Vanderbilt Law Review

Volume 36
Issue 1 *Issue 1 - January 1983*

Article 2

1-1983

Swimming Against the Deregulatory Tide

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Swimming Against the Deregulatory Tide: Maintaining Fixed Prices in Public Offerings of Securities Through the NASD Antidiscounting Rules

*Harry S. Gerla**

Increasing pressure from institutional investors during the last two decades has led to indirect discounting practices that some commentators contend threatens the fixed price offering system. In response to this concern the SEC in 1980 approved new NASD rules designed to bar direct or indirect discounting in fixed price public offerings of securities. In this Article Professor Gerla argues that the SEC erred in approving the new NASD rules. Professor Gerla states that the new rules change drastically the Commission's policy that the fixed price system operate without direct or indirect government enforcement. Further, he contends that the SEC approved the rules without empirical data sufficient to support arguments on either side. Professor Gerla concludes that the rule changes will encourage inefficiency in the investment banking industry and that the Commission's policy shift on the role of government in enforcing anticompetitive agreements in effect has allowed the reregulation of the underwriting industry.

I. Introduction

The Securities and Exchange Commission (Commission or SEC) recently approved a proposed rule change by the National Association of Securities Dealers, Inc. (NASD)[1] designed to elimi-

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1. The NASD is the sole national securities association registered pursuant to the Securities Exchange Act of 1934, § 15A, 15 U.S.C. § 78o-3 (1976). The NASD is a membership organization that regulates primarily the nonexchange securities business of its members. Although membership in the NASD is not mandatory, virtually every significant broker-dealer participating in underwriting offerings belongs to the NASD because the organization's rules forbid members from selling securities to nonmember broker-dealers except at

nate direct or indirect discounting in fixed price public offerings of securities.[2] Although the question whether the NASD should be permitted to bar indirect discounting in fixed price offerings may seem to be of limited import and of interest only to persons in the underwriting field, approval of the antidiscounting rules has broad implications for the role of government in enforcing arguably anticompetitive agreements.

This Article postulates that the Commission erred in approving the NASD antidiscounting rules because the rules are inconsistent with the requirements of the Securities Exchange Act of 1934 (Exchange Act).[3] Although the actual impact of the rules may be slight—because of a Commission-created loophole and enforcement problems[4]—the Commission's approval of the rules nonetheless may portend serious harm to future competition in the securities markets. In approving the NASD rules the Commission reversed a policy of thirty-five years standing[5] and allowed the use of governmental power to support agreements designed to frustrate free market forces. The Commission in the process uncritically accepted many of the traditional arguments made on behalf of governmental economic regulation of industry and on behalf of price fixing among competitors. In effect, the Commission sanctioned the reregulation of the underwriting industry, a development that in the long run may prove to be the principal harm engendered by SEC approval of the antidiscounting rules.

II. Background

A. *The Fixed Price Offering System*

The syndicate system of underwriting, in which a group of investment bankers forms an underwriting syndicate that acts as a middleman in distributing the securities of an issuer to the investing public,[6] has been the predominant mode of publicly distribut-

the price offered to the general public. NASD Rules of Fair Practice, art. III § 25, *reprinted in* NASD MAN. (CCH) ¶ 2175. Section 15A(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o-3(e) (1976), specifically sanctions this rule as a method of inducing broker-dealers to join a registered national securities association.

2. NASD Rules of Fair Practice, art. III §§ 8, 24, 36, *reprinted in* NASD MAN. (CCH) ¶¶ 2174, 2196; *see In re* National Association of Securities Dealers, Inc., Exchange Act Release No. 17371, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,705 (Dec. 12, 1980) [hereinafter cited as Approval Release].

3. 15 U.S.C. §§ 78a-78kk (1976 & Supp. V 1981).

4. *See infra* notes 180-91 and accompanying text.

5. *See infra* notes 122-39 and accompanying text.

6. Approval Release, *supra* note 1, at 83,3849-50; *see* G. ROBINSON & K. EPPLER, 1

ing new issues of conventional debt and equity securities since the end of World War I.[7] The underwriter's profit in this system is the difference between the price that is paid to the issuer and the price at which the securities are sold to the public, a difference known as the "spread." In a "firm commitment offering" the investment bankers place their capital at risk by making an outright purchase of the securities from the issuer.[8] A group of broker-dealers—known as the "selling group"—assist the underwriters by acting as agents in retailing the securities to the public. Because they are acting as agents in the distribution, selling group members in theory do not place their capital at risk. The selling group members make their profit on the selling group spread—the difference between what is paid to the underwriters and the public offering price.[9] A salient feature of both the underwriting agreement, which defines the rights and obligations of the underwriters *inter se,* and the selling group agreement, which defines the rights and obligations between the underwriters and the selling group members, is the requirement that all participants in the distribution sell the securities to public investors only at the fixed public offering price that is stated in a statutorily mandated prospectus.[10] The underwriters in effect have established a system of resale price maintenance in the public distribution of securities. Under this system the price per share or unit of securities is the same whether the purchaser buys 100 or 100,000 shares or units.

Until the 1960's the fixed price underwriting system proved to be remarkably durable, surviving the Great Depression, several declared and undeclared wars, numerous recessions, and a determined challenge by the Justice Department under the federal antitrust laws.[11] The increased importance of institutional investors since the mid-1960's, however, has threatened to undermine the fixed price system.[12] Institutional investors such as bank trust departments, pension funds, insurance companies, and investment companies frequently engage in block transactions for their securi-

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GOING PUBLIC ¶ 22, at 94-96 (1978).

7. Approval Release, *supra* note 2, at 83,849-50; *see* United States v. Morgan, 118 F. Supp. 621, 641-50 (S.D.N.Y. 1953).

8. G. ROBINSON & K. EPPLER, *supra* note 6, ¶ 37.

9. Approval Release, *supra* note 2, at 83,850; G. ROBINSON & K. EPPLER, *supra* note 6, ¶ 37.

10. Approval Release, *supra* note 2, at 83,850; R. JENNINGS & H. MARSH, SECURITIES REGULATION: CASES AND MATERIALS 643 (4th ed. 1980).

11. *See infra* notes 133-34 and accompanying text.

12. Approval Release, *supra* note 2, at 83,851, 83,870.

ties portfolios that may involve thousands of shares of equity securities or hundreds of thousands or even millions of dollars in debt securities.

This growth of institutional investors has had a number of significant effects on the securities markets. For example, this growth hastened, if not in large part caused, the demise of fixed rates of commission on securities exchanges. Until May 1, 1975, all the major stock exchanges maintained fixed minimum rates of commission for most transactions based upon the rate for round lot—100 shares—transactions.[13] Thus, the minimum rate for a 100,000 share transaction was simply one thousand times the minimum rate for a 100 share transaction. Large transactions of institutional investors were particularly profitable for brokers because the costs associated with such transactions were not significantly higher than those associated with smaller transactions.[14] Institutional investors, however, naturally were dissatisfied with a system that forced them to pay the same per share rate of commission as a small individual investor. Institutional investors, therefore, hegan to seek reductions in the minimum commission rates from brokers. The brokers could not openly give institutions rates lower than the minimums set by the exchanges without risking disciplinary action by the exchanges.[15] On the other hand, the brokers could not afford to lose the lucrative business provided by institutional investors.[16] To avoid this dilemma, brokers and institutions circumvented the exchanges' minimum fixed commission rates by devising methods with exotic names such as the "give up"[17] and

13. SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, SUBCOMM. ON SECURITIES, 92D CONG., 1ST SESS., SECURITIES INDUSTRY (INITIAL REPORT) 53 (Comm. Print 1972) [hereinafter cited as SECURITIES INDUSTRY STUDY]; C. WELLES, THE LAST DAYS OF THE CLUB (1975). In April 1971 the exchanges, at the direction of the Commission, allowed negotiated rates on portions of orders exceeding $500,000. The $500,000 "break point" was lowered to $300,000 in April 1972. Adoption of Securities Exchange Act Rule 19b-3, Exchange Act Release No. 11,203 (Jan. 23, 1975), [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,067 at 84,968-69 [hereinafter cited as SEC Release].

14. SECURITIES INDUSTRY STUDY, *supra* note 13, at 53.

15. *Id.*

16. C. WELLES, *supra* note 13, at 67.

17. New York Stock Exchange rules allow members of the Exchange to share the commissions earned on a transaction. Although members ordinarily share commissions with other members that work on a trade, the rules permit sharing at the direction of the customer with a firm that had no connection with the trade. This customer directed "give up" became a method of indirect discounting that large mutual funds used to reward other brokers for selling shares of furnishing services. R. JENNINGS & H. MARSH, *supra* note 10, at 604.

"end run"[18] and the "incorporated deep pocket give up."[19] Use of these devices had become so pervasive by the early 1970's that, as far as institutional investors were concerned, the exchanges' minimum commission rates were virtually nonexistent. As one commentator notes, institutional pressure made minimum fixed commission rates a dying institution long before the SEC formally barred them.[20]

In light of this background, some institutional investors not surprisingly began to seek discounts in fixed price offerings of securities. These institutions insisted that the underwriters or selling group members reduce the spread on transactions. Underwriters and selling group members generally could not afford to forego the business provided by institutional investors. Moreover, an institutional investor's willingness to buy part of a new issue could mean the difference between a successful offering and the ultimate nightmare of all underwriters—having to absorb part of an issue.[21]

Just as brokers could not openly evade the exchanges' minimum commission rates, underwriters and selling group members seeking to give discounts to institutional investors for different reasons could not overtly violate their price maintenance agreements. The underwriting agreements or selling group agreements do not prevent open discounting; any suit against an open discounter for breach of contract is likely to fail either for lack of proof of damages or on antitrust grounds.[22] Further, the threat of sanctions by the NASD was ineffectual in preventing open discounting; at least until the recent Commission approval of the NASD proposed rule

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18. The "end run" was a method that allowed firms to give up portions of commissions to other firms that were not members of the New York Stock Exchange. A customer would pay full commission to his Exchange firm, which would then execute the order or another order on a regional exchange of which the broker-dealer who was the customer-directed recipient of the give up was also a member. The Exchange firm could then give a portion of the commission on the transaction to that designated broker-dealer. *Id.* at 605.

19. The "incorporated deep pocket give up" occurred when institutional investors incorporated subsidiaries and registered these subsidiaries as regional broker-dealers. Thus, indirect discounts through "give ups" and "end runs" came directly back into the institution's pocket. *Id.* at 606.

20. C. WELLES, *supra* note 13, at 67, 85.

21. Proposed Rule Change by the NASD: Papilsky Hearings Before the Securities and Exchange Commission, File No. 4-282, at 753 (1979) (Testimony of John C. Whitehead, Co-Chairman, Management Committee, Goldman, Sachs & Co.) [hereinafter cited as Hearings Transcript].

22. Moreover, even assuming damages could be proven, the pursuit of discounters through litigation probably would be uneconomical. NASD Letter of Comment to George Fitzsimmons, Secretary, SEC, File No. SR-NASD-78-3, at 18 (Augnst 10, 1979) [hereinafter cited as NASD Comment Letter].

change, the NASD did not have the authority to punish discounters.[23] Instead, the realization that any firm which openly engages in discounting in a fixed price offering probably would be excluded from future underwriting syndicates and selling groups prevented most open discounting.[24]

To avoid the loss of institutional business or exclusion from participation in future distributions, some underwriters and selling group members have resorted to variations on the old techniques for evading fixed commission rates to give indirect discounts to institutional investors. Two techniques that seem to be particularly prevalent are the "designated order" and the "overtrade." In the designated order a broker will supply an institutional investor with free goods or services such as research on securities.[25] In return, the institutional investor contacts the managing underwriter of a new issue that the investor is interested in purchasing and asks that the broker supplying the goods or services be included in the selling group and credited with the sale of the securities to the institutional investor. The broker receives the selling group spread and the institutional investor receives the securities at the public offering price and whatever the broker has supplied, which constitutes the indirect discount.[26] The second method of indirect discounting is the overtrade. An institutional investor wishing to

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23. *See infra* notes 123-29 and accompanying text.

24. The Commission in National Ass'n of Sec. Dealers, 19 S.E.C. 424 (1945), noted the use of exclusion from underwriting and selling groups as a deterrent to discounting. The Commission stated that "[c]ivil liability for the breach of contract, or the unfavorable opinions of leading underwriters, are among the risks that group members have always faced when underselling." *Id.* at 445. Of course, if the exclusion involves any form of concerted action, it likely would constitute a group boycott, which is a per se violation of § 1 of the Sherman Act, 15 U.S.C. § 1 (1976). *See* Klor's, Inc. v. Broadway-Hale Stores, Inc., 359 U.S. 207 (1959). If, however, the NASD imposed the exclusionary action pursuant to self-regulatory rules approved by the SEC, the actions likely would be immune from antitrust scrutiny under the principles established in United States v. National Ass'n of Sec. Dealers, Inc., 422 U.S. 694 (1974) (certain vertical and horizontal restrictions of NASD immune from antitrust liability under Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -22f (1976), and the Maloney Act of 1938, 15 U.S.C. § 78o-3 (1976)). During the hearings the NASD indicated that it was concerned not only with a possible attack on the fixed price agreements as price fixing, but also with an attack on informal enforcement of the agreements as a group boycott. Hearings Transcript, *supra* note 21, at 107 (testimony of R. Garrett, Jr.).

