a subsidiary of a mutual fund company, illustrates the problem. The company was admitted only after a bitter fight within the exchange membership. Subsequently, the exchange passed a rule designed to bar admittance to other mutual fund management companies. The rule provides that no new members of the exchange, or parent companies of members, can be publicly owned and requires that the chief business of any member and of its affiliates be that of a broker-dealer in securities. Wall Street Journal, Feb. 19, 1965, p. 5, col. 2. The NYSE long has had such provisions in its constitution and rules. NYSE Const. art. IX, § 7, in 2 CCH NYSE Guide ¶ 1407; NYSE Rule 318, in 2 CCH NYSE Guide ¶ 2318.

In addition to banning future admission of mutual funds, the PCE has placed special restrictions on Kansas City Securities Corporation. These restrictions include requirements that (1) the mutual fund parent limit sales of securities by its salesmen and representatives exclusively to mutual fund shares; (2) all salesmen be registered with the NASD; (3) the company exercise "appropriate surveillance," subject to "review" by the exchange, over its salesmen; and (4) control of ownership of the company be subject to approval of the board of governors of the exchange.

The new PCE rule, the NYSE rule, and the PCE special requirements for Kansas City Securities Corporation are at least partially designed to forbid entry to exchange membership to companies who buy and sell securities for institutional investors, and which as exchange members would bypass regular broker-dealer concerns. See Wall Street Journal, March 26, 1965, p. 3, col. 1; Wall Street Journal, April 26, 1965, p. 6, col. 1.

<sup>219</sup> *Silver v. New York Stock Exch.*, 373 U.S. 341, 361-63 (1963).

competitive check on monopolistic practices in commission rate setting. Proposed Exchange Rule 394(b) and Exchange Act Rule 19b-1 are limited, though encouraging, steps in this direction. The further development of an active Third Market might eventually force the Exchange to re-evaluate its commission policy with an eye toward maintaining a competitive posture with respect to the Third Market. The adjustment surely would not be so violent as would result from the maintenance of competition among Exchange members through the antitrust laws because of the different kinds of attractions provided by a continuous auction market on the one hand and a negotiated over-the-counter trading market on the other.<sup>220</sup> No doubt the NYSE would have to devise methods of servicing the needs of large volume buyers and nonmember professionals if it were to stay competitive with the Third Market in these areas, but it would not face the difficulties involved with unrestrained competition among Exchange members with respect to all types of customers.<sup>221</sup>

The SEC also might interpret the clause in section 19(b) dealing with commission rates<sup>222</sup> to give it the power to require the Exchange to adopt a rule stating that commissions are to be set individually and that the Exchange will police to assure that no agreements among members to fix rates are entered into. Besides the question that can be raised concerning the power of the SEC to require the Exchange to adopt such a rule,<sup>223</sup> another difficulty attends this approach. The Securities Exchange Act gives the Commission no power to review particular applications of Exchange rules. Thus, if it wished, the Exchange could let the rule become a dead letter. It must be remembered, too, that the courts still would have jurisdiction to apply the antitrust laws to commission practices if the Exchange's actions are insufficient to satisfy the criteria of antitrust policy.<sup>224</sup>

### B. *An Amended Exchange Act*

SEC officials are now considering a new securities law which would free securities exchanges from antitrust attack but give the Commission added authority over them.<sup>225</sup> Under the new law, the SEC would acquire the right to review and strike down all new exchange rules and constitutional changes. It would gain direct powers over policies gov-

<sup>220</sup> *Special Study*, pt. 2, at 905-06. For an analysis in this issue favoring SEC regulation over regulation in the courts, *cf.*, Comment, *The Third Market*, 20 Sw. L.J. 640, 647-51 (1966).

<sup>221</sup> See text accompanying notes 178-81 *supra* and text immediately preceding n. 206 *supra*.

<sup>222</sup> 1934 Act § 19(b)(9).

<sup>223</sup> See text accompanying notes 160-181 *supra*.

<sup>224</sup> See text accompanying notes 113-123 *supra*.

<sup>225</sup> Wall Street Journal, April 26, 1965, p. 1, col. 6.



erning admission to membership in exchanges. Moreover, all exchange disciplinary actions affecting member concerns and their relations with nonmembers would be reviewable.

Using these new powers, the SEC could revamp the economic structure of the securities industry, "perhaps allowing or halting expansion of the New York Exchange through new listings; opening up at least some of the benefits of membership on all exchanges to outsiders such as mutual funds and other institutional investors . . . ."<sup>226</sup>

It is interesting to note the approach that the SEC has indicated it will take if given the new statutory powers. The Commission wants to control and possibly lower commission rates, but apparently it does not intend to challenge the Exchange's right to fix them. It wishes to ease somewhat the restrictions on exchange membership, but not to allow completely free access.

This approach smacks of direct rate and entry control by the SEC, similar to that exercised in the transportation industries.<sup>227</sup> A basic policy decision must be made whether the policing of commission policies and attendant practices designed to fortify the commission schedule should be accomplished through direct regulation by the SEC or by the removal of noncompetitive practices through the antitrust laws. This decision should turn on an evaluation of the difficulties inherent in direct rate regulation along with the dangers to the proper functioning of the industry in a competitive setting.

