NYSE Rules and the Antitrust Laws—Rule 394—Necessary Restrictions or Illegal Refusal to Deal?

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NYSE RULES AND THE ANTITRUST LAWS—
RULE 394—NECESSARY RESTRICTION
OR ILLEGAL REFUSAL TO DEAL?

INTRODUCTION

From the year 1820, when the real history of the New York Stock Exchange may be said to have commenced, it has gone on steadily increasing in its members, power, and influence until today it can be safely affirmed to be the most powerful organization of the kind in the world.¹

As evidenced by the above statement, the hegemonic posture of the New York Stock Exchange was already well established in the latter part of the nineteenth century. The last ninety years have by no means demonstrated any diminution in this position. In fact, its dominance in the securities markets has finally prompted recent inquiries into the possible illegality of sundry measures utilized by the Exchange to perpetuate its supereminence in the industry.

Nevertheless, nowhere in its history has the New York Stock Exchange (NYSE) confronted the issues it faces today. Its position as the leading marketplace for securities is presently being challenged. This is due to a great extent to the increased utilization of alternative markets for securities which are providing more competitive prices, an element especially attractive to the increasingly potent institutional investors who have in recent years made a substantial impact on the industry as a whole.² The inability of the Exchange to successfully preempt the trading of block transactions is essentially the result of its unmindful adherence to anti-competitive practices. Fixed commissions and restrictive trading rules, which ironically were instituted to shield the Exchange from competition, now appear to have damaging

¹ J.R. Dos Passos, TREATISE ON THE LAW OF STOCK-BROKERS AND STOCK EXCHANGES 10 (1882).
² See N.Y. Times, Nov. 19, 1970, at 41, col. 1, referring to a recent speech by Robert Haack, President of the NYSE, in which he warns that the Exchange must become more competitive in order to halt the shift of trading away from the Exchange and into the third market and regional exchanges. No doubt, the fourth market could also be included in this list of competitors. The Exchange is losing a great deal of business. As the editorial points out: "The shift of trading away from the Big Board is accelerating; an estimated 35 to 45 percent of block trades, involving 10,000 shares or more, are now conducted in other markets." But see STUDY OF THE FRAGMENTATION OF THE CENTRAL MARKET, BNA, 88 SEC. REG. & L. REP. J-1 (Feb. 10, 1971) which concludes to the contrary that the NYSE has increased its share of the market.
effects on its market position. It seems inevitable that if the NYSE is to continue as the dominant securities market it is going to have to yield to these competitive pressures and modernize its trading practices. First among its priorities is the necessity for the implementation of a negotiated system of commission rates to augment the present fixed commission system. In addition to submitting to competition concerning its rates, the Exchange must also meet a challenge to its policies restricting its members trading practices off the floor of the Exchange and towards non-members access to its facilities. Because of their ability to compete, third market firms desire the opportunity to trade with Exchange members. Indeed, some third market dealers assert that the New York Stock Exchange must yield to this type of open competition if it is to remain a viable force in the industry. Underlying these claims are significant legal issues. Specifically

3 The avowed objectives of organizing the NYSE in 1792 were the setting of minimum commission rates and the establishment of a preference for members of the Exchange in their dealings with other members and were stated as follows:

We, the Subscribers, Brokers for the Purchase and Sale of Public Stock, do hereby solemnly promise and pledge ourselves to each other, that we will not buy or sell from this day for any person whatsoever, any kind of Public Stock at a less rate than one-quarter percent commission on the Specie value, and that we will give a preference to each other in our Negotiations. In Testimony whereof we have set our hands this 17th day of May, at New York, 1792.


4 See BNA, 76 SEC. REG. L. REP. at A-4 (Nov. 11, 1970) (speech by Donald Weeden of Weeden & Co.). A recent chairman of the SEC has specifically recognized the need to revise some industry practices:

... If we can get these interrelationships satisfactorily resolved we should have a healthy capital machinery and well served investors.

Address by Wm. J. Casey, Chairman of SEC on the Public Interest in Our Securities Markets, BNA, 107 SEC. REP. & L. REP. D-1 (June 23, 1971). Recently a class action was filed alleging that rule 394, precluding members from trading with non members in listed issues, was violative of the Sherman Act. Dubbed an illegal monopolist, the Exchange is charged with effectively stifling competition in the investment industry. See BNA, 98 SEC. REG. & L. REP. A-3 (Apr. 21, 1971). In answer to an SEC directive to the Exchange to develop a plan "for reasonable non-member access" to Exchange facilities (SEC Securities Act Release No. 8328 (Oct. 22, 1970)), the NYSE, on June 30, 1971, submitted its plan of reasonable access to the Exchange by non-member broker-dealers. The proposal basically calls for a 30% discount from the minimum commission rates charged non-members. All broker-dealers who are primarily transacting business as a broker or dealer in securities and, who can demonstrate compliance to the Constitution and Rules of the Exchange, are seemingly eligible for the discount. Lest the discounting might have undesirable consequences since there is, according to the NYSE, much uncertainty as to the effects of this "accessibility" on the securities markets as a whole, the Exchange proposes a one year trial period to examine the new discounting in operation. Included in the proposal is a recommendation by the Exchange that the non-member dealers be directed by the SEC (by its rule-making power) to charge the NYSE rate to their customers despite their 30% savings on commissions. The Exchange based this recom-
the restrictions on off-board trading imposed by the Exchange on its members generate genuine controversies involving a balancing of competition and government regulation.

Inquiry into the possible extension of the antitrust laws to the securities markets is of recent origin. Varied, interrelated antitrust claims have been asserted involving substantial questions of law, public policy and economics. The following analysis, however, is limited to the antitrust ramifications of NYSE rule 394 which precludes Exchange members, except in limited instances, from seeking better executions for their customers in listed securities off the floor of the Exchange. The objective of this paper is to examine the rule against the backdrop of antitrust principles and the broad purposes of the Exchange Act amid conflicting policy considerations concerning preservation of competition and self-regulation in the securities industry. Whether or not such a rule is a necessary concomitant of NYSE self-regulation will ultimately turn on the further question of whether or not such a rule is necessary to make the Securities Exchange Act work.

Mendation on the possibility that an abusive degree of rebating would result from the discounts allowed. See NYSE Report on New Minimum Commission Rate Schedule, BNA, 108 SEC. REP. & L. REP. E-1 to E-10 (June 30, 1971).

It is clear that third market firms would gain no advantage from this plan. The precise reason which has enabled the third market to flourish has been their ability to trade NYSE securities at negotiated rates, below the fixed Exchange level. If they are given the discount but then forced to refrain from passing any of the savings to their customers their position is not enhanced.


Recently antitrust challenges have arisen concerning the public ownership proposals of the New York Stock Exchange, see BNA, 25 SEC. REP. & L. REP. X-97 (Nov. 19, 1969) (comments by Antitrust Division on NYSE public ownership proposals); BNA, 71 id. A-3 (Oct. 7, 1970) wherein it is reported that a class action has been instituted on behalf of all stockholders who trade on the exchanges against the NYSE for damages totaling $3 billion resulting it is alleged, from the Exchange's minimum fee structure.

The Third Market

An analysis of rule 394 and its pendent problems necessitates an understanding of the setting in which the rule operates. A thorough examination of the third market is inextricably part of that setting for it is the firms comprising this market as well as member-firms of the NYSE which the rule ultimately affects. Interrelationships between the NYSE and the third market must be explored. Differences and peculiarities must be segregated and the economic and competitive significance of this rival market must be examined. Such a background is necessary, if further discussion of the problems created by the rule is to be meaningful.

Complexion and Growth of the Third Market

The third market is in many ways a peculiar animal. While it possesses characteristics of both the auction (e.g., NYSE) markets and the over-the-counter markets it retains its individuality by performing its own unique functions. “In methods and structure this market is part of the larger over-the-counter market. But its prices are necessarily related to those on the exchanges. It is this unique ambivalence that has produced the fitting designation, third market.” Simply, the third market is nothing more than a market away from the floor of the exchanges, for securities traded on the exchanges.


Within the last few years, still another specialized market for securities has evolved, namely the “Fourth Market.” Individuals there arrange direct trades between institutions. The system often involves a three-way telephone conversation between the individual, the seller and buyer. It is termed the “fourth market” because it “bypasses the three more conventional methods of trading securities: the exchanges, the over-the-counter market and the market for listed stocks created by brokers who are not members of the exchange.” It offers two advantages to those who trade there. First, all trading is secret. This prevents sharp fluctuations in price which occur when rumors of a large offering permeate the financial scene. Secondly, the institutions can avoid the large commission rates that the exchanges charge. One such individual, Tomasco Associates, a Chicago-based firm charges 25 cents per share up to a maximum of $10,000 per year. Thus, a client pays nothing above this amount. By comparison, sales of 40,000 shares of a $50 stock costs $11,360 on the NYSE. The writer points out that the rise of such a market provides more evidence of the need to reconsider the role of the primary auction market in light of increased institutional participation. The NYSE seems to be threatened by the third and fourth markets only because these markets are providing economic incentives (cost savings) to investors to bring their business away from the Exchange. Id.

9 Loss 3345.

10 Throughout its entirety, this paper will be concerned only with the market for NYSE listed securities traded off-board, since rule 394 is a NYSE rule and since the third
The growth of this market has been phenomenal in recent years. Its dollar volume surged from 84 million dollars in 1941 to 2 billion dollars in 1961,\textsuperscript{11} and later in 1965 to 2.5 billion dollars.\textsuperscript{12} There is present in the third market a high degree of professional participation. This is illustrated by the fact that "the estimated value of sales by the public in the third market amounted to only 2 to $2\frac{1}{2}$ percent of such sales on the Exchange."\textsuperscript{13} In addition to increases in dollar volume there has been substantial growth in the number of firms actively making a market in NYSE-listed shares. Since 1950, 14 of the 17 firms now existing have entered the stream of third market business.\textsuperscript{14} In 1940 there were only 5 such firms. These statistics are even more impressive when considered jointly with the fact that firms, involved in third market operations, have been constantly increasing the number of issues in which they make a market.\textsuperscript{15}

In 1941, a Commission Staff Study disclosed that the type of listed stocks traded off the board were of the high quality and inactive type such as shares of real estate, utilities and financial groups. However, there has been a dramatic change since then. Today, the spectrum of shares traded includes "Blue Chips" and less seasoned stocks as well, and "some of the 270 NYSE common stocks traded in the third market are among the most active on the Exchange."\textsuperscript{16}

Transactions in the third market, to a much greater extent than on the Exchange, tend to extremes — either they are very large or very small. Indeed, the larger institutional block transactions have always been immediately identifiable with this market as one of its main areas of concern.\textsuperscript{17}

\textsuperscript{11} SPECIAL STUDY 870.

\textsuperscript{12} Schlesinger, supra note 8, at 690 n.3, citing SEC STATISTICAL BULL., March 1966 at 10.

\textsuperscript{13} SPECIAL STUDY 873.

\textsuperscript{14} Id., 874.

\textsuperscript{15} Id.

\textsuperscript{16} Id., 875. The Special Study sampled one day's trading to elicit still another dimension of growth. In 1962, the over-the-counter purchases and sales of all Exchange stocks amounted to 26.9 million dollars or 6.3 percent, of the total estimated trading (429.4 million dollars) on the Exchanges that day.

\textsuperscript{17} Id., 878, citing Is the Stock Market Obsolete, FORTUNE, Feb. 1954, 129, 158. One market-maker related to the commission the policy considerations involved in choosing to deal in a particular security:

The policy of the firm is to add a security to our trading list only if it is felt that the security has a sufficiently broad and continuous investor interest to
Why such a market should develop seems to be answered by this statement by the *Special Study*:

The reason for the existence of an over-the-counter market in listed stocks—in the face of a highly organized, established exchange market in which the same securities are traded—would appear to lie in its capacity to satisfy needs not met by the exchange market.\(^8\)

**Customers of the Third Market**

The third market, in the main, services large institutional investors and “other public customers” besides individuals.\(^9\) Pension funds, insurance companies and common trust funds typify the customers with whom third market firms deal.\(^20\) Approximately two thirds of the institutional business is transacted on a principal basis through market-makers and one-third by broker-dealers as agents. “Much of the latter consist of transactions in which the broker-dealer brings together an institution desiring to sell (or buy) with another institution wishing to buy (or sell) the same security, in what may be termed an off-board cross.”\(^21\)

In addition to the institutional trade, professional intermediaries are also active as customers on the third market. These individuals trade in a representative capacity for public customers but are not market-makers for their own accounts.\(^22\) The third market is attractive to these professional intermediaries basically for economic reasons. Because they are not members of the NYSE they must pay the full commission rate if they trade on that exchange. This leaves no room

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\(^8\) Id. 877.

\(^9\) Id. 879. Trading on the third market is inviting for several reasons. One is the retention of control over his order which a customer enjoys. Negotiation of price is directly with the market-maker and the institution usually has the opportunity to shop around if more than one market-maker is trading in the stock. In addition, there is always the NYSE if prospects on the third market are not attractive.

\(^10\) Id. 879.

\(^20\) Id. 880-82. Many individuals deal in the third market too. In 1962, their trading represented 38 percent of the dollar volume and 68 percent of the share volume in the third market. This corresponds to the high percentage of odd lot sales that took place on the third market since it is safe to assume that odd lot transactions are predominantly individual transactions. *Id.* 881-82.

\(^21\) Id. 880-82.

\(^22\) Id. 883. See *id.* for a discussion of this transaction.
to charge for its own services. Thus, since a substantial number of these professionals are not members of an exchange, the third market offers the only economically feasible market in which they can trade.

The third category of customer in the third market is the market-maker. The market-maker's competitive position vis-à-vis the Exchange specialist is one of the primary reasons for rule 394's existence. The third type of customer is defined as broker-dealers actively engaged as principals in buying and selling NYSE-listed securities over the counter on a continuous basis and holding themselves out to institutions and other broker-dealers as making markets in such listed securities.

The market-makers rank in size from modest organizations to some of the largest securities firms in the industry. Their trade is almost exclusively with institutions and broker-dealers. "Since institutions trade largely through skilled trading departments, the market is almost exclusively a professional one."

Firms holding themselves out as market-makers stress trading, while omitting various services normally offered by the public commission houses on the Exchange. Business is strictly on a cash and carry basis. There are no research services and investment advice is not for sale among third market brokers.

Prices quoted on the NYSE are significant to the market-makers who keep fully informed of the movements on the Exchange by subscribing to the NYSE ticker service. In addition, many of the market-makers have direct wire connection to the Exchange members at the same time maintaining elaborate communication systems among themselves.

Third Market Operations

Generally, the price on the third market rarely deviates from the NYSE price by greater than the amount of the Exchange commission.