25. The broker most typically provides the institutional investor with free research, but brokers in the past have supplied everything from Christmas cards and "ticker tape neckties" to computer services. C. WELLES, *supra* note 13, at 69-70; Loomis, *Paulette Papilsky's Deadly Threat to Wall Street*, FORTUNE, April 23, 1979, at 90, 92.

26. Practices in Fixed Price Offerings, Exchange Act Release No. 15807, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,073, at 81,759 (May 9, 1979) [hereinafter cited as Practices Release].

purchase a new issue at times does not have cash available to make the purchase or is unwilling to pay cash. Thus, an underwriter often will take in trade securities currently in the portfolio of the investor in return for the new issue of securities. This procedure—called a "swap"—easily can include an indirect discount. Assume, for example, that an institutional investor wishes to purchase debt securities of Company A with a public offering price of $100,000. An underwriter could take in trade securities whose market value is $98,000, thus yielding to the institutional investor a $2,000 indirect discount on the securities in distribution. This type of swap is an overtrade.[27]

A third type of indirect discounting that is not used presently is the "recapture." Under this technique an institutional investor will establish a broker-dealer subsidiary, and the subsidiary will join the NASD. The institutional investor then will contact the managing underwriter of a new issue that the institution wishes to purchase and ask that the institution's broker-dealer subsidiary be included in the selling group for that issue. The institution then purchases the securities in distribution through its subsidiary at the full public offering price. The subsidiary receives the selling group spread from the transaction. Since the parent institution eventually receives the profits of the broker-dealer subsidiary, this recapture yields an indirect discount to the institution.[28]

The frequency of utilization of these indirect discounting devices is a matter in sharp dispute.[29] For at least a short time after the decision in *Papilsky v. Berndt,*[30] which triggered the proposed rule changes by the NASD, more widespread use of indirect discounting devices appeared likely. In *Papilsky* a shareholder of an investment company brought a derivative suit against the investment advisor-manager of the company. The shareholder charged that the manager had failed to inform the outside directors of the investment company of the possibility of utilizing the recapture technique to benefit the fund.[31] The advisor-manager claimed that

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27. *Id.*

28. For a more detailed description of the techniques of recapture, see Papilsky v. Berndt, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,627 (S.D.N.Y. 1976); Approval Release, *supra* note 2, at 83,848.

29. *See* Loomis, *supra* note 25, at 90, 92. *Compare* Hearings Transcript, *supra* note 21, at 25 (testimony of R. Garrett, Jr.) (discounting not widespread) *with id.* at 571-721 (testimony of P. McCarthy, President, McCarthy, Reid, Crisanti & Maffei, Inc.) (discounts are widespread).

30. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,267 (S.D.N.Y. 1976).

31. *Id.* at 90, 122.

section 24 of the NASD Rules of Fair Practice prohibited recapture.[32] The court rejected this defense and held that "in the absence of a Commission or NASD rule to the contrary" recapture was both legal and available. The court concluded that failure of the managers to bring the possibility of recapture to the attention of the independent directors of the fund constituted a breach of the managers' fiduciary duties.[33]

The decision in *Papilsky* caused great concern among managers of institutional investors. Some of these managers, however, noted the "in the absence of an NASD rule to the contrary" language in the opinion and wrote to the NASD requesting its formal opinion on whether recapture was allowable under section 24.[34] The NASD replied that it interpreted section 24 as forbidding recapture.[35] This correspondence came to the attention of the Commission, which informed the NASD that, in the Commission's opinion, this interpretation was, in fact, a change in the NASD rules.[36] Section 19(b) of the Exchange Act[37] requires that virtually all rule changes of a self-regulatory organization, such as the NASD, be filed with the Commission and that the changes cannot take effect until approved by the Commission. The Commission can grant approval only upon an affirmative finding that the proposed change is consistent with the requirements of the Exchange Act.[38] At an open meeting of the Commission a number of Commissioners expressed concern that allowing other means of indirect discounting would be inequitable if the NASD prohibited recapture.[39]

In response, the NASD submitted a formal proposed rule change that barred all of the previously described indirect dis-

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32. NASD Rules of Fair Practice, art. III, § 24, *reprinted in* NASD MAN. (CCH) § 2175 (1967).

33. Papilsky v. Berndt, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,627, at 90,130-32 (S.D.N.Y. 1976).

34. Practices Release, *supra* note 26, at 81,760. An ironic sidelight of the controversy over indirect discounting is that the precipitating cause of the controversy, the decision of the district court in *Papilsky v. Berndt*, has become moot after the decision of the Second Circuit in the case of Tannenbaum v. Zeller, 552 F.2d 402 (2d Cir.), *cert. denied*, 434 U.S. 934 (1977). The *Tannenbaum* court reaffirmed the duty of the advisor of a mutual fund to inform tbe independent directors of the possibility of recapture, but also held that the actual decision on whether to use the technique was committed to the informed discretion of the directors. *Id.* at 417.

35. Practices Release, *supra* note 26, at 81,760-61.

36. *Id.* at 81,761.

37. 15 U.S.C. § 78s(b) (1976).

38. *Id.* § 78s(b)(2).

39. Practices Release, *supra* note 26, at 81,761; Loomis, *supra* note 25, at 94.

counting practices.[40] After extensive public hearings on the proposals, the Commission suggested two changes in the proposed rule change. The first change would allow designated orders in return for research; the second would tighten the provisions barring overtrades.[41] The NASD incorporated these suggested changes, and the Commission approved the amended rules. This Article posits that the Commission erred in approving the new NASD antidiscounting rules for two reasons. First, the Commission could not have found on the record that the proposed rule changes were consistent with the Exchange Act. Second, the approval of the changes places governmental enforcement behind facially anticompetitive agreements.

III. The NASD Rules and the Securities Exchange Act Statutory Requirements

Section 15A(b)(6) of the Exchange Act[42] requires that the rules of a registered national securities association, of which the NASD is the sole example, carry out certain enumerated purposes, and it prohibits rules that have certain effects. Specifically, the rules of the NASD must

> not [be] designed to permit unfair discrimination between customers, issuers, brokers, or dealers, *to fix minimum profits, to impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members*, or to regulate by virtue of any authority conferred by this chapter matters not related to the purposes of this chapter or the administration of the association.[43]

Subsection (b)(9) of section 15A also requires that "[t]he rules of the association do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of [the Exchange Act]."[44]

Opponents to the NASD rule changes argued that the proposals to limit indirect discounting in fact do impose a schedule or fix rates of commissions, allowances, or discounts among members and, thus, that they contravene section 15A(b)(6) of the Exchange Act. To rebut this point, the NASD claimed that the underwriters, rather than the NASD, actually fixed the rates and that the sole function of the NASD in the matter was to enforce the contracts

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40. Practices Release, *supra* note 26, at 81,761.
41. Approval Release, *supra* note 2, at 83,853, 83,856-57.
42. 15 U.S.C. § 78o-3(b)(6) (1976).
43. *Id.* (emphasis added).
44. 15 U.S.C. § 78o-3(b)(9)(1976).

voluntarily entered into by its members.[45] The Commission had rejected this very argument thirty-five years earlier in *In re National Association of Securities Dealers (PSI)*.[46] In *PSI* the Commission stated:

> We cannot accept the NASD's argument that the rule does not "impose" the schedule of prices and discounts on the member. True, the schedule has been accepted by the member for the purposes of his contract, but association rules impose duties *to the association* over and above the member's duties which arise out of his dealings with others. Thus, the duty of a member to deal honestly with a customer has properly been made a multiple obligation, for which the member may be called to account not only by the customer, in civil litigation, but also by the association, in disciplinary proceedings under its rules, as well as by other law-enforcement authorities. So bere, the NASD seeks to impose on participating members an obligation *to itself*, enforceable through disciplinary proceedings, to adhere to a schedule of discounts which would otherwise be enforceable only by tbe parties to the contract through private litigation or such practical economic sanctions as they might bave at their command. And clearly, by the implicit threat of again using its disciplinary powers, it seeks prospectively to impose on participating members *a schedule of discounts that may be established by contract in any future underwritings.*
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> Whether or not the PSI syndicate agreements were voluntarily adopted, and whether or not the minimum profits and schedule of prices and discounts were "fixed" by the agreements, it is the NASD which is seeking to enforce the schedule, and thus to "impose" it and other similar schedules by its application of the rule in disciplinary proceedings.[47]

The Commission's point was valid in 1945, and it is valid today. In fact, the NASD in setting forth its proposed rule changes expressly argued that, but for the weight of NASD enforcement, underwriters and selling group members eventually would disregard the price fixing terms of underwriting contracts, and the fixed price underwriting system would collapse.[48] Thus, the NASD contradicted its own argument when it took the position that the underwriters rather than the NASD were fixing rates of commissions, allowances, or discounts under the new proposals.

Despite these inconsistencies the Commission indicated that it was sympathetic to the NASD position and that it did not wish to give a "broad" reading to the "fix rates of commissions" language of section 15A(b)(6) of the Exchange Act.[49] The Commission, however, did not rest its decision that the NASD proposed rule

45. NASD Comment Letter, *supra* note 22, at 46.

46. 19 S.E.C. 424 (1945). For a detailed analysis of *PSI*, see *infra* notes 122-39 and accompanying text.

47. 19 S.E.C. at 437-38 (emphasis in original).

48. NASD Comment Letter, *supra* note 22, at 2-3.

49. Approval Release, *supra* note 2, at 83,865.

changes were not in contravention of the rate fixing prohibitions of section 15A on those grounds, but instead chose to rely upon section 15A(b)(9). The Commission maintained that Congress intended that subsection (b)(9), which was added to section 15A by the Securities Acts Amendments of 1975,[50] would provide the sole criterion for judging proposed rule changes that might have an anticompetitive impact.[51] The SEC held that if the benefits of the change in furthering the purposes of the Exchange Act outweighed any anticompetitive effects, the proposed change would satisfy section 15A even if it violated a specific prohibition contained in section 15A(b)(6).[52] The Commission cited no authority for this remarkable proposition.[53]

The position taken by the Commission on the relationship between sections 15A(b)(6) and 15A(b)(9) of the Exchange Act at best is strained. The Commission in its interpretation not only ignores the plain language of section 15A(b)(6), but also disregards generally recognized principles of statutory interpretation. The Commission's view that section 15A(b)(9) overrides the specific prohibitions of section 15(A)(b)(6) suggests that in enacting the former section Congress impliedly repealed the prohibitions in the latter section. An elementary principle of statutory interpretation is that one section of a statute should not be read to render another section nugatory.[54] The Commission's interpretation ignores the clear prohibitions in section 15A(b)(6) or, at most, accords them the status of exhortatory guidelines. Yet, the Commission specifically stated that the positive requirements for the NASD rules contained in section 15A(b)(6) retain their vitality.[55] The Commission failed to explain on what basis it concluded that Congress wished to repeal impliedly only certain selected portions of that section. In addition, the Commission's position that the general language of section 15A(b)(9) controls over the specific prohibitions in section 15A(b)(6) defies the principle that specific language in a statute controls over general language.[56] According to traditional techniques of statutory interpretation, the Commission should have read sections 15A(b)(6) and (9) *in pari materia* as say-

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50. Pub. L. No. 94-29, 89 Stat. 97 (1975).
51. Approval Release, *supra* note 2, at 83,866.
52. *Id.*
53. *Id.*
54. *See* 1A C. SANDS, STATUTES AND STATUTORY CONSTRUCTION § 22.10 (4th ed. 1974).
55. Approval Release, *supra* note 2, at 83,866 n.98.
56. 2A C. SANDS, *supra* note 54, § 51.05.

ing that while all proposed rule changes by the NASD must meet a balancing test weighing the anticompetitive effects of the proposal with the benefits in carrying out the purposes of the Exchange Act, proposed rule changes that fall within the specific prohibitions enumerated in section 15A(b)(6) are per se inconsistent with the Exchange Act.[57] Under this interpretation the Commission should have disapproved the proposed NASD antidiscounting rules on the ground that they amounted to a fixing of comissions in violation of section 15A(b)(6).

The Commission's finding that the NASD proposals are consistent with section 15A is not justifiable even if one accepts the Commission's strained reading of that section. The claims by the NASD that its ban on indirect discounting would further the purposes of the Exchange Act are either irrelevant or insufficiently proven. Moreover, the modifications of the proposals insisted upon by the Commission are inconsistent with the justifications for the antidiscounting rules advanced by the NASD and other proponents of the changes.[58]

IV. Justifications for the NASD Proposals

The anticompetitive effects of the NASD prohibition of indirect discounting on fixed price offerings are readily apparent; the admitted purpose of the antidiscounting rules was to insulate underwriters and selling group members from the competitive pressures exerted by institutional investors.[59] The proposals prevent underwriters or selling group members in fixed price underwritings from selling new issues to institutional investors at a price determined by free bargaining between the buyer and seller.[60] It could

57. This position is essentially the one taken by Commissioner Evans in dissent. *See* Approval Release, *supra* note 2, at 83,876 (Evans, Comm'r, dissenting).

58. Other proponents of the NASD antidiscriminating rule included the Securities Industry Association (SIA) and a significant number of individual broker-dealers as well as issuers of securities. *E.g.*, Letter of Comment from E.F. Hutton & Co. to George A. Fitzsimmons, Secretary, SEC, File No. SR-NASD-78-3 (November 15, 1979); Letter of Comment from International Paper Co. to George A. Fitzsimmons, Secretary, SEC, File No. SR-NASD-78-3 (January 14, 1980); Letter of Comment from Mobil Corp. to George A. Fitzsimmons, Secretary, SEC, File No. SR-NASD-78-3 (January 18, 1980); Letter of Comment from Securities Industry Association to George A. Fitzsimmons, Secretary, SEC, File No. SR-NASD-78-3, (July 31, 1979) [hereinafter cited as SIA Comment Letter].

