DECISION IN FLIPPING CASE

Friedman v. Salomon Smith Barney et al.

Earlier this week, Wilmer, Cutler & Pickering won a significant victory for our client Salomon Smith Barney and the entire investment banking community in securing dismissal on implied immunity grounds of a major antitrust and securities class action alleging that Salomon Smith Barney and 17 other investment banks had violated the antitrust and securities laws by colluding with respect to their policies concerning the "flipping," or immediate resale, of shares allocated by the firms in initial public offerings.

The suit, *Friedman v. Salomon Smith Barney et al.*, was filed in the Southern District of New York in February 1999. In it, the plaintiffs alleged that the defendants violated Section 1 of the Sherman Act by adopting various policies designed to discourage the rapid resale of IPO shares by retail investors. These policies included informing retail customers that if the shares were not held for a certain period, those investors might not be allocated shares in future IPOs underwritten by the firms.

Salomon Smith Barney and the other defendants moved to dismiss the complaint on the ground that these practices had been in existence for decades and had been actively reviewed by the SEC and were, therefore, impliedly immune from the antitrust laws. The opinion of Judge Naomi Buchwald agrees with the defendants' motion in all respects and granted our motion with prejudice. The decision is particularly significant given the increased antitrust attention being focused on the securities industries in the wake of the NASDAQ case.

A copy of the decision appears below.

If you have any questions about the decision, or would like to discuss its significance to the securities industry, please contact Ali Stoeppelwerth (who was the principal author of the winning brief) at (202) 663-6589 (astoeppelwerth@wilmer.com) or either Bob McCaw at (212) 230-8810 (rmccaw@wilmer.com) or Bill Kolasky at (202) 663-6357 (wkolasky@wilmer.com).

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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ALAN FRIEDMAN, MENDEL GROUP, INC., SYBIL MEISEL and STEVEN LANGSOM, Trustees u/w/o BENJAMIN MEISEL, and SYBIL MEISEL, on behalf of themselves and all others similarly situated,

Plaintiffs,

- against -

SALOMON/SMITH BARNEY, INC., GOLDMAN SACHS, MERRILL LYNCH & CO., INC., CREDIT SUISSE, FIRST BOSTON, INC., MORGAN STANLEY, DEAN WITTER, PAINWEBBER INC., NATWEST SECURITIES, BT ALEX BROWN, INC., COBURN & MEREDITH, SHAMROCK PARTNERS LTD., PRUDENTIAL SECURITIES INC., RAYMOND JAMES & ASSOCIATES, INC., DONALDSON LUFKIN & JENRETTE, LEGG MASON WOOD WALKER, INC., NATIONS BANC MONTGOMERY SECURITIES LLC, LAZARD FRERES & CO., LLC and MORGAN KEEGAN & CO.,

Defendants.

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MEMORANDUM AND ORDER

98 Civ. 5990 (NRB)

NAOMI REICE BUCHWALD
UNITED STATES DISTRICT JUDGE

Plaintiffs, Allen Friedman, Mendel Group, Inc., Sybil Meisel and Steven Langsom, Trustees u/w/o Benjamin Meisel and Sybil Meisel ("plaintiffs") bring this class action on behalf of themselves and all others similarly situated against Salomon Smith Barney, Inc.; Goldman Sachs & Co.; Merrill Lynch & Co., Inc.; Credit Suisse First

Boston Corp.; First Boston, Inc.; Morgan Stanley Dean Witter & Co.; Painwebber, Inc.; Natwest Securities; BT Alex Brown, Inc.; Coburn & Meredith; Shamrock Partners Ltd.; Prudential Securities Inc., Raymond James & Associates, Inc., Donaldson Lufkin & Jenrette; Legg Mason Wood Walker, Inc.; NationsBanc Montgomery Securities LLC; Lazard Freres & Co, LLC; and Morgan Keegan & Co. (collectively "defendants") seeking injunctive and monetary relief for injuries they have purportedly suffered as a result of defendants' allegedly anticompetitive conduct. Plaintiffs seek to represent all retail brokerage customers who purchased shares of public equity offerings at artificially inflated prices from defendants and their "co-conspirators." Specifically, plaintiffs allege that defendants conspired to restrict plaintiffs' ability to sell their public offering shares in an effort to inflate artificially the stock price for the benefit of institutional investors who were not subject to the purported restrictions.

Now pending is defendants' motion, pursuant to Fed. R. Civ. P. 12(b)(6), to dismiss the complaint for failure to state a claim.[1] For the reasons discussed below, defendants' motion is granted and the complaint is dismissed with prejudice.

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[1] Plaintiffs filed this claim on August 21, 1998. It was transferred to our docket on October 18, 2000.

BACKGROUND[2]

This case concerns practices involved in syndicated equity underwriting ("syndicated underwriting"). Syndicated underwriting is a common method for distributing public shares of a company. It developed in the late nineteenth century has been practiced ever since. See United States v. Morgan, 118 F.Supp. 621, 635 (S.D.N.Y. 1953)("the syndicate system as a means of issuing and distributing security issues was in use at least as early as the 1890's") It generally works as follows. A company wishing to issue stock ("Issuer") will hire an investment bank ("Manager") to manage the distribution of shares to the public ("underwriting"). The Manager is responsible for ensuring that the shares are distributed to the public at the fixed-price ("offering price") agreed upon by the Issuer and the Manager. Typically, the offering price is set below the estimated market value of the stock to make the stock more attractive. The Manager, in turn, will approach several other investment banks and brokerage houses ("Syndicate Members") and hire them to distribute some portion of the offered shares to the

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[2] Unless otherwise indicated, all facts and allegations concerning this case are taken from the Parties' Statements of Material Facts Pursuant to Local Civil Rule 56.1 and the Parties' respective pleadings and answers.

public. By contract and under Securities and Exchange Commission ("SEC") regulation, all shares sold in a syndicated offering must be sold at the offering price -- regardless of the stock's actual market value. In the case of oversubscribed or "hot" public offerings, the Syndicate Members may choose to whom they will sell shares and how many each buyer may purchase. Participation in "hot" offerings is a privilege typically extended to favored customers of the Syndicate Members, a practice popularly known as "friends and families." Syndicate Members may also choose to purchase shares themselves.

