New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
VOLUME 242—NO. 126 WWW.NYLJ.COM THURSDAY, DECEMBER 31, 2009 An ALM Publication

ANTITRUST

Expert Analysis

Short Seller's Antitrust Suit Precluded by Securities Law

By **Elai Katz**

The U.S. Court of Appeals for the Second Circuit ruled that a short seller's claims that financial institutions conspired to fix borrowing fees were properly dismissed by the district court because they presented a conflict with securities regulations. The Federal Trade Commission (FTC) used three different modes of analysis to conclude that a realtor association's discriminatory rules restricting the dissemination of discount brokers' listings unreasonably restrained trade, delineating the commission's approach to full and abbreviated rule of reason analysis.

Other recent antitrust developments of note included an FTC complaint against a leading computer chip maker brought under §5 of the FTC Act, suggesting that the commission may plan to use that provision expansively to pursue anticompetitive conduct.

Implied Preclusion

A short seller of securities claimed that financial institutions acting as prime brokers in short sale transactions conspired in violation of §1 of the Sherman Act to designate and fix the borrowing fees for "hard-to-borrow" securities. A district court dismissed the complaint, on the grounds that securities regulations precluded application of the antitrust laws, and the Second Circuit affirmed, observing that the overarching goal of the analysis is avoidance of conflict between the securities and antitrust regimes.

Typically a short seller who believes that a security will drop in value borrows shares from a prime broker, sells the securities on the open market and later buys replacement securities (at a lower price, if the predicted decline occurred) to repay the loan to the broker. The broker is required by securities regulations to locate the securities—either in its own proprietary accounts or with other investors or brokers—before it can accept a short sale order. The harder it is to find a security the higher the borrowing fee charged by the broker.

The plaintiff alleged that the prime brokers agreed on which securities would be designated arbitrarily as "hard-to-borrow" and artificially inflated the borrowing fees for those securities.

In determining whether the securities laws are "clearly incompatible" with antitrust law in this context, the appel late court methodically applied the four considerations set out in the U.S. Supreme Court's recent decision on the implicit preclusion (sometimes referred to as "implied repeal") of antitrust claims by securities regulation, *Credit Suisse Securities (USA) LLC v. Billing*, 551 U.S. 264 (2007). The Second Circuit panel observed that identifying the appropriate level of particularity for addressing each consideration is crucial to the analysis.

> The Second Circuit concluded that short selling is squarely within the heartland of securities regulation.

The first consideration asks if the practices "lie squarely within an area of financial market activity that the securities law seeks to regulate." The court noted that this factor must be evaluated at the level of the underlying market activity—here, short selling—and not the specific alleged anticompetitive practice—in this case, fixing borrowing fees. The court concluded that short selling is squarely within the heartland of securities regulation.

The second inquiry involves a determination of the relevant agency's authority to regulate. The Second Circuit stated that this consideration should be addressed at a somewhat more particular level than the first consideration. The court found that the Securities and Exchange Commission (SEC) had the authority under the Securities Exchange Act of 1934 to regulate the role of prime brokers in short selling as well as the borrowing fees they charge.

The third consideration asks whether the responsible regulatory agency exercises its authority. The court found "ample evidence" of active exercise of regulatory authority in an SEC regulation and a recent roundtable. Although borrowing fees are not the focus of these regulatory actions, the Second Circuit found that the regulator's attention to the role of prime brokers in short selling was sufficient.

The fourth consideration requires the court to ascertain if the application of both legal regimes would result in "conficting guidance, requirements, duties, privileges, or standards of conduct." The Second Circuit determined that an actual conflict arises in this case because the imposition of antitrust liability would inhibit prime brokers from permissible and efficiency-enhancing communications with one another about the availability and prices of securities.

The court expressed concern that information exchanges that are allowed by

ELAI KATZ *is a partner at Cahill Gordon & Reindel.*

securities law would serve as evidence of conduct forbidden under the antitrust laws. The court also noted the existence of a potential conflict due to the possibility that the SEC will exercise its statutory authority to regulate borrowing fees

Short Sale Antitrust Litigation, 2009-2 CCH Trade Cases ¶76,822

Comment: The Second Circuit's gloss provides useful guidance on the appropriate levels of generality or particularity for application of the four *Billing* factors, which may be called into service more frequently as new regulations come into force in response to the financial crisis.

Restraint of Trade

The FTC commissioners overturned a decision of an FTC Administrative Law Judge (ALJ) and decided that an association of competing Michigan realtors operating a multiple listing service (MLS) violated §1 of the Sherman Act and §5 of the FTC Act by restricting discount brokers' ability to publicize their listings through the MLS. The commission challenged three association policies: (1) refusing to transmit discount brokers' listings from the MLS to publicly accessible Web sites, (2) excluding discount brokers' listings from the default search setting on the MLS and (3) requiring brokers to provide full brokerage services to have their listings included in data feeds to public Web sites, among other benefits. The FTC asserted that the policies were implemented in response to competitive pressures from brokers providing more limited services for a flat fee or other arrangement instead of the prevailing 6 percent commission rate charged by most full service realtors.