An insight into the difficulties that the SEC would face if directed by statute to engage in rate regulation with an exemption from the antitrust laws can be gleaned from an analysis of the problems the Exchange has met in its own attempts to set commission fees. The NYSE has attempted to justify its commission rates on the traditional basis of cost of service.<sup>228</sup> Thus, at an assumed level of rates, the difference between the income generated and the cost in generating such income becomes the focal point. Ordinarily, cost-of-service rate setting for public utilities is done on a company, not an industry, basis.<sup>229</sup> The multiplicity of firms that must be dealt with in the securities industry makes a cost of service analysis a very complex problem.<sup>230</sup>

In a traditional public utility situation, company rates can be set because each company occupies a monopoly position in the market it serves. In the securities industry, however, the firms compete in

<sup>226</sup> *Ibid.*

<sup>227</sup> E.g., Interstate Commerce Act, pt. I, 24 Stat. 379, as amended, 49 U.S.C. §§ 1-27 (1958) (railroads and pipelines); Interstate Commerce Act, pt. II, 49 Stat. 543, as amended, 49 U.S.C. §§ 301-327 (1958) (motor carriers).

<sup>228</sup> *Special Study*, pt. 2, at 333.

<sup>229</sup> E.g., pipelines, telephone companies, electric utilities.

<sup>230</sup> *Special Study*, pt. 2, at 337-40.

the same markets. Thus, the commission rate that is set must be a uniform one that applies equally to each member firm. As a corollary, then, some reasonable method must be found to set a uniform rate that will not be so high that it encourages the existence of very inefficient firms and results in exorbitant profits for the very efficient ones. On the other hand, the rate cannot be set so low that only the most efficient firms survive.

Before any kind of rate determination can be made, a selection of firms that are to be used as the basis of the cost-of-service analysis must be made. Some sort of system for determining a minimum acceptable efficient rate must be devised. The difficult task of devising such a system is dependent upon the reasonable equivalence of cost experience by member firms. The experience of the NYSE indicates that the equivalence is anything but reasonable.

The difficulty of determining a reasonable rate is indicated by the profit experience in 1952 of four different groups of firms. In group one, the high firm achieved a profit rate of 10.6 per cent, the low firm -34.7 per cent. In group two, the corresponding figures were 18.3 per cent and -21.7 per cent; group three, 17.9 per cent and -25.8 per cent; and group four, 24.0 per cent and -16.4 per cent.<sup>231</sup> A 1961 study of income and expenses of 160 member firms showed a range of expenses as a per cent of gross income from 98.1 per cent to 69.8 per cent.<sup>232</sup> Each of these two firms were engaged in the same class of security commission business.

The process is further complicated when it is recognized that naked efficiency provides a poor criterion for a sample of firms. Selection solely in terms of efficiency neglects the important criteria of prudence of expenditures and quality of service. These two factors may well vary among firms as much as does efficiency; yet if the public interest is to be served, their consideration necessarily must be a part of any rate setting process.

Another factor which makes rate regulation in the securities industry extremely difficult is the variations in trading volume over periods of time.<sup>233</sup> The problem posed by volume changes is complicated by the fact that costs remain relatively stable during wide volume swings.<sup>234</sup> These factors affect rate setting in two ways. Cost of service determinations must reflect sufficiently long periods of time to reflect average volume levels. Secondly, if rate setting is to be successful, sophisticated methods of predicting future volumes must be devised.

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<sup>231</sup> *Special Study*, pt. 2, at 337.

<sup>232</sup> *Id.* at 338.

<sup>233</sup> *Id.* at 340-42.

<sup>234</sup> *Id.* at 341.

So far the discussion has been directed solely toward the setting of Exchange commission rates. It must not be forgotten, however, that commission rates in the over-the-counter market are highly sensitive to the level of Exchange rates. As was pointed out earlier, it is likely that Exchange commission rates will act as maximums for rates charged in the over-the-counter market.<sup>235</sup> Thus, the SEC would de facto set over-the-counter rates as well.

Finally, one other point deserves attention. The firms that make up the Exchange membership operate in the over-the-counter as well as the exchange markets.<sup>236</sup> Thus, in calculating cost of service for the purpose of setting Exchange rates, some sort of cost allocation must be made between Exchange and over-the-counter business. Certain expenses can be allocated easily, but the allocation for others will necessarily be essentially arbitrary.

In the face of the great difficulties that would attend direct regulation of commission rates, the likelihood that important objectives of the securities acts would be endangered by a competitive system of rate setting would have to be very strong before the competitive alternative were rejected. This likelihood, at least with respect to the practices discussed in this paper, do not appear to justify a statutory authorization to the SEC to directly regulate exchange commission rates, and to grant them antitrust immunity.

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<sup>235</sup> See note 13 *supra*.

<sup>236</sup> In 1961, NYSE member firms accounted for more than 1/2 of the total over-the-counter dollar volume. *Special Study*, pt. 1, at 17. See also *Special Study*, pt. 2, at 39.