"Flipping" is a practice that many consider disruptive to syndicated underwriting. Flipping occurs when persons who purchase shares in initial public offerings ("subscribers") turn around and sell their shares quickly. It is often very appealing for a subscriber to flip because the combination of public offering publicity and the practice of purposely underpricing offerings serves to drive-up the stock price in initial trading. However, if many subscribers flip, their collective action can cause a glut of shares to enter trading, depressing the stock price. The depressed stock price, in turn, can disrupt the efficient distribution of the stock.

Two methods of combating flipping are relevant to the instant case: (1) "Penalty Bids"; (2) Revocation of Public Offering Privileges ("Privilege Revocation"). A Penalty Bid is a contractual arrangement that permits the Manager to reclaim underwriting fees from Syndicate Members when the securities originally sold by the Syndicate Member are re-purchased by the Manager in connection with the distribution. See NASD By-Laws, Schedule D, Part 1(15) (NASD Manual (CCH) ¶1803). In essence, Penalty Bids make it unprofitable for Syndicate Members to sell public offering shares to retail customers who flip because the Syndicate Members will have to remit their fees.

Syndicate Members, in turn, sometimes discourage subscribers from flipping through Privilege Revocation. Syndicate Members inform subscribers that if they flip their public offering shares during a specified period following the offering (usually 30-90 days), the subscribers will lose the privilege of being a favored customer in future oversubscribed public offerings. Privilege Revocation does not involve any monetary penalty or legal restriction on the alienability of shares, it simply means that the customer who chose to flip will not enjoy the "friends and family" privilege for some time in the future. Plaintiffs allege that, by agreement among the defendants, Privilege Revocation is only applied to retail customers, not to the "institutional customers" (e.g., investment banks, brokerage houses, mutual funds) who provide defendants business. Complaint, ¶4. In furtherance of this conspiracy, plaintiffs claim, defendants and their co-conspirators encouraged the Depository Trust Corporation to develop an automated certificate tracking system that would, *inter alia*, allow defendants to track flipping for the purpose of enforcing Penalty Bids and Privilege Revocation. Complaint, ¶8-10.

Plaintiffs' complaint alleges that defendants have conspired since 1990 to "fix, raise, stabilize and maintain the price of shares of public offerings at levels above free market prices..." by instituting and enforcing Privilege Revocation on retail subscribers. Complaint, ¶3, 11. Plaintiffs assert that this conspiracy is designed to benefit institutional customers by allowing them to flip at "artificially inflated prices" without penalty. Complaint, ¶4. Plaintiffs also contend that the purported conspiracy also benefits the Syndicate Members in two other ways: (1) defendants can purchase up to a 15% over-allocation of the offered stock (a "greenshoe") and can sell it into the "artificially inflated" aftermarket for an additional profit, and (2) the "artificially inflated" stock prices created by the conspiracy improve perception of the underwriters' performance which helps defendants compete for future underwriting contracts. Complaint, ¶11.

Plaintiffs bring this action for injunctive relief and damages pursuant to Fed. R. Civ. P. 23(b)(2) and (b)(3), on behalf of a class comprised of retail brokerage customers (excluding defendants and related persons) who purchased shares of public equity offerings at allegedly inflated prices from defendants during the period of the conspiracy. Complaint, ¶48. The Complaint asserts that the purported conspiracy violates Section 1 of the Sherman Act, 15 U.S.C. §1, and defendants' New York common law fiduciary duty to plaintiffs. Although plaintiffs allege that the conspiracy has given rise to a host of improprieties, Complaint, ¶60-67, the only injury for which they are actually suing is the "inflated" price they paid when they purchased the shares at the offering price. Complaint, ¶1. Thus, they are specifically suing for the difference in value between (1) the offering price they paid and (2) the value of the shares they purchased subject to Privilege Revocation.

Defendants argue that the Complaint should be dismissed on essentially three grounds. First, defendants argue that the challenged conduct enjoys "implied immunity" from antitrust law. Second, defendants maintain that plaintiffs have failed to plead a horizontal price-fixing scheme -- specifically, they have failed to plead adequately a cognizable antitrust injury or conspiracy. Third, defendants assert that the challenged conduct is properly considered under a "Rule of Reason" analysis, not the "Per Se" analysis pled by the plaintiffs. As a result, the Complaint fails to plead adequately a relevant market definition and marketwide anticompetitive effects.

DISCUSSION

Defendants move to dismiss plaintiffs' claims, pursuant to Fed. R. Civ. P. 12(b)(6), for failure to state a claim upon which relief may be granted. In considering a motion to dismiss pursuant to Fed. R. Civ. P. 12(b)(6), we accept as true all material factual allegations in the complaint, Atlantic Mutual Ins. Co. v. Balfour Maclaine Int'l, Ltd., 968 F.2d 196, 198 (2d Cir. 1992), and may grant the motion only where "it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." Still v. DeBuono, 101 f.3d 888, 891 (2d Cir. 1996); see Conley v. Gibson, 355 U.S. 41, 48 (1957). In addition to the facts set forth in the complaint, we may also consider documents attached thereto and incorporated by reference therein, Automated Salvage Transp., Inc. v. Wheelabrator Envtl. Sys., Inc., 155 F.3d 59, 67 (2d. Cir. 1998), as well as matters of public record such as case law and statutes, Pani v. Empire Blue Cross Blue Shield, 152 F.3d 67, 75 (2d. Cir. 1998). fs

