COMMENT & ANALYSIS

REVIEW OF NAFTA TELECOMMUNICATIONS CHAPTER 13 AND CANADIAN FOREIGN OWNERSHIP LIMITS

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The following article which examines the significance of the NAFTA Telecommunications Chapter is a transcription of comments presented at The Evolution of Free Trade in the Americas: NAFTA Case Studies, The American University, Washington, D.C. on October 6, 1995.

The recent collapse of WTO negotiations to introduce greater national treatment in the member regulation of the telecommunications sectors has generated some renewed interest in this NAFTA Chapter, the related Canadian reservation providing for restrictions on foreign ownership of certain telecommunications services suppliers, and the broad exclusion from NAFTA of Canadian cultural industries.

New U.S. Telecommunications legislation now permits a relation of American foreign ownership restrictions for investors of other countries prepared to provide a reciprocal relaxation for U.S. investors. As well, efforts by Telesat Canada to provide for a quick replacement of lost satellite capacity by means of a form of condominium arrangements with American firms upon satellites to be launched into orbital "slots" to date reserved by the Canadian government for Telesat have also raised renewed interest in the current objectives utility of Canadian ownership and control requirements in the Telecommunication services sector.

These remarks will also be published in volume 11:4 of the American University Journal of International Law and Policy.

Unlike the previous speakers, I am going to focus on the actual words of the Telecommunications Chapter. In doing so, I will not talk very much about trade and telecommunications equipment in the North American context.

Briefly, the equipment industry has been globalized, technology is standardized, there are few patents that matter, and software is a global issue. In global terms, the equipment industry is dominated by a few multinational companies. Northern Telecom, headquartered in Canada, is one of them. Northern Telecom was the first to supply low-cost, digital office switches to the newly divested regional Bell companies operating in the early 1980s.

Chapter 13, the Telecommunications Services Chapter, is essentially a highly articulate flow-through from a number of provisions of the Free Trade Agreement. I will look at the Telecommunications Services Chapter as essentially that kind of flow-through, and will look there for the context of the creation of the FTA Telecommunications Provision. I will try to compare that context to the differences in the economic environment of both Mexico and Chile, in terms of what the implications of the new Telecommunications Chapter means to them.

I will also give you a brief summary of Chapter 13. It may seem odd that the chapter is in the NAFTA, because it appears to have less to do with trade in goods and services, and more to do with placing constraints on domestic public utility regulatory policies in individual countries. One might ask what domestic public utility policies have to do with the flow of goods and services across borders. In light of past international trade agreements, Chapter 13 is a foreign element. It does not have anything to do with the tradition of liberalizing international trade rules.

My point, however, is that I believe we see here a little acorn in the telecommunications provisions of the FTA and the NAFTA by becoming a significant presence in future arrangements between States which are designed, in one sense, to codify a commonality of domestic, economic or regulatory policies to facilitate investment flows and trade in goods through consistent and common rules.

The objective of Canada and the United States was partially to avoid any backsliding into a more *dirigiste* or interventionist world, and partially to set a standard by which future agreements on microeconomic policy might be made to be incorporated into future comprehensive, bilateral arrangements. In other words, I look at the Telecommunications Chapter as alien to the tradition of international trade negotiations, and at the same time, see it as the seed of a new form of agreement: an agreement that discloses an increasing convergence, or meeting of the minds, between different states as to the limits to which interventionist microeconomic policy should go in particular sectors of the economy.

In hindsight it is perceived as a win for the two parties, but from a forward looking perspective the two parties have managed to agree on some pretty detailed rules about how to treat telephone companies, and how to demonopolize an industry. They further agreed on how to transform a public service, quasi-state enterprise, into just another industry.

In fact, that is the transition that Canada and the United States were embarking on at the time of the negotiation of the FTA in 1987. There were only slight differences between Canada and the United States in their view of telecommunications services in 1987. In the United States, the telecommunications services industry had completely lost all strategic significance. It was regarded as a sector ripe for development of sustainable competition. More significantly, this sector faced dramatic antitrust restrictions through the 1982 divestiture arrangements which emphasized structural solutions. The terms of the consent agreement involved breaking up companies and providing for nondiscriminatory access to competitors.

Canada, in 1987, was not much different. Perhaps one could argue that Canada continued to attach a greater strategic importance to its telecom sector; and that nationbuilding through telecoms was still a factor in policy making; and that Canada attached slightly greater social policy significance to the telecom sector. But, these were not substantial differences. The overlap in domestic policies was virtually complete.

As a result, it became very easy for Canada and the United States in 1987 to define a set of rules for the regulation of the respective telecom carriers as part of a bilateral trade arrangement. Canada, got an opportunity, finally, to codify, without United States objection, foreign investment limitations in the telecom sector. What the Americans got in 1987, perhaps to a lesser degree than other sectors, was essentially a codification of base-line policies for telecom competition in Canada, which would ultimately provide for greater foreign investment opportunities and would ultimately result in a more efficient North American industry. At the same time, however, it would provide demonstrable evidence to the world that Americans were not alone in believing that the telecom services sector was a key sector for demonopolization. This demonopolization was achieved largely through the kinds of instruments that one sees applied in competition law.

The principles that were adopted in 1987 are articulated in Chapter 13. These are nothing new to Canadians and Americans, but are largely foreign concepts in virtually every other regulatory jurisdiction. The principle of nondiscriminatory, transparent system interconnection rights is the first concept. This requires the monopoly carrier to break up its network services. This results in the opportunity for customers to choose from alternative suppliers who have the right to land their networks on the former monopolist's network at particular points of presence, in order to create complete, switched call paths or private network paths. Transparent, reciprocal, nondiscriminatory interconnection rights are a fundamental proposition of Chapter 13, and flowed from the divestiture of AT&T into local and long distance companies.

A second important development in Chapter 13 are affirmative obligations relating to pricing. The agreement says that telecom services pricing must reflect economic costs. This is close to a microeconomic domestic policy principle. Private leased circuits must be available on a flat rate basis, because flat rate, private-leased circuits provide the bulk product that support an arbitrage-based resale competition in both Canada and the United States.

Another domestic competition policy measure involves certain limitations allowed for access terms within defined parameters. In other words, some public utility discriminatory regulation option is still available. These, however, have to be reasonably necessary in order to receive the safeguard public service responsibilities, or protect public network technically in good integrity.

Frankly, this section has yet to result in any substantial amount of dispute view between Canada and the United States, again, because we are basically in an agreement on the underlying regulatory mechanics

to achieve the principles. But, there may well be reason for Mexico and Chile to reflect upon the extent to which these principles might limit the development of their telecommunications systems.

Other provisions involve essentially opening up the market for enhanced or value added services. Neither Canada or the United States, has foreign ownership rules that apply to businesses that are resellers, who add on enhancements such as software intelligence, or service bureaus who provide 976-type telephone services.

These are the specific types of policy constraints built right into a trade agreement.

I will now address key environmental differences between Canada and the United States, based on my proposition that, Canada and the United States moving into the 1987 FTA, had essentially the same telecommunications services environment. Our systems were completely integrated. We used the same technology, delivered the products the same way, and had essentially the same regulatory environment. Indeed, executives cross-fertilized each country's companies to a high degree, and we bought from the same set of suppliers.

There were, however, some fairly significant environmental factors between Canada and the United States, on one hand, and Chile and Mexico on the other. In fact, one could extend this dichotomy to include, Canada and the United States and, all of the OECD countries on the one hand, and on the other hand, everyone else.

First, in Canada and the United States, an extensive commitment to wire line, microwave and fiber-optic type infrastructure already existed. By the time of the agreement, an extensive, highly engineered infrastructure had already developed.

Chile and Mexico essentially still have an undeveloped telecom infrastructure. Despite its implications, this provides the great advantage of providing far more choices with regard to technological selection. Canada and the United States have low telecom prices. Chile and Mexico have very high telecom prices for services, particularly for long distance.

In 1987, Canada and the United States had near universal penetration rates, both with respect to residence and business customers. Although Chile and Mexico are expanding their penetration rates, they continue to be relatively low.

