March 21, 2005

Roseann B. MacKechnie, Esq.
Clerk, United States Court of Appeals
for the Second Circuit
Thurgood Marshall U.S. Courthouse
40 Foley Square
New York, New York 10007

Re: Response to Court's invitation to file letter brief in Billing v. Credit Suisse First Boston, Nos. 03-9284 and 03-9288 (2d Cir.).

Dear Ms. MacKechnie:

By letter of January 4, 2005, the Court invited the Securities and Exchange Commission to submit a letter brief to address three questions in the above-numbered cases.[1] The Commission responds to those questions as follows.

1. **Does the SEC have the authority, under its enabling statutes, to allow underwriters to engage in the alleged conduct, including a conspiracy to inflate aftermarket securities prices**?

The federal securities laws and the Commission's regulations generally prohibit market manipulation, including the types of tie-in and laddering agreements alleged in the complaints in these actions. The Commission does not now have pending before it, nor does it currently anticipate any proposals that would permit that sort of conduct. Indeed, as we discuss below, the Commission has brought several recent enforcement actions under its existing prohibitions and, as the Court notes, the Commission has also proposed amending Regulation M, 17 C.F.R. 240.100-105, to strengthen those prohibitions.

The Court has asked, however, whether the Commission would have the authority to permit the alleged conduct, including a conspiracy to inflate aftermarket securities prices. As the Commission explained in its Memorandum amicus curiae in the district court, it has broad authority over the registered securities offering process, including authority to permit at least some agreements among underwriters that can

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[1] The Court's letter asks the Commission to respond on behalf of the United States. As an independent regulatory agency, the Commission is not authorized to respond on behalf of the United States.

have the effect of increasing the aftermarket price over the price that would prevail in the absence of those agreements, and which therefore could be viewed as coming within the terms of the question raised by the Court. The Commission's authority rests not only on Section 9(a) of the Securities Exchange Act, the provision on which plaintiffs have focused, but on other provisions as well. [2] In addition, the Commission has oversight responsibility for the rules of self-regulatory organizations, which can also affect market prices and conditions. [3]

Thus, as this Court discussed in its decision in Friedman v. Salomon/Smith Barney, Inc., 313 F.3d 796 (2d Cir. 2002), the Commission has permitted underwriters to enter into agreements that can have the effect of restricting the resale of newly offered securities in the days immediately following the onset of trading, a practice known as "flipping." Plaintiffs in that case alleged that defendant firms violated the antitrust laws by denying or restricting stock allocations or commissions to brokers whose retail customers engage in flipping. The Court acknowledged that "flipping causes stock prices to fluctuate - usually downward - and aftermarket sales restrictions are a form of price stabilization." 313 F.3d at 797. Despite the fact that the challenged restrictions could have an upward effect on aftermarket prices, the Court agreed with the Commission's view that agreements among underwriters to impose them were immune from antitrust challenge because the antitrust laws conflicted with the regulatory provisions of the federal securities laws.

In short, the Commission has the authority to allow aftermarket conduct by underwriters conducting registered offerings, including IPOs, that may have the effect of maintaining aftermarket prices at a level higher than would be realized in a market subject to no regulation other than the antitrust laws. That result is inherent in a regulatory system such as the one established by the federal securities laws, which requires the Commission to weigh in the balance other important public interest considerations in addition to concerns about competition. While the Commission can and has approved conduct that affects aftermarket prices following registered offerings,

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[2] These include, inter alia, Sections 2(a)(3), 5, and 28 of the Securities Act, as well as rules adopted under that Act, as well as Sections 10(b), 15(c), and 36 of the Exchange Act, and rules and regulations adopted under that Act. See, generally, Comm. Mem. At 8-11, 28-29.

[3] These include, inter alia, NASD Rules 2110, 2110-1, 2710. See, generally, Comm. Mem. 12-13. SRO rules may not be approved by the Commission unless the Commission determines that the rules "do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of" the Exchange Act. See Sections 6(b)(8) and 15A(b)(9) of the Exchange Act.

it can do so only where it is persuaded by substantial evidence that the conduct will have other important beneficial effects on the functioning of the securities markets. The Commission may authorize conduct that has anti-competitive effects if the Commission concludes that countervailing benefits demonstrate that such action is necessary or appropriate in the public interest or for the protection of investors.

The precise scope of the Commission's authority to adopt rules or to grant exemptions in this area is difficult to delineate in the abstract because it is impossible to foresee what future developments in the offering process or the Commission's understanding of the public interest and investor protection may require, a difficulty that the district court discussed at the argument in this case. JA 1129-30. Current precedent does not, however, foreclose the Commission's ability in response to future developments to authorize conduct by underwriters that could be characterized as a tie-in or laddering. For example, while it is difficult to envision the circumstances under which the Commission would do so, the Commission could approve an SRO rule that permitted such conduct, assuming the statutory requirements under the Exchange Act were met, including the requirements that the rule be designed to protect investors and the public interest, and that it not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act. (As noted above, that conduct, at present, is prohibited, and the Commission is not contemplating that it should be permitted.)