A. Doctrine of "Implied Immunity"

The Supreme Court has long held that "antitrust laws do not come into play when they would prohibit an action that a regulatory scheme permits." Finnegan v. Campenau Corp., 915 F.2d 824, 827 (2d Cir. 1990)(citing United States v. National Ass'n of Sec. Dealers Inc., 422 U.S. 694 (1975)("NASD"); Gordon v. New York Stock Exch., Inc., 422 U.S. 659 (1975); and Silver v. New York Stock Exch., 373 U.S. 341 (1963)); see generally Finnegan, 915 F.2d at 828-29 (Second Circuit overview of the Silver, Gordon, NASD trilogy of cases in which the Supreme Court outlined the doctrine of implied immunity). This "implied immunity" is found based on: (1) the presumption that Congress does not intend antitrust laws to conflict with regulatory provisions it enacts, see e.g., Finnegan, 915 F.2d at 826 ("Congress was not so muddled that it gave away with the right hand of securities regulation that which it then took away with the left hand of antitrust law..."); Northeastern Telephone, 651 F.2d at 82, and (2) that failure to honor this implied immunity would subject actors to conflicting standards. See, e.g., Gordon, 422 U.S. at 689 (finding immunity because "to deny antitrust immunity with respect to commission rates would be to subject the exchanges and their members to conflicting standards."); Strobl v. New York Mercantile Exch., 768 F.2d 22, 27 (2d. Cir. 1985)("Without antitrust immunity the exchanges would be subject to varying standards or requirements issued by various federal courts and thereby be unable to function in a consistent manner, without violating either the mandate of an antitrust decision of the Rules of the SEC.")

As a general matter, "[i]mplied antitrust immunity is not favored, and can be justified only by a convincing showing of a clear repugnancy between the antitrust laws and the regulatory system." Gordon, 422 U.S. 659; see National Gerimedical Hosp. & Gerontology v. Blue Cross, 452 U.S. 378, 388 (1981); NASD, 422 U.S. at 719-720; United States v Philadelphia National Bank, 374 U.S. 321, 350-351 (1963). And where it is inferred, "[r]epeal is to be regarded as implied only if necessary to make the [regulatory scheme] work, and even then only to the minimum extent necessary."

Silver, 373 U.S. at 357. However, "[t]o be sure," the Supreme Court has held, "where Congress did intend to repeal the antitrust laws, that intent governs..." National Gerimedical, 452 U.S. at 389.

There are two situations in which implied immunity of the Sherman Act is inferred: "first, when an agency, acting pursuant to a specific Congressional directive, actively regulates the particular conduct challenged, [citing Gordon, 659 U.S. at 685-86, 688-89], and second, when the regulatory scheme is so pervasive that Congress must be assumed to have foresworn the paradigm of competition. [citing NASD, 422 U.S. 694, 730; Otter Tail Power Co. v. United States, 410 U.S. 366, 373-74 (1973)]." Northeastern Telephone Co. v ATT, 651 F.2d 76, 82 (2d Cir. 1981). It is with the first ground for implied immunity that we concern ourselves in this case.

"Whenever claims of implied immunity are raised, they must be evaluated in terms of the particular regulatory provision involved, its legislative history, and the administrative authority exercised pursuant to it." Northeastern Telephone Co. v ATT, 651 F.2d at 83; see NASD, 422 U.S. 694 (basing implied immunity decision on detailed analysis of the legislative and administrative history of the statutory provision in question); Gordon, 422 U.S. 659 (same);

Silver, 373 U.S. 341 (same); Finnegan, 915 F.2d 824 (same); Strobl, 768 F.2d 22 (same).

Examining the Supreme Court's and Second Circuit's analyses of implied immunity cases, several factors emerge as particularly important for establishing implied immunity: (1) statutory language empowering the overseeing administrative agency to regulate the conduct;[3] (2) evidence of Congress' awareness of the conduct at the time it enacted the regulating legislation; (3) evidence that the administering agency paid attention to the challenged conduct in considering regulation since the legislation's enactment and, in particular, considered the competitive implications of such regulation;[4] and (4) a reasonable explanation of why allowing antitrust action here would subject actors to conflicting

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[3] The Supreme Court has made it plain that "[i]ntent to repeal 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, 452 U.S. at 389 (citing NASD, 422 U.S. at 730-734; Gordon, 422 U.S. at 689-690).

[4] The Supreme Court has been reluctant to find implied immunity where the regulatory agency sanctioned or required a challenged practice without taking into account the competitive concerns embodied in antitrust laws. See National Gerimedical, 452 U.S. at 390 ("antitrust repeals are especially disfavored where the antitrust implications of a business decision have not been considered by a governmental entity"); United States v. Radio Corp. of America, 358 U.S. 334 (1959).

standards.[5]

Two other aspects of the implied immunity doctrine are material to the instant case. First, the Supreme Court has held that implied immunity may be found not only where an administrative agency has acted, but where it has studied a situation and consciously chosen to refrain from acting. See NASD, 422 U.S. at 728 (finding that "[the] [Securities Exchange] Commission's acceptance of fund-initiated restrictions for more than three decades hardly represents abdication of its regulatory responsibilities... it manifests an informed administrative judgment that contractual restrictions were inappropriate..." and constituted sufficient involvement to justify implied immunity); see also, Finnegan, 915 F.2d 824 ("That the SEC has chosen not to prohibit [the challenged conduct] as fraudulent or manipulative practices... does not reduce the SEC's supervisory authority over [the challenged conduct]. Consequently, because the SEC has the power to regulate... and has implicitly authorized [the challenged conduct]... to permit an antitrust suit to lie against [the challenged conduct] would conflict with the proper function of the

[5] See, e.g., Gordon, 422 U.S. at 689; Finnegan, 915 F.2d at 828 ("The holdings in Silver and Gordon teach that antitrust laws do not come into play when they would prohibit an action that a regulatory scheme permits.") Strobl, 768 F.2d at 27.

securities laws.").