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23 Id. 884. This has led to the creation of various reciprocal arrangements such as customer-directed give-ups which were ultimately prohibited by the Exchange in 1968.
24 Id. 885. The Special Study recommended the establishment of methods to identify third market-makers and to provide for the reporting of their market activity so as to keep the SEC fully aware of the problems that might ensue. The result was the promulgation of SEC rule 17 (a) 9 effective 1965. See Loss 3346-47 for a complete analysis of these reporting requirements.
25 Id. 886 (footnotes omitted). Certain evidence substantiates this point. The merchandising techniques utilized by market-makers are aimed specifically to attract professional customers. A majority of these makers advertise their markets by maintaining bids and offers in the sheets of NQB. Other firms utilize circulars or trading cards which are mailed exclusively to institutions.
26 Id. 887.
27 Schlesinger, supra note 8, at 641.
28 SPECIAL STUDY 888.
However, this relationship is not a mechanical one. The market-makers have diverse trading practices which dictate their policy of pricing in their markets.29

Pricing principles, however, differ according to the particular type of trade being transacted. While odd-lot prices are comparable to NYSE's prices, price is the sole factor in small round-lot transactions, the consideration of depth being insignificant in such a trade.30 Of course, if the market-maker does not remain competitive with the Exchange, the broker-dealers will direct their business to the auction market. In these smaller transactions, there is less room for negotiation and, since the market-makers desire to deal at their quotation,31 they are reluctant to negotiate.

Important to an understanding of trading in the smaller round-lot transaction on the third market is an awareness of the different bases upon which institutions and broker-dealer intermediaries trade with the market-maker. The institution trades directly for its own account as principal. This means that it is generally interested only in the comparative net cost or proceeds of

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29 See id. 888-97. One large diversified market-maker described his pricing practices as follows:

The pricing of a stock or making of a market at any given moment involves a combination of factors. Those factors include the firm's current inventory position, the trader's attitude toward the market, the nature of the inquiry, and other inquiries received in that specific security. After all those considerations, there must be added the desire and the willingness to be competitive. Normally, we try to maintain a ½- or 1/2-point spread between bid and offer price with a minimum of 100 shares bid and offered. In the process of being competitive the following factors are considered:

- The last public transaction price as reported on the NYSE ticker tape.
- The bid and asked quotations as provided by the facilities of the NYSE.
- The off-board market being made in competition to our market.

Id. 889.

The Special Study summarized the pricing policies of the market-makers as being a combination of a realistically narrow spread between the quotes and a balanced straddle, in which the last price on the Exchange falls halfway between the market-maker's quotations, . . .

Id.

Of course, the off-board market available to customers at the time of inquiry is comprised of the best bid and offer in all markets for the stock being made. See Id. 890. Another market-maker added these considerations as influencing his pricing practices:

1. Last sale on the NYSE.
2. Current bid and asked quotations.
3. Range for the day.
4. Size of the block may make it desirable for the buyer and seller to agree mutually upon price.
5. Our judgment as to the relative value of the security involved.

Id.

30 Id. 890-91. The competition is rigorous for the market-makers. They are transacting with professionals who not only have access to the latest price information in addition to the last exchange price and the current quotations but also quotations of other market-makers dealing in the same stock. Id. 891.

31 Negotiations away from the quotes serve only to narrow their spread.
the transaction, the price paid or received on the Exchange, plus or minus commissions. Thus, the institution may find it worthwhile to trade off board where the price is inferior to the price on the Exchange but better than the total of price and Exchange commission.32

In large round-lot transactions the added dimension of depth of the market becomes relevant,33 in addition to price and cost considerations. Of these large round-lot trades, block transactions of institutions present "the most important and intricate aspects of pricing and trading mechanics on the third market."34 One characteristic of market-makers who specialize in institutional trades is their ability to turn their inventories over rapidly and maintain the large position required.35

An examination of the differences between the auction markets and the over-the-counter markets will illustrate why institutional customers, who are free to transact business in either market, may utilize one rather than the other. However, in such an examination it is dangerous to "overstress the bounds of competition."36

32 Id. 892 (emphasis added).
33 Depth is an important concept to the institutional trader. The term refers to the quantity of buying or selling interest in a stock at particular price levels.
34 Id. 983. Some generalizations can be made about market-maker activity in large size transactions. The larger the deal:
(1) the more negotiation is going to play a significant role.
(2) the greater is the deviation from the last price on the Exchange likely to be.
(3) the more likely the market-maker will handle it on an agency basis and not for his own account.
However, the fact remains that the more the market-maker learns of his customer needs, the more likely he will assume the risk in dealing for his own account, and the greater the expectation of his customer that the market-maker will not compete with the customer for any stock but rather will show it to him before offering it to another customer.

35 This ability to take a heavy position, or to negotiate a large deal on an agency basis, undoubtedly constitutes the single attribute of the market-maker's most important to their institutional [sic] customers.

36 Id. 894-95.

37 Id. 895.

Block transactions are often programmed out, on a dollar-cost-averaging or equivalent basis, over a period of time, regardless of whether handled entirely on one market or the other, or both. The markets are likely to be complementary in executing the block as a whole, even though competitive for the individual trades making up the block program. In this respect, the inherent attributes of each market—the auction market of the Exchange and the negotiated off-board market—may suggest differences in method of operation. Thus, while the comparison here is made of the execution of transactions of depth on each market, the choice in any specific case may be between such a transaction on the third market and a larger number of smaller sized transactions on the Exchange. The skilled institutional trader, interested in securing the best average net price for the entire transaction, utilizes the best of each market throughout each trading situation, which is continuously changing to reflect the impact of a variety of forces.

Id.

In addition, whether or not an institution deals with the specialist is to some degree influenced by the awareness of the specialist's power to influence prices on all markets.
The primary difference between the third market and the exchange markets is illustrated by consideration of the role of the specialist on the Exchange, in which he performs two important functions: one as a broker, to hold and execute orders for the public, and that of a dealer, to make a market and trade for his own account. Because of his position, the specialist possesses intimate knowledge of the market for securities. This is made possible by his book and his central position on the trading floor. In contrast, the market-maker relies only on the Exchange tape and quotations as a basis for his trading. The specialist, however, is restricted to some degree in his trading activities, i.e., in his agency versus dealer functions.37

The differences in market structure to a large degree explain the differences in the trading operations. In the third market an institutional customer in most cases deals directly with the market-maker. Theoretically, the same customer could also trade directly with the specialist, but such is not the practice. In either case, however, the institutional customer would pay the full commission.38

Preferences over the Exchange Market

While considerations such as price, cost and depth of the market are all submitted as factors determining market choice, all of these reasons seem bound up in one predominant objective, that is, "the institution’s objective of realizing the best possible net cost or proceeds in each transaction."39

Institutional trading on the Exchange is subject to the fixed commission rate schedule;40 in contrast, when dealing as principals in the third market they pay (or receive) a price net of commissions which is

"Failure to make a deal with a market-maker, over-the-counter presumably does not prejudice the institution's opportunity to deal advantageously elsewhere." Id.

The specialist, however, occupies a key position affecting all markets on which the security is traded. His knowledge of large interest on either side of the market, evidenced by a substantial order overhanging the market or by continuous dealing by a single broker or even a group of brokers, may in itself lead to an adjustment of quotations to anticipate the effect of that interest on the market.

Id.

The result is something approaching a clandestine attitude when institutions are dealing with the specialist on the Exchange as opposed to their dealings in the third market.

37 Id., 896.
38 The significant difference is that in the one case the institution, which often possesses a skilled trading department, deals directly with the market makers; in the other, it negotiates through an intermediary.

Id., 896.
39 Id., 897.
40 In 1968 the Exchange implemented moderate volume discounts on trades over 1000 shares to enhance its competitive position vis-à-vis alternative markets for its listed securities. See Fredman & Johnson, Effect of New NYSE Fee Structure on the Third Market, Fin. Exch., Oct. 1970, at 18. The authors contend commission savings are not the sole motivation for third market activity, citing other important factors such as depth, speed
set by a market-maker who regulates his markups, making it as low or as high as he wishes, in light of all pertinent considerations.41

Depth of the Market

In this context, the concept of negotiating transactions of depth refers to the quantity of buying or selling interest in a stock at particular price levels.42 Since the third market reflects a form of multiple trading, it is a competitive market and as such seems to divert trading from the Exchange's market. It, therefore, affects the depth of the auction market.

The important factor to consider is not that there is diversion but rather the effect of this diversion. Most of the issues traded on the third market enjoy substantial trading activity on the NYSE. In addition, of the 270 stocks traded in the third market, diversion by offboard volume tended to be low, exceeding 10 percent of the Exchange volume in the case of only 21 of 207 stocks which were actively traded on NYSE.43 With respect to the depth factor, the Special Study concluded that "[The] third market, whatever its effect on the depth of the primary market, provides the public customer with overall markets of greater depth."44 This is primarily due to the fact that the institution is given an alternative market in which to trade in the event that the in transactions and secrecy in dealings. They conclude that there was no significant decline in third market trading after the implementation of the volume discounts.

41 SPECIAL STUDY 897.

To simplify grossly for purposes of illustration, in a 10,000-share purchase of a $40 stock, the institution's total cost on the Exchange is $403,900; 400,000 being the price of the shares and $3,900 commission. A market-maker on the third market with a share cost of $40 may quote less than $403,900 on a principal basis by a markup of less than $3,900. Conceivably, with a share cost of 40⅛, or even 40⅝, he can produce a total customer cost less than the Exchange total by settling for a lower markup.

42 SPECIAL STUDY 898. The importance of this concept can readily be seen by considering block transactions. In such trading it is very difficult to ascertain whether buying interest will be maintained at the current quoted price. That is, the last round lot for a particular large sale may have to be traded at a lower price than the first. Another consideration is the impact on price the offering of such a large block will have on the price itself. Thus, the block transaction on the Exchange is riddled with uncertainty. However, in the third market this element is missing. A market-maker can quote a fixed net price for all or part of an order. He may even assume a short position if his inventories are shallow. Schlesinger, supra note 8, at 643.

43 SPECIAL STUDY 902. The Special Study considered the fact that although the percentage of off-board trading has increased relative to NYSE volume, the Exchange volume has grown substantially over the last fifteen years in shares traded on both markets to a much greater extent than before trading of those issues began on the third market.

It is also interesting to note that the Exchange's share volume in the stocks traded by one of the largest market-makers increased 16.5 percent from 1961 to 1962 in the face of substantial growth in the market-maker's volume and a 5.8 percent decline in the Exchange's total share volume. Id. 902 (footnote omitted).

44 Id. 903 (emphasis added).
specialist cannot handle the order or bring it to the Exchange without substantially affecting the price.\textsuperscript{45} The market-maker is thus likened to a “quasi-specialist” or “auxiliary specialist” and adds overall depth to the markets available to the institutional investors.\textsuperscript{46} Although the third market represents a competitor to the NYSE, the market is more accurately viewed as complementary to the auction market, at least insofar as the institutional investor is concerned.\textsuperscript{47}

One additional reason why the third market may enhance the depth of the market is the notion that in the case of large transactions if they were to be fragmented into many smaller trades and disposed on the NYSE over a period of time, it would very likely create an imbalance of demand and supply rather than contributing to any sort of balance of these two variables.\textsuperscript{48}

\textit{Competition with the Exchange}

While there is little price competition in odd-lot sales between the two markets, the competition in the institutional business is intense. Institutional customers usually measure price and depth in the third market against price and depth on the Exchange. In addition, services that are included in the fixed commission rate, are useless to institutional customers who, as professional investors, are fully equipped with their own investment counseling. The third market enables these professionals, not being members of any exchange, to do business with them in listed securities without any fixed commission rate. As mentioned earlier, it also becomes extremely attractive to a non-member, broker-dealer who is not making a market himself. If he were to trade in listed securities on the Exchange, he would have to pay full commission rate. He is then forced to transfer these shares to his customer at zero profit. Many times, this is done to maintain important customers. Hence, the third market becomes profitable for him to trade in listed securities since the commissions are negotiable. The public benefits also because now the nonmember broker-dealer is able to offer a more complete selection of stocks than would be possible were it not for the third market.\textsuperscript{49} On balance then, the third

\textsuperscript{45} It is important to consider that the institutions indirectly represent many people who may not be actual investors in the stock market per se, but who nonetheless represent some public interest.

\textsuperscript{46} \textit{Id.}

\textsuperscript{47} \textit{Id.}

\textsuperscript{48} \textit{SPECIAL STUDY 903. Because the Stock Exchange has recognized the need for special plans to augment the regular auction market machinery, the third market could be viewed as competing with these special plans and not with the regular transactions.}

\textsuperscript{49} \textit{Id. 905.}
market appears as a decidedly pro-competitive force, in many instances merely complimenting the NYSE. In any case, it generates an investment climate which certainly favors the general investing citizenry.\textsuperscript{60}

**The Scope of Exchange Rules**

Considerable controversy has been generated by judicial efforts to ascertain the precise legal nature of exchange rules.\textsuperscript{51} For instance, in *Colonial Realty Corp. v. Bache & Co.*,\textsuperscript{52} a case concerning the implied civil liability of a brokerage firm for breach of an exchange rule, Judge Friendly held that exchange rules were not included within the "rules and regulations" of section 27, the jurisdictional section of the 1934 Act. Thus, no basis for implied civil liability could be predicated on such a breach. However, the court did recognize the possibility of such liability given certain circumstances.\textsuperscript{53} Whatever the legal status

\textsuperscript{50} Id. The Special Study viewed the third market's effect favorably, concluding that the advantages of competition generally outweigh any concern over impairment of depth in the primary market. It would appear that the third market has developed in the shadow of the NYSE only by dint of its ability to perform a useful function. . . . Unlike the unlisted stocks traded over-the-counter, freedom from investor safeguards is not a factor in the case of the listed stocks traded off board. . . . The very existence of this market to satisfy needs not met by the exchange market is indeed affirmation of the inherent strength and viability of a system of free markets.

\textsuperscript{51} See Note, *Private Actions as a Remedy for Violations of Stock Exchange Rules*, 83 Harv. L. Rev. 825, 831 (1970) wherein one interpretation has been expressed which denies to the exchange rules the same force as the Securities Exchange Act of 1934 and rules enacted thereunder. As the writer points out, there is strong basis for this viewpoint, inasmuch as the SEC has disavowed any power to directly enforce exchange rules. This is some indication that the Commission considers violations of such rules as not being a breach of the Exchange Act.

\textsuperscript{52} 358 F.2d 178 (2d Cir. 1966), cert. denied, 385 U.S. 817 (1966).

\textsuperscript{53} That depends, the court stated, on "the nature of the particular rule and its place in the regulatory scheme." 358 F.2d at 182. As one writer has suggested:

Ostensibly the court meant that a stock exchange rule could be the basis for implied civil liability if it were violated in regard to its investor-protection function. and if such function had an integral role in the regulatory scheme of the 1934 Act.