2. **If not, how – if at all – could judgment for plaintiffs in this case impede the SEC's ability to regulate or exempt from regulation any underwriters, securities, or transactions**?

The Court's second question requires a response only if the Commission concludes it does not have the authority to permit the conduct alleged in the complaint. Nevertheless, it may be useful to outline why, in the Commission's view, analysis of the question of implied repeal may entail consideration of issues beyond an assessment of the outer limits of the agency's authority to permit particular conduct. As this Court has recognized, "antitrust immunity is not to be presumed from the mere existence of overlapping authority." In re: Stock Exchanges Options Trading Antitrust Litigation, 317 F.3d 134, 148 (2d Cir. 2003). In this case, however, we believe that antitrust immunity is appropriate in the intensely regulated area of registered offering underwriting to protect the effectiveness of the regulatory regime established by Congress, even in some cases where it may not be clear that the Commission could (or ever would) authorize the specific conduct alleged by particular plaintiffs.

The foundation of the Commission's position, as explained at greater length in its Memorandum, is that syndicate underwriting of public offerings inherently involves agreements and joint actions among potential competitors, including agreements about

price, that, but for the securities regulatory regime, would raise substantial antitrust concern. The Commission, and the NASD subject to Commission oversight, comprehensively and actively regulate the offering process under a set of rules and regulations that have evolved through time to adjust to changes in the market and to regulatory understanding of what is necessary or appropriate in the public interest and for the protection of investors. Under this regulatory regime, competition is one factor that must be weighed in the balance, but it is not necessarily given the predominant weight, nor is the Commission required to adopt the least anti-competitive alternative. See Bradford National Clearing Corp. v. SEC, 590 F.2d 1085, 1104 (D.C. Cir. 1978).

While the Supreme Court has observed that intent to repeal the antitrust laws is "much *clearer* when a regulatory agency has been empowered to authorize or require the type of conduct under antitrust challenge," National Gerimedical Hospital and Gerontology Center v. Blue Cross of Kansas City, 452 U.S. 378, 388-89 (1981) (emphasis added, citations omitted), that is not the only circumstance under which immunity is appropriate. Rather, the ultimate issue is whether permitting antitrust liability is clearly repugnant to the "regulatory *system*." Id., 452 U.S. at 389 (emphasis added). As the Supreme Court phrased the issue in Gordon v. NYSE, 422 U.S. 659, 688 (1975), the question is "whether allowance of an antitrust suit would conflict with the operation *of the regulatory scheme* which specifically authorizes the SEC to oversee" the conduct that is the basis of the antitrust claim (emphasis added). Thus, the Court explained that the issue was not whether the fixed-commission system challenged in that case was necessary to the operation of the exchanges, but whether immunity should be implied "in order to permit the Exchange Act to function as envisioned by Congress." 422 U.S. at 688; see also United States v. NASD, 422 U.S. 694, 730, 734 (1975) (upholding immunity in light of Commission's actively exercised oversight authority under the securities laws); In re: Stock Exchanges Options Trading Antitrust Litigation, 317 F.3d 134, 148-50 (2d Cir. 2003) (same). See Silver v. NYSE, 373 U.S. 341, 358 (1963) (no immunity found when there was nothing "built into the regulatory scheme which performs the antitrust function of insuring that" regulated entities will not unjustifiably limit competition).

The Exchange Act charges the Commission with broad regulatory authority to oversee the underwriting of registered offerings. While tie-ins and laddering are prohibited by the existing regulatory regime, other cases could involve conduct presenting closer questions. Underwriters and other participants in the underwriting process should not be subjected to the fear that in interpreting and applying the comprehensive governing body of securities laws rules, they could find themselves not only liable for violating the securities laws, but also in an antitrust treble damages action. By discouraging useful interactions among participants in the offering process that are permitted under the securities laws, the fear of potentially crippling treble damages awards could over-deter conduct that would serve the interests of the markets

and the capital formation process. In other words, absent a holding of immunity in this case, rather than being one factor to be weighed by the Commission along with other investor protection factors, antitrust concerns will become the predominant considerations in the underwriting process. Nor should the Commission's ability to interpret, apply, and revise the governing law be displaced by introduction of the antitrust laws as an alternative, potentially competing regulatory scheme.

Not only is the Commission's authority here comprehensive; the Commission has been actively exercising that authority, both in the rulemaking and in the enforcement areas. We advised the district court (Comm. Mem. 13-17) of specific steps being taken by the Commission to investigate the alleged misconduct that forms the basis for this case, and to remedy any violations that it found. Since December 2002, when we filed that Memorandum, the Commission has continued its activities.

On May 29, 2003, the NYSE/NASD IPO Advisory Committee, formed in October 2002 at the request of the Commission's then-Chairman, issued its final report and recommendations, which address the problems evidenced during the hot IPO market of the late 1990s and 2000. *See* NYSE/NASD IPO Advisory Committee, Report and Recommendations (May 2003).