Second, in deciding what constitutes the "repugnance" necessary for implied immunity, courts have drawn an important distinction between the overlap and conflict of antitrust and regulatory laws. A mere overlap of the two is insufficient for repugnancy. In Strobl, 768 F.2d 22, the Second Circuit faced a situation where defendants were sued for conduct that violated both the Commodities Exchange Act ("CEA"), 7 U.S.C.A. §1 et. seq., and the Sherman Act. Defendants argued that the CEA specifically outlawed the conduct and, therefore, it enjoyed implied immunity from the Sherman Act's treble damages provision. The Second Circuit rejected defendants' argument, ruling that "price manipulation is an evil that is always forbidden under every circumstance by both the Commodity Exchange Act and the antitrust laws... [and] [t]herefore, application of the latter cannot be said to be repugnant to the purposes of the former." Id. at 28. Thus, a defendant must demonstrate the potential that actors will be subject to conflicting standards, not just overlapping standards, in order to establish that its conduct deserves implied immunity.

B. The Application of Implied Immunity Under Section 9(a)(6)

Defendants argue that the SEC's regulation of syndicated offering practices under 15 U.S.C. 78(i)(a)(6) ("Section 9(a)(6)") enjoys implied immunity from the antitrust laws. Section 9(a)(6) provides that:

> "It shall be unlawful for any person, directly or indirectly...
>
> (6) To effect either alone or with one or more persons any series of transactions for the purchase and/or sale of any security registered in a national securities exchange for the purpose of <u>pegging, fixing or stabilizing the price of such security in contravention of such rules and regulations as the Commission may prescribe as necessary and appropriate in the public interest or for the protection of investors</u>." [emphasis added]

In order to evaluate whether Section 9(a)(6) and the SEC's action under it confer implied immunity on defendants' conduct, we must consider the provision's legislative and administrative history in some detail.

<u>1. Pre-SEC History</u>

Price stabilization to combat flipping has been a feature of syndicated underwriting since the late Nineteenth Century. In <u>United States v. Morgan</u>, 118 F.Supp. 621, 635 (S.D.N.Y. 1953), this Court rejected a United States Department of Justice ("DOJ") antitrust suit against seventeen prominent investment banking firms which alleged that the firms "invented" syndicated underwriting in an effort to exclude competition. Central to the alleged conspiracy were practices designed "to stabilize the business 'by fixing and controlling the prices, terms, and conditions of purchase, sale and resale of securities." Id. at 630. Judge Medina's 211-page opinion, built on a three-year trial record, examined the modern history of syndicated underwriting in great detail. It found that the transition in the early part of this century from the former purchase and banking group underwriting system to syndicated underwriting was a response, in part, to the risk, "appreciated even in those days," that "placing upon the market a large bulk of new securities" could "depress the price and make distribution within a reasonable time difficult if not impossible." Id. at 635-36, 643. Specifically, Morgan found that since early this century, syndicates had employed stabilizing practices such as Penalty Bids to counter the effects of flipping and to maintain the offering price.[6] In order to track flipping

[6] "Through such stabilizing operations, the manager sought to prevent any securities, which had been sold by dealers, from coming back into the market in such a manner as to depress the public offering price. It was felt that with respect to the securities which appeared in the market, the members of the selling syndicate had not performed their function of 'placing'

and enforce penalty bids, "[r]ecords of the serial numbers of securities were kept, and the securities which appeared in the market were thus traced to the dealers who sold them."[7] Id. Contemporaries considered these stabilization practices to be business necessity, not a predatory tactic.[8] Thus, it is clear that stabilization practices such as Penalty Bids were widely utilized to counteract the effects of flipping prior to the creation of the SEC and federal securities laws. They evolved

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with investors, for which they were paid a selling commission; and, consequently, 'repurchase penalties' were provided for, whereby the manager had the right to cancel the selling commission on the sale of those securities which he purchased in the market at or below the public offering price. Under most agreements, the manager had the option of either cancelling the selling commission on the sale of the securities, or of requiring the member who sold the securities to take them up at their cost to the trading account... Stabilizing operations and the repurchase penalty were used in all of the three types of selling syndicates which prevailed throughout this period." Id. at 643.

[7] The fact that this practice has been ongoing for nearly a century and predated the formation of the SEC tends to undermine plaintiffs' suggestion that the advent of the Automated Tracking System and "Penalty Bid Tracker" in the late 1990's was evidence of new unlawful practices by defendants.

[8] Morgan cited the testimony of one industry witness, Harold L. Stuart, who testified that "'you simply had to have such a clause in order to make this business function in putting the securities on the market,' because 'there were many ways that shrewd people could beat the game and spoil the putting of any security issue on the market unless you did this.'" Morgan, 118 F.Supp. at 643.

along with the practice of syndicated underwriting, not as a later exploitation of that system.

2. SEC Creation

In response to manipulative securities practices that contributed to the stock market crash of 1929, Congress conducted a lengthy investigation into securities trading. The investigation produced the anti-manipulation provisions of the Securities Exchange Act of 1934 ("1934 Act"). 15 U.S.C. §§78a et seq. In drafting the 1934 Act, Congress enjoyed "a complete and comprehensive understanding... of [then] current methods of operation in common use in the securities issue business," Morgan, 118 F. Supp. at 646, including common price-manipulation practices. In fact, Congress chose to outlaw outright a number of price-manipulation practices.[9] See S Rep. No. 792, 73d Cong., 2d Sess. 7-8 (1934)("1934 Act Senate Report").

[9] The 1934 Act Senate Committee report stated: "Several devices are employed for the purpose of artificially raising or depressing security prices. Those which appear to serve no legitimate function are specifically prohibited. Among such practices are fictitious 'wash' sales; 'matched' orders, or orders for the purchase and sale of the same security emanating from a common source for the purpose of recording operations on the tape and thereby creating a false appearance of activity; and other transactions specifically designed to manipulate the price of a security." 1934 Act Senate Report at 7-8.

