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Second Circuit Affirms Dismissal Of Antitrust Class Action Due To Implied Preclusion By The Securities Laws

In *Electronic Trading Group, LLC v. Banc of America Securities LLC (In re Short Sale Antitrust Litigation)*, 2009 WL 4350035 (2d Cir. Dec. 3, 2009), the United States Court of Appeals for the Second Circuit affirmed the dismissal of a putative antitrust class action against certain financial institutions that serve as "prime brokers" in connection with short sale transactions, on the ground that the federal securities laws precluded application of antitrust law to the matters at hand. This was the first time the Second Circuit applied the considerations for the implied preclusion of antitrust laws by the securities laws outlined by the United States Supreme Court in Credit Suisse Securities (USA) LLC v. Billing, 551 U.S. 264 (2007).

In *Short Sale*, plaintiff Electronic Trading Group, LLC was a "short seller" of securities. In a "short sale" transaction, the "short seller" identifies securities that he or she believes will drop in market price. The short seller borrows those securities from a broker (prime brokers have the greatest market share), sells the borrowed securities on the open market, purchases replacement securities on the open market, and returns them to the broker — thereby closing the short seller's position. The short seller's profit (if any) is the difference between the market price at which she sold the borrowed securities and the market price at which she purchased the replacement securities, less borrowing fees, brokerage fees, interest, and any other charges levied by the broker.

Plaintiff here alleged that prime brokers arbitrarily designated certain securities as "hard-to-borrow," and then fixed the minimum price of hard-to-borrow lists in violation of Section 1 of the Sherman Act, which caused the short-sellers to pay artificially inflated fees. Defendants moved to dismiss, arguing that plaintiff's Sherman Act antitrust claims were subject to the doctrine of implied preclusion of antitrust laws by the securities laws. Plaintiff argued, among other things, that no actual or potential conflict necessitates immunity because neither securities law nor antitrust law allow collusive fixing of borrowing fees.

The United States District Court for the Southern District of New York considered defendants' preclusion argument and held that implied preclusion from antitrust liability precluded plaintiff's antitrust claims. The Second Circuit explained that the Supreme Court's decision in *Billing* sets forth four considerations that must be examined to determine whether the securities laws are "clearly incompatible" with the antitrust laws and thus preclusive of antitrust liability. Those considerations are whether (1) the area of conduct is “squarely within the heartland of securities regulation”; (2) the Securities & Exchange Commission (“SEC”) has authority to regulate the conduct; (3) there is ongoing agency regulation; and (4) a conflict exists between antitrust laws and securities regulation. *See Billing*, 551 U.S. at 285. The Second Circuit held that the fourth consideration is to be evaluated at the level of the alleged anticompetitive conduct, while the first three considerations should be evaluated at the level “most useful” to the court in avoiding conflict between the securities and antitrust regimes.

As to the first consideration, the area of conduct, the Second Circuit analyzed short selling “at the level of the underlying market activity” (and not at the level of the alleged anticompetitive conduct), and found that “short selling is market activity regulated by the securities law.” As to the second consideration, the authority to regulate, the Second Circuit held that even though no specific SEC provision explicitly references the regulation of borrowing fees, the fact that the SEC has authority to regulate the role of prime brokers and the borrowing fees they charge, weighs in favor of preclusion. Similarly, as to the third consideration, ongoing regulation, the Second Circuit held that ongoing SEC regulation of the role of prime brokers in short selling, in general, weighed in favor of implied preclusion of the antitrust laws (again, even though the SEC has not focused on the regulation of borrowing fees).

Finally, with respect to the fourth consideration, whether a serious conflict exists between antitrust law and securities regulation, the Second Circuit considered the impact of potential antitrust liability on arrangements for borrowing fees. In that regard, the Second Circuit reasoned that because it “is permissible for brokers to communicate about the availability and price of securities,” imposing antitrust liability would create actual and potential conflicts between antitrust laws and securities laws. Actual conflict would arise because antitrust liability would inhibit conduct on the part of prime brokers that the SEC currently permits, namely permissible communications about the availability and price of securities. Thus, the potential for antitrust law damages could result in brokers being more likely to “curb their permissible exchange of information and harm the efficient functioning of the short selling market.” The Court also held that a potential conflict existed because of the possibility that the SEC could at some point in the future regulate the borrowing fees set by prime brokers.

As a result, at least in the Second Circuit, prime brokers who allegedly collude in setting fees to acquire and sell hard-to-borrow securities for short sellers cannot be sued in federal court for violating the Sherman Act.

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