Department of Justice

COMPETITION AND PROGRESS IN THE NEW SECURITIES WORLD

Remarks by

Donald I. Baker
Deputy Assistant Attorney General
Antitrust Division
Department of Justice

Prepared for Delivery at
New York Stock Exchange's
1974 Marketing Conference

New York Hilton Hotel
New York, New York

June 10, 1974

These are times of rapid change, times of great opportunity - if we can only develop the right responses. The Exchange does not understate the situation in labelling today's program "The Securities Industrial Revolution."

You know what happened in the original Industrial Revolution: the handweavers were superseded by big mills with power looms; the gunsmiths were superseded by rifle factories capable of practicing mass production; and the stage coach operators were superseded by the railways using steam locomotives. Now, the handweaver, the gunsmith, and the coachman did not care much for this process and many would gladly have reversed it if they could have. But they could not - because the new factories, however big and ugly, were able to produce what the public wanted at much lower costs than their predecessors. Technology and competition may be merciless to competitors - but they are beneficial to the public. They are also beneficial to the skilled producer. No doubt some of the handweavers and gunsmiths had the skill and energy to flourish in the new industrial world, to flourish far beyond anything they could have dreamt of before.

You might look at yourselves in this light. Your exchange has represented the closest thing we have had to a central securities market in this country. What are you?

In the narrowest sense, you are a large room full of floor brokers, traders, and specialists down at the corner of Wall and Broad Streets. Why are you all there? Because once upon a time the human voice was the fastest form of communication going, and it would not carry beyond a few hundred feet. Business was brought to the single room, the "floor", so that the two sides could "talk" to each other instantaneously and close the deal. But all that has changed in the age of high speed computers and communications systems. The two sides of a deal can now "talk" to each other instantly in a variety of different ways, over great distances. New York is closer in time to London today than it was to Hoboken a century ago.

A market is no longer a place - it is a communications system. An efficient market is a communications system which maximizes the exposure of buy and sell orders, and carries out its function at the lowest possible cost to buyer and seller. To the extent that it can meet that test, the New York Stock Exchange floor should be a part of the new communications system.

Of course, I recognize that the Exchange is a lot more than a room full of floor brokers, traders, and specialists. In 1934, you "went public". The Exchange is responsible for enforcing "just and equitable principles of trade" with respect to its members. This is a challenging task and the Exchange has, I believe, devoted more time and resources to

examining and auditing its members than any other market here or abroad. As a result, the label on the door - "member of the New York Stock Exchange" - has generally conveyed to the investing public a favorable image of honesty and reliability.

But self-regulation is subject to important practical limitations, and this is why antitrust will continue to be important in the securities industry even after fixed commission rates have gone. Self-regulation can too easily become self-service. It is a process poorly designed to weigh the economic interests of the self-regulated firms against those of the public. History is full of examples (and antitrust cases1/) which suggest that self-regulatory organizations will call the economic shots their members' way. This is hardly very surprising.

The securities industry itself offers ample illustration. Back in 1940 (before anyone had given much thought to antitrust in the securities industry), the New York Stock Exchange began enforcing a constitutional provision which prevented a member from trading any NYSE-listed security on any regional exchange. The Exchange made clear that its purpose was to protect its fixed public commission against "unfair competition".

1/ E.g., Eastern States Retail Lumber Dealers Ass'n v. United States, 234 U.S. 600 (1914); Fashion Originators Guild v. Federal Trade Commission, 312 U.S. 457 (1941).

The SEC found this justification unpersuasive; and found the rule injurious to the regional exchanges and to the investing public which relied on them. It analogized the rule to an antitrust boycott - saying that it "would violate one of the basic purposes of regulation under the [Securities Exchange] Act, a purpose which is closely related to the public policy regarding unreasonable restraints and the maintenance of fair competition as declared by Congress in the Sherman Act, the Clayton Act and the Federal Trade Commission Act." 2/ Accordingly, it ordered the Exchange to amend the rule to permit member dealing on regional exchanges. This was the famous Multiple Trading case - the only occasion on which the SEC exercised its formal statutory powers vis-a-vis exchange rules until last year.