\textsuperscript{54} Id. The Special Study viewed the third market's effect favorably, concluding that the advantages of competition generally outweigh any concern over impairment of depth in the primary market. It would appear that the third market has developed in the shadow of the NYSE only by dint of its ability to perform a useful function. . . . Unlike the unlisted stocks traded over-the-counter, freedom from investor safeguards is not a factor in the case of the listed stocks traded off board. . . . The very existence of this market to satisfy needs not met by the exchange market is indeed affirmation of the inherent strength and viability of a system of free markets.

*Note, Stock Exchange Rules — Implied Civil Liability Under the Securities Exchange Act of 1934 For Breach of the "Know Your Customer" Rule*, 44 Tul. L. Rev. 633, 638 (1970). See Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135 (7th Cir. 1969) where the court in applying this test held that a breach of an exchange rule by a member broker will give rise to an implied federal liability for damages as a violation of section 6 of the Exchange Act where it is shown that the rule's purpose is to further the statutory mandates of the Exchange Act in protecting investors.

If then, it can be demonstrated that an Exchange rule occupies such an integral position within the framework of the 1934 Act as to give rise to federal civil liability, the rule is undoubtedly being treated as the equivalent of a rule or regulation promulgated under the Act and therefore as a federal law. However, it must be borne in mind that the *Colonial* decision holds the party asserting such civil liability to a heavier burden of proof in the case of an Exchange rule "than when the violation is of the statute or an SEC regulation" 358 F.2d at 182. In addition, Judge Friendly warned that the inevitable results of permitting carte blanche federal liability in these situations would be an inun-
of these rules, their internal significance is pervasive. Matters involving suspension and expulsion of members for various reasons are entirely governed by the constitutional provisions of the Exchange as enforced by the Board of Governors.54

Considering the recent decisions that have applied the Colonial test,55 and have thus held NYSE members civilly liable for violations of Exchange rules, one might, analogously, impose liability upon member firms for adhering to a rule which necessarily results in added costs to his customer. While conceptually there might be some basis from a historical standpoint for such an extension of liability,56 it seems patently unreasonable that liability should be premised on a failure to avoid a rule (such as rule 394) when such avoidance would assuredly result in the member's estrangement from the Exchange and the loss of its trading privileges. More importantly, the rule, in terms of the purposes of the Exchange Act might be determined to be necessary to make the Exchange Act work.57 Until such a decision the rule has full binding force on the NYSE and they are obliged to adhere to its provisions.

**Rule 394**

Rule 394 is a derivative of section 8, Article XIV of the NYSE constitution which places restrictions on member firms to prevent dealings off the Exchange.58 That section was interpreted, however, until...
the late 1940's as restricting member firms from making private markets for their own accounts in listed securities but was not construed

(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 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 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 the 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.

(6) No member shall effect a purchase for its customer from a market-maker if, on the basis of information supplied to the member by the market-maker, the market-maker's transaction would involve a short sale on a minus or zero minus tick based on Exchange transactions at the time of the solicitation; provided, however, that this shall not prohibit a transaction which includes a short sale of less than one round lot.


Listed below are examples of situations that would not comply with rule 394(b). The rule is intended only to apply to situations where member firms have solicited the participation of a qualified non-member market-maker. If, in the course of such a solicitation, the non-member market-maker asks to participate in the purchase or sale of any other security or of the same security in a different transaction, that transaction does not qualify under rule 394(b).

(1) A member firm solicits a qualified non-member market-maker to
as to prevent members from executing agency transactions off the floor of the Exchange.\textsuperscript{59} In other words, nothing prevented a member from acting as a broker for his customer and seeking a better execution off the floor of the Exchange.

Later construction of section 8 applied the restrictions to some agency transactions, "but only to the extent that such an execution did not benefit the customer or was not requested by him."\textsuperscript{60} It is therefore evident that the third-market was considered an economic threat to the NYSE, and that the Exchange did recognize the duty to seek better executions off the Exchange if it would benefit a member's customer. The reversal of this position was seemingly motivated by self-interest considerations to protect the Exchange market and so priorities were shifted, relegating the customer's right to a better price secondary to the protection of the Exchange's monopolistic position.

In 1948, the Exchange issued Circular 52 which for the first time required prior approval by the Exchange before a member could transact off the floor.\textsuperscript{61} In 1952, the Exchange rejected its former position whereby permission for agency trading off the floor was granted when such trading proved to be advantageous to a member's customer. However, this change of position was not unanimous. In fact, it conflicted with an earlier policy adopted by the Board of Governors which had granted to staff officials of the Exchange the authority to approve cer-

\begin{enumerate}
\item A qualified non-member market-maker advises, other than by the ordinary written advertisements, notification, or publication, a particular member firm during the day that he wishes to be solicited in a given stock or stocks. The subsequent solicitation by the member firm, in response to the third market-maker's request, will disqualify the resulting transaction from qualifying under rule 394(b).
\item A member firm has an understanding with a qualified non-member market-maker to solicit him under rule 394(b) whenever he has customers' orders in these stocks in which the third market-maker is qualified. Such an understanding will disqualify any transaction made pursuant to the understanding from rule 394(b). Any effort to accomplish indirectly that which is not directly permitted by the rule, or the intent of the rule as indicated in the rule itself, and the supplementary material, will result in the transaction not qualifying under the rule.
\end{enumerate}

\textit{Id. }\textsuperscript{59} 2394.10.


\textsuperscript{61} Id. at 45.
tain transactions off the floor. As a result, requests for off-board trading decreased as this new policy became commonly known among the members. In 1957, implicitly recognizing the existence of the third market as an economic threat, the New York Stock Exchange felt it necessary to adopt a specific rule to deal with the problem. Hence, rule 394 was adopted. The rule prevented members from dealing as principals or agents in effecting off-board transactions in listed securities with non-members. However, the Exchange could exempt certain stocks from the application of the rule.

Prior to 1957, the policy of the Exchange concerning off-board transactions was thus permissive in nature. For, although a member could not trade as a dealer for his own account (as a principal), he could trade as a broker, i.e., on an agency basis.

The effect of the rule change is strikingly illustrated by the results produced when Chase Manhattan Bank Stock became a listed security. Non-member dealers had, prior to its being listed, traded substantially in Chase Manhattan Stock, and with the 1964 amendments to the Exchange Act, allowing listing of these shares on the Exchange, the Board of Governors immediately declared the rule applicable to the Chase Stock, and refused to exempt the issue from its application. Thus, they were literally cut off from dealing with NYSE members in Chase Stock.

In 1966 Schapiro & Co. requested the SEC to order the NYSE to rescind or modify rule 394. The ultimate result was the adoption of rule 394(b) by the Exchange. Insistance upon the change in rule 394 by the SEC no doubt reflected its dissatisfaction with the rule as evidenced by the conclusions it reached in its 1965 study of the rule. The modified rule's purpose was to define the procedures to permit members of the Exchange to execute a customer's order off the board with qualified non-member market-makers. The SEC had found that a change was "necessary and appropriate in the public interest and for the protection of investors and necessary for the execution of its functions under the (Securities Exchange) Act."
In its earlier study the Commission had found that rule 394 in its
original form had prevented brokers from obtaining better executions
off the floor of the Exchange and that one of the purposes of the rule
was to inhibit competition of the member firm and non-member dealer
with the specialist and was "geared to the economic interest of Ex-
change members."  

The SEC also found that while rule 394 may have preserved the
depth and liquidity of the primary auction market, it accomplished
such results at the expense of the competing third market. For these
and other reasons the SEC concluded that the rule needed revision
and the Commission recommended the adoption of a permissive rather
than mandatory policy concerning off-board transactions by members
of the Exchange.  

The adoption of rule 394(b) has apparently done little to resolve
the problems. The amended rule immediately drew criticism basically
because it did little to end the discrimination practiced against third
market dealers. An examination of several factors demonstrates why
the modification has been ineffectual. To begin with the procedures
of rule 394(b) are cumbersome and inefficient. This alone discourages
its utilization by members of the Exchange.  

Comparisons of similar rules on regional exchanges reinforce
this criticism leveled against 394(b). Rule 6 of the Midwest Exchange
is illustrative. The differences between rule 6 and 394(b) are sig-

relationship of the third market-maker to the Exchange market specialist. The witness
testified that as third market-makers they operate exactly like the specialist on the
Exchange and thus are in competition with him, each making market for stocks. The
market-makers sell the shares at a net price while the specialists make a market and offer
stock at a specific price. A broker then would take the stock from the specialist and sell
it to his customer at that price plus a commission.

\[\text{Staff Study at 56. The Commission's report went on to conclude that}
\text{[the publication of Member Firm Circular 52 and the evolving restrictive inter-
pretations of rule 394, were the direct result of competitive markets being made}
by non-members. In addition, } \ldots \text{ rule 394, reflected a decision by the Exchange}
\text{that all non-members be required to pay a minimum commission on the execution}
\text{of any order to which they were a party; this decision was enforced through re-
quiring all executions to be done on the floor of the Exchange irrespective of}
\text{whether the non-member was using the member as its agent.}

\[\text{Id. at 47.}
\]

\[\text{See, e.g., Weeden Comments, supra note 59, at 10.}
\]

\[\text{The applicable part of rule 6 of the Midwest Exchange is as follows:}
\text{No member, member firm or member corporation shall buy, offer to buy, sell
or offer to sell shares of stock in issues admitted to dealings on the Exchange off}
\text{the Floor of the Exchange unless permissions shall be requested in writing. } \ldots
\text{Cited in BANK STOCK Q., Nov. 7, 1968 at 33. See Hearings, Jan. 7, 1969, at 4933. The}
\text{officials of the Midwest Exchange testified that the basic philosophy behind its rule is to}
\text{permit off-floor transactions if advantageous to the customer. Furthermore the fixed}
\text{commission charge is not imposed on the non-member market-maker when and if he}
\text{solicits a transaction on the Midwest Exchange. The witness explained that:}
\text{Our member is free to seek the best possible price for his customer and we figure}
significant. The NYSE rule requires a member after receiving a bid or offer from a third market-maker to return to the floor of the Exchange where such bids or offers may be displaced by those made on the floor of the Exchange. Such is not the case on the Midwest Exchange. The Midwest rule places no restrictions on non-members soliciting trades from members of its exchange whereas such action under 394(b) would result in a disqualification of the transaction. It is also important to note that when seeking to proceed under 394(b) a NYSE member must go to the floor first. If a member should seek a quote from the third market first and then come to the floor to obtain permission to go off the board under 394(b), permission would be denied.\(^7\)

The testimony offered by the NYSE to justify the imposition of rule 394 abounds in rhetoric and little else. The rule is defended on the ground that it is a necessary, protective measure to insure the depth and liquidity of the auction market, an objective which the Exchange contends is in the public interest. Characterizing third market dealers as parasitic and proliferous to the point of being a cancerous threat to the viability of the primary market, the Exchange insists that the rule must remain in force if the central market place is to remain the fulcrum of the securities industry. Such "undermining" by third market dealers, the Exchange posited, must be prevented.\(^7\)

Robert Haack, the president of the NYSE, also testified, couching his defense of rule 394 in terms of the regulatory disparities between the Exchange and the third market. Intimating that the NYSE is subjected to more stringent regulation and thus is a more protective market, Haack criticized the fact that dual standards exist in relation to the NYSE specialist and the third market dealer. According to Mr. Haack one such disparity exists concerning the respective market-makers' ability to keep its customers informed. Whereas the NYSE makes data available through its ticker service and transaction journals, nothing comparable exists in the third market. The degree of regulation imposed on each of these market-makers varies greatly. While the specialist on the Exchange is subject to rigid financial requirements in addition to numerous measures to insure a "fair and orderly" market, his counterpart in the third market is subject to no such surveillance. To the market-maker the prime motivation is profit. If it

\(^7\) See Hearings 5129 (testimony of G. Levy, former Chairman of the Board of Governors of the NYSE).

\(^7\) See Hearings 5061-62, 5117, 5127. See also Baxter, supra note 5, at 708-09.
becomes unprofitable to trade in certain issues, he can abruptly cease to trade in that issue, whereas, the specialist, under a duty to maintain markets for the issues he trades, does not enjoy such ease of exit.\textsuperscript{72}

These claims of the NYSE have not been unchallenged. As to the particular charge that the abolition of rule 394 would serve to fractionalize the primary auction market, \textit{i.e.}, destroy the necessary liquidity and depth of that market, it has been contended that just the opposite would result in terms of the overall market for securities, that is, the third market adds rather than detracts from the depth and liquidity of the overall market. In fact, it is in the case of block transactions that the need for such an additional market becomes critical.

The view has been expressed that the auction market lacks the flexibility to assume the bulging demand that has been created by the advent of increased institutional participation in securities. Such large orders create a disequilibrium which inevitably results in the breakdown of the auction system. A negotiated market then develops, requiring position takers and the necessary capital to absorb the generated transactions. The third market, it is claimed, provides a substantial amount of position-taking ability and serves to augment rather than detract from the overall market. In so doing, it provides more stability and depth to the total trading picture.\textsuperscript{73}

Closely akin to third market trading of listed securities is the multiple trading of those issues that takes place on regional exchanges throughout the country. Since third market transactions are considered in substance a form of multiple trading, some of the arguments favoring multiple trading on regional exchanges might be considered in reference to the allegation that the dissipation of trading to the third market destroys the depth and liquidity of the auction market. The results of a Stanford Research Institute Study entitled \textit{The Economic Functions of Modern Regional Stock Exchanges}\textsuperscript{74} tends to refute this argument of the NYSE with respect to the regional exchanges. The study concerned itself with the primary issue of "whether multiple trading of listed securities may be expected to impair market 'quality' or liquidity by diverting trading to regional exchanges."\textsuperscript{75} The conclusions of this study clash with the NYSE charges of fragmentation. The study stated that it is unlikely that depth or liquidity would suffer because of multiple trading and that, in fact, it appears likely that multiple trading

\textsuperscript{72} \textit{Hearings} 5151-52. The obvious answer to this situation would be more \textit{effective} regulation of all transactions where a broker-dealer is trading for his own account.

\textsuperscript{73} \textit{Hearings} 4015-16.

\textsuperscript{74} See \textit{Hearings} 4482-85.

\textsuperscript{75} \textit{Id.} 4482.
tends to enhance liquidity because of the competition it generates between primary and secondary market specialists. In more specific language the study stated:

The only important economic argument advanced against competition in multiply-traded securities is that diversion of trading activity to secondary markets tends to impair the depth of the primary markets. The extent to which depth impairment actually occurs is indeterminable since it is also reasonable to expect — and is widely believed — that multiple trading tends to broaden investor interest in a security.

As to liquidity, the Stanford Study concluded that competition between primary and secondary specialists has served to enhance it. Additionally, the cost of liquidity was found to be reduced by the increases in competition. One third market dealer testified that third market capital tends to complement that of the exchange specialist and thus adds stability and liquidity to the overall market. In addition, the witness offered as evidence the price stability of certain listed utility stocks which are traded in the third market to refute the Exchange's argument that fragmentation leads to greater price swings.