The ALJ declined to conduct an abbreviated or truncated mode of review—a method that permits an assessment of restraints that are "inherently suspect" (yet do not fall within one of the established per se unlawful categories) without requiring proof of market power or anticompetitive effects—instead applying a "traditional rule of reason analysis." The ALJ dismissed the complaint because he was not persuaded that the FTC complaint counsel had demonstrated an actual adverse effect on competition. The ALJ concluded that local discount brokers were able to continue to market their listings despite the hurdles placed by the realtor association's rules.

In a unanimous decision authored by William E. Kovacic, who was chairman of the FTC during the prior administration, the FTC took issue with the ALJ's characterization of inherently suspect analysis as not fully accepted by the courts. Notably, complaint counsel (the FTC staff attorneys prosecuting the case) had also disclaimed reliance on inherently suspect analysis on the basis that courts have not had much experience with the particular restraint at hand and that, in any event, there was no need for truncated examination because the Michigan realtors association did not dispute that it possessed substantial market power. In reaction to these doubts, the FTC's opinion laid out in depth the case that inherently suspect analysis was well accepted in the Supreme Court and other appellate courts and was appropriate for this case.

The commission stated that "an observer with even a rudimentary understanding of economics could conclude that the arrangements in question would have an anticompetitive effect" and observed that horizontal agreements to restrict advertising aimed at rival discounters have been condemned summarily by some courts. The FTC also rejected the associations' justifications, noting that the discount brokers could not be accused of "free riding" since they paid to be members of the MLS and dismissing the contention that the policy compensated for a bidding disadvantage.

Nonetheless, the FTC declined to rely solely on the inherently suspect methodology and went on to analyze the challenged restraints under two modes of traditional rule of reason inquiries. Under the first method, which requires proof of market power coupled with conduct likely to have anticompetitive effects, the defendants had conceded the possession of market power and the FTC had already determined that the policies were "inherently suspect." With regard to the second mode, requiring a showing of actual anticompetitive effects, the commission found that economic analysis showing a decline in the average number of discount listings on the MLS from 1.5 percent to 0.75 percent constituted sufficient direct proof of actual anticompetitive effects

Realcomp II, Ltd. , Docket No. 9320, 2009-2 CCH Trade Cases ¶76,784 (Oct. 30, 2009), also available at www.ftc.gov

Comment: Although the opinion may have been intended to deflect any questions about the validity of inherently suspect review, the FTC's employment of three different modes of analysis to condemn the restraints challenged in the matter reported immediately above undermines the supposed advantage of the inherently suspect methodology—abbreviated and efficient review—and may not provide much guidance as to which type of analysis should be used in a given case.

Unfair Competition

In another development reflecting the FTC's current enforcement agenda, the commission filed an administrative complaint against Intel Corporation, the computer chip maker, alleging that the company used a variety of anticompetitive practices to slow its competitors to enable it to catch up to their technological advances and maintain its monopoly in the market for central processing units as well as to obtain a monopoly in the market for graphics processing units.

The FTC's employment of three different modes of analysis to condemn the restraints challenged in 'Realcomp II, Ltd.' undermines the supposed advantage of the inherently suspect methodology.

Rather than relying principally on §2 of the Sherman Act, the commission alleged stand-alone violations of §5 of the FTC Act, which proscribes "unfair methods of competition" and "unfair or deceptive acts or practices." In a statement accompanying the complaint, two commissioners asserted that §5's reach "extends beyond the borders of the antitrust laws" which have been limited by courts in recent decades in an effort to avoid the "collateral consequences created by private enforcement." They also stated that the commission brought the case under §5—which can only be enforced by the FTC and does not provide for treble damages—in part to limit "Intel's susceptibility to private treble damages cases."

The complaint contemplates injunctive relief that would prevent the chip maker from using bundling or market-share discounts to foreclose competitors from selling to computer makers.

The FTC's complaint against Intel follows several significant antitrust developments in recent months: The European Commission imposed a fine of over €1 billion, Intel paid its principal rival $1.25 million to settle that firm's antitrust claims, and the New York Attorney General filed suit under §2 of the Sherman Act in federal court in Delaware.

Intel Corporation, Docket No. 9341 (Dec. 16, 2009), available at www.ftc.gov

Comment: It appears that the decision to bring the enforcement action reported immediately above using the arguably broader FTC Act §5 was crafted in part in reaction to limitations on Sherman Act claims imposed by the courts in the last several years, yet a few decades ago, some appellate courts had sought to contain the expansion of §5 beyond the borders of the Sherman Act.

Bundling

The U.S. Court of Appeals for the Ninth Circuit affirmed a district court's order vacating in part a jury verdict finding that a medical device maker's sale of its heart and lung function products in a discounted package violated §2 of the Sherman Act. The appellate court cited to its recent announcement of a discount attribution test for examining bundling in *Cascade Health Solutions v. PeaceHealth* , 515 F.3d 883 (9th Cir. 2008), and affirmed that bundled discounts may not be considered exclusionary unless they are predatory.

The court also stated that the challenged bundling could not constitute unlawful exclusive dealing arrangements because the trial record did not support a finding that the conduct foreclosed competition in a substantial share of the relevant market. However, the Ninth Circuit ruled that the district court correctly let stand the jury's finding that the defendant's sole source contracts and market share discounts were unlawful.

Masimo Corp. v. Tyco Health Care Group, L.P. , 2009-2 CCH Trade Cases ¶76,780, 2009 WL 3451725 (not for publication)