In Canada and the United States, by the mid-1980s, the available economies of scale and scope in the telecoms services sector had largely been exhausted; whereas, in Chile and Mexico, there remain potentially tremendous economies of scale and, therefore, productivity gains from system growth are still to be realized. Another difference is that, in Canada and the United States private ownership of telephone utilities

predominated for a long period of time, and in the 1980s there was extensive development of private corporate networks; while in Chile and Mexico, there is state or quasi-state ownership. In the case of TELMEX, privatization still involves an elaborate social contract with the privatizing government.

The final institutional difference is that, in Canada and the United States, telecoms were regulated by an independent regulatory agency. In the United States, the predominate regulatory agency in the 1980s was the antitrust courts. The FCC is now reasserting itself. In Canada we have had a mix of antitrust and regulatory policy, where our regulator, the CRTC, has, over the last few years at least, become a de facto antitrust regulator. Chile and Mexico, however, have essentially state price control.

What are the implications of those differences with respect to provisions of NAFTA? First, I do not necessarily suggest that there are negative implications. But, the implications are that the model of the Telecommunications Chapter is at least as suitable for developing infrastructure industries as it is for a highly developed, advanced, ubiquitous telephone industry, which has already been subjected to substantial competition.

Chapter 13 will, probably, help jump start Chile and Mexico towards the local telecom competition and productivity we have achieved in Canada and the United States. I question, however, whether the codification of Canadian and United States rules will necessarily provide the degree of flexibility during the transition that is required to assure that the social benefits of universal telephone service are available for all consumers in each country. There are many economic advantages to universal telephone service. Anyone who has spent a week in Mexico City can see the enormous potential for substituting telecommunications for automobiles.

My last comment relates to the codification of foreign ownership restrictions in Canada. In 1987, we announced policies just prior to the finalization of the FTA to provide us the opportunity to grandfather foreign investment limits which we consider to be strategically important to telecom carriers. Those provisions were enacted in the early 1990s.

We have a new *Telecommunications Act* in Canada which specifies that foreign voting share ownership in our facilities-based telecoms carriers cannot exceed one-third of the voting shares; and that the company boards have to be 80% Canadian; and finally, that effective control, defined by corporate law, must lie with Canadians.

Some would suggest that we have, in fact, moved backwards in codifying foreign investment limits, given the globalization of the industry. To date, however, I believe that the effect of codifying these rules has been to create some certainty for foreign investors wishing to participate in larger Canadian telecom carriers. Indeed, the three primary long distance carriers in Canada have foreign investment and cross-fertilization within them. Sprint Canada has adopted the name of an American company through a licensing arrangement

by which Sprint U.S. has taken out a 25% nonvoting position in Sprint Canada. AT&T, perhaps much to its chagrin, has become a substantial investor in another long distance carrier, Unitel Communications, which recently was put into what amounts to a bank receivership and equity workout by a bank consortium when the consortium found that it did not have any customers to buy the company, and that the existing investors were going to walk away from their guarantees of close to a $650 million line of credit. Nevertheless, we have certainly, with respect to our foreign investment limits in the telecom sector in Canada, established a reasonable range. They are comparable to that of the United States. I would expect both Canada and the United States to move through the post-Uruguay Round so as to establish that limit worldwide, and then increase it. To date, in Canada, voting share limits have not proven to create a substantial impediment to technology transfer.

One major point that flows from the FTA arrangement is that, from now on, Canada and the United States and any other participant in these agreements will not be able to force technology transfers. Indeed, technology transfer will now have to be freely negotiated between private companies, and that substantially, but non-controlling ownership position is expected to be sufficient inducement to ensuring adequate technology transfers with respect to telecommunications between Canada and the United States. For the time being, it may well prove to be a sufficient inducement for other countries that participate in the NAFTA.

SELF-REGULATION IN THE SECURITIES INDUSTRY — A REGULATORY PERSPECTIVE

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The following article was written as of September 26, 1995 and presented at a conference on ethics and self-regulation in the securities industry.

Introduction

I am here today to discuss a regulator's perspective on self-regulation in the securities industry. Of course, as always, these are my personal comments and not necessarily those of the Commission or its staff generally. As most of you may be aware, I am a relatively recent regulator. I now have a little over 9 months under my belt, and therefore my private sector securities lawyer client-oriented perspective may be starting to give way to a broader "public interest" focus.

One of the most surprising things to me was that, as a securities practitioner, one generally has very little involvement with either the Investment Dealers Association of Canada ("IDA") or The Toronto Stock Exchange

("TSE") from a member regulation perspective. In fact, most of the IDA rule book, and most parts of the TSE by-laws and related instruments apart from the Company Manual applicable to listed companies, were quite foreign to me. I don't believe that I am alone in this. The other day I was speaking to a very experienced securities lawyer who was surprised to learn that TSE decisions could be appealed to the Commission. Accordingly, I was quite interested in learning something about the other half (at least) of the securities industry. In part, that led to my involvement in the IDA's application for recognition as a self-regulatory organization.

Securities regulators such as the Commission rely on self-regulatory organizations to carry out regulation that would otherwise have to be done directly by government. A self-regulatory organization ("SRO") can use the industry's own expertise to regulate the industry. The major concern with the use of SROs is ensuring that the SRO acts in the public interest and does not seek to benefit its members at the expense of the public as clearly there is an opportunity for such behaviour.

My overall sense of the appropriate regulatory stance is that while self-regulation in the securities business can have a number of advantages, it may also have a number of risks. A regulator should accordingly proceed with caution and seek to maximize the benefits and minimize the risks.

Discussion

Recognition, apart from being something of a "good housekeeping" seal of approval, may potentially protect an SRO from jurisdictional challenges similar to those the IDA faced in connection with the inter-dealer bond broker situation.[1] But what is in it for the Commission, and for the broader public interest?

Reading the financial press, one might be forgiven for thinking that the investment business is not conducted with particular regard for ethics. Names such as Boesky, Kidder Peabody, Drexel Burnham Lambert, Nomura, Daiwa, Guinness/Distillers, BCCI, Maxwell, Baring Brothers and, in the Canadian context, Osler Inc. and a number of others spring readily to mind. Allegations of insider trading, market manipulation and outright fraud are far too frequent.

A 1990 survey of its members conducted at the request of the NYSE by the Financial Executives Institute[2] concluded that ethics were high on the list of concerns, with over 70% of the respondents concerned about insider trading, fraud and abuse in the marketplace and the honesty and ethics of stockbrokers.

There is limited "hard" data available about the state of ethics in the securities industry. However, two studies have been sponsored by the Institute of Chartered Financial Analysts into ethics in the investment profession. In a 1992 study into ethics in the United States and Canada,[3] the following findings were reported:

- almost one-quarter of the 400 respondents (representing a response rate of 44.7 percent) had observed unethical behaviour by a colleague during the previous 12 months;

- more than one-fifth of the respondents had been asked to do something unethical, usually by a more senior colleague;

- while respondents observing unethical behaviour usually made the activity known to a supervisor or compliance officer, more than one-third did nothing; and

- the three most frequent violations (in descending order) were failing to use due diligence and thoroughness in making recommendations, writing reports with predetermined conclusions, and communicating inside information, and a significantly greater percentage of respondents indicated that these three types of violation occur frequently or periodically than indicated they occur rarely or never.

The most significant deterrents to unethical behaviour were considered to be (in descending order): (i) governmental sanctions, (ii) moral or religious beliefs, and (iii) the concern that family or friends will find out, with (iv) SRO sanctions and (v) having a published code of ethics ranked significantly lower as deterrents. Perhaps this suggests that SRO sanctions and enforcement processes need toughening up. In addition, while about 85 percent of respondents believed that their firm's senior managers truly seek high ethical standards from all employees, with responses somewhat more positive at larger than at smaller firms, more respondents thought ethical standards had deteriorated than thought they had improved over the previous 10 years. This certainly leaves room for improvement, and most respondents expected improvements over the next 10 years.

This survey was conducted among both buy-side and sell-side analysts, rather than brokers generally, so it is difficult to extend its findings to the general level of ethical behaviour in the industry.[4]

It may be that we need securities industry leaders to make it clear that strong business values and high ethics are essential to participate in the investment business. Reputations, careers, futures and, ultimately, profitability may well turn on ethical conduct. Such conduct must be directed from the top. This calls for a higher standard than mere compliance.