Again, in the late 1950's, when the "third market" emerged, the Exchange adopted a similar rule: Rule 394 prohibited members from dealing off the NYSE floor except on regional exchanges. Again, the SEC investigated. This time its staff found that the purpose of the rule was to protect NYSE fixed commission rates and to protect the specialists against competition. The SEC then negotiated an amendment to the rule - an amendment which has proven singularly unsuccessful in assuring that a member's customer gets best execution.

2/ The Rules of the New York Stock Exchange, 10 S.E.C. 270, 287 (1941).

I shall confine myself to these two examples, since they make my point clearly: the Exchange has continuously opted for rules which would favor its market over others; its interest has clearly been (as was openly conceded in 1941) to protect brokers' and specialists' incomes. The investing public's interests might be better served by lower commission or better executions on other markets when such were available. One could hardly expect the Exchange to balance these issues (any more than we could expect it to balance public interests on the current "third market" controversy). Public agencies often tend to serve their constituencies - and there is no reason to expect that self-regulatory agencies would be less prone to this tendency!

Therefore, some independent public check is needed on this power. Antitrust is well suited to the role - because it is a body of law dedicated to economic efficiency and administered by an independent forum, the federal courts. It is a policy which the Commission in 1941 rightly said was "closely related" to the purposes of exchange regulation under the 1934 Act. Moreover, it is a policy which both the Commission and the courts can apply. Indeed, the Commission can serve as what the Supreme Court recently characterized as "the first line of defense against those competitive practices that might later be the subject of antitrust proceedings." 3/

3/ Gulf States Utilities Co. v. Federal Power Commission, 411 U.S. 747 (1973).

Some may say that the application of the antitrust laws will tend to narrow the "regulatory" discretion of both the SEC and the Exchange. In a sense, this is true: antitrust does effectively prevent the Exchange from adopting (even with SEC approval) a clearly anticompetitive scheme not justified by overriding public benefits. Beyond that, the application of antitrust tends to force out into the open a lot of critical economic policy questions formerly settled by the SEC and the Exchange in closed door bilateral negotiations. 4/ I happen to think that both results are highly desirable.

The exact scope of antitrust rules is not beyond reasonable dispute (and my views do not necessarily coincide with today's sponsor!). Suffice it to say that in 1963, the Supreme Court rejected the Exchange's sweeping argument that its actions were exempt from the antitrust laws because they were regulated under the Exchange Act. This was the famous case of Silver v. New York Stock Exchange 5/, from

---

4/ See Senate Banking Committee, Securities Industry Study, pp. 201-204 (1973); Note, Informal Bargaining Process: An Analysis of the SEC's Regulation of the New York Stock Exchange, 80 Yale L.J. 811 (1971).

5/ 373 U.S. 341 (1963).

which everything else has followed. The Court said that antitrust law was repealed here "only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary." The Court added that traditional antitrust concepts are flexible enough to give the Exchanges sufficient breathing space within which to carry out the mandate of the Securities Exchange Act. What this means is that the Exchange may adopt an anticompetitive rule if it is truly necessary to carry out some overriding purpose of the Exchange Act - but that nothing can be truly necessary if it could be carried out in a less anticompetitive way. Both House and Senate securities industries studies have adopted this approach; and therefore I think you had better assume that it will continue to be a factor in Exchange actions. 6/

Antitrust is of course concerned with more than the Exchange and the central institutions of the future. It is concerned vitally with the initiative of individual firms. As we get away from the fixed commission rate system - and hopefully the mentality which went with it - the public will expect a lot more in the way of competitive innovation

---

6/ House Commerce Committee, Securities Industry Study, 160-167 (1972); Senate Banking Committee, Securities Industry Study, 220-227 (1973); Report of the Senate Banking Committee accompaning S. 2519, Senate Report No. 93 - 865, p. 11 (1974).

from individual firms. You will have a great deal of new discretion over how to package and price brokerage services. Indeed, this potential is already becoming clear in new offerings intended for the smaller investor. All this is highly desirable, and will bring nothing but cheers from antitrust enforcers.

