UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

UNITED STATES OF AMERICA, Plaintiff, - v - STEINHARDT MANAGEMENT COMPANY, INC.; and CAXTON CORPORATION, Defendants, -and- $12,500,000 THAT IS THE PROPERTY OF STEINHARDT MANAGEMENT COMPANY, INC.; Steinhardt Management Company, Inc., Real Party in Interest -and- $12,500,000 THAT IS THE PROPERTY OF CAXTON CORPORATION, Caxton Corporation, Real Party in Interest.	94 Civ. 9044 12/16/94

COMPETITIVE IMPACT STATEMENT

Pursuant to Section 2(b) of the Antitrust Procedures and Penalties Act, 15 U.S.C. § 16(b)-(h), the United States submits this Competitive Impact Statement relating to the proposed Final Judgment submitted for entry in this civil antitrust proceeding.

I.

NATURE AND PURPOSE OF THE PROCEEDING

On December 16, the United States filed a civil antitrust complaint alleging that Steinhardt Management Company, Inc. ("SMC"), Caxton Corporation ("Caxton") and others conspired to restrain competition in markets for specified United States Treasury securities, in violation of Section 1 of the Sherman Act, 15 U.S.C. § 1. The complaint seeks injunctive relief and forfeiture of property owned by SMC and Caxton pursuant to the alleged conspiracy under Section 6 of the Sherman Act, 15 U.S.C. § 6.

The complaint alleges that, beginning in April 1991 and continuing into September 1991, the defendant entities and others (collectively, the "conspirators") violated Section 1 of the Sherman Act by agreeing to coordinate their actions in trading the two-year Treasury notes auctioned by the United States Treasury on April 24, 1991 ("April Notes"). During that period, the conspirators coordinated trading in the secondary markets for the April Notes, including both the cash market (where purchases and sales occur) and the financing market (where, in effect, persons with leveraged long positions, such as the defendant entities, borrow money in order to buy or to continue to hold an issue). The alleged conspiracy affected the price of the April Notes in both the cash market and the financing market.

The United States and the defendant entities have stipulated to the entry of a proposed Final Judgment, which will grant the relief sought in the complaint and terminate this action.

II.

DESCRIPTION OF THE PRACTICES INVOLVED IN THE ALLEGED VIOLATION

A. The Treasury Securities Markets

The Treasury finances the debt of the United States by issuing Treasury securities in the form of bonds, notes and bills. Treasury bonds, notes and bills are sold by the Treasury through periodic auctions conducted by the Federal Reserve System. At each such auction, the Treasury awards securities to the bidders willing to accept the lowest yield levels (effectively, interest rates) on their cash.

A week before an auction of a particular issue, the Treasury announces the size of the issue to be auctioned. "When-issued" trading for that issue begins immediately thereafter. In a when-issued trade, no money changes hands; rather, sellers agree to deliver the securities on the date the Treasury settles with successful bidders, generally one week after the auction ("settlement"). At settlement, the Treasury transmits the new issue to the successful bidders in exchange for payment. On settlement day, when-issued buyers must pay for their purchases and when-issued sellers must deliver the securities they sold. Persons who sell short an issue in the when-issued market must deliver <u>that issue</u> to the purchaser at settlement; they cannot substitute another Treasury issue.[1]

After settlement, trading to buy and sell the issue continues in the secondary or "cash" market until the maturity date, when the issue is redeemed. In every when-issued or cash market trade, a seller who does not already own the issue is said to be "short," and the buyer "long." The "short" seller may obtain the securities it is required to deliver by purchasing them at the Treasury auction or in a when-issued or cash market trade. Alternatively, the short may borrow them in the "financing market," generally through a repurchase or "repo" transaction, and delivering the borrowed securities to the buyer.

Traders of Treasury securities frequently use repurchase agreements not only to effectuate delivery when they have "short" positions, but also to finance their "long" purchases. A repurchase transaction is the functional equivalent of a loan using Treasury securities as collateral, in which the owner of an issue sells it and simultaneously agrees to repurchase it on a specified date for a specified price. The repurchase price is somewhat higher than the sale price; the difference between the two prices represents an interest rate, and is often called the "repo" rate.