59. Hearings Transcript, *supra* note 21, at 26 (testimony of R. Garrett, Jr.) (defending the proposed rules as "[t]he principal bulwark of the well-intentioned [NASD] member against the pressures of his economically more powerful institutional customer").

60. *See* Approval Release, *supra* note 2, at 83,873-74 (Evans, Comm'r, dissenting); *cf.* Hearings Transcript, *supra* note 21, at 26, 55-56, 105 (testimonies of R. Garrett, Jr. and L.

be argued that the competitive benefits of the antidiscounting rules, particularly in terms of the structure of the underwriting industry may outweigh the obvious anticompetitive effects. One commentator in fact has argued that the antidiscounting rules, on balance, will be procompetitive in the long run.[61] Nevertheless, the NASD did not contest seriously the point that the rules would have anticompetitive effects. The NASD—and ultimately the Commission—instead chose to emphasize how the antidiscounting rules would further the purposes of the Exchange Act. Specifically, the NASD attempted to justify its restraint on competition on three grounds: the rules were necessary (a) to prevent fraud on investors; (b) to prevent unfair discrimination between investors; and (c) to preserve the fixed price offering system and the entire capital raising system of the United States. This Article addresses individually each of these justifications.

A. The Prevention of Fraud

The NASD maintained that its antidiscounting rules were needed to protect investors against fraud.[62] Specifically, the NASD argued that the failure of issuers and underwriters to disclose the existence of indirect discounting in the prospectus constituted a fraud against investors because indirect discounting rendered the disclosure of the price of the securities in the prospectus false and misleading.[63] In approving the NASD proposals, the Commission totally dismissed this justification on the ground that a generalized disclosure in the prospectus of indirect discounts could cure any misleading of investors.[64]

The issue of disclosure is more complex than the Commission was willing to admit. As the NASD pointed out, any disclosure of indirect discounting practices made in the prospectus can only be extremely general and speculative. The issuer and underwriters who prepare the prospectus generally are ignorant not only of who is granting or receiving indirect discounts and the amount of any such discounts, but also of whether the discounts even exist in the

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Hambrecht).

61. Brunelle, *The Papilsky Rule and the Emerging Antitrust Dimensions of the Securities Exchange Act*, 9 SEC. REG. L.J. 50 (1981); *see infra* notes 160-78 and accompanying text.

62. Approval Release, *supra* note 2, at 83,867.

63. NASD Comment Letter, *supra* note 22, at 12-13.

64. Approval Release, *supra* note 2, at 83,867-68.

particular offering.[65] Thus, by stating that some type of vague generalized disclosure could cure any disclosure problems associated with indirect discounts, the Commission was positing, in effect, that persons who prepare the prospectus need only do as best they can—a view the Commission might not always wish to follow.[66] Nonetheless, for the Commission to have held otherwise in this instance would have been surprising. If the Commission had ruled that a failure to disclose indirect discounts in detail made a prospectus materially misleading, the logical implication would be that the signers of a large majority of the prospectuses over the last decade had violated not only sections 11 and 17(a) of the Securities Act of 1933,[67] but also section 10(b) of the Exchange Act and rule 10b-5 thereunder.[68] Evidence exists that indirect discounting is fairly widespread, particularly in offerings that are selling slowly,[69] yet no witness before the Commission or commentator on the antidiscounting rules was able to point to a prospectus that disclosed the existence of indirect discounts. The Commission, therefore, eschewed reliance on the prevention of fraud as a statutory justification for the NASD antidiscounting rules rather than risk subjecting issuers and underwriters to large civil liabilities for violations of both the Securities Act of 1933 and the Exchange Act.

B. The Prevention of Unfair Discrimination Among Investors

Section 15A(b)(6) of the Exchange Act[70] prohibits the rules of the NASD from unfairly discriminating between investors. The NASD claimed that the existence of indirect discounts discriminated unfairly against smaller investors who lacked the bargaining

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65. Hearings Transcript, *supra* note 21, at 12 (testimony of J.S. Putnam, President, F.L. Putnam & Co., and Chairman of the Board, NASD); *cf.* NASD Comment Letter, *supra* note 22, at 68.

66. As the NASD pointed out, the Commission's General Counsel has taken the position that "hedge clauses" in the literature of brokers, dealers, and investment advisors, which state "that the information furnished is obtained from sources believed to be reliable but that no assurance can be given as to its accuracy," violate the antifraud provisions of the federal securities acts when the clauses are "likely to lead an investor to believe that he has in any way waived any right of action he may have." Opinion of General Counsel, Relating to Use of "Hedge Clauses" by Brokers, Dealers, Investment Advisors and Others, SEC Release No. 4593, 3 FED. SEC. L. REP. (CCH) ¶ 25,095, at 18,207-08 (April 10, 1951).

67. 15 U.S.C. §§ 77k, 77q (1976).

68. 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10(b)(5) (1980).

69. *See supra* note 26; *cf.* Hearings Transcript, *supra* note 21, at 735 (testimony of J.C. Whitehead) (economic pressure for discounting is very heavy, particularly in declining market).

70. 15 U.S.C. § 78o-3 (1980).

power of large institutional investors to obtain these discounts.[71] The NASD also claimed that inequities would result if large investors were permitted to pay a lower per share price than that paid by the small investor for new issues of securities. Ray Garrett, Jr., a former Chairman of the Commission and special counsel for the NASD, stated his position during the hearings:

> I realize market forces are very popular today but our whole structure is based to a degree upon prohibiting the rich and popular from taking it out on the poor . . . . [The NASD antidiscounting rules are] an application of the same thing. We are saying that this application of the market forces produces an inequitable result and therefore market forces should be interrupted to that degree for [the period of the public offering].[72]

The Commission chose not to rely on this argument in approving the proposed rule change.[73] Although the Commission probably was correct in not basing its decision on the argument, the justification merits some detailed consideration for two reasons. First, prior to 1975 the unfair discrimination argument had some strong historical support. Second, the argument has some interesting parallels in deregulation disputes in other regulated industries and in the arguments made on behalf of price fixing arrangements by competitors.

In the United States the concept that the government should regulate an industry to ensure that all buyers pay the same per unit price regardless of the size of their purchases dates back to the Grange and Populist movements of the late nineteenth century. The early Populists objected to a number of railroad pricing practices, including the use of secret rebates to grant large shippers rates more favorable than those given small shippers.[74] The railroads themselves undertook numerous efforts to curb the use of secret rebates because the rebates produced competition that eroded profits.[75] The discontent of the small shippers, combined

71. NASD Comment Letter, *supra* note 22, at 13-14.

72. Hearings Transcript, *supra* note 21, at 128 (testimony of R. Garrett, Jr.).

73. Approval Release, *supra* note 2, at 83,868.

74. *See* D. Hicks, The Populist Revolt 67-68 (1931). The populists, however, were not anticompetitive Luddites. Many of the railroad practices that angered the populists would offend deeply any modern day proponent of free competition. For example, railroads in the late 19th century often attempted to engage in pooling arrangements, which are simple price fixing arrangements by competitors. *See* S. Buck, The Granger Movement 12 (1913).

75. For an extensive discussion of the efforts of the railroads to stem the practice of rebating, see G. Kolko, Railroads and Regulation 1877-1916 (1965). *See also* P. MacAvoy, The Economic Effects of Regulation chs. 3-4 (1965) (detailing the effects of "cheating" on successive rate fixing agreements and railroad profits).

with the desire of the railroads to avoid competition, led to the ban on rebates contained in section 2 of the Interstate Commerce Act of 1887[76] and later to the strengthening of that ban in the Elkins Act of 1903.[77]

The 1930's witnessed a resurgence of populist sentiment inspired by the New Deal. What makes the era of the 1930's relevant is that section 15A of the Exchange Act, including the prohibition against "unfair discrimination between investors," was a product of that era.[78] One of the more important tenets of political and economic faith in the New Deal era was the belief that unbridled competition was in part responsible for the Great Depression. Thus, the New Deal witnessed a deemphasis on promotion of free competition through both the antitrust laws,[79] and an emphasis on industrial cooperation through industrial codes promulgated under the authority of the National Industrial Recovery Act (NIRA).[80] These codes reflected a renewed interest in protecting small businesses from what was viewed as price discrimination through the grant of discounts to big businesses.[81] For example, among the codes promulgated under the NIRA was one devised by the Investment Bankers Conference, which was a forerunner of the NASD. The predecessor section to current section 24 of the NASD Rules of Fair Practice was a provision of the Investment Bankers Code[82] that prohibited the rebating in fixed price offerings of underwriting spreads or brokerage commissions.

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76. Ch. 104, 24 Stat. 379 (1887).

77. Ch. 708, 32 Stat. 847 (1903). The current debate over indirect discounts in underwritings resembles greatly the controversy over secret railroad rebates in tbat the NASD joins the claim that indirect discounting will reduce drastically the profitability of firms in the underwriting field with expressions of concern for the "small" investor. *See infra* part IV(C).

78. The Maloney Act of 1938 added this provision to the original Securities Exchange Act. Ch. 677, 52 Stat. 1070 (1938).

79. *See* Appalachian Coals, Inc. v. United States, 288 U.S. 344 (1933); R. POSNER & F. EASTERBROOK, ANTITRUST: CASES, ECONOMIC NOTES AND OTHER MATERIALS 126-28 (2d ed. 1981); L. SULLIVAN, HANDBOOK OF THE LAW OF ANTITRUST § 66q, at 181 (1977).

80. Ch. 90, 48 Stat. 195 (1933).

81. F. ROWE, PRICE DISCRIMINATION UNDER THE ROBINSON-PATMAN ACT 10 (1962).

82. NATIONAL RECOVERY ADMINISTRATION, CODE OF FAIR COMPETITION FOR INVESTMENT BANKERS, Amend. No. 2 art. V §§ 4(a)-(b), *reprinted in* 8 CODES OF FAIR COMPETITION 672 (1934). At least one goal of the provision was to enforce the ideal of all purchasers paying the same unit price for securities. As the administrator of the National Recovery Administration (NRA) stated in his letter of transmittal to President Roosevelt, "[p]rovisions are included which will tend to establish one price for all investors irrespective of the size of the transaction or the importance of the purchase." Letter from Hugh S. Johnson, Administrator, National Recovery Administration, to Franklin D. Roosevelt, (March 23, 1934), *reprinted in* 8 CODES OF FAIR COMPETITION 660 (1934).

The Supreme Court in *Schechter Poultry Corp. v. United States*[83] declared the NIRA unconstitutional. The movement to prevent discounts based upon the size of purchases, however, continued unabated and reached its pinnacle in 1936 with the passage of the Robinson-Patman Act,[84] which amended section 2 of the Clayton Act.[85] The purpose of the Robinson-Patman Act was to prevent price discrimination against small businesses—when the effect of the discrimination is to injure competition—by prohibiting quantity discounts except as justified by cost savings or meeting competition.[86] The Robinson-Patman Act was a concrete manifestation of the populist notion that the "little guy" should pay the same per unit price as the "big guy."[87]

This background is relevant to the present day NASD proposals approved by the Commission because the supporters of the antidiscounting rules could have maintained that Congress in 1938, in prohibiting the rules of a registered national securities association from "unfairly" discriminating between investors, in fact intended that the rules of the association should promote the ideal of all investors paying the same unit price.[88] Under this approach the NASD could have argued that its new rules on indirect discounting help avoid "unfair discrimination" by ensuring that the small investor in a fixed price offering pays the same price for each of his 100 shares as that which the giant institutional investor pays for each of its 100,000 shares. In fact, the NASD could have pursued the point even further by pointing out the analogy between its ban on rebating the underwriting compensation and section 2(c) of the Robinson-Patman Act[89] and section 22(d) of the Investment Company Act of 1940.[90]

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83. 295 U.S. 495 (1935).

84. 15 U.S.C. § 13(a) (1976) (original version at ch. 592, 49 Stat. 1526 (1936)).

85. *Id.*

86. J. Van Cise, Understanding the Antitrust Laws 67-72 (1976).

87. *See* F. Rowe, *supra* note 81, at 19-23; *The Robinson-Patman Act: Policy and Law*, 1 A.B.A. Sec. Antitrust L. Rep. 22-24 (1980) [hereinafter cited as ABA Monograph]. *See also* E. Kintner, A Robinson-Patman Act Primer 9-10 (1970); J. von Kalinowski, 16C Antitrust and Trade Regulation § 28.02, at 28-8 to 28-10 (1982); A. Neale & D. Goyder, The Antitrust Laws of the United States of America, 212-13 (3d ed. 1980) (all emphasizing the Robinson-Patman Act's goal of curbing discriminatory prices in favor of large customers, particularly chain stores).

88. *Cf.* Hearings Transcript, *supra* note 21, at 46 (testimony of R. Garrett, Jr.) (Congress was concerned about the problem of underpriced shares and favorable prices for large investors when it passed the Securities Act of 1933).

89. 15 U.S.C. § 13(c) (1976) (original version at ch. 592, § 2(c), 49 Stat. 1527 (1936)).

90. 15 U.S.C. § 80a-22(d) (1976) (original version at ch. 686, § 22(d), 54 Stat. 824 (1940)).