History of Self-regulation in the Securities Industry

As noted above, the Commission relies on self-regulatory organizations such as the IDA and TSE to assist with the overall regulatory burden. However, self-regulation in the securities industry is not something new. Formalized or not, it has a long history in Canada and elsewhere, which is not to say that its rationale has always been well articulated or that its merit is universally accepted.[5]

Historically, the stock exchanges were the securities industry's only SROs, and they were, for a long time, effectively the only securities regulators that existed. They regulated members, markets and listed companies. In 1934, the U.S. imposed statutory obligations on stock exchanges to regulate their members. In 1938, the U.S. created a new type of SRO, the national membership association. Somewhat later, membership in a national membership association was made compulsory for brokers-dealers. Unlike the exchanges, this new type of SRO did not sponsor an exchange, and so was responsible solely for member regulation and not also for market or listed company regulation. Over time, however, the association, the National Association of Securities Dealers, Inc. ("NASD"), has also taken on a market regulation function through its operation of the Nasdaq over-the-counter automated quotation system. It has recently been suggested by a committee headed by former U.S. senator Warren B. Rudman (the "Rudman Committee") that governance changes are necessary in light of these different functions.[6]

In Ontario, for many years, the TSE has been a creature of statute and has been recognized as a stock exchange by, and regulated under the supervision of, the Commission. Prior to 1994, however, Ontario legislation did not recognize SROs, and the role of the IDA was restricted under the *Securities Act* principally to setting audit standards for its members and reviewing the audits conducted on members to ensure that they were acceptable.

New Commission Recognition Powers for SROs

Amendments to the *Securities Act* which became effective in 1994 defined SROs as organizations which represent registrants and which are organized for the purposes of regulating the operations and standards of practice and business conduct of members and their representatives with a view to protecting investors and the public interest. The amendments specifically contemplate the existence of SROs which are not recognized by the Commission, while also allowing the Commission to recognize an SRO.

Recognized SROs are subject to the oversight of the Commission: their by-laws, regulations and policies may be reviewed and changed by the Commission where that is appropriate. In addition, the Commission has the right to review any decision made by a recognized SRO. The Act also allows the Commission to assign to a recognized stock exchange or SRO the ability to register dealers and their representatives. Currently, both the IDA and TSE review the applications of proposed salespersons of members to determine whether to approve them. Staff of the Commission also reviews these applications in order to decide whether to register the salesperson. This is somewhat duplicative, and the law now allows for delegation of the registration function to a recognized SRO or stock exchange.

In December 1994, the Commission granted recognition as an SRO to the IDA until August 31, 1995. This was done for two reasons. First, the amendments which came in during the summer of 1994 took away the IDA's legislated audit supervisory role until the IDA became recognized as an SRO; the IDA continued to perform that role under its own by-laws and the Commission did not have the resources to accomplish

that role; second, since 1988, the IDA has been operating as a de facto recognized SRO under a series of letters (the "protocol") between the IDA and the Commission. Under this protocol, the IDA voluntarily submitted its by-laws to the Commission for review and non-disapproval, in the same manner that the TSE submits its by-laws to the Commission.

The recognition granted in December 1994 was recently extended until October 31, 1995 to give the IDA time to prepare its formal application in response to the recognition criteria proposed by Commission staff.[7] These criteria seek to take advantage of the benefits of self-regulation while minimizing its disadvantages.

The Advantages and Disadvantages of Self-regulation

Self-regulation in the securities business has a number of advantages, including:

(a) the ability to utilize industry expertise;

(b) the potential for higher standards than may be imposed by law;

(c) potentially greater compliance with mutually agreed rules set by peers than with externally imposed requirements; and

(d) greater flexibility and responsiveness.

However, self-regulation also has a number of risks arising from the inherent conflict of interest between the interest of members and the public interest, which has been recognized at least since the time of Adam Smith.[8] These risks[9] include:

(a) operational failures resulting from lack of resources or commitment, such as the application of inconsistent standards or arbitrary penalties or the failure to respond promptly to problems;

(b) anti-competitive behaviour, such as entry barriers and sub-optimal market structure, which favours the interests of intermediaries over those of investors;

(c) self-serving regulation generally;

(d) a heightened possibility of "regulatory capture", including through control of the information necessary to regulate properly and increased regulatory dependency on the SRO for policy input and expertise; and

(e) the chilling effect on dissent that may result from a well-organized interest group that is generally able to speak with a single voice.

The question for a regulator is how best to capitalize on the advantages while minimizing the risks.

The "Shotgun" Approach to Self-regulation

William O. Douglas, an early chairman of the SEC before his career as a U.S. Supreme Court judge, described the appropriate regulatory stance as follows:

> Government would keep the shotgun, so to speak, behind the door, loaded, well-oiled, cleaned, ready for use but with the hope that it would never be used.

If he was speaking today in Canada, no doubt he would also have referred to registration of the shotgun!

This "shotgun" approach is largely the stance adopted today in Ontario. Any more activist approach would be open to the criticism that it involves undue micromanagement of the SRO, thus defeating the purpose of having an SRO in the first place. The "shotgun" approach appears to be an appropriate manner of responding to SRO compliance and enforcement activities, but a different and more "hands-on" standard may have to be applied to potentially anti-competitive conduct, especially in the context of rule review.

Danger of Anti-competitive Conduct

As noted above, one of the principal risks of relying on self-regulation is the risk of anti-competitive conduct. The IDA and TSE, for example, have been described as a cartel operated for the benefit of the big firms.[10]

Clearly SROs are subject to significant conflicts of interest. One question that arises is whether an SRO can be an effective regulator if it also carries on or participates in trade association activities, as is the case with the IDA. While views may differ, my personal view, as a member of both a self-regulatory professional organization and a professional trade association, is that it is unrealistic to imagine that self-interest is not always going to play a role, whether or not the organization is also a trade association. Accordingly, as long as trade association activities do not undermine self-regulatory activities, in my mind the two activities are not incompatible. Clearly the presence of strong and effective public governor representation is key. In this regard, as a result of the recognition review process, the IDA has agreed to add a public director to its executive and nominating committees.

On the question of public directors, it is interesting to note that the Rudman Committee has proposed increasing public representation on the NASD board to 60 percent from the current 20 percent.[11]

Another question, and one that is more interesting in my view, is whether an SRO can effectively carry out both member regulation and market regulation. Canadian stock exchanges have sought to carry out this task for a number of years, as have stock exchanges and the NASD in the U.S., arguably with mixed results. The Rudman Committee has an interesting perspective, and proposed a governance structure utilizing proposed separate boards of directors with 50-50 public/industry representation for the market regulator. According to the Rudman Committee:

> The NASD's governance structure has failed to keep pace with the significant growth and continuing evolution of the Nasdaq market. [It] blurs the distinction between regulating the broker-dealer profession and overseeing the Nasdaq stock market....
>
> The NASD's relationship with Nasdaq should be structured so as to put substantial "daylight" between the membership association and the market, with separate governing bodies whose compositions are tailored to the particular requirements of their respective missions and constituencies....
>
> A divorce [as opposed to some separation] would be undesirable, in the committee's view, because it would remove the regulator of the broker-dealer profession entirely from the dealer market.... A divorce would also require duplicative enforcement machinery.[12]

The Canadian SROs have also been discussing a proposal to merge their member regulation functions into a national organization distinct from the stock exchanges, although at the time of writing this initiative appears to have stalled and its current status is unclear.

In order to deal with the fundamental conflicts of interest to which SROs are subject, a regulator must be alert to potentially anti-competitive conduct, especially in the context of proposed rules and market structure proposals, which is a role that the Commission may not be ideally suited for.[13] Staff is proposing an "improved" Commission oversight and rule review process to seek to address this issue more effectively in future.

One area that has probably received insufficient attention over the years is the extent to which Commission supervision may provide an "antitrust umbrella" and shield the securities industry from antitrust actions. This has certainly happened to some extent in the United States,[14] and the relatively limited case law on point in Canada[15] suggests that similar protection may well also be available here.[16] The effect of the express statutory exemption for underwritings is unclear.[17]

An "Improved" Commission Oversight and Rule Review Process

Commission staff has also been interested in opening up SRO processes generally to public scrutiny. In part, the new portion of the Commission Bulletin related to SRO decisions should assist in this process. One of the most common criticisms of Commission/SRO relationships in the past has been a lack of transparency, and many of the proposed terms and conditions of recognition of the IDA are directed to this end and to a more open and efficient Commission/IDA relationship.