The NYSE has submitted its own study entitled Economic Effects of Negotiated Commission Rates on the Brokerage Industry, the Market for Corporate Securities, and the Investing Public, which it claims supports its argument that multiple trading in listed securities tends to weaken its own market. The study asserts:

Recent research studies confirm the important economies of scale achieved by concentrating transactions in a particular stock on a single exchange. Centralizing orders in a single market reduces bid-offer spreads and increases the ability to handle volume.

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76 Id.
77 Id.
78 Id. 4483. The Stanford Study further points out that when a market is so unbalanced that a primary market specialist must take a substantial position in order to preserve price continuity and orderliness, diversion of orders to regional exchanges can remove some of the pressure on price by supplementing the capital of the primary market specialist with that of the competing regional specialist. If a regional specialist takes a position when blocks are offered in the regional (sic) market, the pressure on the primary market specialist is immediately reduced. Even though the regional specialist may ultimately liquidate his position in the primary market, he will do so at a later date and usually at a limit, and thereby tend to promote liquidity.

79 Hearings 4020.
80 Id. 4015.
82 Hearings 16 (NYSE Exhibit 20).
The Exchange relied heavily on a paper published by Professor Harold Demsetz in making the above assertion. It claims that studies by Demsetz and others confirm that

... fractionalized equity markets produce wider spreads in quotations. These diseconomies of scale or operational inefficiencies are virtually inevitable once a central auction for stocks becomes weakened.

The Exchange study also contends that Professor Demsetz's study fully supports the conclusion that:

A splintering of the NYSE central market would undoubtedly reduce the ability of specialists to handle volume and to minimize short-run price fluctuations, i.e., to provide a continuous, liquid, and deep auction market. The loss of trades on the floor would make for a "thinner" auction market and for wider spreads between bid and asked quotations.

Professor Demsetz, however, has criticized the NYSE study, especially in the use of his paper, contending that the NYSE study, in fact, misinterpreted his conclusions. Indeed, he testified that his study did not suggest or imply that there should, for all time, be one central market for any particular stock. When questioned as to the desirability of having a rule requiring that all transactions be brought to a centralized market, Professor Demsetz replied that he would not favor such a rule but rather felt that the cheapest avenue should be open to firms and investors. While offering the view that at the present time the NYSE was the cheapest place to deal he said so with reservations, noting that "I have no reason to believe that this will always be the case." In his article, Professor Demsetz pointed out the existence of competing markets as one form of competition that would tend to keep the observed spread close to the specialist's cost, an economically desirable objective from the standpoint of investors.

There are two predominant arguments lodged against rule 394:

84 Hearings 24 (NYSE Exhibit 20).
85 Id. 34.
86 Hearings 18 (Demsetz Exhibit 1).
87 Hearings 3817-18.
88 Id. 3857.
89 Id. Professor Demsetz, when asked for his opinion as an economist whether the NYSE should be prohibited from combining in order to offer the services of a centralized market in competition with other people who necessarily would offer a variety of markets, explained that he was not in favor of prohibiting member firms from trading elsewhere if they wish to.
90 Demsetz, supra note 83, at 43.
(1) that the rule causes the member broker-dealer on the Exchange to breach his common-law fiduciary duty to obtain the most favorable execution for his customer,\(^9^1\) and (2) that rule 394 constitutes a group boycott or concerted refusal to deal and as such is violative of federal antitrust law.

Concerning the first argument, authorities, along with opponents and critics of rule 394 have indicated a belief that the operative effect of the rule results in a violation of this common-law duty.\(^9^2\) Although

\(^9^1\) See, e.g., Schlesinger, supra note 8, at 652 n.71 and accompanying text; Jennings, The New York Stock Exchange and the Commission Rate Struggle, 21 Bus. Law. 159, 169, 170 (1965); Loss 5168.


It is significant to note that the Securities Exchange Act of 1934 did not operate to preempt common-law rights, which might have been fully adjudicated and enforced in a state forum prior to the enactment of the Exchange Act. See Beury v. Beury, 127 F. Supp. 786, 790 (S.D. W. Va. 1954); section 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78 aa provides:

The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder. . . .

And section 28(a) of the Act, 15 U.S.C. § 78bb(a) provides that:

The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. . . .

One court has held that section 27 fixes the venue of actions referred to in section 28 in the federal courts. See American Distilling Co. v. Brown, 295 N.Y. 36, 39, 64 N.E.2d 347, 348 (1945). Moreover, it is clear that suits brought to enforce rights and duties created by the Exchange Act are within the exclusive jurisdiction of the federal courts; McCollum v. Billings, 53 Misc. 2d 661, 279 N.Y.S.2d 609 (Sup. Ct. Queens County 1967). The McCollum court rejected the view that the SEA preempts the existing common-law rights, finding "a more likely construction of the statute is that it confers exclusive jurisdiction on federal courts to entertain only those actions which involve some right of recovery which go beyond such common-law rights." Id. at 664-65, 279 N.Y.S.2d at 614. See also Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Vine v. Beneficial Fin. Co., 252 F. Supp. 240 (S.D.N.Y. 1966). Nevertheless the federal courts still have the power to take cognizance of any non-federal claims under the doctrine of pendent jurisdiction.

\(^9^2\) See Hearings 5130-31.
there is same disagreement as to what constitutes the “best execution” it is clear that lower prices are available in the third market. However, it is one thing to allege that the price in the third market is less than on the Exchange and quite another to contend that a rule, as yet quite legal, causes a member to breach his principal-agent relationship with his customer. While the rule may effectively prevent a member from seeking the cheaper price, it has not been adjudicated by any competent tribunal that the rule violates any law. In fact, it could be found to be a necessary part of Exchange regulation. In the event that the rule is struck down by the SEC or through the antitrust machinery of the courts, this fact, that a customer is denied a more competitive price would undoubtedly be of primary concern in reaching such a decision. But, until such an event occurs, the “breach of the fiduciary duty” argument is premature.

Related Issues

Interrelated with the major assault against the continued imposition of rule 394 are several related contentions which merit some observation. It is claimed that the Exchange illegally discriminates against third market dealers in that it permits its own members to go off the Exchange and trade in listed securities on the regional exchanges or where trading is permitted in exempted securities while denying them the opportunity to transact business in the third market. The Exchange’s justification for this discriminatory treatment is less than convincing. Its only explanation reveals that it considers itself powerless to prevent its members who are also members of a regional exchange from trading in that market. Furthermore, if a single member of the Exchange desires to trade on a regional exchange, there is no rule restricting such activity even though this “lack of control” explanation has no application in that case. Additionally, it is maintained that Congress has given the SEC the power to change the rules of National Securities Exchanges where such changes are “deemed necessary and appropriate for the protection of investors or to insure

93 See Hearings 5137. (Testimony on behalf of NYSE by G. Levy — former chairman of the Board). Witness Levy testified that the broker does not have the obligation to seek out the third market because when his client gives him an order, he expects it to be executed on the Exchange. He also claimed that since the existence of the third market is well-known, the client knows that unless in the judgment of a member firm, a proper execution is unobtainable, the transaction will occur on the NYSE. For a detailed discussion of broker-dealer activity under the Exchange Act see Cohen & Rabin, Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in Their Development, 29 Law & Contemp. Probl. 691 (1964).

94 Rule 394 (b) on Probation, Bank Stock Q., Nov. 7, 1968, at 36.

95 Hearings 5058.
fair dealing in securities traded in, upon such exchange or to insure fair administration of such exchange.”

Furthermore, it has been submitted that there exists a clearcut conflict of interest involving member firms on the Exchange. All members of the NYSE are also members of National Association of Securities Dealers (NASD) and as such are presumably bound by its rules and regulations. It is thus postulated that rule 394 prevents members of the Exchange who are also members of NASD from dealing with fellow members of that organization and thereby provides their customers with “the benefit of the diversity and competition which may exist in the inter-dealer market.” A counterpart of this “conflict of interest” argument is the assertion that Exchange members are prima facie violating section 8 of the Clayton Act by maintaining and perpetuating interlocking directorates.

Trouble in Paradise: Rule 394 Under the Antitrust Microscope

Notwithstanding the assumption that the operation of rule 394 does not effect a breach of the broker’s fiduciary duty to his customer, the question still exists as to the very legality of such restriction under the antitrust laws. The essence of this challenge against the rule is that it amounts to a concerted refusal to deal by Exchange members in violation of the Sherman Act. As will be seen, this second charge is well supported by analogous case law and raises a serious question concerning the validity of rule 394.

Probing the Primary Jurisdiction Problem

In concentrating upon the applicability of the antitrust laws to exchange practices and rules, there lurks in the shadows a pro-

97 See Statement of Morris A. Schapiro before the Securities and Exchange Commission at the hearing on November 7, 1968 on the subject of Competition Between the Securities Markets 5 [hereinafter Schapiro].
98 Id.
100 Readers accustomed to observing more traditional forms of micro-organisms will recall that, for best results, it is necessary to keep both eyes open when using this apparatus.
101 The application of the doctrine of primary jurisdiction to antitrust situations has, in general, been subject to staunch criticism. One writer has stated that the doctrine has evolved from a “choice of forum rule to a substantive, judge-made exemption from the competitive dictates of the antitrust laws.” Schwartz, infra note 102, at 446; see also Jaffe, infra note 102, at 508. Professor Schwartz has chastised the judiciary for relinquishing its responsibility to formulate national economic policy by its invocation of the “primary”
cedural device capable of postponing or preventing judicial resolution of the issues. That device is, of course, the doctrine of primary jurisdiction. Legal scholars have substantially differed on the doctrine's utility and its limitations.\textsuperscript{102}

It has been simply explained as a device to determine which forum—agency or court—will make the incipient ruling in the matter.\textsuperscript{103}

One writer's definition is as follows:

Primary jurisdiction is a judgemade doctrine resting upon consideration of effective regulation. It holds that, whenever "cases raising issues of fact not within the conventional experience of judges or cases requiring the exercise of administrative discretion" are presented to the courts, the courts should not adjudicate until issues of fact and discretion have been passed on by the regulatory agency concerned.\textsuperscript{104}

doctrine in the antitrust sector. See id. 473. However, these charges have met with rebuttal from several authorities. See, e.g., 3 Davis, Administrative Law 35-39 (1958) [hereinafter Davis]; see also Stokes, infra note 102. Professor Davis seems to answer Professor Schwartz's complaint of "judicial abdication" by stating that the fault, if any, is to be found with the substantive policy of review and not with the timing of judicial intervention. Davis 37. Alleviating some of this fear are the ameliorating effects of judicial review.

After the administrative determination has been made, and after the regulatory advantages of departing from the principle of competition have been developed, the reviewing court will then be in a position to weigh the pros and cons of the overall problem, and on the question of fundamental policy, to substitute its judgment to whatever extent may seem desirable in the circumstances.

Davis 27.

Perhaps of greater significance is the fact that the scope of judicial review of agency determinations has been severely limited by the Supreme Court. Baxter, supra note 102, at 686. The danger lies in the fact that this has been the court's policy even when the ramifications of such an agency resolution extend considerably beyond the borders of agency responsibility. Id. If the resolution is left to the agency, even initially, it creates the possibility that substantive antitrust policy might be overwhelmed by a narrow attitude towards judicial review.


\textsuperscript{103}Davis 2. Professor Davis emphasizes the point that the doctrine does not concern itself with the question of who will make the final decision. Id.

\textsuperscript{104}von Mehren, supra note 102, at 929, citing Far East Conference v. United States, 342 U.S. 570, 574 (1952). Another writer views the doctrine as requiring "judicial abstention in cases where protection of the integrity of a regulatory scheme dictates preliminary resort to the agency which administers the scheme." Stokes, supra note 102, at 531, citing United States v. Philadelphia Nat'l Bank, 374 U.S. 353 (1962). Still another legal scribe sees the doctrine as merely a device to determine who will have "home court advantage"—the agency or the court. Baxter, supra note 102, at 683.
Another eminent commentator on Administrative Law sees the doctrine as

...an attempt to resolve the procedural and substantive conflicts inevitably created when there is carried out for an agency an area of original jurisdiction which impinges on the congeries of original jurisdictions of the courts.\textsuperscript{105}

Why initial resort to the agency is desirable is best answered by the Supreme Court, which has upheld the "primary" doctrine in the interest of the orderly administration of an agency's regulatory functions.\textsuperscript{106}

Although the Supreme Court has only once addressed the problem of applying the antitrust scheme to Exchange activity,\textsuperscript{107} its treatment or, rather, its non-treatment of the primary jurisdiction issue in Silver casts serious doubts as to its applicability in future adjudications of stock exchange rules and practices. The Silver Court avoided\textsuperscript{108} confrontation with the doctrine on the ground that although the SEC under section 19(b) of the Exchange Act could seek changes in the rules of the New York Stock Exchange, the Act did not grant to the

\textsuperscript{105}Jaffe, \textit{supra} note 102, at 1037. Professor Jaffe has rejected any simplistic approach in explaining the essence of the doctrine. \textit{See id.} He portrays the setting in which the doctrine comes to bear thusly:

Primary jurisdiction situations arise when the original jurisdiction of a court is being invoked to decide the merits of a controversy: the facts, the law, the relief; and it is held that the jurisdiction of the court either to decide one of the relevant issues or to entertain the action at all has been superseded by agency jurisdiction.

\textit{Id.} 1037-38.

One criticism of the expansive application of the doctrine has been the fact that, originally, the doctrine was intended to apply to situations where the agency and court both had concurrent and original jurisdiction. \textit{See} Stokes, \textit{supra} note 102, at 532, who is strongly opposed to any carte blanche application of the doctrine.

\textsuperscript{106}See \textit{Far East Conference v. United States}, 342 U.S. 570, 574-75 (1952) wherein the Court stated:

Uniformity and consistency in the regulation of business entrusted to a particular agency are secured, and the limited functions of review by the judiciary are more rationally exercised, by preliminary resort for ascertaining and interpreting the circumstances underlying legal issues to agencies that are better equipped than courts by specialization, by insight gained through experience and by more flexible procedure.