The parallel between the NASD antidiscounting rule and section 2(c) of the Robinson-Patman Act is apparent; both sections are designed to prohibit the granting of discounts to favored customers through "dummy" brokerage commissions. Section 2(c) of the Robinson-Patman Act, which prohibits disguised price discrimination through the use of brokerage commissions, states that:

> It shall be unlawful for any person engaged in commerce, in the course of such commerce, to pay or grant, or to receive or accept, anything of value as a commission, brokerage, or other compensation, or any allowance or discount in lieu thereof *except for services rendered in connection with the purchase of goods, wares, or merchandise . . . .*[91]

The new NASD antidiscounting rules attempt to end indirect discounting of designated orders by prohibiting the receipt of brokerage commissions—either the underwriting or selling group spreads—"except as consideration for services rendered in distribution."[92]

The parallel between the NASD antidiscounting rules and section 22(d) of the Investment Company Act of 1940 is even more striking. Section 22(d), which prohibits the sale of investment company shares to the public "except . . . at a current public offering price described in the prospectus,"[93] is a price fixing provision that requires "retail price maintenance."[94] The explicit purpose of section 22(d) was to destroy a two-tiered system of distribution of investment company securities under which purchasers could pay less than the ostensible public offering price for investment company shares by purchasing them from "bootlegging" dealers who engaged in discounting.[95] The ideal that all purchasers should pay the same per unit price in part motivated the adoption of section 22(d); thus, the enactment of that section supports the notion that Congress in 1938 intended the NASD rules to enforce that same ideal.

Although possibly valid in 1938, the argument that preventing "unfair discrimination between investors" means that all investors pay the same per share price is questionable today because of the enactment by Congress of the Securities Acts Amendments of 1975.[96] When the Commission was considering whether to abolish

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91. 15 U.S.C. § 13(c) (1976) (emphasis added).
92. Approval Release, *supra* note 2, at 83,857-58.
93. 15 U.S.C. § 80a-22(d) (1976).
94. D. Ratner, Securities Regulation in a Nutshell 237 (2d ed. 1982).
95. *See* United States v. National Ass'n of Sec. Dealers, Inc., 422 U.S. 694, 706-10 (1974).
96. Pub. L. No. 94-29, 89 Stat. 97 (1975).

stock exchange rules mandating minimum fixed rates of commission, two principal arguments of the exchanges were: first, that the fixed rates provided a useful cross-subsidy to small investors; and second, that requiring all investors to pay the same rate regardless of bargaining clout was only "fair."[97] The Commission rejected these arguments and abolished fixed minimum rates.[98] Congress ratified the Commission's decision in the Securities Acts Amendments of 1975. Congress in Section 6(e) of the Exchange Act, as amended, banned fixed commission rates on exchanges unless the Commission affirmatively found that fixed rates were necessary to further the purposes of the Exchange Act.[99] Thus, Congress implicitly approved the Commission's conclusion that considerations of equity do not demand that all investors pay the same per unit price.

In addition, the argument that all investors must pay the same per unit price in public offerings of securities calls for economic price discrimination against large purchasers. The only meaningful definition of price discrimination is a difference in the cost/price ratios for two purchasers.[100] Securities dealers achieve substantial cost savings in large-scale sales of securities.[101] The actual per unit cost of the large purchases of institutional investors, therefore, is significantly lower than the actual cost of the small purchases of individual investors. Thus, if both the large scale and small scale investors pay the same per unit price, the system discriminates against the large investor. To paraphrase what Professor and now Assistant Attorney General William Baxter wrote in the context of the debate over fixed commission rates on securities exchanges, the NASD argument was "essentially an argument in favor of discrimination: Big, rich institutional investors should pay high-price cost ratios, and poor, little individual investors should pay low ratios."[102]

Proponents of the antidiscounting rules may argue that notions of fairness and equity justify that large investors pay more per unit; thus, small investors can pay less per unit. Proponents of

97. *See* SENATE COMM. ON BANKING HOUSING AND URBAN AFFAIRS, SUBCOMMITTEE ON SECURITIES, 93d Cong., 1st Sess. 58-60 (1973). [hereinafter cited as Industry Study].

98. SEC Release, *supra* note 13 at 84, 981.

99. 15 U.S.C. § 78f(e) (1976).

100. *See* R. WEST & S. TINIC, THE ECONOMICS OF THE STOCK MARKET 122 (1971); Baxter, *NYSE Fixed Commission Rates: A Private Cartel Goes Public*, 22 STAN. L. REV. 675, 694-95 (1970).

101. Baxter, *supra* note 100, at 694.

102. *Id.*

regulation in other industries have proffered a similar argument, which is known as a "cross-subsidization" or "internal subsidization" argument.[103] In the telephone industry, for example, the cost of providing service to rural areas is much higher than the cost of serving urban areas. Phone rates, however, are based on distance, the value of the service to the consumer, or statewide averaging rather than on the actual cost of providing the service.[104] Thus, rural areas do not pay significantly more for their phone service than urban areas although the costs of providing service to high density areas are significantly lower than the costs of providing service to low density areas.[105] Customers in urban areas, in effect pay supra-competitive rates to keep rural rates artificially low. Proponents of continued regulation argue that only through continued regulation and noncompetitive limited market entry can urban rates be high enough to maintain rural phone service.[106] Trucking and airline deregulation opponents make the same argument about the relationships between rural and urban areas and between small shippers and large shippers.[107]

Many objections, however, exist to the concept of cross-subsidizing small investors through fixed prices in public offerings. First, as Alfred E. Kahn points out, cross-subsidies are, in general, allocatively inefficient; the loss to those providing the subsidy is greater than the gain to those subsidized.[108] Moreover, unlike a direct subsidy, a cross-subsidy is insulated from the increased scru-

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103. *See* Posner, *Taxation by Regulation*, 2 BELL J. OF ECON. & MGMT. SCI. 22, 23-24 (1971).

104. AMERICAN ENTERPRISE INSTITUTE, TELECOMMUNICATIONS LAW REFORM 4-5 (1980).

105. *Id.* at 31-32.

106. *See* United States v. Am. Tel. & Tel. Co., 524 F. Supp. 1336, 1358 (D.D.C. 1981); AMERICAN ENTERPRISE INSTITUTE, *supra* note 104, at 31-32.

107. *See, e.g., Economic Regulation of the Trucking Industry: Hearings Before the Comm. on Commerce, Science, and Tranportation*, 96th Cong., 1st Sess. 216, 218-19 (statement of the American Trucking Association, Inc.) (deregulation will injure small shippers and rural areas); *Reform of the Economic Regulation of Air Carriers: Hearings Before The Subcomm. of Aviation of The House Comm. on Public Works and Transportation*, 94th Cong., 2d Sess. 632-33 (1976) (statement of Paul R. Ignatius, President, Air Transport Association) (restricted entry and rate setting needed to maintain airline service to smaller communities). The trucking associations drew an explicit analogy to "the securities industry under deregulation" and claimed that just as the "small investor" was paying higher rates under deregulation, the small shipper would pay increased rates and received poor or nonexistent service if trucking were deregulated. Commerce Committee Hearings, *supra* at 216.

108. 1 A. KAHN, THE ECONOMICS OF REGULATION 191 (1970). *But see* Posner, *supra* note 103, at 41-42 (claiming that while cross subsidies are less efficient than some hypothetical ideal, they are not necessarily more allocatively inefficient than the real-world alternatives of tax or direct subsidies).

tiny and give and take of the political process. For example, if telephone service were deregulated and rates to rural areas increased dramatically, legislators representing rural areas might sponsor a direct subsidy to allow their constituents to maintain some reasonable level of telephone service. Rural legislators promoting the legislation then might be disinclined to vote against programs that subsidize urban dwellers—such as rat eradication, urban housing, and mass transit programs—for fear that urban legislators would vote against rural telephone subsidies. Under the current system of hidden subsidization through regulation the subsidy to rural telephone users remains virtually immune from this political compromise.[109]

Second, a cross-subsidy argument based upon an equitable notion of assisting the "small" investor makes little sense because an individual investor may be an extremely wealthy person.[110] The person of limited income, on the other hand, is much more likely to be involved in the securities markets through pension funds or insurance policies. Thus, the institutional investor in fact may represent the truly small investor.[111]

Last, the claim that large investors should cross-subsidize small investors lacks the moral weight that other claims for cross-subsidies often possess. The proposition that small investors should be subsidized to enable them to purchase securities does not seem to be in the same class as claims that persons living in rural areas should be able to enjoy telephone or transportation services, or even that shippers in rural areas should be able to get their goods to markets at affordable prices. The argument that a just society should not allow its members in rural areas to be deprived of basic telecommunication and transportation services seems eminently reasonable. In contrast, the argument that a society is unjust because it does not allow its less wealthy members to own debt or equity securities in corporations hardly seems to merit serious consideration.

109. This statement does not say that direct subsidies are necessarily more visible than indirect subsidies to the general public. As Professor—now Judge—Posner points out, legislatures often enact direct suhsidies with scarcely any public scrutiny. *Id.* at 43-44. Nonetheless, a direct subsidy more easily seems to arouse the general public than does a hidden subsidy. The divergent degrees of public emotion over welfare payments and trucking regulation are perfect examples of this phenomenon. In addition, direct subsidies are visible to those *directly involved in the political process*—such as legislators—and thus are subject to the normal political processes.

110. INDUSTRY STUDY, *supra* note 97, at 60.

111. *See id.*

V. Are Antidiscounting Rules Necessary to Preserve the Capital Raising System?

A. *The NASD's Claims and Our Current Knowledge*

The strongest argument raised by the NASD in support of the antidiscounting rules—and the argument that the Commission principally relied upon—was that without the rules the entire fixed price offering system and the entire American capital raising system might collapse. The NASD claimed specifically that without its new rules an upsurge in indirect discounting would lead to decreased willingness on the part of small investors to participate in public offerings.[112] Moreover, the absence of rules against discounting would lead to increased risks for underwriters including a preclusion of successful stabilization,[113] which in turn would increase the cost of raising capital for issuers.[114]

The NASD claim about the effects of a failure to approve the antidiscounting rules on the ability of United States issuers to raise capital contains the questionable assumption that the collapse of the fixed price underwriting system would be tantamount to the collapse of the entire capital raising process. As Commissioner Evans in dissenting from the Commission's approval of the NASD rules asserted, the equation of the health of the fixed price underwriting system with the well-being of the entire American capital raising mechanism displays a distinct lack of faith in the ability of that mechanism to evolve and flourish through competition.[115] If the fixed price underwriting system were to collapse under the pressure of indirect discounting, the system that would evolve under free competition might be more efficient than the current system. Indeed, if only quasi-governmental enforcement can maintain the current fixed price system as the NASD claims, then perhaps the current fixed price system is inherently inefficient and should be replaced. Even if the demise of the fixed price offering system would make capital raising more difficult and expensive, the issue remains whether indirect discounting actually will lead to the demise of the system or to the other specific ill

112. *See* NASD Comment Letter, *supra* note 22, at 15-17, 24-25; SIA Comment Letter, *supra* note 58, at 28.

113. Stabilization is the process of effecting purchases for the purpose of retarding a decline in the price of securities. N. Wolfson, R. Phillips, & T. Russo, Regulation of Brokers, Dealers and Securities Markets ¶ 4.01 (1977).

114. SIA Comment Letter, *supra* note 112, at 27-28.

115. Approval Release, *supra* note 2, at 83,877 (Evans, Comm'r, dissenting).

effects claimed by the NASD and accepted by the Commission.

The NASD and the other supporters of the rule changes provided only conclusory statements in support of the proposition that indirect discounting will destroy the American capital raising system.[116] In fact, the Antitrust Division of the Justice Department and other opponents of the proposed antidiscounting rules also had no factual basis to support their positions because of a general lack of current empirical data on the workings and economics of the new issue markets. The problem with documenting how much indirect discounting currently occurs is an excellent example of this climate of ignorance. The NASD and the other supporters of the new rules—notably the Securities Industry Association—claim that the current fixed price offering system is the best capital raising system ever devised.[117] If indirect discounting is a prominent feature of the system, then a rule banning discounting would be superfluous because, in the NASD's and Security Industry Association's view, the system is functioning perfectly well. The NASD, therefore, has maintained that indirect discounting is relatively uncommon and that only future indirect discounting threatens the underwriting system.[118] Those who claim that indirect discounting is currently a widespread phenomenon dispute this view.[119] No evidence exists in the public record that the Commission investigated how much indirect discounting occurs before it approved the NASD rules. The ignorance of the Commission on this matter is symptomatic of the more general lack of information with which the Commission considered the new NASD rules—a failing not only of the Commission but of outside scholars as well.[120] Although the Commission now plans to remedy some of the general lack of knowledge with respect to the securities markets by sponsoring a series of studies on those markets, including the new issue mar-

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116. *Id.* at 83,874. Even former Commissioner Roberta Karmel, a strong supporter of the antidiscounting rules, admitted that the hearings were singularly unenlightening. Commissioner Karmel writes, "[T]he overarching policy issues were not aired at the public hearings that the Commission held to develop a record for deciding the *Papilsky* controversy. Indeed, considering the real drama involved, the hearings were very boring to artend. They were simply a repeat of legal arguments already in the record." R. KARMEL, REGULATION BY PROSECUTION 134 (1982).

117. *See* NASD Comment Letter, *supra* note 22, at 21; SIA Comment Letter, *supra* note 112, at 13.

118. NASD Comment Letter, *supra* note 22, at 20 nn. 14-15; Hearings Transcript, *supra* note 21, at 25 (testimony of R. Garrett, Jr.).