As one of the principal dangers of SROs is anti-competitive conduct, clearly the Commission will have to be particularly focussed on the competitive impact of proposed SRO rules. In this regard, the marketplace can help the Commission assess the impact of proposed SRO rule changes. For this reason, and also due to the general preference for open processes, Commission staff is proposing that, in the future, proposed SRO rule changes, and particularly potentially controversial ones, should be subject to a public review process before being considered for approval by the Commission. The Commission should be in a much better position to assess the public interest, particularly from a competitive standpoint, with the benefit of the views of market players, and I would encourage market players to make these views known to the Commission. Conversely, failure to comment should probably generally be viewed as indicative of the fact that there are not significant problems with a proposed rule. In this way, it is hoped that a public review process will assist the Commission in its review process.

Looking to the Future

There are a number of areas in which, as a regulator, one could see room for improvement in the securities industry. Some may be appropriately addressed by the SROs. I will only mention a few.

In a May 1995 Investment Executive survey (see note 4), ongoing broker training of the seven largest Canadian firms was rated at between 5.6 and 6.9 out of 10, and account statements at between 5.3 and 8 out of 10. There appears to be obvious room for improvement in both of these areas. SROs could spearhead mandatory continuing education, and could also assist in developing improved account statements to provide more information to customers, particularly with respect to overall performance and costs.

Other areas of potential improvement could include:

(i) to deal with the problem identified in the 1992 CFA study (see note 3) to the effect that a significant number of investment professionals do not report unethical behaviour, the SROs could institute a "whistle-blowing" rule such as applies in certain other professional contexts; and

(ii) to improve the confidence and fair treatment of clients and in recognition of the high cost of litigation, the SROs could encourage the development of a broadly accessible arbitration process to enable customer disputes to be arbitrated at the customer's option. It is my understanding that there is currently an IDA-sponsored pilot project going on in British Columbia, and that a committee reviewing the issue in Quebec has recommended that arbitration be brought into effect.

Conclusion

The self-regulatory process in Canada's securities industry has a great deal to be proud of. Nonetheless, there is room for improvement, and we are trying to assist in that process. At this time, we have tried to open up the process to more public scrutiny and to make SROs more accountable to the public interest for their actions.

However, improvements in standards of ethical conduct in the securities industry must be a continuing process. In the immortal words of Charles Ritchie, I will be satisfied as long as it can't fairly be said of what we have done to date: "They improved it worse."

Notes

[1] In August 1993, Cantor Fitzgerald commenced an action against the OSC, the IDA and others alleging that a MOU published in the July 23, 1993 edition of the OSC Bulletin among certain inter-dealer bond brokers, the IDA and the OSC, and the IDA's rules regarding inter-dealer bond brokers, as well as certain ancillary acts, were illegal and ultra vires on the part of both the IDA and the OSC and also contravened the federal *Competition Act* and Common Law. The action also alleged that the Commission's nondisapproval procedures were invalid and ultra vires. In September 1993, at the IDA's request, the Commission announced that its consideration of the MOU was being deferred pending completion of a further review of issues that have been raised about transparency in the domestic debt markets.

[2] Mimi Deitsch, "The economy and the stock market: views of financial executives" (1990) 6:4 Financial Executive 48.

[3] E. Theodore Veit and Michael R. Murphy, *Ethics in the Investment Profession: A Survey (1992)* (The Research Foundation of the Institute of Chartered Financial Analysts, 1992).
In a 1995 companion study conducted on non-North American investment professionals in eight countries, the results were not terribly dissimilar, although the most common response to a colleague's unethical behaviour was to do nothing, and trading on inside information, in addition to communicating inside information, failing to use due diligence and thoroughness in making recommendations, and writing reports with predetermined conclusions, were all reported to occur often or sometimes more frequently than seldom or never. Interestingly, outside North America, the most significant deterrents to unethical behaviour were listed (in descending order) as: (i) employer disciplinary action, (ii) governmental sanctions, (iii) SRO sanctions, (iv) moral or religious beliefs, (v) having a published code of ethics and (vi) the concern that family or friends will find out. Only 59.8% of respondents believed that their firm's senior managers truly sought high ethical standards from all employees, with responses in the 50th percentile in Hong Kong, Japan, Singapore, Thailand and Switzerland. However, unlike in North America, most respondents thought ethical standards had improved over the previous 10 years. Once again, most expected this to continue. See H. Kent Baker, E. Theodore Veit and Michael R. Murphy, *Ethics in the Investment Profession: An International Survey (1995)* (The Research Foundation of the Institute of Chartered Financial Analysts, 1995).

[4] In a 1995 survey of brokers at the seven largest Canadian firms, brokers rated the overall ethics of their respective firms at between 8.4 and 9.1 out of 10. See *Investment Executive* (May 1995). On particular topics, legal and compliance ratings varied from 7.6 to 8.6 out of 10, fixed income pricing from 7.0 to 8.2 out of 10, ongoing training from 5.6 to 6.9 out of 10, and account statements from 5.3 to 8 out of 10.

[5] An analysis of the role of self-regulation in the securities industry is contained in Sam Scott Miller, "Self-Regulation of the Securities Markets: A Critical Examination" (1985) 42 Washington and Lee Law Review 852. Mr. Miller notes that the regulators and the regulated have different objectives in adopting self-regulatory schemes, and comments that "perhaps it is the vagueness of the concept and its chameleon aspects that account for its mutual attraction". As regulatory objectives, he lists reduced costs and the ability to focus attention on higher priorities, as well as possible unwillingness to handle "delicate or taxing" problems; as industry objectives, he lists flexibility, reduced rigidity and cost savings and, perhaps most importantly, insulation from direct governmental involvement. He queries why

self-regulation has not been extended to other financial sectors if it works as well as its proponents claim, noting the lack of empirical support. He also notes that self-regulators are charged somewhat paradoxically with both expensive and enthusiastic over-regulation and ineffective "part-time volunteer" regulation by industry personnel who may "have very little capability to perform unfamiliar regulatory tasks". SROs are also charged with creating duplication due to the need for governmental oversight, abusing rights and, perhaps most importantly, engaging in anti-competitive behaviour either through the enforcement of standards of business conduct that are based more on economics than prevention of wrongful conduct or through the uneasy compromises which may result in cases where member regulation is combined with market regulation. Martin has noted that while the *Silver* case (*infra*, note 10) "represents an effective judicial response to an anti-competitive abuse of its power by an SRO, ferreting out such abuses can be difficult [as anti-competitive rules] may be mixed with and camouflaged by regulatory purposes, citing as examples both the "long saga" of institutional membership on the NYSE, which he indicates "illustrates the obfuscation of anti-competitive purpose by regulatory trappings" to protect commissions, and the various prohibitions on offexchange trading. If self-regulation is in fact ineffective regulation, he writes, then the danger of an "illusory facade of protection" exists.

In a comment on the SEC's *Market 2000 Report* published in the Spring 1994 edition of The Journal of Corporation Law at 483, Prof. Dale Oesterle of the University of Colorado questions the validity of self-regulation by outlining the scandals that plagued the NYSE in 1938 during the Whitney era and the American Stock Exchange during 1961, the "back office" crisis of the 1960s that led to the failure of numerous broker-dealers, and the 1973 report by the Senate Subcommittee on Securities, which included the following sceptical statement:

> The inherent limitations in allowing an industry to regulate itself are well known; the natural enthusiasm for regulation on the part of the group to be regulated, the temptation to use a facade of industry regulation as a shield to ward off more meaningful regulation, the tendency for businessmen to use collective action to advance their interests through the imposition of purely anti-competitive restraints as opposed to those justified by regulatory needs, and a resistance to changes in the regulatory pattern because of vested economic interests in its preservation.