\textsuperscript{108}The doctrine has also been circumvented when the subject matter of the controversy concerned conspiracy, on the basis that such activity traditionally has been the peculiar problem of the judiciary. von Mehren, \textit{supra} note 102, at 942; \textit{see, e.g.}, \textit{Georgia v. Pennsylvania R.R.}, 324 U.S. 439 (1945). However, the \textit{Georgia} case is considered aberrant by the authorities. von Mehren criticises this reasoning for shunning the doctrine and points out that the majority in the \textit{Far East} case rejected it outright, while the dissent adopted it. Indeed, the court opined that conspiracy was appropriate for agency consideration especially where technical problems are involved and where the kind of competition is a vital concern of the regulatory body involved. \textit{Far East Conference v. United States}, 342 U.S. 570, 578 (1952), \textit{cited in} von Mehren, \textit{supra} note 102, at 942.
Commission any jurisdiction "to review particular instances of enforcement of Exchange rules."[109]

The court's reasoning on this issue has not existed in a criticism-free atmosphere. One authority, terming the court's handling of the primary jurisdiction issue "sophistic," has intimated that the court consciously evaded the doctrine.[110] This "absence of pervasive regulation" consideration[111] which influenced the court's decision is, however, supported by Professor Louis L. Jaffe. Professor Jaffe has noted analogous situations where no pervasive control is exercised and where the judiciary has been granted concurrent jurisdiction over practices within the agency's area of concern.[112] Here "the courts generally have exercised that jurisdiction without prior recourse."[113]

Insofar as the boycotting situation in Silver is concerned, Professor William F. Baxter has argued that the doctrine of primary jurisdiction should have attached, allowing the SEC to resolve the problem under its section 19(b) powers.[114] According to Professor Baxter, the lower court in Silver could have granted a continuance and, following the SEC deliberations, implemented the necessary antitrust sanctions.[115] Furthermore, the same writer charges that in refusing to so act, the lower court was usurping a congressional grant of power, by its actions which closely resembled the SEC functioning under its section 19(b) powers, enabling the Commission to alter or add to Exchange rules.[116]

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[109] 373 U.S. at 357. Justice Goldberg further stated that this lack of specific oversight by the Exchange avoided any issue as to "conflict or coextensiveness of coverage with the agency's regulatory power." Id. at 358; see also id. n.12. This reasoning of the court is, however, at odds with the interpretations of several authorities on the subject of primary jurisdiction. For instance, Professor Davis has stated that

Because of the purpose of the doctrine—to assure that the agency will not be by-passed on what is especially committed to it—and because resort to the courts is still open after the agency has acted, the doctrine applies even if the agency has no jurisdiction to grant the relief sought.

Davis 39.

Another writer contends that the agency's lack of jurisdiction is irrelevant:

The critical question should be the nature of the inquiry, for the doctrine rests on the premise that, if administrative questions and technical matters are presented for determination, the agency must act before the court can adjudicate.

von Mehren, supra note 102, at 945.

But see Schwartz, Primary Administrative Jurisdiction and the Exhaustion of Litigants, 41 Geo. L.J. 495, 502 (1953), wherein the author states that if the agency is without the power to grant the sought after relief, initial resort to the administrative body is a fruitless endeavor and "a dichotomization of justice, which results only in needless duplication of effort on plaintiff's part . . . ." cited in Davis 37 n.48.

[110] Baxter, supra note 102, at 687; see id. at 697-88 for complete analysis of this criticism.


[112] Jaffe, supra note 102, at 1041.

[113] Id.

[114] Baxter, supra note 102, at 687.

[115] Id.

[116] Id. at 688.
Potentially, section 19(b) is broad enough in its language to permit a pliant antitrust approach in dealing with Exchange rules.

In addition, there are precedential SEC decisions which have explicitly referred to antitrust principles in their determinations. Indeed, there is a general body of case law fully supporting agency determinations moulded against the background of antitrust considerations. However, in light of the passivity displayed by the Commission in utilizing its section 19(b) powers, such an aggressive undertaking seems unlikely.

117 15 U.S.C. § 78s (1964). Under section 19(b) the Commission is empowered to request changes in exchange rules and, if these requests go unheeded, it may alter or supplement the same. General criteria of fair dealing and investor protection serve to guide the SEC in its decisions to change a rule. Despite the fact that the Commissioner’s rule changing power is limited to 13 areas of concern, and, that none of these categories refer explicitly to anticompetitive practices, the last category, entitled “similar matters,” is appropriately broad to permit such a consideration. However, the SEC has been reluctant to utilize this section.

A novel approach has been offered by one writer who suggests that the SEC exercise its own rule making powers under section 10 and 11 of the Exchange Act. Under section 11 the Commission, while avoiding completely the mechanisms of self-regulation, can enact its own rules directly affecting the exchanges and their members with respect to off-floor trading by members. However, the SEC has not seen fit to follow this suggestion regarding rule 394. It has continued to allow the Exchange to dictate what form and shape its members’ activity with non-members is going to take. See Jennings, Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission, 29 LAW & CONTEMP. PROB. 663 (1964).


119 See In re Nat’l Ass’n of Securities Dealers, 19 S.E.C. 424, 486-87 (1945); In re Rules of NYSE, 10 S.E.C. 270 (1941).

120 Despite the possible application of the doctrine of primary jurisdiction to a particular Exchange activity, the agency is not precluded from considering antitrust principles in its decision making process. See McLean Trucking Co. v. United States, 921 U.S. 67, 80 (1949) wherein the court recognized that agencies may be obliged to consider other legislative schemes when particular issues come before its tribunal which present “overlapping and at times inconsistent policies embodied in other legislation enacted at different times and with different problems in view.” The court in Hale v. FCC, 425 F.2d 556 (D.C. Cir. 1970), has recently spoken on this subject, adopting a concurring opinion from one of its earlier decisions:

The decisions of the Supreme Court and this court over a period of at least 25 years have evolved and defined a substantial jurisprudence making clear that the administration of federal regulatory statutes calling for determinations of the public interest establish the authority, and in some instances the duty, of the cognizant agency to take into account what has been aptly called the nation’s “fundamental national economic policy,” namely the principles of the antitrust laws. . . . It is fair synthesis of the cases that a statute providing for licensing or other regulation is presumed to permit consideration of antitrust principles, with the harmonizing approach [applied to conflicts between antitrust policies and the agency’s other regulatory objectives] . . . unless a contrary intent appears expressly or by necessary implication.

Id. at 561.

121 Only once has the Commission asserted its power under 19(b) to strike down a particular Exchange rule. See In re Rules of the New York Stock Exchange, 10 S.E.C. 270 (1941).
The most recent decision regarding Exchange rules and the antitrust laws has again side stepped the primary jurisdiction issue. However, the concurring opinion in that case, in which Chief Judge Swygert advocated the invocation of the doctrine, has been adopted by that same Seventh Circuit in a recent case concerning the commodity exchanges and the antitrust laws. Whether this decision represents a change in judicial attitudes towards anti-competitive practices in the securities industry as well, remains to be seen. Of course, only the Supreme Court can definitively answer this question.

It is submitted, that if the SEC demonstrates a willingness to constructively contribute to the resolution of anticompetitive practices, then, the doctrine of primary jurisdiction should attach thus allowing the specialized knowledge of the agency its due weight. However, such an abrupt change in policy seems unlikely in the near future.

Perhaps the problem is more deeply rooted than is apparent. In resolving this issue the following questions, among others, might be considered on remand: (1) whether and to what extent the SEC is empowered to consider antitrust laws and policy in fulfilling its duty of review of exchange self-regulations; (2) whether an aggrieved party may initiate SEC review of Exchange rules under the provisions of the Securities Exchange Act or the Administrative Procedure Act; (3) whether and to what extent SEC expertise would be useful in resolving in the first instance, the question of whether a given rule is necessary to make the Securities Act work; and (4) whether the anticompetitive aims of the Sherman Act can be achieved without subjecting the exchanges to treble damage suits which necessarily result if the doctrine of primary jurisdiction is unavailable to the defendant in this case.

122 Thill Sec. Corp. v. NYSE, 433 F.2d 264 (7th Cir. 1970).
123 Judge Swygert envisioned the issue in Thill as being intimately bound up in considerations of the primary jurisdiction doctrine. Specifically he sought to determine whether the doctrine dictated prior resort to the SEC in adjudications regarding Exchange rules. To aid in this determination, Judge Swygert offered this list of factors to be considered:

[In resolving this issue the following questions, among others, might be considered on remand: (1) whether and to what extent the SEC is empowered to consider antitrust laws and policy in fulfilling its duty of review of exchange self-regulations; (2) whether an aggrieved party may initiate SEC review of exchange rules under the provisions of the Securities Exchange Act or the Administrative Procedure Act; (3) whether and to what extent SEC expertise would be useful in resolving in the first instance, the question of whether a given rule is necessary to make the Securities Act work; and (4) whether the anticompetitive aims of the Sherman Act can be achieved without subjecting the exchanges to treble damage suits which necessarily result if the doctrine of primary jurisdiction is unavailable to the defendant in this case.

433 F.2d 277.
125 Perhaps the seed of change has already been sown. See SEC Securities Exchange Act Release No. 8299 (Jan. 26, 1968) expressing a view that the Commission shall consider more closely antitrust laws in its decisions.
126 Professor Jaffe has enumerated the various alternatives a court confronted, for instance, with an Exchange rule adjudication can choose in reaching its decision:

If an agency has not been given power expressly to immunize from the antitrust laws but merely to approve a transaction within the purpose of the statute committed to its administration, the court may reach any of several conclusions: that the antitrust law has been so far superseded that sanctions, if any, are to come from the agency, or that there is a cause of action as to certain sanctions and not as to others, or that unless the agency approves the transaction, the antitrust laws are in force or, finally, that the agency's jurisdiction does not at all displace the court's jurisdiction under the antitrust laws (though the agency's views might be entitled to respect insofar as relevant).

Jaffe, supra note 102, at 1083-9.
127 For an adverse criticism of agency expertise see Schwartz, supra note 102, at 471-75. For an opposite view see Stokes, supra note 102, at 538.
128 Professor Schwartz has criticized agencies, especially the personnel, for being content with "small victories over those whom they regulate," while avoiding or post-
Possibly, a reappraisal of the concept of self-regulation is needed.

**Antitrust “Immunity” in Perspective: Silver v. NYSE**

The application of the federal antitrust laws to the New York Stock Exchange can be successful only if, in fact, the Exchange is subject to that statutory scheme, i.e., it is not exempted from the operation of those laws. At common law, the securities and commodities exchanges together enjoyed freedom from antitrust impingement and were free to enforce their rules “and to take aggressive steps to hamper non-members.” As long as the exchanges were reasonable in their actions, they

poning the more substantial issues. Schwartz, supra note 102, at 474. In some respects self-regulation breeds this kind of attitude. The Commission relies heavily upon the self-implementation of various measures by the Exchange itself. Indeed, the Exchange adopts proposals for the Commission's approval. This failure by the agency to confront the problems directly, inherent in self-regulation, may tend to cause a perpetual ping-pong postponement of many consequential issues facing the industry.

129 See Hearings on Stock Exchange Practices Before the Senate Comm. on Banking and Currency, 73d Cong., 1st & 2d Sess. (1933-34); S. REP. No. 792, 73d Cong., 2d Sess. (1934); H.R. REP. No. 1838, 73d Cong., 2d Sess. (1934); S. Doc. No. 185, 73d Cong. 2d Sess. (1934); H.R. REP. No. 1838, 73d Cong., 2d Sess. (1934), cited in Baxter, supra note 102, at 685. Based on the legislative history of the Exchange Act, there was a definite lack of interest by Congress in the problems concerning the competitive structure of the securities industry. Emphasis was rather placed on the eradication of deceptive and manipulative practices. Id.

130 See, e.g., von Mehren, supra note 102, at 954; Schwartz, supra note 102, at 475; Jaffe, supra note 102, at 1041; Stokes, supra note 102, at 532; see also Jennings, Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission, 29 LAW & CONTEMP. PROB. 653 (1964); Cary, Administrative Agencies and the Securities and Exchange Commission, 29 LAW & CONTEMP. PROB. 653 (1964).

131 See generally Antitrust Exemptions, 33 ANTRUST L.J. (1967) for a collection of articles concerning the different areas of American industry that have been exempted from the antitrust laws, including: Agricultural Cooperatives, Fisheries, Government Contracts, Insurance, Labor, The Learned Professions, Ocean Shipping, Patent and Copyrights, Professional Sports, Resale Price Maintenance, Small Business, State Approved Transactions and Securities and Commodities Exchanges; see C. KAYSEN & D. TURNER, ANTRUST POLICY: AN ECONOMIC AND LEGAL ANALYSIS 41 (1959) [hereinafter KAYSEN & TURNER], wherein the authors comment on the exempted portion of American industry and state that the standards imposed by the regulators are less rigorous than those in the antitrust laws "so that the exemptions, combined with the operations of the regulatory agencies, give market behavior in these industries a monopoly character of varying degrees and form." For further analysis of the applicability of antitrust to the regulated sector and a discussion of the exemption problem, see Johnson, The Application of the Antitrust Laws to the Securities Industry, 20 SW. L.J. 536, 546-54 (1966); see also Hale & Hale, Competition or Control VI: Application of Antitrust Laws to Regulated Industries, 111 U. PA. L. REV. 46 (1962). The authors suggest a "mushroom theory" of economics whereby "interventionists" (the SEC for example) are said to have the tendency to naturally expand their coverage over practices in the industry they regulate to such a degree that eventually there is no room (nor a need) left for the courts to apply antitrust doctrines. Asch, The Antitrust Laws and the Regulated Securities Markets, 11 ANTTRUST BULL. 209 (1966); see Bloom, Securities and Commodities Exchanges, 33 A.B.A. ANTTRUST L.J. 88 (1967); see also Anderson v. United States, 171 U.S. 604 (1898) (holding that a live stock exchange could restrict its members from dealing with non-members).

Before the Securities Exchange Act of 1934 exchanges were deemed to have the
“appeared to be beneficiaries of some sort of antitrust exemption”, provided by the courts. And then along came Silver.133

inherent power to enact rules and by-laws. See Cohen v. Thomas, 209 N.Y. 407, 103 N.E. 708 (1915); Members, however, were bound only by rules that were valid. If a rule contravened either the law or public policy, it was held to be invalid. See In re Haebler v. New York Produce Exch., 149 N.Y. 414, 44 N.E. 87 (1890); Of course, these early cases were decided in a setting which still considered Exchanges “private clubs” (see Belton v. Hatch, 109 N.Y. 593, 17 N.E. 225 (1888)), rather than public institutions, a view more prevalent today. But see Annot., 54 A.L.R. 304 (1928), for a collection of cases standing for the proposition that exchanges and boards of trade are affected with a “public interest.”

Courts were even more liberal with unincorporated exchanges than with those that were chartered by the state, on the theory that a chartered organization could not exceed its grant of corporate power. See Parish v. New York Produce Exch., 169 N.Y. 34, 61 N.E. 977 (1901). If a particular by-law were unreasonable in light of the purposes of the exchange’s activity, it was held to be unauthorized. It is evident then that even in the era of the “private clubs,” there existed a legal limitation on the rules promulgated by the exchanges in that rules contrary to laws of the land were held ineffectual and invalid. See White v. Brownell, 2 Daly 329 (1868). However, one blatant shortcoming of the judicial treatment of this period before the Exchange Act was the courts’ “hands-off” policy concerning the enforcement of the Exchanges rules. The courts generally left the enforcement of rules up to the Exchanges themselves. See Cohen v. Thomas, 209 N.Y. 407, 103 N.E. 708 (1913).