119. *See supra* note 30.

120. *See* Wolfson, *The Need for Empirical Research in Securities Law*, 49 S. CAL. L. REV. 286 (1976).

ket,[121] the Commission should have undertaken studies before making a final decision on the antidiscounting rules.

The Commission and the supporters of the proposed rule change conceivably could justify their failure to develop any hard empirical—or even anecdotal—data in support of their claims if the burden of proof were on those opposing the change or if the claims put forth by the NASD were self-evident. Neither of those conditions, however, exists.

B. Burdens of Proof and the Legacy of the PSI *Case*

Section 19(b)(2) of the Exchange Act requires that the Commission approve a proposed rule change "if it finds that such proposed rule change is consistent with the requirements of [the Exchange Act] and the rules and regulations thereunder."[122] The section does not indicate who bears the burden of proof to demonstrate the need for a change. Moreover, the legislative history of the Securities Acts Amendments of 1975, which created section 19(b)(2), gives no guidance on the burden of proof question. No matter what the general rule might be, the burden of proof on the proposed NASD rule changes should have been assigned to the NASD because it sought a radical change in the Commission's view of the role of governmental—or at least quasi-governmental—authority to enforce agreements designed to frustrate free market forces.[123] The Commission advanced this view in *PSI*[124] in which it stated that while the government should not actively challenge fixed price agreements in underwritings, those agreements must stand on their own without governmental support.[125]

PSI concerned an attempt to distribute thirty-eight million dollars in bonds issued by the Public Service Company of Indiana (hence the name *PSI*). The effective date of the registration statement was December 7, 1939. The outbreak of war in Europe made the bonds extremely difficult to sell at the fixed public offering price, and a number of underwriters and selling group dealers began to sell the bonds at a discount below the public offering price. The NASD brought disciplinary proceedings against the discounting underwriters during which the NASD found that the under-

121. Publication of Commission Capital Market Working Papers, Securities Act Release No. 6246, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,663 (Oct. 9, 1980).

122. 15 U.S.C. § 78s(b)(2)(B) (1976).

123. *See supra* notes 59-60 and accompanying text.

124. 19 S.E.C. 424 (1945).

125. *Id.* at 425-31.

writers had violated section 1 of its Rules of Fair Practice, which required NASD members to adhere to just and equitable principles of trade.[126] The NASD then imposed nominal fines on the underwriters.[127] On its own motion the Commission brought the disciplinary action before it for review.

The Commission in *PSI* addressed two issues. First, in a seeming exercise in dictum the Commission held that the price maintenance sections of underwriting agreements did not violate section 1 of the Sherman Antitrust Act.[128] Second, the Commission held that the NASD disciplinary actions could not stand. The Commission stated that "a rule specifically requiring adherence to price maintenance agreements would be contrary to section 15A(b)(7)," which was the predecessor section to present section 15A(b)(6) of the Exchange Act. The Commission held that a rule of this type would contravene section 15A(b)(7) by creating impediments to free and open markets and by in effect fixing rates of commissions.[129]

The Commission's decision drew a sharp dissent from Commissioner Healy, who expressed puzzlement at how the Commission could support the fixed price offering system by approving and regulating the practice of stabilization and at the same time deny the NASD authority to help preserve the system.[130] Commissioner Healy believed that the Commission was ascribing to Congress an irrational intent in enacting section 15A(b)(7).[131] Commis-

126. NASD Rules of Fair Practice, art. III § 1, *reprinted in* NASD MAN. (CCH) ¶ 2151 at 2014.

127. 19 S.E.C. 424, at 432-33 (1945).

128. *Id.* at 464.

129. *Id.* at 443-45.

130. *Id.* at 488, 495 (Healy, Comm'r, dissenting).

131. *Id.* (Healy, Comm'r, dissenting). Commissioner Healy expressed amazement at how the Commission could find the fixed price system necessary for the successful distributions and a reasonable restraint under the antitrust laws yet at the same time find that the imposition of sanctions against those who sought to defy the system was an "impediment" to competition in violation of § 15A(b)(7). As Healy stated:

> Although the agreements were necessary and reasonable, and probably not in violation of the Sherman Act, nevertheless, it is said they were impediments within the meaning of Section 15A (b) (7) and the NASD cannot discipline those of its members who violate, without equitable excuse, necessary and reasonable contracts they make with each other! All three of my associates seem to press for a rigorous construction and application of the word "impediments". They all seem agreed that the considerations which led the Supreme Court to give a reasonable construction to the Sherman Act, and to hold that not every restraint in commerce was illegal, are lacking when the effect of Section 15A (b) (7) on the disciplinary powers of the NASD is reached. I do not believe that anyone who worked on the Maloney Act,—Senator Maloney, the Congress, the Commission, investment bankers, brokers or dealers,—had the slightest intention of promoting a statute with more rigorous standards than were found in the

sioner Healy's dissent, however, failed to address the true point of the opinion, a point that is relevant today. The Commission never gave, as Commissioner Healy seemed to assume it did, its endorsement to the fixed price underwriting system as an ideal for capital raising mechanisms. On the contrary, the Commission pragmatically recognized that the fixed price offering system was an institution that seemed to function efficiently on its own and, thus, should not be exposed to governmental attacks such as challenges under the antitrust laws.[132]

The philosophy underlying *PSI* also is apparent in *United States v. Morgan.*[133] The court in *Morgan,* in an opinion by Judge Medina, dismissed criminal indictments brought by the Government against major underwriters. The indictments alleged that the underwriters willfully violated section 1 of the Sherman Antitrust Act by fixing prices through the resale price maintenance clauses of underwriting agreements.[134] Scholars rightly have criticized as fictitious the *Morgan* court's articulated basis for its decision—that the underwriters in a public offering are really a single entity and therefore cannot violate section 1 of the Sherman Act.[135] In fact, underwriters expressly provide in the underwriting agreements that their liability for the offering shall be individual rather than joint and several.[136] Nevertheless, the lengthy opinion in *Morgan* contains not only a tone of strong admiration for the fixed price underwriting system as an efficacious capital raising system, but also an equally strong disinclination to risk tampering with that system through the antitrust laws.[137] This Article sub-

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> Sherman Act . . . .
>
> It seems to me that all statutes, not merely the Sherman Act, should be given a reasonable construction. I think it is sensible and necessary that Section 15A (b) (7) be given a reasonable construction. In construing it and applying it, I know of no more sensible guides than those laid down by the late Justice Brandeis in his splendid opinion in the *Chicago Board of Trade* case, from which my associates quote.

Id. at 493-94 (Healy, Comm'r, dissenting) (citations omitted).

132. *Id.* at 469.

133. 118 F. Supp. 21 (S.D.N.Y. 1953).

134. *Id.* at 628.

135. *See* Brunelle, *supra* note 61, at 71-72; Note, *The Investment Bankers Case: The Use of Semantics to Avoid the Per Se Illegality of Price Fixing,* 63 YALE L.J. 399, 402-03 (1954).

136. *See* Brunelle, *supra* note 61, at 71-72; NASD Comment Letter, *supra* note 22, at 19 n.13.

137. 18 F. Supp. 621 (S.D.N.Y. 1955). Judge Medina's admiration for the fixed price offering system is exemplified by the following excerpts in his opinion in *Morgan:*

> It would be difficult to exaggerate the importance of investment banking to the national economy. The vast industrial growth of the past fifty years has covered the

mits that these two considerations provide the actual basis for the decision in *Morgan* as well as the basis for the Commission's dictum in *PSI* about the applicability of section 1 of the Sherman Act to the price fixing provisions of underwriting agreements.

An important corollary, however, exists to the Commission's advocacy in *PSI* of governmental nonintervention in the fixed price underwriting system. The Commission in *PSI* implicitly recognized that if the fixed price underwriting system requires quasi-governmental enforcement mechanisms to continue functioning, then the Commission's own assumption that the system was an efficient and necessary impediment to pure free markets could no longer stand unchallenged. If the fixed price offering system were the effective and efficient system its advocates claimed, the participants would adhere to it without quasi-governmental compulsion. Thus, the Commission in *PSI* established the principle that while the government should not dismantle the fixed price underwriting system, it had to exist without government help, either directly or indirectly through the NASD. Commissioner Healy and the other Commissioners who approved the present day NASD antidiscounting rules failed to perceive this subtlety.

In proffering these rules banning indirect discounting the NASD in effect asked the Commission to make a drastic policy shift that contradicted the long standing *PSI* principle. The rules

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United States with a network of manufacturing, processing, sales and distributing plants, the smooth functioning of which is vital to our welfare as a nation. They vary from huge corporate structures such as the great steel and automobile companies, railroads and airlines, producers of commodities and merchandise of all kinds, oil companies and public utilities, down to comparatively small manufacturing plants and stores. The variety and usefulness of these myriad enterprises defy description. They are the result of American ingenuity and the will to work unceasingly and to improve our standard of living. But adequate financing for their needs is the life blood without which many if not most of these parts of the great machine of business would cease to function in a healthy, normal fashion.

. . . .

The present method for issuing and distributing new security issues thus has its roots in the latter part of the nineteenth century. It is the product of a gradual evolution to meet specific economic problems created by demands for capital, which arose as the result of the increasing industrialization of the country and the growth of a widely dispersed investor class. It was born in large part because of, and gradually adapted itself to, conditions and needs which are peculiar to the business of raising capital.

. . . .

The utility and reasonableness of the [fixed price offering system], and the fact that functionally it serves a legitimate business and trade-promoting purpose, is amply demonstrated by its unchallenged growth by a gradual process of evolution over a period of a half-century, more or less.

Id. at 635-36, 689.

sought to make the government an active—if indirect—participant in preventing two sophisticated parties from freely bargaining with each other. The NASD proposed, and the Commission eventually accepted, the rules in the name of preserving the status quo of the fixed price underwriting system. As one former Commissioner said, "This nine-year dispute over the extent to which underwriters can offer indirect or soft dollar discounts to institutional investors who buy portions of new offerings ended by leaving the industry where it was."[138] The antidiscounting rules, however, were actually a presciption for radical change. The true status quo was an underwriting system that functioned without resort to the quasi-governmental compulsion that the NASD antidiscounting rules add.[139] Thus, the Commission should have placed on the NASD the burdens of proof to justify the rule changes. The conclusory opinions given by the NASD and its supporters with respect to the ill effects of a rejection of the new rules would not sustain those burdens unless the opinions were intuitively obvious. This Article, however, demonstrates that those opinions are not self-evident.

C. *Possible Threats to the Capital Raising System Without the New Rules*

Supporters of the NASD ban on indirect discounting claimed that a failure to implement the prohibition would lead to ill effects that at best would increase the cost to issuers of raising capital and at worst undermine the entire American capital raising system.[140] Specifically, those in favor of the new NASD rules expressed concern that small investors would desert the new issues markets[141]

138. R. KARMEL, *supra* note 116, at 135.

139. The NASD argued that its actions were private rather than quasi-governmental. Commissioner Evans effectively rebutted this contention by pointing out that,

> While it might be argued that the regulation is being imposed by the NASD and not by the Commission, I find that distinction not to be meaningful in this context. I do not mean to suggest, of course, that the NASD is an arm of the Federal Government. Indeed it is not, but it does exercise quasi-governmental authority. Moreover, this proposal would not be before the Commission if it could be implemented without our approval.

Approval Release, *supra* note 2, at 83,873 n. 1 (Evans, Comm'r, dissenting) (citations omitted). Further, the Exchange Act explicitly authorizes the NASD to bar from membership, or association with a member, persons who violate the NASD rules, including presumably the antidiscounting rules. *See* 15 U.S.C. § 78o-3(g)(2) (1976). For an argument that the NASD actions amount to state action in a variety of contexts, see Note, *Governmental Action and the National Association of Securities Dealers*, 47 FORDHAM L. REV. 585 (1979).

140. *See* NASD Comment Letter, *supra* note 22, at 17-25; SIA Comment Letter, *supra* note 112, at 28-34.

141. NASD Comment Letter, *supra* note 22, at 34.

and that investment bankers either would abandon the field because of decreased profitability or an inability to stabilize new offerings, or would increase their charges to issuers, which would increase the cost of raising needed capital.[142] Because of the general lack of knowledge about the economics of the primary distribution markets, one cannot merely postulate that these concerns are unfounded; on the other hand, enough reasons exist for doubting the basis for the concerns so that one cannot merely accept the concerns as axiomatic as the Commission apparently did.

The thesis that indirect discounting will drive small investors out of the market is based on the assumption that when small investors discover that institutional investors are receiving indirect discounts in new issues offerings, the small investors will withhold their participation in the offerings because of a sense of unfairness. Empirical studies suggest that small investors in securities exchange transactions believe that they are the victims of discrimination in favor of large investors and that this belief might be a factor in nonparticipation in the securities markets.[143] These studies, however, indicate that the real issue for small investors is not that others are paying more favorable rates of commission on securities transactions, but that the brokers simply do not want the business of small investors and, consequently, are not giving small investors proper services or information.[144] No empirical evidence exists that small investors believe they are victims of price discrimination or that this belief causes small investors to alter their investment behavior. The small investor abandonment argument underestimates the degree to which most people accept quantity discounts as a fact of life and business. Consumers in general recognize that a person who buys a case of canned tomatoes pays a lower per unit price than does the person who merely buys a single can.