In his view, they demonstrate what he refers to as the "script":

> Scene One — a period of SEC inaction; Scene Two — a public scandal; Scene Three — SEC hand-wringing on self-regulation; Scene Four — exchange or securities association amendments to their constitution or rules and procedures; and, in the final scene, a heartfelt SEC reaffirmation of the wonders of self-regulation.

Today, he has concerns with off-exchange trading prohibitions, which are argued by their proponents to prevent market fragmentation, difficulties placed on the ability of listed companies to delist their shares on a stock exchange in favour of a listing or quotation on another market, the now-abandoned fixed commission structure (which he suggested has not led in any way to the market collapse predicted by the NYSE), eighths pricing rules and specialist trading rules and practices. He questions whether SEC oversight is effective, describing the SEC as a "shrinking violet".

In the *Market 2000 Report* itself, at 29, the SEC stated as follows:

> As competition for order flow increases, it is likely that the different marketplaces will act in ways that may restrict the activities of their competitors. Past experience has shown that competitive interests can cause an SRO to take actions to disadvantage competitors, while cloaking these actions with regulatory purposes. Regulatory and self-regulatory proposals must be examined with this in mind. At a minimum, the Commission must ensure that proposals by the markets do not impose restrictions on where the users of the markets can conduct transactions, and that restrictions on professionals are consistent with notions of fair competition.

[6] See Floyd Norris, "Investors to Get Bigger Role in Running NASDAQ Market" *New York Times* (20 September 1995); William Power, "Nasdaq is Urged to Split Off From its Parent" *Wall Street Journal* (20 September 1995); "Excerpts From Rudman Report on NASD" *Wall Street Journal* (20 September 1995); and Richard Siklos "Nasdaq eyes regulatory split-up as SEC wants all U.S. bourses to open up" *The Financial Post* (26 September 1995).

[7] Commission staff's proposed recognition criteria for the IDA were published at (1995), 18 OSCB 2647ff. The IDA's recognition was extended until October 31, 1995 at (1995), 18 OSCB 3803.

[8] Adam Smith described this conflict of interest in *The Wealth of Nations* (1776), (Penguin Books Ltd., Markham, 1977) at 358, as follows:

> The interest of the dealers, however, in any particular branch of trade or manufactures, is always in some respects different from, and even opposite to, that of the public. To widen the market and to narrow the competition, is always the interest of the dealers. To widen the market may frequently be agreeable enough to the interest of the public; but to narrow the competition must always be against it, and can serve only to

> enable the dealers, by raising their profits above what they would naturally be, to levy, for their own benefit, an absurd tax upon the rest of their fellow-citizens. The proposal of any new law or regulation of commerce which comes from this order ought always to be listened to with great precaution, and ought never to be adopted till after having been long and carefully examined, not only with the most scrupulous, but with the most suspicious attention. It comes from an order of men whose interest is never exactly the same with that of the public, who have generally an interest to deceive and even to oppress the public, and who accordingly have upon many occasions, both deceived and oppressed it.

Smith also wrote at 232-3:

> People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices. It is impossible indeed to prevent such meetings, by any law which either could be executed, or would be consistent with liberty and justice. But though the law cannot hinder people of the same trade from sometimes assembling together, it ought to do nothing to facilitate such assemblies, much less to render them necessary....
>
> An incorporation not only renders [such assemblies] necessary, but makes the act of the majority binding upon the whole. In a free trade an effectual combination cannot be established but by the unanimous consent of every single trader, and it cannot last longer than every single trader continues of the same mind. The majority of a corporation can enact a by-law with proper penalties, which will limit the competition more effectually and more durably than any voluntary combination whatever.

[9] For a discussion of the advantages and disadvantages of self-regulation in the Canadian context, see Dey and Makuch, "Government Supervision of Self-Regulatory Organizations in the Canadian Securities Industry" in *Proposals for a Securities Market Law for Canada*, Vol. 3 (1978). Advantages listed include greater expertise, informality and flexibility, the potential for establishing and enforcing higher ethical standards, the "psychological acceptability" of regulation by one's peers and the opportunity to participate in the regulatory process, increased likelihood of detection of breaches by peers that results from competition in the brokerage industry, and the incentive to police vigilantly in order to preempt government regulation. Limitations of self-regulation identified include less zealous and more lenient regulation arising from complacency (i.e., acceptance of the status quo) and avoidance of adverse publicity, the countervailing danger of overzealous regulation to impress government regulators and a tendency towards anti-competitive conduct. The authors suggest that while "some degree of impairment of competition ... will result from self-regulation", "[s]upervision is necessary, not only to ensure that such impairment is compensated for by effective regulation, but also to ensure that the kinds and extent of impairment are no greater than required by the exigencies of regulation".

[10] See the comments to Commission staff's proposed recognition criteria and Commission staff's responses thereto, which are summarized at (1995), 18 OSCB 3798.

[11] *Supra*, note 6.

[12] *Ibid.*

[13] In a March 1995 doctoral thesis by Stephen L. Harris entitled "The Political Economy of the Liberalization of Entry and Ownership in the Canadian Investment Dealer Industry," the author comprehensively analyses the history of the liberalization of entry into and ownership of the Canadian securities industry, as well as briefly reviewing the demise of fixed commissions and rise of bank-owned discount brokerage operations.

The thrust of the thesis is well illustrated in the following extracts:

> ... [T]he theoretical justification for regulation is to protect the public interest on the one hand, but on the other hand private interests are equated with the public interest. Thus, private interests can seek the sponsorship of the state to support their own interests....
>
> In the context of the investment dealer industry...the demand for public support of the industry, in the form of entry barriers and [fixed] commission regulations, can be seen to be argued from the perspective of destructive competition, concentration of power, efficient capital markets, [and] absence of foreign intervention — all of which were categorized as being in the public interest. In reality, however, it will be shown that these demands had little to do with the public interest and more to [do] with the industry's private rent-seeking objectives. (at 37)

Harris expresses the view that the stream of industry-sponsored reports on the topic of foreign, public and bank ownership were thinly disguised efforts at protectionism and that the status quo survived as long as it did because the regulators of the day (the Commission and the Ontario government) lacked the information necessary and, for many years, the will, to make changes.

However the pressure for change was building in the 1980s. Gordon Capital was pressing to raise foreign capital, and

McLeod Young Weir Limited was also expressing a desire for change. Harris quotes from a speech by Austin Taylor, chairman of McLeod Young Weir Limited, as follows:

> I criticize... the industry of which I am a member, as I am of the opinion that we have used the regulation of the securities industry to our advantage, rather than to that of the consumer and user of our services, by building protective measures around the Canadian securities industry to the virtual exclusion of competition.... (at 300)

Harris describes the pressure for change as emanating principally from a combination of the growth of institutional investors as the dominant players in the securities markets, and their unwillingness to bear the costs of protecting the dealer industry, and the increasing globalization of the financial system. Harris also notes that "the real public was [not retail investors but] the client base of the institutional investors — for example, the policy holders of insurance companies, the individual contributors to the numerous pension funds, and investor in mutual funds" (at 76). Harris quotes (at 295ff) from a September 1984 stock exchange — and IDA — sponsored Joint Securities Industry Committee report entitled "Regulation and Ownership of Market Intermediaries in Canada" which called for, among other things, regulation of the exempt market to protect investors, even sophisticated investors, and avoid prejudice to retail investors (this in fact occurred in 1987 in conjunction with the liberalization of entry and ownership) and which expressed the view that reciprocity was not a compelling issue in the context of limiting foreign access to the Canadian capital markets. Even though the Committee expressed the belief that Canadian investors and users of capital should continue to have access to the international financial markets, the local considerations were viewed by it as "so important that they should not be diluted through a desire to assure other countries that their firms are receiving full access to [the] Canadian markets."

Interestingly, as was the case with fixed commissions and bank-owned discount brokerages, the Director of Investigation and Research under the *Combines Investigation Act* weighed in with economic arguments that opposed the industry's goals, supporting the removal of foreign ownership controls and ready access to public capital. The Director has the express statutory power to make representations to federal and provincial regulatory boards.

