Department of Justice

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JUSTICE DEPARTMENT CHARGES 24 MAJOR NASDAQ SECURITIES FIRMS WITH FIXING TRANSACTION COSTS FOR INVESTORS

WASHINGTON, D.C. -- The Department of Justice and 24 major Nasdaq securities firms reached a settlement today that will stop the firms from following an industry-wide practice that fixes transaction costs for investors who buy and sell stocks on the Nasdaq market. As a result of the settlement, millions of investors will no longer be subject to the anticompetitive conduct which resulted in higher trading costs for individual investors and institutions who bought or sold stocks.

Nasdaq is a computerized public market in which investors can buy and sell over-the-counter stocks. It is the second largest securities market in the U.S., which traded about $2.4 trillion of stock last year. Founded in 1971, it is the largest electronic screen based equity market in the world.

The Department's settlement is significant because--for the first time in an Antitrust Division settlement--the settling firms will be required to monitor and tape record telephone conversations of their Nasdaq traders. Each firm will install taping systems to monitor and record no less than 3.5 percent or a maximum of 70 hours per week of all trader telephone conversations on its over-the-counter desk. Any conversation that violates the proposed order must be provided to the Department by an antitrust compliance officer within 10 business days.

Also, Department representatives can show up at a firm's office, unannounced, to listen in on trader conversations as they occur. These unprecedented enforcement provisions were put in place to ensure that the firms do not engage in further anticompetitive conduct.

"As a result of this conduct American investors had to pay more to buy and sell stocks than they would have if there had been true competition," said Attorney General Janet Reno. "We have found substantial evidence of coercion and other misconduct in this industry. By providing for the random monitoring of traders' telephone calls, we expect to deter future price fixing on Nasdaq."

The Department's Antitrust Division filed a civil antitrust suit charging 24 major Nasdaq market makers who buy and sell stocks to the investing public with inflating the quoted "inside spread" in certain Nasdaq stocks, resulting in investors having to pay more to buy or sell stocks than they would have in a competitive market. The inside spread is the difference between the best buying price and the best selling price of a stock. Transaction costs were raised through a long-standing "quoting convention" followed by traders and enforced industry-wide for many years, according to the Department's court papers.

At the same time, the Justice Department settled the case with a proposed court order forbidding the firms from continuing their illegal practice. Both the complaint and proposed court order were filed in U.S. District Court in the Southern District of New York in Manhattan.

Reno said that the proposed settlement provides all the relief the Department could expect to get if it litigated the case to conclusion. The law does not provide the Department with statutory authority to recover damages or monetary penalties in such cases.

The Department's investigation began in the summer of 1994, shortly after the publication of an economic study by Professors William Christie of Vanderbilt University and Paul Schultz of Ohio State University about the Nasdaq market.

The Department alleged in its complaint that the firms and others adhered to and enforced a quoting convention" that was designed to deter price competition among the firms and other market makers in their trading of Nasdaq stocks.

The quoting convention required market makers to update the prices they quoted to buy and sell Nasdaq stocks on the Nasdaq screen by a quarter (25 cents) rather than an eighth (12« cents), whenever their individual "dealer spreads" were 75 cents or more per share. A "dealer spread" is the difference between the price an individual market maker offers to buy a stock and the price it offers to sell the same stock, on a per share basis.

"If traders always quote their prices in quarters instead of eighths, then simple arithmetic tells you that the difference between the best buying and selling price will never be less than a quarter," said Anne K. Bingaman, Assistant Attorney General in charge of the Department's Antitrust Division. "The market makers on Nasdaq kept the difference between the best buying and selling prices wider than they would have been in a competitive market, which cost investors money."

The quoting convention imposes a penalty on Nasdaq market makers who want to narrow the "inside spread" in a stock. Because of this penalty--increased risk of trading the stock on the "wrong" side of the market--market makers had an incentive to avoid using eighth-point increments to update their stock quotes. The result has been that the inside spreads in a significant number of Nasdaq stocks have been wider than they would have been in a competitive market. This meant that investors were paying higher trading costs for buying and selling stocks on the Nasdaq market.

The Department alleged that traders used the telephone to enforce adherence to the quoting convention. Traders who mistakenly entered a price quote of an eighth were promptly telephoned by other traders and told to correct their price quote. Traders would also make harassing calls to other traders who did not adhere to the quoting convention. The Department said that some traders often refused to deal with other traders who did not follow the convention.

The Department said that new traders were trained to update their price quotes in quarters for stocks with wide dealer spreads, and taught that quoting those stocks in eighths was unethical and unprofessional. The Department alleged that market makers used peer pressure to enforce the agreement. A market maker who deviated from the quoting convention might be told– "You're spoiling it for everybody."

The Department's competitive impact statement notes that:

- Market data show that market makers began to change their price quoting practices when confronted by the adverse publicity from the Christie/Schultz economic study and the increasing pressures from government investigations.

- Market data show that while the market makers refused to publicly quote prices in eighths on the Nasdaq screen, they did trade stock in eighths with each other on a comparable trading system, called Instinet.

The proposed order contains strong remedial measures designed to prevent and detect violations of its terms, and if approved by the court, would:

- Prohibit market makers from agreeing with other market makers to adhere to the quoting convention, or to fix, raise, lower, or maintain prices or quotes for Nasdaq securities.

- Prevent market makers from harassing or intimidating other market makers for lowering their spread in any Nasdaq security or about the quantity they are willing to trade at its quoted price.

- Require each firm to designate an antitrust compliance officer to instruct traders and others concerning the requirements of the proposed order, and to listen to tapes created under the order.

- Allow representatives of the Antitrust Division, without pre-arrangement, to appear at a firm's office to listen in on trader conversations the firm is taping as they are occurring.

- Provide that the Antitrust Division receive complaints of possible violations and direct taping of particular traders in response to complaints, or on its own initiative, to deter and ferret out violations of the proposed order.

- Provide for punishment by civil and criminal contempt, if it is violated. Thus, traders with knowledge of the proposed order could, after hearing and judgment, be required to pay large monetary penalties or even be sentenced to jail, if found to be in willful violation of the prohibitions.

Also, the Department designated an attorney in the Division's New York Field Office, Geoffrey Swaebe, to begin serving immediately as the Antitrust Division's principal Nasdaq compliance officer.

The Antitrust Division has established a hotline to receive complaints about Nasdaq or any other subject, which is operative as of today at 1-888-7DOJATR.

Among the 24 firms are some of Nasdaq's biggest market makers. They are:

Alex. Brown & Sons Inc.

Bear, Stearns & Co. Inc.

CS First Boston Corp.

Dean Witter Reynolds Inc.

Donaldson, Lufkin & Jenrette Securities Corp.

Furman Selz LLC

Goldman, Sachs & Co.

Hambrecht & Quist LLC

Herzog, Heine, Geduld Inc.

J.P. Morgan Securities Inc.

Lehman Brothers Inc.

Mayer & Schweitzer Inc.

Merrill, Lynch, Pierce, Fenner & Smith Inc.

Morgan Stanley & Co. Inc.

Nash, Weiss & Co.

OLDE Discount Corp.

PaineWebber Inc.

Piper Jaffray Inc.

Prudential Securities Inc.

Saloman Brothers Inc.

Sherwood Securities Corp.

Smith Barney Inc.

Spear, Leeds & Kellogg LP (Troster Singer)

UBS Securities LLC

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