132 Bloom, supra note 131, at 90.
133 Silver v. NYSE, 379 U.S. 341 (1963); see, e.g., United States v. New York Coffee & Sugar Exch., 263 U.S. 611 (1924); Moore v. New York Cotton Exch., 270 U.S. 593 (1926); United States v. New England Fish Exch., 258 F. 733 (D. Mass. 1919); Winn Avenue Warehouse v. Winchester Tobacco Warehouse, 341 F.2d 287 (6th Cir. 1965); but see United States v. Tarpon Springs Sponge Exch., 142 F.2d 125 (5th Cir. 1944). In that case the Exchange was indicted for violating the Sherman Act for conspiring and concertedly acting to compel fisheries to sell natural sponges only through the Exchange and for refusing to allow persons purchasing sponges outside of the Exchange the use of its facilities. Although the case concerned itself primarily with a deficiency in plaintiff’s pleadings, the court found that the substance of an antitrust claim was present. The court stated:

It appears that . . . the defendants have conspired unlawfully to . . . control . . . that supply, and by means of their exchange to control the sale of sponges and exclude competitors. . . . [To determine the illegality of the exchange] [m]uch depends upon the purpose with which the exchange is operated and the intended results to interstate commerce.

Id. at 127-28.

In Silver the NYSE directed a certain number of its members to curtail wire services they had been providing to non-member over-the-counter securities dealers without giving the non-members any reason for the discontinuance, nor affording them notice or the opportunity to be heard. The Exchange had ordered the stoppage pursuant to its own rules, promulgated under the power of the Securities and Exchange Act of 1934 (rule 355 of NYSE). Petitioners alleged that the Exchange had conspired to deprive them of their private wire services, in violation of sections 1 & 2 of the Sherman Act. The Supreme Court reversed the court of appeals’ decision which had found, in reversing the district court case, that the Exchange was exempt from the antitrust laws. Initially the Court noted that absent any federal legislation this action by the Exchange would have amounted to a per se violation of section 1 of the Sherman Act, a clear case of a group boycott, depriving petitioners to their economic disadvantage. The Court also recognized that traditionally such concerted refusals had long been held violative of antitrust law. 373 U.S. at 347. See also American Federation of Tobacco Growers Inc. v. Neal, 183 F.2d 869 (4th Cir. 1950). The defendant in that case was an unincorporated tobacco association operating as a board of trade and controlling the selling of tobacco on the Danville market, one of the largest tobacco markets in the tobacco belt, and also controlling the individual warehousemen who were members of the organization. The tobacco produce
A careful examination of this decision is mandatory since future litigation, possibly involving NYSE rule 394, will likely be premised upon the guidelines espoused in this case, to date, the Supreme Court's only definitive statement encompassing antitrust concepts within the framework of the securities industry.

Essentially the Silver court determined that Stock Exchanges do not enjoy absolute immunity from antitrust attack. Moreover, that broad freedom can only be supported by a showing that such action is necessary to make the Exchange Act work "and then only to the minimum extent necessary." The Court elected a reconciliatory approach in an attempt to inject a degree of harmony between the two apparently conflicting statutory schemes. The difficulty, the Court noted, lies in the promotion of a realization of the aims of each regimen — antitrust law promoting free competition while the Exchange Act contemplating self-government by the Exchanges.
Mr. Justice Goldberg explained that the SEC was not given the power to curb specific instances of abuse but in the alternative the exchanges were under a duty to register with the Commission and such registration could be refused unless the exchanges' rules were "just and adequate to ensure fair dealing and to protect investors."  

Since the SEC lacked jurisdiction over specific applications of Exchange rules, "the question of antitrust exemption does not involve any problem of conflict or coextensiveness of coverage with the agency's regulatory power." In addition there is no explicit exemption from the antitrust application in the Securities and Exchange Act and as a basic rule of construction such repeals by implication are not favored. The court fortified the result it reached by noting the impotency of the exchange's regulatory scheme especially the absence of any provisions capable of fostering traditional antitrust goals. However, the Silver court left unresolved the question of the quantum of substantive justification necessary in an antitrust suit when and if such a confrontation arises.

Although the Silver decision has been interpreted as merely requiring procedural safeguards, it nevertheless represents the rejection by the Supreme Court of the idea that exchanges enjoy immunity from antitrust liability and provides a basis for resolving other anticompetitive charges lodged against the exchanges. The United States Department of Justice has interpreted Silver as clarifying the fact that:

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of the Kaplan holding is questionable since the SEC lacks review power for specific enforcement for exchange rules. See criticism to this effect in Thill Sec. Corp. v. NYSE, 433 F.2d 26 (7th Cir. 1970).

138 373 U.S. at 352.

137 Id. at 358. Realizing that in a given circumstance the enforcement of exchange rules may very well competitively injure a non-member and that such imposition may well be outside the goals of the Exchange Act, the Court carefully advised that:

"Enforcement of exchange rules, particularly those of the New York Stock Exchange with its immense economic power, may well, in given cases, result in competitive injury to an issuer, a non-member broker-dealer, or another when the imposition of such injury is not within the scope of the great purposes of the Securities Exchange Act. Such unjustified self-regulatory activity can only diminish public respect for and confidence in the integrity and efficacy of the exchange mechanism. Some form of review of exchange self-policing whether by administrative agency or by the courts, is therefore not at all incompatible with the fulfillment of the aims of the Securities Exchange Act."

Id. at 358.

Furthermore, the Court reasoned, the antitrust laws should serve to fill a serious and wholly unwarranted void in the securities industry:

"Since the antitrust laws serve, among other things, to protect competitive freedom, i.e., the freedom of individual business units to compete unhindered by the group action of others, it follows that the antitrust laws are peculiarly appropriate as a check upon anti-competitive acts of exchanges which conflict
There is a fundamental antitrust interest in assuring broker-dealers equitable and nondiscriminatory access to the "important business advantages" which flow from access to NYSE as the Nation's dominant securities market. Under the Silver case and other well-established antitrust principles, such access can be denied only on the ground that the restriction is necessary to make the Exchange Act work.\footnote{Richard W. McClaren, Assistant Attorney General, Antitrust Division, has stated that members of stock exchanges are liable under the antitrust laws for anticompetitive activity in which they engage unless it can be demonstrated that those practices are \textit{legitimate} aims of the Securities Exchange Act.\footnote{The question is whether these practices are necessary — and I stress the word "necessary" — to achieve a legitimate goal of Exchange Act. If they are necessary, then they are legal. If they are not necessary, then they are subject to the Sherman Act, just like any other agreement in restraint of trade. The question of necessity is a matter of evidence — not emotion.\footnote{In \textit{United States v. Third National Bank in Nashville}, the Court explained that exemption from antitrust must be based on genuine necessity rather than mere convenience and that the statutory scheme of the Exchange Act which places public responsibilities on the Exchanges, "cannot be satisfied by any particular measure placing more than the minimum necessary restriction on competition for 'otherwise, the benefits of competition, acknowledged by Congress, would be sacrificed needlessly.'"\footnote{The NYSE position on the matter of immunity conflicts greatly with their duty to keep their operations and those of their members honest and viable.\textit{Id.} at 359.}}}}

Richard W. McClaren, Assistant Attorney General, Antitrust Division, has stated that members of stock exchanges are liable under the antitrust laws for anticompetitive activity in which they engage unless it can be demonstrated that those practices are \textit{legitimate} aims of the Securities Exchange Act.\footnote{Richard W. McClaren, Assistant Attorney General, Antitrust Division, \textit{Antitrust and the Securities Industry: An Address} by Richard W. McClaren, Assistant Attorney General, Antitrust Division, Before the Investment Banker's Association of America, Oct. 29, 1969, \textit{reprinted in} BNA, 23 SEC. REG. L. REP. X-4 (Nov. 5, 1969).}

The question is whether these practices are necessary — and I stress the word "necessary" — to achieve a legitimate goal of Exchange Act. If they are necessary, then they are legal. If they are not necessary, then they are subject to the Sherman Act, just like any other agreement in restraint of trade. The question of necessity is a matter of evidence — not emotion.\footnote{Id.}

In \textit{United States v. Third National Bank in Nashville},\footnote{390 U.S. 171 (1968).} the Court explained that exemption from antitrust must be based on genuine necessity rather than mere convenience and that the statutory scheme of the Exchange Act which places public responsibilities on the Exchanges, "cannot be satisfied by any particular measure placing more than the minimum necessary restriction on competition for 'otherwise, the benefits of competition, acknowledged by Congress, would be sacrificed needlessly.'"\footnote{Id. at 359.}

The NYSE position on the matter of immunity conflicts greatly with their duty to keep their operations and those of their members honest and viable.\footnote{Id. at 359.}
with the Justice Department’s and, in view of several decisions by the Supreme Court, seems fallacious.\footnote{See Letter from Milbank, Tweed, Hadley & McCloy to the New York Stock Exchange dated Sept. 8, 1969, cited in Justice Department’s Comments, \textit{supra} note 140, at X-39.} By its reasoning the Exchange would hold all rules which are within the scope of the Exchange’s obligation to self-regulate exempt from the antitrust laws as long as these rules are subject to review under the powers granted to the SEC under section 19(b) of the 1934 Act. In the Exchange’s view, then,

the Commission would have \textit{exclusive} jurisdiction over any anticompetitive act arguably falling within Section 19(b); and it would have this jurisdiction regardless of whether it had affirmatively acted with respect to a particular matter.\footnote{Justice Department’s Comments, \textit{supra} note 140, at X-39.}

Such an interpretation is clearly contrary to the basic rule that repeals of the antitrust laws by implication are not favored. It also conflicts with the ordinary way the antitrust laws are applied to regulated industries.\footnote{Id.; see 49 U.S.C. § 5 (11), 5(b) (1964) (Railroads and Trucks); 49 U.S.C. §§ 813a, 814 (1964) (Shipping); 49 U.S.C. § 1384 (1964) (Airlines), cited \textit{id}.} Insofar as supervision is concerned, the Commission, under its section 19(b) responsibilities, lacks the inclusiveness illustrated by the regulatory agencies in the transportation and utilities industries. It is only in these business sectors that any blanket exemptions from the antitrust laws has been permitted.\footnote{United States v. Radio Corp. of America, 358 U.S. 334, 348 (1959), cited in Justice Department’s Comments, \textit{supra} note 140, at X-39.} Antitrust immunity in these cases is justified on the grounds that activities which receive the approval of a regulatory agency must of necessity be free from the infringing quality of the antitrust laws, lest, “sporadic action by federal courts . . . disrupt an agency’s delicate regulatory scheme, and . . . throw existing rate structures out of balance.”\footnote{Justice Department’s Comments, \textit{supra} note 140, at X-39.} The Justice Department thus favors the position that every restrictive practice by the Exchange must be demonstrated to be essential to make the Exchange Act work and that it is not enough to justify these restrictions solely on the basis that they fall under the umbrella of the reviewing power of the SEC.\footnote{See KAYSEN \& TURNER 189. The authors demonstrate three situations that may make departure from antitrust policy appropriate. None of the situations seem to represent a legitimate justification for exempting the Exchange from antitrust scrutiny.} It must also be noted that, viewed from the standpoint of the usual economic criteria proffered to sanctify such an exemption, there exists little justification for exempting the securities industry.\footnote{Id.}
Rule 394 and The Sherman Antitrust Act: Concerted Refusals to Deal\textsuperscript{152}

One subtle danger inherent in concerted refusals to deal is illustrated by an argument which has been passed over with little recognition. Its applicability to the New York Stock Exchange is striking. The argument proceeds along these lines: as a private governmental body, the Exchange, or any other collective group, has the ability to institute its own standards of conduct and correspondingly wields this power to sanction violations thereof to such an extent that the power approaches that of a sovereign and is thus inappropriately in the hands of a private organization.\textsuperscript{153}

The mere exercise of sovereign-like power, however, is not sufficient to indict such activity. It must also be evident that the combination in question maintains an overwhelming position in the market in which it carries on its business to make this "private government" argument more palatable.\textsuperscript{154}

Added to the fears generated by the presence of misplaced sovereign power is the potentiality that private self-governing bodies, absent effective monitoring by some government body, may tend to act capriciously or overzealously even in the name of the public interest.\textsuperscript{155} The Exchange, favored with a quasi-governmental status, has...
been granted the authority by Congress to formulate reasonable standards of conduct. However, the critics contend, there are, of necessity, limitations upon such powers, beyond which any private governmental body begins encroaching upon the sovereign. At this point, however, the argument becomes conceptually imprecise—for it is not readily determinable at what point the proper authority has been exceeded.

At the outset, a distinction must be made between the usual commercial boycott and a non-commercial concerted refusal to deal inasmuch as antitrust approaches differ accordingly. The typical group boycott situation usually has as its primary purpose some form of coercion or exclusion. "The distinguishing feature in group boycott cases is group action to coerce third parties to conform to the pattern of conduct desired by the group or to secure their removal from competition." To date, the leading case concerning commercial boycotts is *Klors' Inc. v. Broadway-Hale Stores Inc.* In that case plaintiff and

(b) Prevention of arguably unfair or unlawful competitive practices.
(c) Advancement of public policy goals unrelated to the group's immediate material advantage.

Whereas a commercial boycott has the sole underlying motivation of profit, a non-commercial boycott not being primarily concerned with profit per se can be and is most often motivated by economic factors such as the group's economic self interest. *Id.* at 249.

Barber, *Refusals to Deal Under the Federal Antitrust Laws*, 103 U. PA. L. REV. 847, 875 (1955). See, e.g., *White Motor Co. v. United States*, 372 U.S. 253 (1963); *Times-Picayune Publishing Co. v. United States*, 345 U.S. 594 (1953); *Stewart Co. v. Joseph E. Seagram & Sons*, 340 U.S. 211 (1951); *Fashion Originators Guild of America v. FTC*, 312 U.S. 457 (1941); *Binderup v. Pathe Exch., Inc.*, 263 U.S. 291 (1923); *Standard Sanitary Mfg. Co. v. United States*, 226 U.S. 20 (1912); *Loewe v. Lawlor*, 208 U.S. 274 (1908); *Montague & Co. v. Lowry*, 193 U.S. 38 (1904). A leading case in this area is *Eastern States Retail Lumber Dealers Ass'n v. United States*, 234 U.S. 600 (1914), which was an action under the Sherman Act against certain alleged combinations of retail lumber dealers who conspired as an association to prevent wholesalers from selling directly to consumers. The association issued reports which required all its retail dealers to apprise the organization of any wholesaler who sold to consumers. The "guilty wholesaler" was then in effect blacklisted. The keeping of these lists although the retailers had no express agreement to do so, resulted in the banning of those wholesalers from trading with the association. The court held that such activity by these dealers was directly and unreasonably in restraint of trade in prohibition of the Sherman Act. The Court in an admonishing tone stated:

When the retailer goes beyond his personal right, and, conspiring and combining with others of like purpose, seeks to obstruct the free course of interstate trade and commerce and to unduly suppress competition by placing obnoxious ... influence of a condematory report circulated among others, ... he exceeds his lawful rights, and such action brings him and those acting with him within the condemnation of the act of Congress. ...