[14] In *Silver* v. *New York Stock Exchange*, 373 U.S. 341 (1983), the U.S. Supreme Court found (at 364-65) that the NYSE, in denying without notice or procedural safeguards to non-member broker-dealers, the ability of certain of its members to continue to provide the non-members with previously temporarily approved teletype and stock ticker communications connections, had exceeded its authority under securities laws and therefore had "not even reached the threshold of justification under [securities laws] for what would otherwise be an anti-trust violation ... and ... [had] therefore violated s. 1 of the Sherman [Anti-trust] Act". In so doing, the Supreme Court harmonized the ability of the NYSE to adopt rules governing its members' relations with non-members with the anti-trust laws by holding (at 357) that an exemption from anti-trust laws would be implied only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary". No route of SEC appeal of the NYSE's decision was available and the Court noted that if there had been such a process the result may have been different. In *Gordon* v. *NYSE*, 422 U.S. 659 (1975), the U.S. Supreme Court indicated that SRO action which was the subject of explicit SEC review, in the context of fixed commissions, was immune from federal anti-trust statutes, a position also adopted in *United States* v. *National Association of Securities Dealers, Inc.*, 422 U.S. 694 (1975), with respect to the NASD. In the latter case, the Court indicated that to hold otherwise would compromise the SEC's authority, and also held that the "pervasive supervisory authority" given to the SEC suggested that Congress intended to exempt SEC-approved NASD activities from anti-trust laws. Martin (*supra*, note 5) has described governmentally-approved self-regulation as an "anti-trust umbrella" (at 880).

[15] In Canada, an "anti-trust umbrella" for regulated conduct has been fashioned in two cases. In the *Reference re the Farm Products Marketing Act,* [1957] S.C.R. 198 at 206, the Supreme Court of Canada found an agricultural products marketing board not to have violated the then *Combines Investigation Act* by carrying out a scheme to control prices which unduly restricted competition "to the detriment or against the interests of the public", because the legislation in effect deemed the carrying out of the scheme to be in the public interest. An alternative basis underlying the regulated conduct defence, which appears in the concurring judgement of Rand J., is that compelled activity is not sufficiently voluntary to result in a breach of the *Combines Investigation Act*. In *R.* v. *Canadian Breweries Ltd.,* [1960] O.R. 601 at 629, McRuer J. of the Ontario High Court of Justice found the accused not guilty of violating the merger and conspiracy provisions of the *Combines Investigation Act* in acquiring 23 brewing firms. He noted that the beer industry was regulated both by a provincial regulatory body and a marketing co-operative composed of breweries, and held that:

> Where a provincial legislature has conferred on a Commission or board the power to regulate an industry and fix prices and the power has been exercised, the Court must assume that the power is exercised in the public

> interest. In such cases, in order to succeed in a prosecution under the Act with respect to the operation of a combine, I think it must be shown that the combine has operated, or is likely to operate, so as to hinder or prevent the provincial body from effectively exercising the powers given to it to protect the public interest.... There may, however, be areas of competition in the market that are not affected by the exercise of the powers conferred on the provincial body in which restraints on competition may render the operations of the combine illegal.

In *Jabour* v. *Law Societv of British Columbia* (1982), 137 D.L.R. (3d) 1 (S.C.C.), the Supreme Court of Canada held that the actions of the Law Society in restricting advertising by its members did not violate the conspiracy provisions of the *Combines Investigation Act* as the conspiracy provisions were held not to apply to the Law Society, which was viewed as a statutory governing body acting in accordance with its legislative authority.

The extent to which this exemption would be available in the case of rules of a recognized self-regulatory organization or in the non-criminal context is not completely clear, but it may well provide a substantial shield. See Gordon Kaiser, "Competition Law and the Regulated Sector" which appears as chapter 14 (at 347-65) in the text *Canadian Competition Policy*, by Robert S. Prichard. See also C. Michael Flavell, *Canadian Competition Law: A Business Guide*, (McGraw-Hill Ryerson Limited, Toronto, 1979) at 45-53, and, for an interesting review in the telecommunications field, see Lawson Hunter, Martine Band and Susan Hutton, "Hello, Competition Calling... Is Anybody There? The Intersection of (De)regulation and Competition Law in Telecommunications", in *Profiting from Canada's Telecommunications Act: New Rules for a Dvnamic Industry* (Insight/Globe & Mail, 1993).

In a speech to the Canadian Association of Members of Public Utility Tribunals in September 1986, the then Director of Investigation and Research, Calvin Goldman, expressed the view that conduct that hinders regulation, as well as the non-exercise of authority by a regulator (i.e., regulatory forbearance), may provide an opportunity for challenge.

It is interesting that, in a May, 1972 submission by the IDA in respect of the proposed overhaul of federal competition laws, the IDA called for an exemption from federal competition laws "co-extensive with the regulatory and supervisory authority of" provincial securities commissions in order to avoid "serious adverse consequences ... for the capital markets and the securities industry". The IDA was concerned that the wholesale application of federal competition laws would render subject to attack a range of IDA rules including those relating to capital requirements, know your client rules, trading and settlement rules and margin and contingency fund requirements. The IDA also noted that many stock exchange rules, "for example minimum commission rules", might be subject to attack.

[16] In a May 1, 1977 article on the fixed commission structure entitled "Brokerage Commissions Charged by Toronto Stock Exchange Members, at 92-97, Richard van Banning has noted that the Commission's supervisory role over stock exchanges, which was the model for its supervisory role over SROs generally, was enacted against the backdrop of the Windfall scandal and general dissatisfaction with the operations of both the OSC and the TSE, and that it was never contemplated that the OSC "would become, in effect, an umbrella protecting securities firms from the forces of price competition". In his view, "the practical (and probably legal) effect of O.S.C. approval of fixed commissions" was "to protect TSE members from [the *Combines Investigation Act*]." He states:

> ... the O.S.C., by accident more than design, is in a position to determine the applicability of Canadian competition policy to the brokerage business ... [which was a] role never envisaged by those delegating authority to the O.S.C....
>
> The ability to make a decision on the applicability of competition laws to an industry may require skills and knowledge different from those needed to make the kinds of decisions that the O.S.C. is regularly called upon to make.

Mr. van Banning also considered the hearing process to be inadequate, especially where staff is not going to take "an active inquisitorial or adversarial role in the process", noting that "[n]obody forcefully presented the case for competitive commissions at [those] O.S.C. hearings".

[17] Investment dealers have a statutory exemption from the conspiracy and price maintenance provisions of federal competition laws in the context of underwritings. See section 5 of the *Competition Act*, R.S. 1985, c. C-34, as amended.

FIXING PRICE-FIXING LAWS

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The following article is a revised condensed version of an article entitled "Rethinking Price-Fixing Law" that appeared in (1993) 38 McGill L.J. 679.

Introduction

There is a consensus among most competition law scholars that conspiracy laws which prohibit price-fixing and other anti-competitive horizontal arrangements amongst competitors or potential competitors both historically and currently lie at the core of competition policy.

In 1990 two lower court decisions cast into question the constitutionality of the price fixing provisions of the Canadian Competition Act.[1] In the light of these decisions, the authors undertook a comparative review of the price-fixing experience of the United States, the EU, England, Germany, Australia and New Zealand, and proposed amendments to the Canadian price-fixing provisions which would survive a constitutional challenge as well as reflect the experience from other jurisdictions. The comparative review and the proposed amendments were published elsewhere.[2] While the constitutional challenge ultimately was rejected by the Supreme Court of Canada,[3] we believe that there are sound policy reasons for rethinking existing price fixing laws. In this paper, we develop a revised proposal.

Whether a horizontal arrangement among competitors or potential competitors ought to attract liability under competition laws depends on the arrangement's ultimate effects on economic welfare. Arrangements which ultimately reduce economic welfare should be prohibited. Not all horizontal arrangements reduce economic welfare. For example, it is generally accepted that horizontal arrangements (integration) effected by *ownership*, through mergers and acquisitions, are capable of producing net welfare increases. The Canadian Parliament adopted this view in 1986 when amendments to the *Competition Act* decriminalized mergers and placed merger review within the purview of the Canadian Competition Tribunal. Accordingly, it follows that horizontal arrangements (integration) effected by *contract*, in the form of agreements among rivals, may also often be capable of producing similar welfare increases.[4] In evaluating horizontal arrangements among competitors, it quickly becomes obvious that, with few exceptions, *ex ante* generalizations about the ultimate welfare effects of horizontal arrangements are impossible.