However, Congress specifically excepted from its ban manipulation to achieve price stabilization in syndicated public offerings. Instead, it empowered the SEC to regulate these practices. The 1934 Act Senate Report explained:

> "The impropriety of practices such as '_pegging,' or fixing or stabilizing_ the price of a security received most careful consideration by the committee. The committee recommends that _such practices not be abolished by statute but subjected to regulation by the Commission_." 1934 Act Senate Report at 8-9 (emphasis added).

See also _Morgan_, 118 F. Supp. at 695 ("Congress decided not to prohibit such [stabilization] activities, or to include any specific statutory regulations thereof, but left it to the SEC to prescribe appropriate rules and regulations"); _In re Nat'l Ass'n. of Securities Dealers, Inc._, 19 S.E.C. 424, 460 (1945)("_In re NASD_") ("Congress, in enacting Section 9(a)(6) of the Securities Exchange Act of 1934, decided against the outright prohibition of stabilization... and delegated to this Commission the authority to make rules and regulations defining the permissible limits of stabilization."). Section 9(a)(6) of the 1934 Act codified Congress' delegation of regulatory authority over "pegging, fixing or stabilizing" securities prices in conjunction with public offerings.[10]

3. 1939 Regulations

In 1939, the SEC promulgated its first rules pursuant to Section 9(a)(6) regulating price-stabilizing activities. The rules permitted existing practices to continue subject to duties of: (1) notice, to be given in the offering prospectus if the underwriters intended to engage in price stabilization during the distribution, see 17 C.F.R. § 240.17a-2, and (2) disclosure, in the form of reports of stabilizing activity. See 17 C.F.R. 230.426 ("Rule 426").

4. 1940 Statement

In 1940, the SEC issued its first policy statement on "The Regulation of 'Pegging Fixing and Stabilizing' of Securities Prices." SEC Release No. 34-2446 (March 18, 1940)("1940

[10] See 1934 Act Senate Report at 17 ("The "pegging" of securities prices is left to regulation by the Commission under paragraph (6) [of Section 9(a)] as it may deem necessary for the prevention of activities detrimental to the interests of investors."); H.R. Rep. No. 1383, 73d Cong., 2d Sess, 10, 21 (1934)(The 1934 Act delegates to the SEC the authority to prescribe "such regulation... as [the SEC] may deem necessary for the prevention of activities detrimental to the interests of investors").

Statement"). In the 1940 Statement, the SEC began a pattern of analysis and action that characterized its approach to regulating price stabilization over the next 60 years. First, the SEC observed that stabilizing is inherently anti-competitive, but is considered important to combat flipping and to facilitate efficient distribution of shares to the public. Next, it recognized that it had a statutory duty to weigh competitive concerns and investor protection in acting under Section 9(a)(6). Finally, having weighed competitive concerns and investor protection, the SEC chose to allow the practice to continue, subject to regulation.

The SEC began the 1940 Statement by acknowledging that stabilizing is a form of market manipulation and that elements of it are undesirable. It declared, "[t]he Commission is unanimous in recognizing that stabilizing is a form of manipulation. The statute itself so recognizes. The Commission also agrees that stabilizing in many respects is undesirable." Id. at 2; see id. at 5-6 ("stabilizing represents a form of manipulation which interferes with free and open markets.").

However, despite these misgivings about the anti-competitive nature of manipulation, the SEC recognized that "[s]tabilization... is now an integral part of the American system of fixed-price security distribution." Id. at 9. The 1940 Statement specifically noted that one of the primary justifications given for stabilization was combating flipping. It first observed that flipping was a problem: "Selling pressure result[s] from the fact that some purchasers change their minds and almost immediately resell [shares of public offerings]. In part, this selling comes from so-called 'free-riders' or speculators who purchase in the hope of quickly selling out and taking a profit on an early rise." Id. at 5. Stabilization was offered as a means for combating the market disruption caused by flipping. Id. at 7-8 ("[S]tabilization is warranted in order to offset the market 'abnormalities' which result from... 'free riders,' as well as other buyers who change their minds, [and] sell... at a time when there is a temporary imbalance between supply and demand created by the offering... exert[ing] a market influence which, according to the underwriters, is all out of proportion to their real significance."). Although the SEC was uncomfortable with the anti-competitive nature of stabilizing, it recognized the its justifications and importance to the capital markets.

The SEC next explicitly acknowledged that it had a statutory duty to take account of these competitive concerns in regulating under Section 9(a)(6). The 1940 Statement explained: "[T]he Securities Exchange Act, while primarily directed towards the protection of investors, is also concerned with the protection of the nation's credit and banking structures and the health of the capital markets... Therefore, by section 9(a)(6) of the Securities Exchange Act, it is assigned to this Commission the duty of finding a reasonable middle ground between the two objectives..." Id. at 10 (emphasis added). In regulating under the Section 9(a)(6), the SEC strove to meet this statutory obligation.[11]

Having weighed the competitive concerns, the SEC chose to allow stabilizing to continue under regulation. In doing so, it rejected the petitions of many who sought to have the practice outlawed altogether, finding that abolition would violate Congress' intent.

> "In the first place, Congress did not abolish stabilizing. It authorized this Commission, by regulation, to eliminate only the 'vicious and unsocial aspects of those practices.' It will not do for this Commission to proceed on the basis of a viewpoint which Congress, in its wisdom, did not find acceptable."

1940 Statement at 12. The SEC undertook a "piecemeal" approach to

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[11] "In determining whether the solution to the problem lies in prohibiting stabilizing, in subjecting it to regulation or in continued nonaction, the Commission has sought to weigh the relative advantages and disadvantages to the investor and to the national economy which may attend each of these alternatives." Id. at 6.

regulation, enacting several regulations and leaving the door open to further action in the future. See 1940 Statement at 14.

The 1940 Statement strongly suggests that the SEC believed its authority to regulate stabilizing under the 1934 Act enjoyed immunity from antitrust regulation. Clearly, the 1940 Statement demonstrates that the SEC understood its power to be broad and exclusive in regulating stabilizing under the 1934 Act.