*Id.* at 614.

*Id.* 359 U.S. 207 (1959); accord, *Radiant Burners Inc. v. Peoples Gas Light & Coke Co.*, 364 U.S. 696 (1961). There a manufacturer of gas burners brought an action claiming that a gas association conspired to restrain interstate commerce in the manufacture and sale and use of gas burners in violation of section 1 of the Sherman Act. The association included members who were in competition with petitioner. The association it was alleged, could approve or disapprove new burners and that the criteria it used to judge
defendant had competing stores dealing in radios, televisions and other appliances. Klor claimed that the defendant and ten other manufacturers had conspired to restrain and monopolize commerce in violation of sections 1 and 2 of the Sherman Act. The plaintiff alleged that it was equally capable of handling the appliances distributed by the defendant manufacturers and was likewise as able as the defendant to offer them for sale. Despite this fact the defendant in conjunction with the distributors and manufacturers of the appliances conspired not to sell to the plaintiff or to do so in a discriminatory fashion. The plaintiff also contended that as a result of this refusal to deal it had suffered great losses of profits, good will and reputation and that its ability to compete had been severely handicapped. The Supreme Court, reversing the court of appeals, held that the group boycott was one belonging to a group of restraints which by their very nature were unduly restrictive and thus was illegal per se.

Adversaries of Rule 394 have placed considerable reliance on Klor in contending that the Rule amounts to an illegal group boycott. However, it is quite evident from the teachings of Silver that a per se approach to exchange rules would only be possible absent the existing federal regulation in the securities industry and that a better approach is one approximating "a rule of reason" test although the Court left unanswered exactly what standards would be determinative in such a test.

However, where coercion or exclusion are not primary goals of the concerted action, but rather the economic advancement of the combination is, the effects on third parties are indirect. One writer has adduced that:

a new product were arbitrary rather than objective and thus illegally precluded petitioner from offering his product for sale. Finding for the petitioner, the Court noted that the tests lacked the necessary objectivity because such testing could be influenced by those who are in competition with the petitioner. The denial of approval resulted in petitioner's product being eliminated from the market. This prevented the burner from being purchased even though it was safer and more efficient than those already approved by the association. See Crane Distrib. Co. v. Glenmore Distilleries, 267 F.2d 343 (6th Cir. 1959); Sunkist Growers Inc. v. Winckler & Smith Citrus Prods. Co., 284 F.2d 1 (9th Cir. 1960); Granader v. Public Bank, 281 F. Supp. 120 (E.D. Mich. S.D. 1967); Wholesale Auto Supply Co. v. Hickok Mfg. Co., 221 F. Supp. 935 (D.N.J. 1963).

However, there are certain agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use.

See Northern Pac. R. Co. v. United States, 356 U.S. 1, 5 (1958), wherein the Court stated:

However, there are certain agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use.

373 U.S. at 347.

Id. at 866.
The issue in these cases is not the existence or non-existence of a concerted refusal to deal, but rather whether the purpose and effect of the operation of the contract, association, exchange or joint sales agency was such as unreasonably to exclude outsiders from participation in the trade in question.163

The courts have appreciated the fact that in this area parties may legally accept limitations on their individual freedom to deal with others outside the group164 for the real goals of such concerted action is to better the business position of the group and not to hinder outsiders directly. However this very foreclosure of a portion of the market renders such agreements suspect under the antitrust laws. Consider *Associated Press v. United States.*165 This case concerned a claim that the By Laws of the Associated Press news gathering association, which prevented members of the Association from selling news to non-members, by definition a concerted refusal to deal, were in violation of the Sherman Act. As are New York Stock Exchange members, the A.P. members were bound by the Association's rules under penalty of suspension or expulsion for their violation. All members under the By Laws could not sell news to any agency or publisher except to Associated Press.166 Justice Black noted that the result of these By Laws was to effectively prevent non-members from gaining the opportunity to purchase news from Associated Press or its publisher-members. Therefore, membership in the Association was necessary to obtain news or to buy it from its members.167 The Supreme Court affirmed the lower court's finding that the By Laws were illegal as contracts in restraints of trade, and that they had seriously hindered competition by preventing the growth of competing newspapers in the newspaper publication sector.168 The *majority* emphasized the dominant position of Associated Press in the industry and the effect that the By Laws had on limiting

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163 Barber, *supra* note 152, at 877.
164 Id. at 876-77; *see* Appalachian Coals, Inc. v. United States, 288 U.S. 344 (1933); Moore v. New York Cotton Exch., 270 U.S. 593 (1926); Board of Trade v. United States, 246 U.S. 231 (1918).
166 326 U.S. at 9.
167 Id. at 11.
168 Id. at 11-12.
competition by non-members. Justice Black in reaching this decision relied in part on Paramount Famous Lasky Corp. v. United States\textsuperscript{166} and cited with approval the following passage:

Trade restraints of this character aimed at the destruction of competition tend to block the initiative which brings newcomers into a field of business and to frustrate the free enterprise system, which it was the purpose of the Sherman Act to protect.\textsuperscript{170}

"Such hampering of business rivals" the court related, "can only be attributed to that which really makes it possible — the collective power of an unlawful combination."\textsuperscript{171} Nor did the Court accept any offer of good motive as a justification for such a combination.\textsuperscript{172} It has been asserted that as a lawful monopolist, the Exchange, is subject to the antitrust limitation that those who control a central resource as did Associated Press, in an industry, the essential resource in the case of the Stock Exchange being its control over trading facilities in stocks, must grant access to this resource and make it available on a non-discriminatory basis to all those in the trade.\textsuperscript{173} The underlying rational for this principle is to prevent those holding this unique monopoly position from using the lawful monopoly to destroy competition in related activities which desirably should remain competitive.\textsuperscript{174} The Justice Department views Associated Press as a clear precedent for the attack on Rule 394:

If the requirement of non-discriminatory access applies to a private organization such as Associated Press, it applies even more forcefully to an institution specifically charged by Congress with an obligation to serve the public interest. The private club approach to Exchange membership, where the interests of only existing members are taken into account in formulating Exchange policy, was banned by the Securities Exchange Act of 1934. In reporting the bill which became the Securities Exchange Act, the House Committee on Interstate and Foreign Commerce had this to say on national stock exchanges' obligations to the public interest:

The bill proceeds on the theory that the exchanges are public institutions which the public is invited to use for the purchase and sale of securities listed thereon, and are not private clubs to be conducted only in accordance with the interests of their members. The great exchanges of this

\textsuperscript{166} 282 U.S. 30, 42 (1930).
\textsuperscript{170} 326 U.S. 1, 13-14 (1945) (footnote omitted).
\textsuperscript{171} Id. at 15.
\textsuperscript{172} Id. at 16 n.15.
\textsuperscript{173} Justice Department Comments, supra note 140, at X-39.
\textsuperscript{174} Id.
country upon which millions of dollars of securities are sold are affected with a public interest in the same degree as any other great utility.

The present NYSE members should not be permitted to use restrictive membership policies to deny their competitors access to this vital facility (the Exchange floor) or to those other benefits they enjoy themselves. The Exchange should therefore give careful consideration to the artificial numerical limitation on membership as well as all other specific membership restrictions and require elimination of those not demanded or required for the survival of the Exchange market, or the regulatory scheme established under the Securities Exchange Act.\footnote{175}{Id. at X-40; see United States v. Terminal R.R. Ass'n., 224 U.S. 383 (1912).} \footnote{176}{282 U.S. 30 (1930).} \footnote{177}{Id. at 44.} \footnote{178}{Id.} \footnote{179}{326 U.S. at 17.}

It takes little imagination to see the remarkable similarities in Associated and the situation involving rule 394. The third market dealers closely resemble the non-members in Associated who were denied access to the news. The market-makers are denied access to the Exchange. While it could be contended that whereas in Associated the non-members were almost totally unable to compete with the association unless they could obtain the news from that organization, and that such is not the case in respect to rule 394 since they are able to compete effectively, this lack of total inhibition of competition is not fatal to an antitrust claim. \footnote{177}{Paramount Famous Lasky Corp. v. United States,\footnote{178}{326 U.S. at 17.} makes clear the fact that it is not germane to an antitrust claim that the victim be able to show that the suspected illegal combination destroys all competition between the parties.\footnote{179}{"Rather the interest in the public in the preservation of competition is the primary consideration." Justice Black in Associated also made a similar comment saying that "merely because restraint doesn't inhibit all objects of the trade, does not save it from condemnation."} Indeed the situation could grow worse for the third market dealers in the event that a negotiated commission rate is implemented. The competitive advantage for seeking executions off the Exchange would then be diminished. Thus the incentive for going to the third market in the first place, that is, avoidance of the fixed commissions would be absent. However, these dealers have demonstrated that they are beneficial to the industry especially for their ability to take substantial positions in trades and thus complementing the auction market which may find some difficulty in absorbing the entire transaction. Given the benefits
derived, some protection needs to be provided to insure that this alternative market continues to thrive.

In *United States v. Columbia Steel Co.*, the Court indicated that given a concerted refusal to deal with non-members, an association would be liable per se, regardless of the amount of competition obstructed. However, this approach to voluntary limitations of freedom has been criticized on the ground that not enough flexibility is afforded business groups in their activities under this strict rule.

The voluntary acceptance of limitations on one's own freedom to deal with others disassociated from a purpose to coerce or exclude is not necessarily unlawful; if adequate scope is to be given to the requirements of trade and the productive capabilities of group activities, the purpose and effect of such a contract or combination ought to be examined in the context of its operation. . . . This is an area where the public interest requires careful regard for the balancing of competing interests within the framework of the rule of reason.

Moreover, as pointed out earlier, a per se approach is not applicable to a situation involving the statutory regulation of an industry.

It is worth noting that the Supreme Court has conceded that there are circumstances where even a dominant group might be justifiably refusing to deal. The Court admitted that:

\[\ldots\] [The prohibitions of the Sherman Act] do not prevent the adoption of reasonable means to protect interstate commerce from destructive or injurious practices and to promote competition upon a sound basis. Voluntary action to end abuses and to foster fair competitions opportune in the public interest may be more effective than legal processes. And cooperative endeavor may appropriately have wider objectives than merely the removal of evils which are infractions of positive law.

This declaration might provide some basis for justifying the imposition of rule 394. If the threat to the primary auction market is real and is determined to be of paramount interest vis-à-vis increased competition and lower prices and it is inevitable that the primary market would be destroyed by the removal of the rule, the Exchange might be acting in a salutary rather than a destructive manner by insisting on the rule's application.

180 334 U.S. 495, 522 (1948).
181 Id. at 522-23 (dictum).
182 Barber, *supra* note 152, at 879.
183 Id.
The approach the Silver court offers is one of reconciliation between the two statutory schemes involved, namely, the antitrust laws and the Exchange Act. This leads to a determination of whether the practice or rules is deemed necessary to the proper functioning of the Exchange under the Securities Exchange Act. If it is not, antitrust liability may attach. This is nothing more than another form of the "rule of reason." Careful consideration should be given to the often-quoted passage by Justice Brandeis, in Chicago Board of Trade v. United States, a case involving the validity of an Exchange rule in which he set forth a now famous test to determine whether or not restraints were reasonable:

But the legality of an agreement or regulation cannot be determined by so simple a test as whether it restrains competition. Every agreement concerning trade, every regulation of trade, restrains. To bind, to restrain, is of their very essence. The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition, or whether it is such as may suppress or even destroy competition. To determine that question the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint and its effect, actual or probable. The history of the restraint, the evil believed to exist, the reason for adopting the particular remedy, the purpose or end sought to be attained, are all relevant facts. This is not because a good intention will save an otherwise objectionable regulation, or the reverse; but because knowledge of intent may help the court interpret the facts and to predict consequences.

The Board of Trade decision still remains a viable opinion today because of this cogent enumeration of considerations for determining the reasonableness of a particular restraint. Many of the listed factors have relevance to rule 394. Moreover,

where the need for self-regulation has been statutorily recognized and a scheme of federal regulation established which clearly contemplate self-regulation, application of the per se rule would frustrate this scheme.

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185 See Standard Oil Co. v. United States, 211 U.S. 1 (1911); see also Jaffe, supra note 102, at 1041.
187 Id. at 298.
188 Bird at 290 (footnote omitted). In Northern Pac. Ry. Co. v. United States, 356 U.S. 1 (1958) the Court in referring to the benefits of adopting a per se approach stated: it also avoids the necessity for an incredibly complicated and prolonged economic
Furthermore, from society's point of view a per se approach may result in social losses. That is, concerted refusals to deal which would be upheld by a court utilizing a rule of reason approach and those cases in which the harms would outweigh the benefits of the per se approach, would nonetheless be struck down under this type of "strict liability." However, mere federal regulation in an industry it is contended, should not foreclose the applicability of a per se approach. "[I]t must be clear that the policy of the statute contemplates the exercise of boycotting power to further the statutory purpose."

One "rule of reason" approach has been suggested as being applicable to such organizations as the New York Stock Exchange in determining antitrust liability. Under this approach a joint facility or exchange when exercising its exclusionary power would have to satisfy the following requirements in order that it be free from antitrust encroachment: (1) ample notice and an opportunity to be heard would have to predate the Exchange's use of its boycotting power, (2) the Exchange's power to exclude would have to be demonstrably germane to the statutorily recognized need for self-regulation and (3) the structure must go no further than necessary to achieve the group's valid self-regulatory goals. Applying this approach to rule 394 the case for eradicating the rule grows stronger. While the procedural aspects of condition (1) could easily be met by the Exchange, the last two conditions would seem, considering the weak justification for the rule in addition to its discriminatory treatment of non-members to be less than satisfied.


Since the inauguration of the Securities Exchange Act in 1934, the NYSE has enjoyed an uncertain antitrust immunity. Never precisely defined, either legislatively or judicially, the Supreme Court traced the limits of this freedom in its 1963 Silver decision. In the investigation into the entire history of the industry involved, as well as related industries, in an effort to determine . . . whether a particular restraint has been unreasonable. . . .

Id. at 5.

In the case of the Stock Exchange, however, because of the clash of two statutory schemes instant dismissal of a restraint under a per se approach is not feasible.