At one extreme, naked price-fixing cartels among competitors or potential competitors almost always reduce economic welfare. A cartel charges monopoly prices, but unlike some monopolies and many horizontal mergers, a cartel almost never generates offsetting efficiency gains from greater economies of scale, since the scale of the cartel members' output does not change when the cartel is formed (indeed it is likely to fall). The cartel's monopoly prices drive consumers from the market, and force consumers to allocate their resources to less preferred forms of consumption. At the other extreme, partnership agreements among professionals almost always increase economic welfare. Partners may share administrative and overhead costs and provide a broad range of services to clients which professionals working on their own could not offer. The renowned American judge Oliver Wendell Holmes once remarked that if antitrust laws were interpreted so as to prohibit partnership agreements, this "would make eternal the *bellum omnium contra omnes* and disintegrate society so far as it could into individual atoms."[5]

Between the two extremes of price-fixing and partnership agreements, horizontal arrangements among competitors may take a wide variety of forms and produce welfare effects which cannot be determined without extensive case-by-case inquiries into the surrounding circumstances of the arrangements. Joint research ventures, for example, are horizontal arrangements which can often lead to welfare increases. Yet it is impossible to generalize, *ex ante*, about the welfare effects of joint ventures. Some horizontal arrangements which purport to be joint ventures may in fact be naked price-fixing arrangements in disguise. Similar ambiguities arise with various forms of so-called "strategic alliances".[6]

This suggests that competition laws ought to condemn naked price-fixing arrangements and allow partnership arrangements. Ambiguous arrangements which lie between the two extremes ought to be evaluated on a case-by-case basis.

The Canadian Experience

The Canadian price-fixing regime attempts to categorize horizontal arrangements. Bid-rigging and agreements among banks to set interest rates are *per se* illegal.[7] Collective bargaining agreements, joint ventures, export agreements and other special arrangements are *per se* legal.[8] Between these extremes, courts analyze price-fixing arrangements which lessen "unduly" competition. The "unduly" test requires courts to evaluate arrangements on a partial rule of reason basis.[9] That is, courts consider various surrounding circumstances of arrangements before condemning them as lessening competition "unduly".

We believe that the current prohibition is both under and over-inclusive. It is under-inclusive because it can allow manifestly anti-competitive arrangements to escape condemnation. Since the current prohibition requires the Crown to prove on a criminal burden of proof that an arrangement has lessened competition "unduly", specious arguments about the collateral benefits of price-fixing may allow price-fixers to escape conviction. In *Aetna Insurance*,[10] for example, the Supreme Court of Canada upheld the conviction of an association of insurance underwriters, representing fifty to seventy percent of the Nova Scotia insurance

market, which had fixed the price of insurance over ten years. The Court concluded that the association performed various collateral, socially useful functions, including providing assistance to fire departments on fire prevention techniques and ensuring that the insurance companies remained profitable.

At the same time, the current prohibition is over-inclusive because it subjects all horizontal arrangements to criminal prohibitions and casts a shadow over many arrangements that may increase welfare. Apart from the obvious price-fixing case, many horizontal arrangements have ambiguous welfare effects and do not justify the deterrent of criminal sanctions.

Lessons from the Comparative Experience

Elsewhere we have undertaken comparative reviews of the U.S., E.U., U.K., German, Australian, and New Zealand competition policy experience to determine the extent to which other jurisdictions have been able to maintain workable distinctions between naked price-fixing and potentially pro-competitive arrangements.[11] The jurisdictions surveyed disclose a striking commonality of approach towards naked price-fixing arrangements. In every jurisdiction they are subject to a *per se* prohibition, but greater diversity of practice exists in terms of both the substance of absolute and qualified exemptions with respect to other kinds of horizontal arrangements, and the procedures by which those absolute or qualified exemptions are established.

The United States has attempted to maintain a distinction between pure price fixing (which is *per se* illegal) and other forms of horizontal arrangements (which attract rule-of-reason review) for much longer than any other jurisdiction, yet a watertight distinction between the two categories of arrangements has proved elusive. That is, in many contexts, the exercise of characterizing an arrangement as a price fixing or *per se* illegal arrangement requires a full review of the terms and context of the arrangement much like rule-of-reason review in other cases. While U.S. courts now try to distinguish "naked" price fixing from price fixing that is ancillary to a pro-competitive objective, this line is not sharp or stable, and it has shifted over time as courts have been confronted with new arrangements or have re-evaluated their views on previous classes of arrangements. Well-known cases such as *Broadcast Music,*[12] *NCCA*[13] and *Maricopa County*[14] amply demonstrate the difficulties of drawing this line. Australian courts, in recognizing the same distinction, appear to have encountered similar difficulties. Canada's current categorization approach to horizontal arrangements is vulnerable to the same problems that have plagued the American *per se* illegal/rule of reason distinction.

From the jurisdictions surveyed, we concluded that a *per se* criminal prohibition for naked price-fixing cannot be formulated with complete precision, and will unavoidably target potentially pro-competitive arrangements. Even arrangements which appear to lessen competition "unduly" may generate offsetting efficiencies which produce net welfare gains. Yet, a broadly-cast criminal prohibition which would require criminal courts to engage in complex rule-of reason analyses for all horizontal arrangements offends both widely-held notions of due process with respect to criminal liability and notions of the relative institutional competence of criminal courts as compared to specialized administrative agencies.

We believe that the way around the impasse is to redefine the focus of a criminal prohibition. A criminal prohibition should target only naked price-fixing arrangements. What are the characteristics of such arrangements? Obviously, naked price-fixing arrangements lessen competition. However, a second distinguishing characteristic of such arrangements is that they are generally covert. As Warren-Boulton notes in the U.S. context:

> The overwhelming number of price fixing, bid-rigging and market allocation cases are brought against relatively small, owner-managed firms with limited assets that might be exposed to damages claims. These firms tend to operate in local or regional markets where concentration and barriers to entry are low. In such markets, implicit collusion and dominant firm behaviour is neither likely nor treatable by structural policies. In the absence of substantial barriers to entry, customers and/or potential competitors would simply enter if they knew that supra-competitive prices were being charged. ... [B]id-rigging and price fixing cases are thus essentially *simple frauds*, where customers or suppliers are deceived into believing that their suppliers or customers are competing with each other.[15]

We thus propose a criminal prohibition which focuses on the *covertness* of horizontal arrangements. Rather than targeting "naked" price-fixing arrangements (as distinguished from price-fixing arrangements which are ancillary to pro-competitive objectives), we believe that a criminal prohibition should target *covert* (as distinguished from *overt*) price-fixing arrangements. In this respect, the American naked/ancillary distinction is highly misleading. Most "naked" price-fixing arrangements are in fact covert, and anything but overt, obvious or shameless. We believe that the covert/overt distinction reflects both the U.S. experience and the Canadian prosecutorial experience under the *Competition Act* and its predecessors.

Following Warren-Boulton, we conceive of a criminal prohibition against price-fixing as being essentially an *anti-fraud* statute directed at covert but explicit forms of price-fixing. Having identified covert price-fixing as the appropriate focus of a criminal prohibition, we believe that it would be inappropriate to remit covert price-fixing arrangements to rule-of-reason review by the Competition Tribunal. The principal sanction available to the Tribunal is merely a prospective cease and desist order. Yet apprehension rates for covert forms of naked price-fixing are typically quite low — U.S. Department of Justice officials estimate no higher than ten percent[16] — and to abandon criminal sanctions would seriously undermine socially desirable deterrence objectives.

In light of the foregoing analysis, we proceed to elaborate our proposal for redesigning the price-fixing provisions of the *Competition Act.*

Proposed Reforms of the *Competition Act*

Our proposal draws in large part on two sources: (1) Section 45A of the *Australian Trade Practices Act 1974*, which deems price fixing arrangements to be *per se* violations of the general prohibition against horizontal

arrangements that substantially lessen competition; and (2) legal practice under Article 85 of the *Treaty of Rome*, where notification of an agreement confers immunity from subsequent fines (although not from cease and desist orders, breach of which can lead to fines).