The argument by the NASD that indirect discounting will reduce the profitability of underwriters has some merit. Indirect discounting is a form of competition, and to the extent it is barred, underwriters are better able to increase their return through diminished competition. The NASD conclusion, however, that the decrease in profitability will lead investment bankers to cease underwriting new issues should not be accepted readily. The NASD

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142. *Id.* at 24-28.

143. *See* Branson, *Securities Regulation After Entering the Competitive Era: The Securities Industry, SEC Policy, and the Individual Investor,* 75 Nw. U. L. Rev. 857, 881-90 (1980).

144. *Id.*

in effect argued that indirect discounting must be prohibited to maintain needed underwriting capacity. The argument that the underwriting market requires relief from competition to assist in maintaining capacity is not unique to the securities industry, and scholars have questioned its validity.[145] The preservation of capacity argument is a classic plea made on behalf of horizontal price fixing in general[146] and as support for regulation of various industries.[147] Whatever its validity in other contexts, the argument has doubtful applicability in the underwriting area. First, the key ingredient supplied by underwriters is capital—the most fungible of all goods. Thus, even if a system of free indirect discounting diminished profits to the point that, with the present level of demand, a number of established firms left the field, reentry would not be difficult when the demand for underwriting increased. Moreover, operations within the securities industry historically

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145. P. Areeda, Antitrust Analysis, 324-25 (4th ed. 1981); S. Breyer, Regulation and Its Reform 31 (1982); E. Gellhorn & R. Pierce, Regulated Industries in a Nutshell 260-63 (1982). Professor Areeda succinctly summarizes the general case against the argument:

> (1) It is not clear that capacity is truly in jeopardy. Not much "damage" could occur during a short recession; even bankruptcy may involve a realignment of ownership interests rather than a withdrawal from the industry. And businessmen often recognize their long-run need for capacity and avoid pricing at the level of out-of-pocket costs for prolonged periods. In any event, if it is truly cbeaper to maintain currently unneeded capacity rather than to retire and rebuild it, then businessmen would do just that even without price-fixing. (2) There are few, if any, historical examples in which national economic fluctuations were accompanied by wasteful alternation of scrapping and rebuilding of an industry's capacity. (3) The need for industry adjustments, sometimes masked by inflationary euphoria during boom periods, becomes obvious during recession and retrenchment. Relative prices remain important even in the course of a depression. (4) We cannot easily identify the occasions when the argument justifies the preservation of some capacity. A particular industry's problem might be chronic rather than temporary even though its decline coincides with the onset of a national recession. (5) The price fixed may be higher than necessary and may continue longer than warrantcd. And there may be no suitable agency to make these decisions. The firms involved may not be entirely motivated by the public interest.

P. Areeda, *supra*, at 324-25.

146. P. Areeda, *supra* note 145, at 329. A closely related argument is that free competition does not yield a sufficiently large rate of return to encourage firms to enter the field and that firms, therefore, must be encouraged to enter the field through cartelization. *See* R. Karmel, *supra* note 116, at 304 (Commission approval of the antidiscounting rules properly recognizes the importance of "maintaining underwriting as a profitable business").

147. E. Gellhorn & R. Pierce, *supra* note 115, at 53-55, 260-63. Specifically, proponents of minimum rate regulation traditionally have used this argument. *Id.* at 260-63. The New York Stock Exchange in attempting to defend fixed minimum commission rates made an interesting and particularly relevant argument along these lines. For rebuttals to the Exchange contentions, see SEC Release, *supra* note 98, at 84,978-80; Baxter, *supra* note 100, at 697-703; *infra* note 148.

have a low ratio of fixed to total costs,[148] a characteristic that facilitates reentry in response to changes in demand.

Second, strong indications exist that even if some firms were to leave underwriting, a number of other firms—regional broker-dealers and discount broker-dealers—would be willing to take their places. When the Commission initially solicited comments on the new NASD rules, it received a number of written complaints from regional broker-dealers charging that managing underwriters did not allow the dealers to join in desirable underwritings and, thus, that they could participate only through designated orders made by institutions.[149] In addition, during the hearings on the proposed rule changes a vice president of a major discount broker-dealer concern testified that his firm would be willing to enter the underwriting field.[150] The written comments and testimony of regional and discount broker-dealers are not sufficient to prove that a plethora of brokerage firms are waiting to enter the underwriting arena should some of the present participants depart; decreased profitability may diminish the desire of these firms to enter the field. Nonetheless, the comments of the firms should have been sufficient to prevent the Commission from accepting without question the contention that continual indirect discounting will lead to a shortage of underwriting capacity.

Reason exists also to doubt the assumption that indirect discounting will destroy stabilization. The need for stabilization arises when an active secondary market exists for a new issue of securities. The injection of a large block of new securities in theory may have a depressing effect on the price of the securities trading in the secondary market.[151] If the price for the security in the secondary market declines to a point below the price of the new issues, the decline will jeopardize the distribution of the new issue because buyers will prefer to buy the security at the lower secondary market price. To prevent this effect, the underwriters of a new issue enter bids for the securities at the public offering price for the new

148. *See* R. West & S. Tinic, *supra* note 100, at 123-34; Mann, *The New York Stock Exchange: A Cartel at the End of Its Reign*, in Promoting Competition in Regulated Markets 306-12 (A. Phillips, ed. 1975).

149. *See* Practices Release, *supra* note 26, at 81,770 nn.69-71.

150. Hearings Transcript, *supra* note 231, at 690-92 (testimony of R.W. Arnold, vice-president, Finance, Charles Schuab & Co., Inc.); *see also* Blotnick, *Discount Brokers and New Issues*, Forbes, July 21, 1980, at 90-91 (suggesting that other discount brokers may be interested in becoming involved in underwriting.

151. *See* Pegging, Fixing and Stabilizing Security Prices, SEC Release No. 34-2446, 2 Fed. Sec. L. Rep. (CCH) ¶¶ 22,513-22,547, at 22,531 (Mar. 18, 1940).

issue and purchase securities coming into the secondary market.[152] The NASD and the other supporters of the new antidiscounting rules argued that if indirect discounting were allowed, institutional investors would receive their indirect discounts, and make an "instant profit" by selling the securities into the stabilizing bid of the underwriters, bankrupt the underwriter's stabilization fund, and destroy the offering.[153] Again, no hard data exists on how often this activity currently occurs. In fact, institutions receiving indirect discounts have a desire to continue receiving discounts, which is a motive to avoid selling the indirectly discounted securities into the stabilizing bid. If investors continually undermined stabilizing efforts, underwriters would no longer be able to offer indirect discounts regardless of the bargaining power an institutional investor may have.[154] To participate in underwritings in which arbitrage continually breaks stabilizing bids is to invite financial catastrophe—through absorption of unsalable securities—an outcome no underwriter could tolerate even in the face of the strongest institutional pressure. Moreover, underwriters might stabilize an offering at the net price paid by selling group members and, thus, eliminate the profitability of selling indirectly discounted securities into the stabilizing bid.[155]

Last, the NASD contended that because indirect discounting would lower profit margins, underwriters would be forced to raise the cost of their service to issuers, which would increase the cost of raising capital.[156] Fierce competition, however, exists among broker-dealers who wish to act as underwriters.[157] Thus, underwriters may find that to increase their profits by lowering the amount paid to issuers would be impossible. This competition for issuers' business may apply only to those firms who wish to sell desirable low risk securities. If this theory is correct, issuers of riskier securities may in fact be forced to pay higher costs for raising capital if indi-

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152. *See id.* ¶ 22,523.

153. NASD Comment Letter, *supra* note 22, at 25-26.

154. Indeed, the NASD premised its entire argument about stabilization on the notion that stabilization is essential and that a lack of an ability to stabilize successfully would lead to financial disaster for underwriters.

155. *See* Approval Release, *supra* note 2, at 83,867 n.106.

156. NASD Comment Letter, *supra* note 22, at 24.

157. *See* Hearings Transcript, *supra* note 21, at 55,207 (testimony of W. H. Hambrecht, partner, Hambrecht & Quist and R. A. Powers, chairman and chief executive officer, Smith, Barney, Harris Upham & Co., Inc.); SIA Comment Letter, *supra* note 112, at 16-17. *But see*, Logue & Rogalski, *Does It Pay to Shop for Your Bond Underwriter?*, HARV. BUS. REV., July-Aug. 1979, at 111, 112-16 (suggesting that major Wall Street underwriters do not compete on price in debt offerings).

rect discounting is allowed, but only if one assumes that investment bankers do use or will use the profits they receive from more desirable offerings to lower costs on riskier offerings. This assumption may not be accurate.[158] In addition, the notion that issuers of less risky securities should pay supra-competitive capital raising costs to afford issuers of risky securities an opportunity to pay lower costs is a cross-subsidization argument that suffers from the same weaknesses as all such arguments.[159]

In summary, current knowledge of the securities markets neither proves nor disproves the claims of the NASD about the impact of continued indirect discounting on capital raising. In addition, those claims are not sufficiently evident that the Commission should have accepted them on faith. The Commission, however, made precisely that mistake in approving the NASD antidiscounting rules.

IV. Protecting the Competitive Structure of the Investment Banking Industry

The basic theme of the arguments made on behalf of the NASD antidiscounting rules is that the utility of the rules in furthering the purposes of the Exchange Act outweighs their obvious anticompetitive impact. The NASD and other supporters of the rules, when they insisted that failure to adopt antidiscounting rules would lead to a decrease in the number of investment banking firms and an increase in concentration in the industry, obliquely argued that the rules are, on balance, procompetitive.[160] In a recent article Mr. George Brunelle develops that argument with more detail and sophistication than did the NASD.[161] Mr. Brunelle contends that in considering the competitive impact of the rules banning indirect discounting, the Commission was obligated to adhere to the spirit, if not the letter, of all antitrust laws, including the Robinson-Patman Act. He notes that the type of indirect discounting barred by the NASD rules amounts to price discrimination that would violate the Robinson-Patman Act if that statute

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158. *See* S. Robbins, The Securities Markets 172-75 (1966) (suggesting that older, "established" underwriters tend to avoid backing new ventures and unseasoned companies). Professor Robbins bases his conclusion upon data gathered in the late 1950's and early 1960's. Therefore, one must utilize the data with caution.

159. *See supra* note 108 and accompanying text.

160. *See* R. Karmel, *supra* note 116, at 134; SIA Comment Letter, *supra* note 112, at 35.

161. *See* Brunelle, *supra* note 61.

applied to securities transactions.[162] Mr. Brunelle then argues that this price discrimination will exacerbate the already existing trends toward a decreased number of participants in the underwriting field and an increased concentration in the investment banking industry.[163]

Numerous weaknesses exist in Mr. Brunelle's defense of the NASD antidiscounting rules. He assumes that in requiring the Commission to consider the competitive impact of the rules of the NASD and the other self-regulatory organizations, Congress intended that the Commission utilize some of the substantive standards of the Robinson-Patman Act. Although the Robinson-Patman Act, as part of the Clayton Act, embodies procompetitive purposes such as the prohibition of predatory pricing, it also embodies values that are anticompetitive. These anticompetitive values make the Act more a small—or inefficient—business relief act than a competition fostering act. In recent years scholars and practitioners from across the antitrust and political spectrums have criticized the Robinson-Patman Act, not only because they view it as promoting inefficiency, but because they see the Act as encouraging anticompetitive price rigidity, price fixing efforts, and oligopolistic behavior.[164] The assumption, therefore, that the NASD antidiscounting rules further competition by promoting the values of the Robinson-Patman Act rests on an extremely questionable foundation.

Assuming, however, that the Robinson-Patman Act values are relevant, serious weaknesses still exist in the contention that the NASD rules actually foster competition. No clear explanation demonstrates how price discrimination through indirect discounting will lead to decreased competition; no competitive injury will occur to investors because institutional and individual investors are not in competition. Moreover, indirect discounting should not injure competition among underwriters. Price discrimination is harmful to competition only if it becomes predatory pricing.[165] No indica-

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162. At least one court has held that the Robinson-Patman Act does not cover transactions in securities. Baum v. Investors Diversified Servs., 409 F.2d 872 (7th Cir. 1969).

163. Brunelle, *supra* note 61, at 73-76.

164. *See, e.g.*, R. BORK, THE ANTITRUST PARADOX 384-85 (1978); F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 580-82 (2d ed. 1980). In Professor—now Judge—Bork's colorful phrase, "[T]he scholarly and professional literature on the [Robinson-Patman Act] resembles a cascade of vituperation." *Id.* at 385.

For a concise summary of the case against the Robinson-Patman Act, see ABA Monograph, *supra* note 27, at 27-37.

165. *See* L. SULLIVAN, *supra* note 79, at 682; Hurwitz & Kovacic, *Judicial Analysis of*

tion, however, exists that the present practice of indirect discounting in new issue underwriting amounts to predatory pricing. Opponents of discounting have proffered no evidence that the indirect discounters have been giving discounts sufficient to price the securities below average variable cost, marginal cost, total cost, or any other cost-based standard. In addition, no evidence exists that the indirect discounters have been giving discounts with the desire—or even knowledge—that the discounts will drive their competitors out of business. As one witness testifying on behalf of the antidiscounting rules stated during the hearings, "[W]hen these [indirect] discounts do occur, they more often occur on the part of someone who is willing to accept less profit for whatever the reason."[166]

Mr. Brunelle's argument also rests on another questionable assumption—that the decreasing number of firms in the securities industry indicates that the industry is becoming less competitive. A number of antitrust scholars have noted that neither a decrease in the number of competitors nor an increase in an industry's concentration necessarily means that the industry is becoming a monopoly or an oligopoly.[167] In the securities industry indications are that the industry remains competitive despite the decrease in the number of firms that occurred after the abolition of fixed rates of commissions on securities exchanges. SEC Chairman John R. Shad recently testified before a House of Representative subcommittee that the large number of firms still in the securities business and the above average returns on equity of smaller regional firms point to the continued competitive nature of that industry.[168]

No evidence links indirect discounting to decreased competition. In fact, evidence suggests that indirect discounting has made the underwriting field more competitive. One commentator characterizes the underwriting industry as "a tight club-like fraternity."[169] "Caste-like" would be a more accurate description. Under-

Predation: The Emerging Trends, 35 VAND. L. REV. 63, 66-83 (1982).