Antitrust will only become concerned when individual firms seek to limit this new potential by private arrangement. Thus, for example, if several retail firms in a city got together and agreed not to charge less than a set figure for brokerage, they would be engaged in straight old-fashioned price fixing; and they would be proceeded against - perhaps even criminally. 7/ Similarly, if they agreed among themselves to refrain from soliciting certain customers or from offering particular services, they would be running serious antitrust risks. 8/

Antitrust law of course applies to more than agreements among competitors. Anticompetitive activities by a single firm are covered. Thus, for example, it would be illegal for a brokerage firm with any degree of market power at all to require customers to take and pay for a package of separate services; in antitrust parlance, this is a tie-in

---

7/ See United States v. Socony-Vacuum Oil Co., 310 U.S. 150 (1940).

8/ See Standard Sanitary Mfg. Co. v. United States, 226 U.S. 20 (1920).

and is illegal per se. 9/ It is also illegal for a single firm to price its product below long run costs for the purpose of driving out its competitors in a market. In fact, actual examples of this practice are very few 10/; and yet antitrust law here stands as an effective barrier to what many in the securities industry say they fear - namely, that a very few large firms will drive everyone else out by predatory pricing.

Antitrust prohibitions will also apply to mergers among brokerage firms. 11/ Generally, these would be looked at in terms of their impact on price and service competition, both in local markets for retail customers and national markets for wholesale customers. Where significant direct competition was eliminated by the merger in either type of market, it might well violate the antitrust laws - unless it could qualify for what is known as the "failing company" defense.

9/ Fortner Enterprises v. U.S. Steel Corp., 394 U.S. 495 (1969); United States v. Loew's Inc., 371 U.S. 38 (1962).

10/ See Standard Oil Co. v. United States, 221 U.S.1, 43, 76 (1911); United States v. New York Great Atl. & Pac. Tea Co., 173 F.2d 79, 88 (7th Cir. 1949); United States v. Corn Products Refining Co., 234 Fed. 964, 1010-15 (S.D.N.Y. 1916). See also Forster Mfg. Co. v. Federal Trade Comm., 361 F.2d 340 (1st Cir. 1966).

11/ If the merger involved corporations it would be governed by Clayton Act §7 (15 U.S.C. §18); and, if not, it would be reached by Sherman Act §1 (15 U.S.C. §1).

This completes my quick trip through the antitrust issues you may face as you venture forth into the new world - the world of competitive rates and competitive market making, the world of large computers and communications systems. While legal rules will be part of that world, what will be really important will be your skill and initiative. The public's ultimate interest is in efficiency not tradition. We enforce antitrust rules to serve that end. As the Supreme Court has put it,

> "Basic to the faith that a free economy best promotes the public wealth is that goods must stand the cold test of competition; that the public, acting through the market's impersonal judgment, shall allocate the nation's resources and thus direct the course its economic development will take." 12/

What is true for goods is true for services - brokerage services, underwriting services, and even legal services! Given a free choice, will the public pay for what you are offering - or will it turn to others, here or abroad? That is the ultimate question.

The securities industrial revolution is thus a challenge for all and an opportunity for the skilled and efficient firm. Some would prefer to go back to a quieter past (an attitude well illustrated by the Martin Report), but I see little inclination in Washington to try that. Even if tried,

---

12/ Times-Picayune Publishing Co. v. United States, 345 U.S. 594, 605 (1953).

it would fail in the long run. You cannot legislate new technology back into some broom closet forever, even if this were advantageous to the practitioners of the old technology. It always sneaks out. We can see it in NASDAQ which makes over-the-counter markets more competitive here - and we can see it in the new ARIEL system in Britain, a system which would exist and compete regardless of what we do in Washington. We have had the best capital market in the world because historically it was the most efficient in using the available technology. Will it continue to be with the next generation's technology? That is the challenge for you. The Federal Government cannot legislate efficiency (even if it can sometime legislate its opposite). The challenge is not one of regulation, but of initiative and skill. If you fail to meet the challenge, then not only will the public suffer a lost opportunity - but you in the industry will suffer the pain of watching savings and transactions slip away to other institutions and other markets, here and abroad.