> "Under the Securities Exchange Act as it now stands, many forms of stabilizing, no matter how vicious, are lawful except to the extent that they may violate rules of the Commission or other provisions of law... In the absence of regulation, stabilizing may be lawfully employed under many other circumstances where it is both ethically and economically indefensible."

1940 Statement at 12-14 (emphasis added). Given that the SEC had already acknowledged that stabilizing was inherently manipulative and anti-competitive, the "vicious" and "ethically and economically indefensible" conduct to which it referred would otherwise have run afoul of antitrust law.[12] Yet, the SEC clearly stated that these

[12] Indeed, the Supreme Court ruled later that year that "[u]nder the Sherman Act a combination formed for the purpose and with the effect of raising, depressing, fixing, pegging, or stabilizing the price of a commodity in interstate or foreign commerce is illegal per se." United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 223 (1940).

anticompetitive actions would be lawful in the absence of SEC regulation. Furthermore, the SEC appears to have recognized that stabilizing could cause antitrust harm to investors:

> "There is no denying the fact that to allow any stabilizing, in order to achieve the Congressional objective of not seriously interfering with the needs of industry for capital, may to some extent block the other Congressional objective of protecting the individual, direct investors who buy securities."

1940 Statement at 13. Nevertheless, it is evident that the SEC believed that the power to remedy anti-competitive injury from stabilizing lay exclusively in its hands and that the regulations it enacted took account of this risk.

> "The possibilities of injury to such buyers, resulting from stabilizing, can be reduced - although perhaps they cannot be wholly eliminated - by careful regulation of stabilizing. To that limited extent the one objective of Congress [facilitating capital markets] must give way to the other [investor protection]."

Id. Finally, the SEC made clear that if anticompetitive injuries to investors grew too serious, the proper remedy was further rulemaking after congressional consultation, not antitrust relief.

> [A]nd if, after a period of working with regulated

> stabilizing, we find that the injury to purchasing investors is uncontrollably too great, then, *but not before*, we should request Congress to determine which of these two objectives [capital markets efficiency and investor protection] is to be present."

Id. Thus, the 1940 Statement gives compelling evidence that even at the beginning of the SEC's involvement in regulating stabilizing, it believed its regulatory authority over stabilization practices was exclusive.

5. SEC Action 1940-1990

Over the next half century, the SEC returned several times to the issue of regulating stabilization practices and consistently upheld the approach it laid-out in its 1940 Statement. In In re NASD, 19 S.E.C. 424 (1945), the SEC vacated an NASD disciplinary ruling concerning underwriters and dealers who sold bonds below offering prices. In the course of its ruling, the SEC reaffirmed its belief "that Congress intended this Commission to consider all aspects of stabilization problems," id. at 461, and explained its views on "price-maintenance" provisions including Penalty Bids. Id. at 428. It noted that these provisions "were in use prior to the creation of this Commission and long before the registration of the NASD... [and concluded that] [o]ur views with respect to such provisions are very much the same as our views on the 'pegging, fixing and stabilizing of securities prices... i.e., that we should not prohibit such provisions." Id. at 443-44. In 1955, the SEC adopted the "Trading Practice Rules" which codified its positions "in considering questions relating to manipulative activity and stabilization in connection with an offering." SEC Release No. 34-5040 (May 18, 1954). 17 CFR § 240.10b-7 ("Rule 10b-7"), applied specific restrictions on what types of stabilization could be used and at what prices,[13] but otherwise allowed the practice to continue. SEC Release No. 34-5194 (July 5, 1955).

Between 1961 and 1963, the SEC undertook a massive audit of all stock exchange and securities association rules and submitted

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[13] "Rule 10b-7 prohibits certain specific activities, including bids or purchases not necessary for the purpose of preventing or retarding the decline in the open market of the price of a security, and stabilizing at a price resulting from illegal activity. The rule establishes the price level at which a stabilizing bid may be entered, and rules of priority for the execution of independent bids at times when a stabilizing bids [sic] has been entered. In addition, the rule regulates the number of stabilizing bids that an underwriting syndicate may enter in any one market at any one time, and the entry of stabilizing bids on markets other than the principal market for the security being stabilized. The rule also requires that notice be given that the market will be or is being stabilized, and requires a person effecting stabilizing transactions to keep the information and make the notification required by Rule 17a-2 under the Exchange Act." SEC Release No. 33-7075, 34-33924, 56 S.E.C. Docket 1302 (April 19, 1994).

a "monumental" five-volume report in which it made suggestions "to strengthen the mechanisms facilitating the free flow of capital into markets and to strengthen investor protections." H.R. Rep. No. 1418, 88th Cong., 2d Sess., 1964 U.S.C.C.A.N. 3013, 3017 (May 19, 1964). The report directly addressed the incidence of "free riders" in oversubscribed public offerings and observed that underwriters "attempted to place stock where long-term investment was likely," rather than to investors likely to "sell their allotments in the immediate aftermarket." H.R. Doc. No. 95, Pt. 1, 88th Cong., 1st Sess. 523, 526 (1963). The SEC recognized that underwriters sought to combat flipping through practices including Revocation of Privilege, the very conduct challenged in the instant suit.

> "Some firms place restrictions not upon the salesman but upon <u>the customer</u>. Firms 'flagged' or identified customers who sold stock in the immediate after-market by reviewing the transfer sheets; <u>those who sold were unlikely to receive allotments of subsequent oversubscribed issues</u>... Some customers stated that they were told not to sell for varying periods, usually 30 to 60 days."

<u>Id</u>. at 525-26 (emphasis added). Yet despite considerable attention paid in the report to stabilizing practices such as Penalty Bids and Revocation of Privilege, not one of its 175 recommendations

identified them as problematic. In sum, during the 50-plus years following the 1940 Statement, the SEC actively examined and considered the propriety of stabilizing practices such as Penalty Bids and Privilege Revocation, and chose to allow them to continue subject to regulation.