As the Court notes in its letter to us, on October 13, 2004, the Commission proposed amendments to Regulation M (the anti-manipulation rule governing securities offerings). The proposed amendments are intended to prohibit certain activities by underwriters and other distribution participants that can undermine the integrity and fairness of the offering process, particularly with respect to allocations of offered securities. Among other things, the proposed amendments would add a new Rule 106 to expressly prohibit distribution participants, issuers, and their affiliated purchasers, directly or indirectly, from demanding, soliciting, attempting to induce, or accepting from their customers any consideration in addition to the stated offering price of the security. *See* Securities Exchange Act Release No. 50831 (December 9, 2004), 69 FR 75774 (December 17, 2004).

On December 20, 2004, the Commission published for comment proposed rule changes by the NASD and NYSE arising from recommendations of the IPO Advisory Committee regarding the allocation and distribution of IPOs. *See* "Notice of Filing of Proposed Rule Changes by the New York Stock Exchange, Inc. and the National Association of Securities Dealers, Inc. Relating to the Prohibition of Certain Abuses in the Allocation and Distribution of Shares in Initial Public Offerings," Securities Exchange Act Release No. 50896 (December 20, 2004), 69 FR 77804 (December 28, 2004) [SR-NYSE-2004-12 and SR-NASD-2003-140]. The SRO proposed rule changes include proposals regarding, among other things, *quid pro quo* allocations, "spinning," and penalty bids.

These proposals, like the enforcement proceedings and other steps discussed below, reflect the Commission's comprehensive authority to regulate the underwriting process, and its continued active exercise of that authority. They are additional evidence that Commission regulation of the offering process during the last seventy years has involved a continual adjustment of previous rules to newly emerging or identified problems, balancing and re-balancing relevant factors to protect investors and the public interest. The Commission should be free to revise the applicable regulations to meet new issues as they emerge, giving competitive concerns their due weight under the statutory scheme. See Section 3(f) of the Exchange Act, 15 U.S.C. 78c(f).

Further, the Commission has recently completed three enforcement injunctive actions involving underwriters' violations of Regulation M. The Commission's complaints allege that the underwriters attempted to induce customers who received IPO allocations to place purchase orders for additional shares in the aftermarket. See Morgan Stanley & Co. Incorporated, Lit. Rel. 19050 (January 25, 2005); Goldman Sachs & Co., Lit. Rel. 19051 (January 25, 2005); J.P. Morgan Securities Inc., Lit. Rel. 18385 (October 1, 2003) (Commission Litigation Releases are available at SEC.gov/litigation). The Commission also brought an injunction action alleging that an underwriter violated the federal securities laws and NASD rules by allocating shares of "hot" IPOs to customers and receiving, in return, profits – in the form of excessive commissions or markdowns – mace by the customers on their IPO stock. See Robertson Stephens, Inc., Lit. Rel. 17923 (January 9, 2003).

In addition, private class actions *under the securities laws* are proceeding in the district court. See In re Initial Public Offering Securities Litigation, 2005 U.S. Dist. LEXIS 2121 (S.D.N.Y. February 15, 2005); In re Initial Public Offering Securities Litigation, 241 F. Supp.2d 281 (S.D.N.Y. 2003).

These steps are the appropriate responses to any alleged securities law violations. They should not be effectively supplanted by an antitrust action which does not take into account the sensitive countervailing considerations that the securities laws, and the Commission's expert administration, are charged with weighing in the balance.

Finally, we note another possible harmful effect of allowing these actions to proceed. While our response has focused to this point on alleged conduct that the Commission does not allow, the complaint in this case goes further. Plaintiffs' antitrust claims combine "allegations" that defendants engaged in collective conduct permitted under the securities regulatory regime (Comm. Mem. 34-36) with conclusory allegations that in the course of doing so they engaged in impermissible anti-competitive conduct. If this action is permitted to go forward, it could force participants in the securities markets to focus not on complying with the securities laws, but predominantly on

avoiding antitrust liability. Thus, as we noted in the district court (Comm. Mem. at 38), one of the claims raised by plaintiffs is that defendants failed to make certain prospectus disclosure, which defendants argue is not required by the applicable Commission regulation and NASD rules. The Commission has not had occasion to address this particular disclosure issue, yet plaintiffs now ask this Court to interpret those provisions as part of the determination of whether defendants violated the antitrust laws, to lift the antitrust immunity if defendants' interpretation is incorrect, and to hold defendants liable for treble damages. The *in terrorem* effect of that sort of liability could distort market participant behavior in ways that are harmful to the overall securities markets. The issue should be addressed under the securities laws, not the antitrust law.

3. **In light of your answers to (1) and (2), are defendants-appellees entitled to implied antitrust immunity in this action?**

Based on how judgment for the plaintiffs could impede the Commission's ability to regulate underwriting in registered offerings, as explained in the preceding discussion, we believe that the defendants in this case are entitled to antitrust immunity. We emphasize that a different analysis, and a different result, might be required with respect to conduct that, unlike underwriting in registered offerings, has not been subject to comprehensive and active Commission oversight and regulation.

Enclosed please find three copies of this letter for distribution to the panel considering this case. If you have any questions, please call Mark Pennington, Assistant General Counsel, at 202-942-0928.

Respectfully submitted,

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