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[1] Each Treasury security of a particular issue is unique and bears an identification number (known as a "CUSIP number") which distinguishes it from all other securities. Thus, all April Notes (all of which were issued on the same date) bore the same CUSIP number.

Treasury securities can be financed either through "special" repo agreements, in which the collateral is a particular, identified issue, or through "general" repo agreements, in which no particular issue need be specified for delivery. When there is specific demand for an issue because short sellers need to borrow the issue in order to deliver it to persons who have bought it, owners can lend the issue in a special repo-market transaction at a "special rate."[2] The issue generally is said to be "on special" when the interest rate that owners (such as SMC and Caxton in the case of the April Notes) are required to pay to borrow cash against the issue is significantly lower than the "general collateral rate." The general collateral rate is an overall rate for loans collateralized by Treasury securities, and usually fluctuates only in relation to short-term, money-market rates. Because the demand, as reflected by price, for a particular issue is unique in both the cash market and in the financing market (while the issue is on special), there are separate product markets for each Treasury security issue within the meaning of the antitrust laws.

If the supply of an issue is artificially constricted by agreement among the holders of the issue, both the price of the

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[2] A Treasury security may trade "on special" in the collateral markets for various reasons. Special rates could be the result of ordinary market supply and demand, but could also be induced by persons acting together to distort normal market forces. Potentially, if the holders of an issue withhold enough of it from the "specials" market, unmet demand may cause some percentage of the issue to be financed at interest rates approaching zero.

issue in the cash market and the cost of borrowing the issue in the financing market increase.[3] When the cost of purchasing an issue in the cash market or the cost of borrowing it in the financing market is significantly different than the cost of buying or borrowing securities of comparable maturities, a "squeeze" is said to occur.

B. The Conspiracy

SMC and Caxton both manage investment funds -- sometimes known as "hedge funds" -- which generally make large, "leveraged" investments with borrowed capital. The hedge funds managed by the defendant entities compete with numerous other traders and investors in the when-issued, cash and financing markets to sell purchase and finance various Treasury security issues. Prior to their purchase of April Notes, the defendant entities had a history of interaction. Beginning in January 1990, Caxton became co-managing general partner of two of SMC's funds, and Caxton's chairman became the president of SMC. The formal affiliation of Caxton and its chairman with SMC ended after one year, but employees and agents of the defendant entities continued to

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[3] Due to the manner in which the financing market works, the increased cost of borrowing the security occurs when short sellers earn lower interest rates on money they lend to holders in order to borrow the security overnight or for a short term. The cost of borrowing the securities increases when short sellers -- who must borrow the security to avoid a default (failure to deliver or "fail") on their contractual obligations -- receive, say, only 4.25% on the money they lend when, if the issue were not "on special," they would have been able to borrow the securities in the repo market and earn a higher interest rate, say, 5.75%.

communicate regularly with each other, including during the period encompassed by the conspiracy.

As charged in the complaint, beginning in or about April 1991, the defendant entities agreed on a scheme to acquire control of the supply of April Notes and to limit the supply of the issue in the cash and financing markets in order to cause a squeeze. This scheme ensured that persons who had sold notes short in the when-issued market or the post-settlement cash market could obtain such notes only by purchasing them at artificially high and non-competitive prices in the cash market or by borrowing them at artificially low and non-competitive special rates in the financing market. This course of conduct continued for a period of time during which the defendant entities, with the assistance of others, earned supracompetitive rates on transactions in the April Notes.

Through numerous purchases made through various dealers, in the when-issued market, the cash market and at auction, SMC and Caxton obtained substantial positions in the April Notes. Indeed, from May until mid-September 1991, the defendant entities controlled more than the "floating supply" of the issue, giving them the power to cause short sellers of the April Notes to fail to meet their security-specific delivery obligations.

As part of the alleged scheme, SMC and Caxton conferred on the subject of their activities or planned activities with respect to April Notes. They exchanged information about the size of their positions, the likely size of the short positions in the markets and ways to finance positions so as to keep their notes from becoming available to meet the demand for specials financing. The defendant entities gave tacit assurances to each other that they would continue to hold their substantial long positions in the April Notes, and would limit the supply of April Notes they would make available to the cash and financing markets from the positions they controlled.