166. Hearings Transcript, *supra* note 21, at 55 (testimony of J. Hambrecht).

167. *See, e.g.*, P. AREEDA & D. TURNER, 4 ANTITRUST LAW ¶ 910b, at 54-55, ¶ 910c, at 56-57 (1980).

168. [Jan-June] SEC. REG. & L. REP. (BNA) No. _, at A-5 (June 24, 1981). The most thorough treatment of the competitive effects of the merger trend in the securities industry is Schneider, *Evolving Proof Standards Under Section 7 and Mergers in Transitional Markets: The Securities Industry Example*, 1981 WIS. L. REV.. 1. Mr. Schneider, a former Justice Department Antitrust Division official and current SEC official, concludes that the securities industry is becoming more competitive despite the merger trend. *Id.* at 95-96.

169. C. WELLES, *supra* note 13, at 70.

writing firms are grouped in hierarchical "brackets"[170] that often are based on historical relationships and past forms of reciprocal dealing rather than on ability to manage, sell, or capitalize underwritings. These brackets frequently determine whether, and perhaps more importantly, to what extent, a broker-dealer will permit an underwriter to participate in an underwriting.[171] In commenting on the NASD rules, several broker-dealers noted that indirect discounting—particularly designated orders—frequently allows broker-dealers to obtain a share larger than its bracket normally would dictate of a desirable underwriting.[172] Thus, indirect discounting may lead to a dismantling of the underwriting bracket system and make the industry more competitive rather than less competitive.

Finally, Mr. Brunelle's conclusion that indirect discounting will lead to increased concentration in the underwriting field is challenged by evidence that the usual conditions conducive to destructive competition and dominance by a few large firms are not present in the securities industry. Specifically, the data developed in the debate over fixed commission rates on exchanges indicates that the securities industry is *not* characterized by high fixed cost to variable cost ratios or by large economies of scale.[173] The absence of these characteristics makes it unlikely that free competition in the industry automatically will turn destructive and lead to the creation of a monopoly or oligopoly.[174]

Mr. Brunelle's argument that the NASD antidiscounting rules are procompetitive is not new. The argument is the same as those advanced for the proposition that price fixing among competitors increases competition;[175] they are also the same arguments ad-

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170. Schneider, *supra* note 168, at 65-66.

171. Hayes, *Investment Banking: Power Structure in Flux,* 49 HARV. BUS. REV., Mar.-Apr. 1971, at 141.

172. *See* Practices Release, *supra* note 26, at 81,770.

173. *See supra* note 142.

174. *Id.*

175. *See* P. AREEDA, *supra* note 145, at 322-28; Posner & Easterbrook, *supra* note 79, at 115. In addition to the arguments discussed in the text of this Article, Mr. Brunelle also contends that the antidiscounting rules are needed to supply countervailing power to protect the competitive structure of the securities industry against the power of institutional investors. Brunelle, *supra* note 61, at 76-77. This argument, which customarily is made on behalf of price fixing among competitors, has been discredited by scholars of all antitrust persuasions. *See* P. AREEDA, *supra* note 145, at 327-28; L. SULLIVAN, *supra* note 79, at 204; Posner & Easterbrook, *supra* note 79, at 115. As Professor Sullivan points out,

> if there is excess market power at any level, the public is not likely to be benefited by allowing those at other levels of the chain to act concertedly. The result will likely be a battle or a concord between the giants about how the spoils from excess market power

vanced in opposition to deregulation of industries such as trucking.[176] Courts have rejected these arguments and, antitrust scholars have given them no support.[177] One defensibly can argue as did Ray Garrett, Jr., on behalf of the NASD that the forces of competition in the underwriting field produce inequitable results and that these forces, therefore, should be restrained.[178] One, however, should not claim that these restraints in fact foster competition. Thus, while the Commission may have been incorrect in approving the NASD rules, it was correct in not relying on arguments that the rules were in fact procompetitive.

VII. Commission-Ordered Modification of the Rules—A Study in Unprincipled Decisionmaking

The Commission did not approve the NASD antidiscounting rules until after the NASD adopted two major modifications insisted upon by the Commission. The first modification, which alters the definition of overtrades to bring more swap transactions within the prohibition against overtrading,[179] comports with the various justifications for the antidiscounting rules. The second modification, however, which permits the provision of research to be considered as services in distribution,[180] in effect allows continued indirect discounting through designated orders in return for research[181] and is inconsistent with all of the justifications advanced on behalf of the new rules. Allowing the use of research as a form of indirect discount in the absence of a formal disclosure requirement is inconsistent totally with the notion that this discounting renders misleading the price disclosure in the statutorily required prospectus. In addition, the modification is inconsistent

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> are to be shared; it would be better for the public that those segments displaying a competitive structure be maintained that way, and that ways be found to reduce power at the other level.

L. Sullivan, *supra* note 79, at 204.

176. *See, e.g.*, American Trucking Association, *Should the Present Regulatory System of the Trucking Industry Be Fundamentally Changed: Con*, 58 Cong. Dig. 235, 245 (1979) (making explicit analogy to concentration in the securities industry); Brock, *The Pros and Cons of Deregulating the Truckers*, Fortune, June 18, 1979, at 142.

177. *See, e.g.*, Arizona v. Maricopa County Medical Soc'y, 102 S. Ct. 2466 (1982); Catalano v. Target Sales, 446 U.S. 643 (1980) (per curium); United States v. Socony-Vacuum Oil Co., 310 U.S. 150 (1940); P. Areeda, *supra* note 145, at 322-28; L. Sullivan, *supra* note 79, at 203-04; Posner & Easterbrook, *supra* note 79, at 113-16.

178. *See supra* note 72 and accompanying text.

179. *See* Approval Release, *supra* note 2, at 83,853-54.

180. *Id.* at 83,857-58.

181. Sec. Reg. & L. Rep. (BNA) No. 583, at A-2 (Dec. 17, 1980).

with the NASD equity argument because small investors will not be able to receive free research in return for purchasing new issues of securities.

One could argue that the modification is not inconsistent with the goals of preservation of the capital raising system and competitive industry structure, and that, with the limits on demand for research by institutional investors, the research loophole will allow relatively little indirect discounting. The reactions of institutional investors to the NASD rules as originally proposed, testimony provided at the public hearings on the antidiscounting rules, and past experience with respect to the evasion of the old exchange fixed commission rates, however, strongly suggest that designated orders in return for research is the largest single form of indirect discounting in new issue underwriting.[182] If this suggestion is correct, then a significant amount of indirect discounting may still occur that, according to the supporters of the antidiscounting rules, will have the above-mentioned deleterious effects on the underwriting industry. Thus, the Commission's modification in favor of research is inconsistent with all the articulated justifications for the new rules and casts serious doubt on whether the Commission relied in its approval on any of the rationales advanced on behalf of the proposed rules.

The Commission in fact made a political compromise. The NASD and the securities industry strongly desired the antidiscounting rules; on the other hand, the proposed ban on designated orders in return for research disturbed institutional investors.[183] The Commission's modification and ultimate approval of the rules gave the NASD most of the antidiscounting rules it sought, yet allowed institutional investors to continue utilizing designated orders in return for research. The spirit of compromise, however, does not render the rules consistent with the Exchange Act. As this Article has discussed, the antidiscounting rules impose obvious and acknowledged burdens on competition.[184] The Exchange Act allows the imposition of these burdens only when they are necessary to further the purposes of the Act.[185] The NASD and the other sup-

182. *See, e.g.*, C. WELLES, *supra* note 13, at 69; Hearings Transcript, *supra* note 21, at 276 (testimony of W. Williams); Letter of Comment from Prudential Insurance Co. to George A. Fitzsimmons, Secretary, SEC, File No. SR-NASD-78-3 at 8-9, (Aug. 1, 1979) [hereinafter cited as Prudential Comment].

183. *See, e.g.*, Prudential Comment, *supra* note 182, at 8-9.

184. *See supra* note 60 and accompanying text.

185. *See supra* note 44.

porters of the antidiscounting rules posited a number of purposes they believed the rules would serve. In approving the antidiscounting rules, the Commission purportedly relied upon one of these purposes—the preservation of the fixed price offering system—to justify the anticompetitive aspects of the new rules. The Commission's insistence on allowing indirect discounting through the provision of research, however, indicates that the Commission gave no real credence to its stated justification for approving the rules. Thus, the Commission knowingly approved a set of anticompetitive rules that had no proven justification for furthering the purposes of the Exchange Act. In addition to being contrary to the mandates of the Exchange Act, this action was an exercise in unprincipled decisionmaking.

VIII. THE FUTURE OF THE ANTIDISCOUNTING RULES—WHAT IS THE HARM?

The new NASD rules possibly will have little long-term effect. The fixed price underwriting system is under tremendous pressure.[186] As the NASD pointed out, the antidiscounting rules do not mandate fixed price offerings on the part of underwriters; they merely require adherence to the resale price maintenance terms once a fixed price underwriting is utilized.[187] Thus, if fixed price offerings are inefficient, the antidiscounting rules in the long run will not preserve the system from the pressures of institutional investors.

Significant questions also exist about how efficacious the new antidiscounting rules will be in the short run because the rules may be unenforceable. A broker-dealer—particularly a large firm—supplies a myriad of investment services to institutional investors. If a broker-dealer wishes to give an indirect discount to a favored institutional customer, the broker-dealer simply can decrease the price of one of the other services it supplies to the institutional investor. No agreement need be in writing; a tacit understanding is sufficient.[188] This discounting is undetectable unless the NASD manages to establish a fair market value for every product or service that a broker-dealer supplies to institutional customers. The

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186. *See* Hayes, *The Transformation of Investment Banking*, HARV. BUS. REV., Jan.-Feb. 1979, at 153; SIA Comment Letter, *supra* note 112, at 13-22.

187. NASD Comment Letter, *supra* note 22, at 23.

188. *See* Hearings Transcript, *supra* note 21, at 306-07 (testimony of S. Bernstein) (tacit understandings already exist in the industry about rewarding through underwritings firms that supply research to institutional investors).

area of reciprocal dealings offers other fruitful possibilities for evading the antidiscounting rules. For example, an insurance company may purchase securities in a fixed price public offering from a particular underwriter at the public offering price. To obtain the insurance company's business, the broker-dealer may purchase "key man" life insurance for some of its executives from that company. Thus, the insurance company obtains an indirect discount that cannot be detected. This example is not extraordinary; broker-dealers utilized precisely this type of reciprocity to evade fixed commission rates on exchanges.[189] Indeed, the NASD admitted during the hearings that discounts granted through reciprocal dealings and services would be virtually undetectable.[190] Thus, any firm wishing to evade the antidiscounting rules could do so with practically no threat of detection or punishment.[191]

If the NASD rules, then, will have little practical effect, one may ask "what is the harm in the rules?" First, although the rules are not likely to prevent the decline of the fixed price system, they may delay its natural demise. If only quasi-governmental authority can preserve the fixed price underwriting system, then the system is little more than a price fixing cartel, and, like all cartels, is likely to crumble under competitive pressures. Commentators long have recognized that cheating by cartel members is a key factor in the dissolution of cartels.[192] Although limited, the ability of the NASD to detect indirect discounting is distinctly superior to the ability of individual syndicate members to detect cheating. According to the NASD, the modern clearing and settlement system makes the detection capacity of individual syndicate members nonexistent.[193] The NASD at least has some hope of detecting indirect discounting because of the right of the NASD to inspect its members'

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189. *See* C. WELLES, *supra* note 13, at 69-70.

190. Hearings Transcript, *supra* note 21, at 98 (testimony of R. Garrett, Jr.).

191. In reply to this point the NASD maintained that as "law-ahiding citizens" its members and institutional investors would ohey the antidiscounting rules. NASD Comment Letter, *supra* note 22, at 51 & n.40. The NASD did not explain why many of these same "law-abiding citizens" were willing to flaunt exchange rules in the era of fixed commission rates on securities exchanges by granting indirect discounts. Nor did the NASD explain why institutional investors would be any less willing than they were in the era of fixed exchange commission rates to press for discounts. Indeed, witnesses for the NASD stated that today's institutional investors are more performance conscious than ever and negotiate strongly for the best possible deal in every transaction. *See, e.g.*, Hearings Transcript, *supra* note 21, at 105 (testimony of J.S. Putnam).

192. *See, e.g.*, F. SCHERER, *supra* note 164, at 172-73; ABA Monograph, *supra* note 87, at 29.

193. *See* NASD Comment Letter, *supra* note 22, at 17-18.

books.[194] To the extent that the NASD can detect "cheating"—indirect discounting in underwriting agreements—the decay of the fixed price underwriting system may be delayed, even if not prevented.