6. Regulation M and Automated Certificate Tracking System

During the past decade, the SEC reconsidered its entire regulation of stabilizing practices under Section 9(a)(6). Once again, it chose to permit the practices subject to new, more flexible, regulation. In 1994, the SEC announced that it was undertaking a "comprehensive review" of the Trading Practice Rules "in light of significant changes in the securities markets and distribution practices in recent years." SEC Release No. 33-7075, 34-33924, 56 S.E.C. Docket 1302 (April 19, 1994). In its announcement, the SEC focused on the increase in flipping[14] and the shift in stabilizing practices to the "aftermarket" period

[14] The SEC noted that, "immediate aftermarket selling by substantial purchasers in the offering, known as 'flipping' ha[d] become common," and recognized that it "appear[ed] to be a longstanding phenomenon." Id. at n.92.

following distribution of shares in a public offering.[15] It solicited comments on the implications of both phenomena.

In 1996, based on responses to its 1994 solicitation and intensive study, the SEC proposed and adopted Regulation M which reaffirmed the legality of Penalty Bids and other stabilizing activities. See SEC Release Nos. 33-7282, 34-37094, 61 S.E.C. Docket 1713 (April 11, 1996)("Proposing Release"); SEC Release Nos. 33-7375, 34-38067, 63 S.E.C. Docket 1141 (December 20, 1996)("Adopting Release"). Regulation M replaced the old Trading Practice Rules with "a more flexible framework for stabilizing transactions."[16] Adopting Release at 1141. In choosing this approach, the SEC recognized that "[o]ne of the objectives of a penalty bid is to encourage syndicate participants to sell the securities to those persons who intend to hold them rather than

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[15] "[T]he 'aftermarket' of the offered security [is] the period following cessation of the sales efforts in the offering... '[S]tabilization' of the market in connection with offerings may have shifted from the sales period to the aftermarket period." Id. at 1316.

[16] The SEC explained: "Regulation M significantly eases regulatory burdens on offering participants by eliminating the trading restrictions for underwriters of actively-traded securities; reducing the scope of coverage for other securities; reducing restrictions on issuer plans; providing a more flexible framework for stabilizing transactions; and deregulating rights offerings." Adoption Release at 1141 (emphasis added).

engage in short-term profit-taking, *i.e.*, to combat flipping." Proposing Release at 1740; see also id. at 1739 ("underwriters... have an incentive to provide 'support' in the aftermarket to counterbalance pressure on the security's price from 'flipping' and other selling activity that could adversely affect the investors who have purchased the offering"). Regulation M accepted the utility of stabilizing in combating flipping and created flexible regulations to facilitate its implementation, while guarding against abuse.

Finally, in 1996, the SEC adopted a proposal to create an automated certificate tracking system ("automated tracking system") for the purpose, *inter alia*, of combating flipping through stabilization practices. The proposal was the result of a 1992 SEC blue-ribbon task force report on reducing dependence on physical securities certificates in order to accelerate trading settlement. See Report of the Bachmann Task Force on Clearance and Settlement Reform in the U.S. Securities Markets (May 1992)("Bachmann Report"). The task force found that tracking trades in order to combat flipping was a central function of the settlement system[17]

[17] The Bachmann Report stated that: "One obstacle to achieving depository eligibility for new issues is the current use of physical certificates to track potential inappropriate

and that "[t]he ability to monitor this practice [flipping] should not be lost in a certificateless environment." See Letter from John W. Bachmann to Hon. Richard C. Breeden dated May 26, 1992, accompanying Bachmann Report at 5. In response to the Bachmann Report, the SEC adopted ten rule changes to facilitate adoption of a "flipping tracking system."[18] In May 1996, the SEC adopted the Depository Trust Corporation's proposal for an automated tracking system and recognized approvingly that the system would help Managers combat flipping. See SEC Release No. 34-37208, 61 S.E.C. Docket 2365, n.7 (May 13, 1996).

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trading of [public offerings] back to the syndicate during the stabilization period. This inappropriate trading, commonly known in the industry as 'flipping', occurs during the new issue stabilization period... Syndicate managers rely on the certificate number to identify which member of the syndicate sold the issue to the investor who 'flipped' it back to the syndicate so that they can recoup a portion of the seller's concession paid to that syndicate member." Bachmann Report at 28 (emphasis added).

[18] SEC Release No. 34-36778, 61 S.E.C. Docket 465 (Jan. 26, 1996); SEC Release No. 34-36568, 60 S.E.C. 2312 Docket (Dec. 8, 1995); SEC Release No.34-35798, 59 S.E.C. Docket 986 (June 1, 1995); SEC Release No. 34-35772, 59 S.E.C. Docket 935 (May 26, 1995); SEC Release No. 34-35773, 59 S.E.C. Docket 936 (May 25, 1995); SEC Release No. 34-35774, 59 S.E.C. Docket 938 (May 26, 1995); SEC Release No. 34-35740, 59 S.E.C. Docket 853 (May 19, 1995); SEC Release No. 34-35734, 59 S.E.C. Docket 779 (May 18, 1995); SEC Release No. 34-35735, 59 S.E.C. Docket 781 (May 18, 1995); SEC Release No. 34-35711, 59 S.E.C. Docket 725 (May 12, 1995).

7. Summary

In sum, when we apply the requirements for implied immunity discussed earlier, it is clear that the conduct plaintiffs challenge is immune from the antitrust laws. Section 9(a)(6)'s legislative and administrative history establishes that defendants' conduct is a species of the "pegging, fixing or stabilizing" of securities over which the SEC has exclusive jurisdiction. The SEC's sanction of the conduct is "clearly repugnant" to the application of the antitrust laws as alleged in plaintiffs' complaint. Thus, it is entitled to immunity.