The conspirators agreed to coordinate SMC's and Caxton's financing efforts so as to restrict the supply of April Notes available in the financing and cash markets. The conspirators began to implement their squeeze on May 23, 1991.[4] An essential part of the scheme involved the defendant entities entering into financing agreements with two primary dealers to ensure that the supply of April Notes available to shorts in the secondary markets would be reduced.

SMC concentrated the financing of its position with one dealer, and actively directed that dealer to withhold some or all of SMC's notes from the financing and cash markets. For example, SMC directed the dealer to refuse to make its notes available for

[4] The conspirators waited until May 23 to implement the squeeze because the subsequent issue of two-year notes was auctioned on the previous day. By waiting until the Treasury auctioned a succeeding issue, the conspirators minimized the risk that the Treasury would reopen the April-Note issue, which would have reduced or eliminated their ability to control the supply of the issue. If the issue had been reopened, the Treasury would have auctioned more notes with the April Notes' CUSIP number, rather than auctioning notes with a new CUSIP. Reopening would have effectively flooded the secondary markets with increased supply of the issue, and would have eroded the market power the conspirators had obtained through their purchases of the April Notes.

special repo transactions unless the repo rate had dropped below a certain level. At other times, SMC ordered the dealer to refuse to make the notes available at all for special financing transactions for periods of time ranging from hours to days, with the intent and effect of causing unmet demand that forced rates lower. For its part, Caxton financed a portion of its April-Notes in a series of transactions with another dealer in a manner that largely caused a quantity of the notes to be withheld from the cash market. Beginning in early August, 1991, SMC moved the majority of its position to the dealer already financing the majority of the Caxton position. This resulted in a renewed concentration of the issue that enabled the dealer to drive down repo rates.

The coordinated withholding of supply allowed SMC and Caxton to enrich themselves at the expense of other market participants both as a result of low rates at which they were able to finance their securities and as a result of cash sales at prices that were inflated by the squeeze.

The conspiracy described above injured numerous persons who traded the April Notes, especially those with short positions, by artificially inflating prices for that issue in the cash market and repo rates in the financing market. Further, the conspiracy had a dangerous probability of damaging the Treasury of the United States. As noted in the Joint Report on the Government Securities Market issued by the Treasury, the SEC and the Federal Reserve Board, an acute, protracted squeeze resulting from illegal coordinated conduct, such as the one alleged here, "can cause lasting damage to the marketplace, especially if market participants attribute the shortage to market manipulation. Dealers may be more reluctant to establish short positions in the future, which could reduce liquidity and make it marginally more difficult for the Treasury to distribute its securities without disruption."[5]

III.

EXPLANATION OF THE PROPOSED FINAL JUDGMENT

The United States and the defendant entities have stipulated that the Court may enter the proposed Final Judgment after compliance with the Antitrust Procedures and Penalties Act, 15 U.S.C. § 16(b)-(h). The proposed Final Judgment provides that its entry does not constitute any evidence or admission by any party with respect to any issue of fact or law. Under the provisions of Section 2(e) of the Antitrust Procedures and Penalties Act, 15 U.S.C. § 16(e), the proposed Final Judgment may not be entered unless the Court finds that entry is in the public interest. Paragraph VIII.E. of the proposed Final Judgment sets forth such a finding.

The United States submits that the proposed Final Judgment is in the public interest. The proposed Final Judgment contains injunctive provisions that are remedial in nature and designed to

[5] See Department of the Treasury, Securities and Exchange Commission, Board of Governors of the Federal Reserve System; Joint Report on the Government Securities Market at 10 (Jan. 1992).

assure that the defendant entities will not engage in the future in the same or similar anticompetitive practices as those employed in furtherance of their conspiracy.