Second, the Commission, which commentators generally regard as one of the best federal administrative agencies,[195] ignored and misread its controlling statute and then approved a rule on the basis of questionable evidence. More importantly, the Commission changed its attitude with respect to the role of the government in enforcing anticompetitive agreements. By approving the NASD antidiscounting rules the Commission has reversed a sensible policy of thirty-five years standing and has lent the weight of quasi-governmental enforcement to a practice with anticompetitive effects. The Commission in the process uncritically accepted the outworn arguments traditionally advanced on behalf of government regulation and price fixing. The SEC in effect has allowed the reregulation of underwriting.

The Commission's actions not only are inconsistent with movements to deregulate other industries, but also are contrary to the Commission's own goal of attempting to increase competition in the securities industry.[196] The Commission's approval of the NASD rules may not affect the nature of the underwriting field, especially over the long period. Nonetheless, the approval may send precisely the wrong signal to the underwriting community.

The underwriting industry sees itself—perhaps quite accurately—as an industry "beset" by competition. In addition to the bargaining power of institutional investors, underwriters face the possibilities of new methods of raising capital and new actors in the underwriting field. For example, at least one major corporation—utilizing a "Dutch Auction"[197]—recently raised capital directly without benefit of underwriters.[198]

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194. *Id.*

195. Ratner, *supra* note 94, at 14.

196. The best examples of the Commission's efforts to increase competition in the securities industry are its abolition of fixed commission rates on securities exchanges, *see* Abolition of Fixed Commission Rates Release, *supra* note 98, and its efforts to remove off-board trading restrictions on securities exchanges, *see* Off-Board Trading Restrictions, Exchange Act Release No. 16,888, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,608 (June 11, 1980) (adoption of rule 19c-3).

197. A "Duteh Auction" is a process in which an issuer raises capital by selling its securities through competitive bidding to any purchaser, whether an investment banker or not. BUSINESS WEEK, Nov. 13, 1976, at 148.

198. *See* SIA Comment Letter, *supra* note 58, at 20.

Securities Act rule 415,[199] recently promulgated and reenacted on a temporary basis, perhaps poses a more significant threat than new capital raising methods. Rule 415 allows an issuer to use shelf registration to sell its securities "on a nonfixed price basis over time depending on market conditions."[200] The rule also allows issuers to sell 'securities registered on the shelf in a succession of different kinds of offerings."[201] The underwriting industry has objected to rule 415 on the ground that the rule will encourage issuers to deal directly with institutional investors and, thus, destroy the fixed price offering system and the underwriting industry.[202] Rule 415 may signify to the underwriting industry the materialization of its worst fears—that institutional investors will establish direct links with firms seeking to raise capital and that institutions such as commercial banks will enter into direct competition with existing underwriters.

Underwriters, instead of increasing efficiency and service, may seek to meet the competitive challenge with governmental action led by the Commission. The hope that the Commission will attempt to stop the competitive processes undermining the position of the existing underwriting firms may be unrealistic. The promulgation of rule 415 and the Commission's recent support for amending the Glass-Steagall Act to allow banks to underwrite industrial revenue bonds and to allow bank holding companies to own brokerage firms[203] indicate that the Commission is unwilling to

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199. Securities Act Rule 415, 1 FED. SEC. L. REP. (CCH) ¶ 3383 (1982).

200. Examination of Registration of Securities to be Offered and Sold on a Delayed or Continuous Basis in the Future, Securities Act Release No. 6391, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,108, at 84,936 (Mar. 12, 1982) [hereinafter cited as Rule 415 Release].

201. *Id.*

202. *See* SEC. REG. & L. REP. (BNA) No. 532-33 (Mar. 24, 1982).

203. The Glass-Steagall Act is the popular name of the Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.). Particularly relevant to the discussion in this Article are § 21 of the Act, which makes it a felony for a bank to engage "in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities," 12 U.S.C. § 378 (1976), and § 20 of the Act, which prohibits any member bank of the Federal Reserve System from being affiliated "with any corporation, association, business trust, or other similar organization engaged principally in the issue, fioatation, underwriting, public sale, or distribution" of securities. *Id.* § 377.

Over the past two decades banks and memhers of the securities industry have been engaged in a variety of battles about whether particular bank activities violate the Act and whether Congress should amend the Act to permit more extensive bank involvement in the securities business. For a brief history of some of these battles, see Clark & Saunders, *Glass-Steagall Revised: The Impact on Banks, Capital Markets, and the Small Investor*, 97 BANKING L.J. 811 (1980); Clark & Saunders, *Judicial Interpretation of Glass-Steagall: The* stop completely the competitive erosion of the underwriting industry.[204] On the other hand, the Commission's actions in these areas indicate that it may not be averse to slowing the competitive challenge. For example, the Commission adopted and repromulgated rule 415 only on a temporary basis and has held public hearings in which it considered the impact of the rule on the fixed price system and underwriters.[205]

Perhaps an even more significant indicia of the Commission's ambivalent attitude toward free competition in the securities industry and rule 415 is subsection (a)(3) of that rule. Subsection (a)(3) requires that an offering made at the market—one made at whatever the market is willing to pay rather than at a fixed price—be made with an underwriter.[206] This provision has the effect of protecting underwriters from the competition of issuers who attempt to retail securities directly and eliminate the middleman. In a comment letter the Justice Department called the provision "little more than an 'underwriter relief act.' "[207]

In addition, the Commission has voiced support for requiring banks to compete through affiliates rather than allowing them to engage directly in underwriting.[208] Considerations other than a desire to shield investment bankers from competition may motivate the Commission's stance on these issues.[209] Nonetheless, the Commission's actions in these areas and its uncritical approval of the NASD antidiscounting rules at least implies that the Commission is pursuing a policy designed to slow the competitive processes that are eroding the economic position of investment bankers.

Last, the Commission's approval of the antidiscounting rules casts doubt upon its willingness to evaluate and abrogate other NASD rules that are anticompetitive. A prime example is the NASD mark-up policy, which prohibits a member acting in its capacity as a dealer or principal from charging a price for securities

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Need for Legislative Action, 97 BANKING L.J. 721 (1980).

204. SEC. REG. & L. REP. (BNA) No. 6, at 251 (Feb. 10, 1982) (testimony of Chairman John S.R. Shad before the Senate Committee on Banking, Feb. 4, 1982).

205. Rule 415 Release, *supra* note 200, at 84,936.

206. Securities Act Rule 415(a)(3), *supra* note 199.

207. 14 SEC REG. & L. REP. (BNA) 1099 (June 18, 1982).

208. *See supra* note 204.

209. For example, Chairman Shad of the SEC has expressed concerns that banks would be exempt from antifraud rules under some of the proposals allowing them to compete directly with investment bankers. *See supra* note 204. In announcing hearings on Rule 415, the Commission raised questions whether disclosure to investors would be adequate under the rule. Rule 415 Release, *supra* note 200, at 84,936.

that is not reasonably related to the current market price.[210] The NASD generally has interpreted an unreasonable price to be a price greater than five percent over market price.[211] The policy is a form of price control, and if it were not immune from antitrust scrutiny under the Exchange Act, it would constitute a per se violation of section 1 of the Sherman Act.[212]

The NASD possibly could justify the mark-up policy despite its anticompetitive aspects as a reasonable regulation designed to protect buyers and sellers of securities from fraud and overreaching by securities dealers. A brief review of the origins of the policy, however, reveals that the motivation for the policy was not the protection of consumers, but the avoidance of competition among securities dealers. In 1942 the Commission published for comment a rule that would have required dealers acting as principals in over-the-counter trading transactions to disclose to their customers the "inside market price" of the securities that the customers were buying or selling.[213] The Commission defined the "inside market price" as the best current independent bid and asking price for the security.[214] This pricing information would allow a customer to ascertain easily the amount of the markup—in the case of a customer purchase—or markdown—in the case of a customer sale—being charged in the transaction. The NASD and the securities industry vigorously opposed the proposed rule. To forestall adoption of the proposed SEC disclosure rule the NASD presented its mark-up policy.[215] The NASD, therefore, developed the mark-up policy not as a consumer protection mechanism, but as a device to block a rule that both would have protected the consumer and would have enhanced competition among securities dealers. Thus,

210. Interpretation of the NASD Board of Governors, after art. III § 3 of the NASD Rules of Fair Practice *reprinted in* NASD MAN. (CCH) ¶ 2154 at 2054-58.

211. *Id.* at 623.

212. *See* Arizona v. Maricopa County Medical Soc'y, 102 S. Ct. 2466 (1982); Kiefer-Stewart Co. v. Joseph E. Seagram & Sons, 340 U.S. 211 (1951) (fixing of maximum prices held to be per se violation of § 1 of the Sherman Act); United States v. National Ass'n of Real Estate Bds., 339 U.S. 485 (1950) (fixing of standardized commission rates by real estate board held to be per se violation of § 1 of the Sherman Act). The SEC's oversight and approval of the NASD's mark-up policy would seem to render it immune from antitrust attack under the principles enunciated in United States v. National Ass'n of Securities Dealers, 422 U.S. 694 (1974). *See supra* note 24.

213. REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 2, at 646 (1963).

214. *Id.*

215. *Id.*; *see* Ratner, *Regulation of the Compensation of Securities Dealers*, 55 CORNELL L. REV. 348, 370 (1970).

the NASD mark-up policy arguably should be a prime candidate for abrogation by the Commission on the ground that the policy places an unnecessary burden on competition. The NASD recognized that its mark-up policy and several other of its rules[216] were anticompetitive and that Commission disapproval of the antidiscounting rules would threaten disapproval of those other rules.[217] The uncritical approval by the Commission of the antidiscounting rules, however, now may signal a lack of commitment to take action against other self-regulatory organization rules, such as the mark-up policy, that unnecessarily restrict the competitive process.

IX. Conclusion

The Commission still may rectify its error in approving the NASD antidiscounting rules. Section 19(c) of the Exchange Act gives the Commission the power to abrogate, add to, or delete from the rules of self-regulatory organizations.[218] The Commission should begin proceedings pursuant to section 19(c) of the Exchange Act to abrogate the NASD new antidiscounting rules.

If the Commission were to take this step, the NASD probably would argue that res judicata and collateral estoppel bar the attempts by the Commission to abrogate the antidiscounting rules. The Supreme Court in recent years has retreated from the traditional rule that res judicata principles do not apply to administrative actions,[219] and the NASD could argue that the Commission's previous finding that the rules were consistent with the Exchange Act bars the Commission from subsequently finding that the rules are inconsistent with the Exchange Act. Nonetheless, two reasons exist why the doctrine is inapplicable to any reconsideration by the Commission of the antidiscounting rules. First, section 19(c) of the Exchange Act implicitly authorizes reconsideration of previously approved self-regulatory organization rules. Second, courts generally have confined res judicata principles in administrative proceedings to agency decisions clearly resembling judicial actions

216. The other rules cited by the NASD were its rule limiting the amount of underwriting fees members can charge issuers, Interpretation of the Board of Governors—Review of Corporate Financing, following NASD Rules of Fair Practice, art. III, § 1, *reprinted in* NASD Man. (CCH) ¶ 2151 at 2019-33, and its rule prohibiting reciprocal dealings in the sale of investment company securities. NASD Rules of Fair Practice, art. III, § 26(1)(3), *reprinted in* NASD Man. (CCH) ¶ 2176 at 2106.

217. NASD Comment Letter, *supra* note 22, at 38-43.

218. 15 U.S.C. § 8s(c) (1976).

219. *See* W. Gelhorn, C. Byse, & P. Strauss, Administrative Law: Cases and Comments 401 (7th ed. 1979).

that are based on past facts and involve the award of money.[220] In contrast, when "the prior determination involves distinctively administrative action in which public interest considerations predominate," courts have not strictly applied the doctrine of res judicata.[221] Any Commission reconsideration of the new NASD antidiscounting rules likely would fall into the latter category.

The Commission could overcome any estoppel or res judicata problem since in its approval of the antidiscounting rules the Commission left open the possibility of reexamination. In the release approving the rules, the Commission indicated that it would reexamine the rules for difficulties with the fair and effective enforcement of the rules.[222] Given the motivation for and ease of evading the rules, the Commission readily could find instances suggesting that the rules are unenforceable. Thus, the enforcement problem could be a justification for abrogating the rules.

The proceedings incident to the abrogation of the antidiscounting rules would furnish an opportunity for supporters of the rules to present the empirical evidence that was lacking in the initial approval proceedings. If supporters cannot present this evidence, the Commission should abrogate the rules. If the NASD and its supporters can prove that the absence of antidiscounting rules will threaten the existence of the fixed price underwriting system, then the Commission must face a more complex and troubling question—whether a capital raising system dependent on quasi-governmental compulsion to coerce its members to adhere to the system is worth preserving. The Commission clearly had no desire to address that issue in discussions of the NASD antidiscounting rules. If the fixed price system cannot be preserved without resort to NASD authority, however, then the Commission must consider directly whether that system is both sustainable and desirable. The Commission must undertake this evaluation not only to consider intelligently the problem of indirect discounting, but also to shape properly its role in assuring that the capital raising system of the United States functions in the most efficient manner possible.

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220. *Id.* at 402 (citing International Union of Mine, Mill & Smelter Workers v. Eagle-Picher Mining & Smelting Co., 325 U.S. 335 (1945)).

221. *Id.* (citing Bourough of Lansdale, Pa. v. FPC, 494 F.2d 1104 (D.C. Cir. 1974); Mulcahy v. Public Service Comm'n, 101 Utah 245, 117 P.2d 298 (1941)).

222. Approval Release, *supra* note 2, at 83,860.