189 Id. at 282.
190 Id. at 290.
191 Id. at 292. Consideration should be given to the fact that changes in an industry may make limitation on access to a joint facility once necessary for the proper functioning of that industry no longer needed for successful self-regulation. See Memorandum of the United States Department of Justice on the Fixed Minimum Commission Rate Structure, In re Commission Rate Structure of Registered National Securities Exchanges, SEC No. 4-144, at 149-52, Jan. 17, 1969, cited in Bird at 291 n.174.
tervening years there has been a significant absence of Supreme Court decision on the whole question of Exchange immunity from antitrust regulation. Indeed, the court has not passed on the merits of any case since Silver.

It is in this light then that the Seventh Circuit handed down a landmark decision in Thill Securities Corp. v. New York Stock Exchange.193 Thill, a non-member broker-dealer instituted a treble damage class action against the exchange, alleging violations of both the Sherman Act and the Clayton Act. Specifically, Thill asserted that, through its rules194 the Exchange prevented its member firms from sharing commissions with non-member brokers, without regard to the fact that the non-member might have originated the order. This, Thill charged, effectively prevented investors from dealing with non-member firms, and clearly constituted an illegal conspiracy in restraint of trade.

Surprisingly the Exchange elected not to deny the substantive charges complained of but resolutely determined to stand behind its assertion that the 1934 Act expressly limited review of exchange practices to the Securities and Exchange Commission and hence, the Federal courts were without jurisdiction to impose antitrust liability. The district court agreed, ordering judgment summarily in the Exchange's favor.195

The court of appeals initially discounted the proposition that the mere fact that Exchange practices were subject to SEC review pro se gave rise to antitrust immunity. A reconciliation of the two statutory schemes was eminently preferable argued Judge Campbell, writing for the court. Perceiving no express exemption in the Securities and Exchange Act, the court relied on Silver for the proposition that "[antitrust immunity] is to be implied only if necessary to make the Exchange Act work, and even then to the minimum extent necessary."196 Moreover, the court could unearth in the Silver decision "no intimation that the mere possibility of SEC review wraps the conduct of the Exchange in an impregnable shield of antitrust immunity",197 as the defendant had urged. To gain this coveted exemption, Judge Campbell continued, would require of the NYSE a demonstration of

193 433 F.2d 264 (7th Cir. 1970) [hereinafter Thill]. See Faces Behind the Figures, Forbes, Oct. 1, 1970, at 61 for some interesting background to this case.
194 The rule is derived from Art. XV, § 1 of the Constitution of the NYSE. Thill at 267 n.2.
195 Id. at 268.
197 Id. at 269.
genuine necessity. More precisely, in order for the Exchange to establish necessity, it must show that without the exemption it could not effectively discharge its responsibility under the Securities and Exchange Act.

Shifting his attention then to the district court's summary disposition of the case Judge Campbell criticized the trial court for its failure to heed the evidentiary mandate carefully prescribed by the Supreme Court in *Silver*. He meticulously noted the absence of evidence in the record, specifically the failure of the trial judge to adduce the precise extent to which NYSE rules are subjected to examination by the SEC. Furthermore, he failed to identify any inquiry concerning why the anti-rebate rule — the very fulcrum of the matter — should be preserved as necessary for the Exchange to operate.

Rejecting the Exchange's argument that all judicial investigations of the possible antitrust implications of NYSE rules must halt upon demonstrations that such rules were adopted pursuant to its duty of self regulation (and accordingly subject to SEC review), the court relied on the authority of *United States v. Philadelphia National Bank*. Moreover, the court observed that while the SEC might have the power to consider the antitrust ramifications of Exchange rules, it was nowhere required to do so, and indeed had repeatedly demonstrated a pronounced reluctance to do so.

**Thill and Beyond**

While *Thill Securities* represents a judicial adoption of the Justice Department view, its progeny might be far more significant. Conceivably it might signify a new or more acute awareness on the part of the federal courts of antitrust violations in the securities industry. Concurrent with the realization that the courts and not the SEC are the desired forum for allegations of anti-competitive behavior is the probability of closer scrutiny of Exchange practices and the likelihood of a higher standard for judging those rules and practices within the concept of "operational necessity." Much stricter evidentiary requirements might be forthcoming, although at this date such prognosticating amounts to mere guesswork. In line with this thinking, however, the *Thill* court suggested that an offspring of its decision might per-

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198 Id.
199 Id.
200 Id. at 270; see Baum v. Investors Diversified Servs., Inc., 286 F. Supp. 914 (N.D. Ill. 1968), which similarly interpreted *Kaplan* as solely concerning a per se violation.
201 Id. at 272, citing 374 U.S. 321 (1963).
202 Id.
haps be a more widespread involvement of the Securities and Exchange Commission, together with the Department of Justice, in litigation involving antitrust claims against the securities exchanges.

In any event, the decision in *Thill* strongly suggests a warning to the Exchanges, that the courts are going to follow their Congressional mandate to protect competition and are not going to shun their judicial responsibility to an agency which has proven to be ineffectual in resolving anti-competitive controversies within the industry.

Hereafter the burden shall be upon the Exchange to offer substantial justification in court for practices which might be considered anticompetitive. In this realm rule 394 represents a primary illustration, and there appears to be very little which the NYSE might offer in its defense. At best it is an anachronistic holdover, at worst a premeditated, last ditch effort to maintain a rapidly perishing monopoly. In the face of a judicial examination, with the paramount concern that of protecting the public investor, there appears little doubt over the fate of such restrictions.

**The Competitive Makeup of the Securities Industry:**

**An SEC Assessment**

Since 1934 the competitive policies of the NYSE have, broadly speaking, remained constant, while the social and technological environment in which the Exchange exists has undergone almost continuous upheaval. The SEC's *Special Study* has anticipated the cumulative impact of this process on the daily stock exchange activities and suggests that certain structural reforms should be accompanied by modification of key rules and practices. Furthermore, the *study* recommends that these rules should be subject to periodic review to ensure that they are utilized to effect changes which "might be in the interest of the public." Surveying the probable effects on the industry of such contemporary developments as the increasing importance of the O-T-C market, the proliferation of institutional investors and the rise of the third market, the *Study* urged that immediate consideration be given by the Exchange toward reform of outdated methods and practices, particularly the fixed commission system.

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203 See, e.g., *Special Study* 952.
204 *Id.*
205 *Id.* 953-54. Recently the Commission rejected NYSE proposals to continue and raise its fixed commission fee system. The Commission's repudiation was based primarily on its desire to see negotiated rates implemented on sales aggregating over $100,000.

The Commission reached the conclusion that fixed commission rates on large orders
Recognizing that the presence of multiple securities markets would produce competitive incentives and, hence, more optimal economic conditions in each marketplace, the commission emphasized that the extent of governmental regulations of the securities industry would ultimately depend upon the existence of effective competition.\textsuperscript{206} Moreover, concerning the depth of the market the \textit{Study} discounts the argument that the primary auction market might have to sacrifice some depth since the overall effect of multiple markets would be beneficial to the public investor.\textsuperscript{207}

The fundamental policy of the securities industry, the Commission recommended, should remain unchanged. Theoretically at least, that policy had been since 1934 a policy designed to stimulate free and open competition and this presumably included the prevention of unfair and anti-competitive practices. The Commission underscored the fact that such a policy is in the public interest, but cautioned that effective implementation would demand a continuing awareness of changing circumstances and emerging problems.\textsuperscript{208} Thus in a modern economy, restricted access to the exchange machinery no longer appears justifiable. Indeed, all indicia would seem to demonstrate that the concepts of the favored marketplace is neither socially nor economically tenable today.

Recently, a third market dealer, addressing the National Investor Relations Institute, cautioned that the Exchange must submit to more competitive practices if it is to remain a dominant force in the industry.

\textsuperscript{206} \textit{Special Study} 957.
\textsuperscript{207} \textit{Id}.
\textsuperscript{208} \textit{Id.} 957-59.
try.\textsuperscript{209} In addition, both government figures and economic experts alike have opted in favor of increased competition in the securities industry. Former Assistant Attorney General Donald F. Turner has warned that the effect of competitive inertia in the Securities industry is increased costs and poorer service, even with regulations.

[W]here there is regulation and no competition, firms may become lazy, for they may feel that they are, in effect, guaranteed a profit. On the other hand, if regulated firms also face some competition, they may work harder to keep costs down, to improve the quality of their service, or to devote sufficient resources to research and innovation.\textsuperscript{210}

Similarly, the Nobel Prize-winning economist Paul A. Samuelson has expressed the viewpoint that

[\textit{t}]he Securities markets are one live, interconnected whole and the important thing is that there be freedom for equitable and sufficient competitive forces to operate throughout that network and not that we protect volume or appearances on one particular domicile of the securities business.\textsuperscript{211}

Professor Henry C. Wallich testified that with sufficient communication links there might well be a market with more than one physical location\textsuperscript{212} and supporting this statement was Professor William Baumol who disclosed at the SEC hearings that the existence of one single market is not critical in view of the current state of electronics.\textsuperscript{213}

Professor Demsetz testified to the absence of any coercive arrangements in the over-the-counter market like those found on the exchanges. The market forces, he related, serve in the absence of this coercion "channelling transactions to the particular specialist in the over-the-counter market precisely because these specialists can offer the services of making the market more cheaply than could 10 or 20 specialists."\textsuperscript{214} The witness identified the economic phenomenon working in the over-the-counter market as being a "natural gravitation of transactions to particular specialists in the over-the-counter market."\textsuperscript{215}

To gain the benefits of economies, he explained he did not favor or

\begin{footnotesize}
\begin{enumerate}
\item[209] BNA, 76 SEC. REG. L. REP. A-4 (Nov. 11, 1970).
\item[211] \textit{Hearings} 3540-41, 3550-53.
\item[212] \textit{Id.} 3801, cited \textit{id.}, Jan. 22, 1969, at 4489.
\item[213] \textit{Id.} 3643-44, cited \textit{id.}, Jan. 22, 1969, at 4489.
\item[215] \textit{Id.}
\end{enumerate}
\end{footnotesize}
think it desirable to coerce members to bring their transactions there. 216 “Whenever you introduce that coercion, you do frustrate the development of avenues of competition that we have not yet thought of.” 217

As to the specialist on the Exchange, one third market dealer noted the monopoly position enjoyed by that trader and pointed to still another discriminatory practice since brokers who are members are not prevented from by-passing the specialist and seeking bids or offers directly from other members. He failed to see why some members could not effectively seek third market makers too. 218

All of the above statements certainly deserve close attention in respect to rule 394. The New York Stock Exchange must awaken soon to the realities of the situation if it is to remain the bulwark of the securities industry. 219 The Justice Department found that the evidence adduced at the SEC hearings did not establish the need for restraints such as 394 and 394(b) to preserve the central market. In fact, the central market, it related, would continue to thrive without the force of these restrictive practices. 220

CONCLUSION

The testimony elicited at the SEC hearings, attests to the fact that rule 394 is demonstrably discriminatory in its applicability to members of the NYSE. Additionally, there are the observed inequities of the rule’s operation which, in effect, unreasonably preclude non-member dealers in the third market from gaining access to the “resource” which the Exchange as a lawful monopolist holds or should hold in “trust” for the benefit of the entire industry. Indeed, Congress has expressly

216 Id., May 2, 1969, at 3861.
217 Id.
218 Id.
219 Id.

One might consider as a final thought on competition this exegesis by the Supreme Court in Northern Pac. Ry. Co. v. United States, 356 U.S. 1 (1957), delineating the purposes of the antitrust regimen:

The Sherman Act was designed to be a comprehensive charter of economic liberty aimed at preserving free and unfettered competition as the rule of trade. It rests on the premise that the unrestrained interaction of competitive forces will yield the best allocation of our economic resources, the lowest prices, the highest quality and the greatest material progress, while at the same time providing an environment conducive to the preservation of our democratic political and social institutions. But even were that premise open to question, the policy unequivocally laid down by the Act is competition.

356 U.S. at 4. See also KAYSEN & TURNER 44, wherein the authors see the policy of antitrust laws as being the limitation of undue market power. They suggest amending the antitrust laws to enable an attack on undue market power even absent any conspiracy in the legal sense.
declared a policy of promoting competition within the securities industry, reasoning that the ultimate effect of such a policy is to enhance the position of the public investor, an end certainly within the scope of the 1934 Act. These factors weigh heavily against the continued vitality of the rule. There seems to be little justification for the hampering of business rivals by the Exchange under the rule especially since the evidence does not tend to support the imposition of such a restriction as a necessary cog in the machinery of self-regulation. The restriction simply does not appear to be germane to legitimate self-regulation goals. It amounts to a clear suppression of competition in the securities markets. While the Securities Exchange Act quite agreeably mandates self-regulation, it by no means dictates that this duty be exercised at the expense of competitors no matter what the cost to these rival firms and the public at large.\footnote{Indeed, despite the existence of the self-regulation mechanism in the securities industry, it is evident that some form of government oversight is necessary “to insure that action in the name of self-regulation is neither discriminatory nor capricious.” Cary, Self Regulation in the Securities Industry, 49 A.B.A.J. 244, 246 (1963). At the root of this need for oversight is an obvious though scarcely emphasized concept of the profit motive. Quite properly, the profit motive is at the root of our economic system. But given this motive, regulation of the industry in the interest of the public cannot be left exclusively to the practitioners (exchanges) public spirited though they be. Id. at 244.}

It is submitted that a better view is to deem the exchanges, rather than having an unqualified duty to self-regulate at any social cost, to have the duty to do so without substantially destroying competition, especially when such stifling is superfluous to the statutory scheme governing the securities industry. It is further submitted that this viewpoint is fully consistent with the mandates of the Securities Exchange Act.

The one question left then is: What body is to adjudicate competitive abuses by the Exchange? Both Silver and now the recent Thill case strongly suggest that the most efficacious machinery is to be found in the antitrust laws and the judiciary. The Justice Department has indicated that there are certain attributes to be derived from a judicial approach:

Our own view is that antitrust serves as preferable alternative
to ever-increasing government regulation. The American public long ago determined that if the free market did not function well as an economic regulator, government must do the regulating. Our job as antitrust enforcers is to keep the free market mechanism functioning so that government regulation will be held to an absolute minimum. The drama now being played out before the SEC presents the rather curious spectacle of a government agency—in this case, the Department of Justice—arguing for free market competition, and private business—in this case the stock exchanges—battling in effect for government price regulation. As a firm believer in competition, I strongly suspect that if the exchanges win the battle, they may lose the war.\textsuperscript{222}

One might add, in favoring this approach, an often-stated reason for contrarily holding that the regulatory agency is more qualified to deal with the particular industry they oversee, as a justification for applying antitrust laws through the courts! The argument, of course, is the "agency expertise" rationale. It is beyond debate as to who possesses the expertise in antitrust matters. The courts, having been congressionally chosen as the depository of this protective scheme, will serve the securities industry well in maintaining the competitive atmosphere necessary to achieve the proper allocation of resources within the securities market.

\textsuperscript{222} Justice Department Comments, \textit{supra} note 140, at X-40.