In addition, the proposed Final Judgment provides for a substantial asset forfeiture that will act as a deterrent to future illegal conduct and serve as a warning to others of the possible consequences of similar illegal behavior. Pursuant to the proposed Final Judgment and the Settlement Agreements attached hereto, SMC and Caxton will each pay $12.5 million (plus interest accruing at a rate of 5.75% to the date of payment) to the United States within five business days of the entry of the Final Judgment. This payment reflects a cash settlement in lieu of forfeiture of the securities held pursuant to the alleged conspiracy.

A. <u>Global Settlement of Charges</u>

On the same date that this action was filed, the Department of Justice ("Department") and the Securities and Exchange Commission ("SEC") announced a global settlement with SMC and Caxton that resolves the defendant entities' liability under the antitrust and securities laws with respect to the conduct alleged in the complaints filed by the Department and the SEC. The terms of the settlement provide that SMC pay a total of $40 million -- $19 million in fines and forfeitures and establish a $21 million disgorgement fund to be used to compensate victims of its misconduct. The settlement also provides that Caxton will pay a total of $36 million -- $22 million in fines and forfeitures and establish a $14 million disgorgement fund.

B. Specific Injunctive Provisions

The proposed Final Judgment prohibits the defendant entities from agreeing with each other or with other persons to take certain actions affecting the markets for Treasury securities. The prohibited agreements are either impermissible under the antitrust laws, or were determined during the Department's three-year investigation of the Treasury securities markets to be significant mechanisms for facilitating collusion. The proposed Final Judgment, however, is not intended to discourage or prohibit normal communications between the defendant entities and other participants in the markets for Treasury securities. Traders in these markets often, and appropriately, exchange views about events that may affect interest rates, and consequently, the value of Treasury securities. Such an exchange of views, without more, is not ordinarily harmful to competition.

1. Section III, Applicability

The proposed Final Judgment applies to the defendant entities and each of their subsidiaries, officers, directors, employees, agents, successors and assigns. It also applies to any entity for or in which any person who is a shareholder in a defendant entity as of the date of entry of the Final Judgment engages in or directs asset management or investment advisory activities, whether directly or indirectly, that involve transactions in the cash or financing markets ("related entity");

and to all persons acting in concert with any defendant entity that have actual notice of the Final Judgment. But the proposed Final Judgment does not apply to any fund or other entity whose assets are managed or invested in whole or in part by a defendant entity or by a related entity.

This applicability provision ensures that the Final Judgment will apply not only to the defendant entities, but also to any related entity or any person acting as an agent of a defendant entity.[6] It also applies to any existing or newly formed entity in which a shareholder of one of the defendant entities has decisionmaking or trading authority involving Treasury securities. This provision ensures that the defendant entities will be unable to evade the terms of the Final Judgment by conducting Treasury security trading through some other entity. The Final Judgment, however, does not generally bind other participants in the Treasury security markets who merely engage in ordinary principal-to-principal counterparty trades with the defendant entities.

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[6] The complaint filed by the Department alleges that various persons, not identified in the complaint, were co-conspirators along with the defendant entities. These "others," defined as being within the collective category of "conspirators" in section I of this Competitive Impact Statement, above, include certain persons who acted directly as agents of one or the other of the defendant entities in the trading and financing of the April Notes.

2. Section IV, Prohibited Conduct

a. Subsection A generally prohibits defendant entities from entering into agreements to restrain trade, within the meaning of the antitrust laws, in the purchase, sale or financing of any issue in the cash or financing markets. This subsection is to be construed by reference to the defined terms used therein (e.g., "agreeing"), and by the general purpose of the antitrust laws as set forth in Section 1 of the Sherman Act, 15 U.S.C. § 1, and the Federal case law construing and interpreting the Sherman Act.

b. Subsection B prohibits defendant entities from entering into agreements to purchase or sell an issue, or to refrain from purchasing or selling an issue, through any particular person, subject to limited exceptions, discussed below, contained in Subsections E and F. Subsection B prohibits, for example, a defendant entity from agreeing with another holder of an issue to coordinate its purchases or sales of the issue by acquiring the issue only through particular primary dealers, or by agreeing to spread out their coordinated purchases among different dealers to conceal the size of their purchases and holdings. The defendant entities acquired their positions in April Notes largely from separate dealers, indicating possible coordination of their acquisition strategies.