Congress was well aware of stabilization practices at the time it created the SEC and Section 9(a)(6). These practices "received most careful consideration" by the Senate Committee on Banking and Currency when it was drafting the 1934 Act. However, unlike insidious manipulation practices that it outlawed outright, Congress sanctioned stabilizing practices and delegated to the SEC regulatory authority over them in Section 9(a)(6). As the 1940 Statement noted, Congress' decision to delegate regulatory authority over stabilization practices to the SEC is a strong indication that it found these practices to be lawful, despite their manipulative nature. Furthermore, in light of Congress' perennial interest in the efficient function of the capital markets, it is noteworthy that Congress has not chosen to intervene during the sixty six years in which the SEC has permitted the challenged conduct.

The SEC has actively studied and regulated stabilization practices over the past 60 years. Through the 1939 Rules, the 1940 Statement, the 1945 In Re NASD decision, the 1955 "Trading Practice Rules," the 1961-1963 audit, the 1994-1996 Regulation M proceedings, and the 1996 decision to support an automated tracking system, the SEC has kept a vigilant eye over stabilization practices and has adjusted its regulation to facilitate stabilization while guarding against its abuse. Consistent through all of these actions has been the SEC's studied assessment that the benefits of price stabilization to the capital markets outweigh the admitted anti-competitive aspects of stabilizing manipulation. To any extent that the SEC's regulations did not explicitly authorize the precise practices alleged by plaintiffs, its conscious decision not to prohibit this activity over which it had explicit authority "implicitly authorized" the conduct and, therefore, "to permit an antitrust suit to lie against [the conduct] would conflict with the proper functioning of the securities laws." Finnegan, 915 F.2d at 831; see NASD, 422 U.S. 694.

The potential conflict between Plaintiff's reading of the antitrust laws and the SEC's regulation of stabilizing under 9(a)(6) could not be clearer. The SEC has held that the challenged conduct is permissible under Section 9(a)(6) while Plaintiff claims that antitrust laws forbid it. An actor seeking to engage in the stabilization practices challenged in this suit would plainly be subjected to conflicting standards.

Plaintiffs respond that even if 9(a)(6) does give implied immunity to "pegging, fixing or stabilizing," the practice of Privilege Revocation challenged in this suit is different from the stabilization practices sanctioned by the SEC and, thus, is not immune to antitrust law. This argument is flawed for two reasons. First, plaintiffs seem to ignore clear examples of the SEC's awareness of Privilege Revocation, see, e.g., supra discussion of 1961-1963 SEC audit. Second, and more important, whether or not Privilege Revocation is an appropriate "pegging, fixing or stabilizing" practice is not a question for this Court. Although we might have jurisdiction to impose antitrust penalties on defendants for practicing Privilege Revocation if the SEC had declared the practice unlawful, see Strobl, 768 F.2d 22 (holding that antitrust penalties may apply to conduct outlawed by the SEC because does not present a conflict between SEC regulation and antitrust law), it remains within the SEC's exclusive jurisdiction to declare whether Privilege Revocation is unlawful. The SEC has not done so. Indeed, by every indication it has sanctioned this conduct subject to regulation.[19]

For the reasons discussed above, we find that defendants' challenged conduct is immune from the application of antitrust laws because the SEC has exclusive authority to regulate it under Section 9(a)(6). Because this conclusion disposes of Plaintiff's federal claim, we do not reach defendants' other defenses.[20] Accordingly, the First Count of plaintiffs' amended complaint is

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[19] The SEC continues to regulate actively in this area. Just this week, the Wall Street Journal reported that the SEC had prohibited certain "quid pro quo" aftermarket stabilizing practices on the grounds that they could "violate longstanding antifraud and antimanipulation provisions of federal securities law." See, e.g., Susan Pullman and Randall Smith, "Seeking IPO Shares, Investors Offer to Buy More in After-Market, And Pledges Can Be a Factor, Underwriters Say, Though They Deny Quid Pro Quo - Trying to Avoid the Flippers", Wall St. J., Dec. 6, 2000, at A1 (The SEC recently). However, the SEC chose not to crack-down on the practices challenged in this suit, providing further evidence of its continued sanction.

[20] We note, however, that plaintiffs' alleged antitrust injury is dubious. Plaintiffs claim that they were injured because they overpaid for the offering shares. This Court cannot find an injury because it sees no overpayment -- plaintiffs bought their shares at the same price as the institutional investors and were free to sell them in the aftermarket without legal restriction. This claim is rendered even less compelling because plaintiffs, unlike the public at large, purchased the shares at the offering price, a price generally set below the shares' estimated market value.

dismissed with prejudice.[21]

D. Breach of Fiduciary Duty

We have dismissed plaintiffs' federal antitrust claim which was the sole predicate for federal jurisdiction. When federal claims are dismissed, retention of state law claims under supplemental jurisdiction is left to the discretion of the trial court. See 28 U.S.C. §1367(c)(3)(1994)("[d]istrict courts may decline to exercise supplemental jurisdiction over a claim... if... (3) the district court has dismissed all claims over which it has original jurisdiction."); Purgess v. Sharrock, 33 F.3d 134, 138 (2d Cir.1994); In re Merrill Lynch Ltd. Partnerships Litig., 7 F. Supp. 2d 256, 258 (S.D.N.Y. 1997). We decline to exercise supplemental jurisdiction over Plaintiff's New York state law claim for breach of fiduciary duty. Accordingly, the Second Count of plaintiffs' amended complaint is dismissed with prejudice.

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[21] Plaintiffs have been given ample opportunity to cure their pleadings. After defendants moved to dismiss in November 1998, plaintiffs amended their complaint. In amending their complaint, plaintiffs had the benefit of analyzing defendants' memorandum of law supporting the first motion to dismiss. Plaintiffs' amended complaint still failed to state a claim on which relief could be granted and we see no way in which they can cure their claim through re-pleading.

CONCLUSION

For the reasons stated above, defendants' motion to dismiss plaintiffs' claims under Fed. R. Civ. P. 12(b)(6) is granted and plaintiffs' claims are hereby dismissed with prejudice.

IT IS SO ORDERED.

DATED: New York, New York
December 7, 2000

NAOMI REICE BUCHWALD
UNITED STATES DISTRICT JUDGE