c. Subsection C prohibits defendant entities from agreeing with another holder of an issue to withhold such other holder's position from the cash or financing markets for any period of time. This subsection, for example, prohibits a defendant entity from agreeing that another holder of an issue will withhold the other holder's position from the cash or financing markets. The Department has alleged that a central component of the conspiracy charged in this case were agreements between SMC and Caxton to withhold their positions from the cash and financing markets in order to effectuate the squeeze of the April Notes. The Department has identified only one circumstance -- prevention of "front-running" -- in which one holder of an issue agrees with another, competing holder, to withhold the other holder's position in the same issue from the markets could possibly have a procompetitive purpose. With the exception of preventing front-running, which is the subject of a limited exception, discussed below, contained in subsection F, this subsection contains an outright prohibition on a defendant entity agreeing that another holder will restrict supply of an issue by withholding the other holder's position from the cash or financing markets.

d. Subsection D similarly prohibits the defendant entities from agreeing with another holder of an issue to withhold the defendant entity's position in the issue for the purpose of maintaining or increasing the value of the other holder's position in the cash or financing markets for any period of time. The limited purpose contained within this subsection makes clear that a defendant entity may continue to decide when and whether to trade or finance its own position.[7] If, however, the purpose

[7] Because of the current structure of trading and financing of Treasury securities, investment funds such as the (continued...)

of a defendant entity's withholding of a position is to attempt to maintain or increase the value of the other holder's position in the markets, that is prohibited. The Department has identified no legitimate pro-competitive reason to agree to restrict supply by withholding one's own position in an issue for the purpose of benefitting another, ordinarily competing, holder of the same issue.

e. Subsection E makes clear subsection B is not intended to prohibit customary practices in trading positions in Treasury securities. Specifically, this subsection makes clear that nothing in the proposed Final Judgment is intended to prohibit normal principal-to-principal counterparty agreements to purchase or sell a position in an issue.

f. Subsection F is an exception to subsections B and C that permits a defendant entity to request (and obtain an agreement) that another holder, such as a primary dealer, will not trade its position while also endeavoring to transact a trade with or on behalf of a defendant entity. This exception is intended to permit a defendant entity to obtain commitments from primary dealers or other counterparties that they will not engage in

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[7](...continued)
defendant entities must ordinarily enter into agreements with counterparties to trade or finance their positions, including perhaps agreements restricting the timing or form of sales or financing. Thus, if the defendant entities are to retain control over the manner in which they trade or finance their positions, they must remain free to enter into agreements with others that literally might involve "withholding" their positions for some period of time.

"front running"[8] or other self-dealing actions to the detriment of the defendant entity while the counterparty is effectuating the purchase, sale or financing of a position on behalf of the defendant entity. This provision is necessary because, in the ordinary course, non-dealer traders such as the defendant entities must transact trades through persons such as primary dealers, who may also be competing holders of the same issue. Merely requesting that the counterparty to a transaction not engage in self-dealing while also acting on behalf of a defendant entity should not, by itself, be harmful to competition.

3. Section V, Compliance Provisions

Section V of the proposed Final Judgment requires the defendant entities to institute antitrust compliance programs. Each defendant entity must appoint an antitrust compliance officer, who will be responsible for monitoring the activities of all persons with responsibility for trading or financing Treasury securities. The antitrust compliance officer will also establish an antitrust compliance program, including specific obligations described in this section, designed to provide reasonable

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[8] "Front running" occurs when a person, such as a dealer or broker who has advance knowledge of another trader's intended actions in the market, uses that advance knowledge to trade on his own behalf ahead of the other trader. Thus, for example, if a dealer were to learn that a defendant entity intended to make substantial purchases of an issue through the dealer, so that the price of the issue in the cash market would likely rise, the dealer could use this advance knowledge to purchase the issue before the price begins to rise, and then to sell the issue at the inflated price. Defendant entities are not prohibited from obtaining commitments that a dealer will not trade against them in this fashion before committing to trade through the dealer.

assurance that the defendant entity will comply with the Final Judgment and the antitrust laws. The antitrust compliance officer will certify to the Court and the Assistant Attorney General in charge of the Antitrust Division within forty-five days after entry of the Final Judgment that the defendant entity has taken specified steps required by this section.

IV.

REMEDIES AVAILABLE TO POTENTIAL PRIVATE LITIGANTS

Section 4 of the Clayton Act, 15 U.S.C. § 15, provides that any person who has been injured as a result of conduct prohibited by the antitrust laws may bring suit in federal court to recover three times the damages suffered, as well as costs and reasonable attorney's fees. Pursuant to separate agreements reached by SMC and Caxton with the SEC and the Department, the defendant entities will pay $35 million into a fund to be available for damages claims from private parties that have been injured by their conduct, including damages incurred as a consequence of violations of the antitrust laws.[9] Entry of the proposed Final Judgment itself will neither impair nor assist the bringing of such actions. Under the provisions of Section 5(a) of the Clayton Act, 15 U.S.C. § 16(a), the Final Judgment has no <u>prima</u>

[9] The specific permitted grounds for successful claims against the disgorgement fund and the mechanics of fund operation under the auspices of the SEC are set forth in the <u>Final Judgment of Permanent Injunction and Other Relief</u> as to each defendant entity, filed contemporaneously with the SEC's complaint against SMC and Caxton.

facie effect in any subsequent lawsuits that may be brought against SMC or Caxton in this matter.

V.

PROCEDURES AVAILABLE FOR MODIFICATION OF THE PROPOSED FINAL JUDGMENT

As provided by the Antitrust Procedures and Penalties Act, any person believing that the proposed Final Judgment should be modified may submit written comments to John F. Greaney, Chief, Computers and Finance Section, U.S. Department of Justice, Antitrust Division, 555 Fourth Street, N.W., Room 9901, Washington, D.C. 20001, within the 60-day period provided by the Act. These comments, and the Department's responses, will be filed with the Court and published in the Federal Register. All comments will be given due consideration by the Department of Justice, which remains free to withdraw its consent to the proposed Judgment at any time prior to entry. The proposed Final Judgment provides that the Court retains jurisdiction over this action, and the parties may apply to the Court for any order necessary or appropriate for the modification, interpretation or enforcement of the Final Judgment.

VI.

ALTERNATIVES TO THE PROPOSED FINAL JUDGMENT

The proposed Final Judgment provides all the relief that the United States sought in its complaint. The Department believes that litigation on the allegations in the complaint would involve substantial cost to the United States and is not warranted given the relief to be obtained in the proposed Final Judgment. In specifying the relief set forth in the proposed Final Judgment, the Department consulted with and considered the views of experts in the Treasury securities field, including the United States Department of the Treasury and the SEC. The specific injunctive provisions are tailored to ensure that the defendant entities will not again engage in the same illegal conduct, and in the event of violations, are enforceable through civil and criminal contempt. Further, the payment by defendant entities under Section 6 represents the second-largest forfeiture or other penalty ever paid to the government by defendants in a single antitrust case, and will provide a substantial deterrent to future anticompetitive conduct in the Treasury securities markets.

Another alternative to the proposed Final Judgment would be to prosecute this conspiracy as a criminal violation of Section 1 of the Sherman Act, 15 U.S.C. § 1, rather than through a civil complaint. The Department carefully considered this alternative. The Department determined, in the exercise of its prosecutorial discretion, that charging this matter as a civil violation was most appropriate. The releases from criminal prosecution set forth in the Settlement Agreements attached hereto merely confirm the Department's decision that the case is more appropriately brought as a civil matter.

VII.

DETERMINATIVE MATERIALS AND DOCUMENTS

No materials or documents of the type described in Section 2(b) of the Antitrust Procedures and Penalties Act, 15 U.S.C. § 16(b), were considered in formulating the proposed Final Judgment.

Dated: December 16, 1994

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Kenneth W. Gaul, an attorney in the Department of Justice, Antitrust Division, certify that on this date I have caused to be served by hand the attached COMPETITIVE IMPACT STATEMENT upon the following counsel for defendant entities in the matter of United States v. STEINHARDT MANAGEMENT COMPANY, INC. and CAXTON CORPORATION, et al. (94 Civ. ____).

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