The Proposed Criminal Prohibition

(A) Everyone who enters into a contract, agreement or understanding with a competitor or potential competitor, a provision which has or is likely to have the effect of fixing, controlling, or maintaining the price for goods or services supplied or acquired or to be supplied or acquired by the parties to the contract, agreement or understanding, and who knew or ought reasonably to have known that the contract, agreement, or understanding has or would be likely to have, the effect of fixing, controlling, or maintaining the price of such goods or services is guilty of an indictable offence.

(B)(1) In this section,

"arrangement" means the contract, agreement or understanding which forms the basis for the prosecution under subsection (A);

"Bureau" means the Canadian Competition Bureau

"notification" means a written statement which discloses each of the following:

(i) the names of all parties to the arrangement;

(ii) the fact that the accused is or was a party to the arrangement;

(iii) the nature of the accused's rights and obligations under the arrangement with respect to pricing, output, innovation and product or service quality decisions;

(iv) the date of execution of the arrangement, and

(v) the date, or other triggering event, at which the arrangement takes effect.

(2) In a proceeding under subsection (A), the court shall not convict the accused if the accused has filed a notification with the Bureau either prior to the time at which the arrangement takes effect, or within 30 days of the execution of the arrangement, whichever is earlier.

(C) In a proceeding under subsection (A), the court shall not convict the accused if:

(i) the court is satisfied that the accused, in good faith, made all reasonable attempts to comply with the provisions of subsection (B)(2); and

(ii) the court is satisfied that the accused has, within a reasonable time, complied with any demands for particulars the Bureau may have issued in connection with a notification.

(D) Where the parties to an arrangement collectively account for less than twenty percent of the output or inputs in the relevant market, the arrangement shall conclusively be presumed not to have the effect of fixing, controlling, or maintaining the price of goods or services supplied or acquired by parties to the arrangement.

(E) The Crown shall have the onus of proving that a notification satisfying the conditions prescribed in clauses B and C was not filed by the accused.

Our proposal requires some explanation. The core prohibition removes any reference to "unduly lessening competition". Instead it merely requires courts to look at the price effects or likely price effects of a horizontal arrangement. Clause D incorporates a *de minimus* requirement that excludes from the ambit of the proposed provision arrangements where the parties thereto account for such a small share of output in the relevant market that no market-wide price effect can plausibly be presumed. To require notification in such cases to secure immunity from prosecution would needlessly burden both the parties and the Bureau with paper filing and review requirements. The intent requirement pertains only to the actual or likely price effects of an agreement, and it incorporates an objective element. It is therefore consistent with the subjective and objective intent elements of the current prohibition which the Supreme Court of Canada upheld in *PANS*.[17] We believe that the addition of clause D represents an improvement over the initial version of our proposal.

While more precise than the current provisions, our prohibition, on its face, is over-broad because it completely disregards the distinction between "naked" and ancillary price-fixing restrictions. Greater precision comes at the cost of undesirable over-breadth. However, we believe that our proposed notification procedure is fully responsive to the over-breadth concern. By the mere act of filing a notification with the Bureau pursuant to clause B of our prohibition, parties to horizontal arrangement with potential price effects are granted immediate and permanent immunity from criminal liability. The optional notification mechanism gives parties to arrangements which might otherwise violate clause A a unilateral entitlement to avoid criminal liability. The immunity from criminal prosecution will obviously no longer obtain if the parties significantly modify the arrangement described in the notification. If the parties are prosecuted, it will be up to the court to determine whether the arrangement described in the indictment is the same as that described in the notification.

The central rationale for our proposal is that the covert forms of price fixing to which Warren-Boulton refers become self-defeating through the mere act of filing a notification before the agreement is acted upon. Notification renders arrangements which might otherwise have been *covert* now *overt*. To this end, we would make all notifications immediately publicly accessible through a public filing system. The benefit of notification is already recognized in the bid-rigging offence contained in section 47 of the Act: liability for bid-rigging is expressly made conditional upon the agreement not being known to the party soliciting the bids. Like bid-rigging, the efficacy of price-fixing depends critically on concealment. But, under our proposal, if concealment occurs (i.e., the parties do not file a notification) the Crown can properly prosecute under clause A, and it can probably secure convictions more easily than under the present less precise legal standards. On the other hand, horizontal arrangements that may have positive welfare effects can easily escape the risk of criminal sanctions by the election of the parties themselves.

In addition to conferring benefits on third parties, notification also confers benefits on the Bureau. Notification gives the Director of the Bureau an information set on which to evaluate arrangements. If the Director considers the notified arrangement to be ambiguous, he or she may ask the parties to provide relevant particulars. Failure to comply, in good faith, with Bureau demands for particulars vitiates the immunity conferred by notification. If the Director considers the notified arrangement to be anti-competitive, he or she may pursue a civil review proceeding before the Competition Tribunal, as described below.

The Bureau's current "whistle-blowing" policy recognizes that voluntary notification confers benefits on the Bureau. Under this policy, the Bureau offers immunity from criminal sanctions to parties who notify the Bureau of violations of the Act, provided that the notifying parties are the first among the violators to notify the Bureau of the violation. The Bureau then has evidence with which to prosecute the other violators. The "whistle-blowing" policy applies to notifications which are received *after* violations and anti-competitive effects have occurred, and it restricts criminal immunity to the first notifying party. In contrast, our proposed notification defence applies to notifications received *before* violations and anti-competitive effects have occurred, and it confers criminal immunity on all parties to a notified arrangement, but not necessarily immunity from civil review.

We cannot emphasize too strongly that the notification regime we propose is *not* a registration or authorization procedure. To empower the Director to review notifications and decide whether to accept, reject or propose modifications to the underlying agreement as a pre-condition of the parties' immunity from criminal prosecution would impose heavy burdens on both the parties and the Bureau. Conferring such powers on the Director risks creating the same paper nightmare that has bedeviled both the European Commission, with negative clearance and exemption applications under Article 85 of the *Treaty of Rome*, and the Office of Fair Trading in the United Kingdom under the *Restrictive Trade Practices Act*. Under both regimes, parties are subjected to enormous delays and great uncertainty pending the administrative review of often trivial or benign arrangements by official agencies.

We believe that our proposal avoids the bureaucratic mire of a registration or authorization system while at the same time focusing criminal deterrents on precisely that class of transactions where they are most warranted. First, our proposed criminal prohibition clearly targets naked price-fixing. Second, our proposed prohibition will not deter potential pro-competitive behaviour because our notification regime is simple to invoke, since parties need only file a summary of their arrangements, and it provides legal certainty to parties. Parties receive immediate and absolute immunity from criminal sanctions upon filing an appropriate notification with the Bureau. Canadian public companies are already subject to the obligation to disclose all material information about their business to securities regulators, so an additional obligation to provide a summary of the competition law aspects of agreements should not prove unduly onerous. In our view, concerns over loss of commercial confidentiality from a public filing system are outweighed by the private benefits of immunity from criminal and civil liability and the social benefits from the incentives created for self-correcting action. Third, our proposed regime makes efficient use of the enforcement resources of

the Bureau. Criminal sanctions give parties strong incentives to notify arrangements to the Bureau, and notified arrangements give the Bureau an information set on which to evaluate arrangements for possible civil review before the Tribunal. Unlike the EU and U.K. regimes, the Bureau is not burdened with the task of evaluating arrangements as a precondition to parties' immunity from criminal sanctions. As well, the Bureau is not burdened with having to expressly approve trivial arrangements because, like the German regime, notified arrangements become legal by the Bureau taking no action at all.

The Proposed Civil Review Procedure

Our proposed criminal prohibition would constitute the sole route for the criminal prosecution of horizontal arrangements, and criminal prosecutions would be limited to parties who had not notified their arrangements to the Bureau. We recommend that the criminal prohibition be complemented with a civil review mechanism which would entail vesting in the Competition Tribunal a power of civil review. We propose that Part VIII of the present Act concerning reviewable practices be amended to make it a reviewable practice for competitors or potential competitors to enter into any contract, agreement, arrangement, or understanding with each other that "substantially lessens competition". The "substantially lessens competition" test should be the same test which the Tribunal currently applies to mergers under section 92 of the *Competition Act*, and would place horizontal integration by ownership and horizontal integration by contract on the same legal footing in all notified cases.

Under our proposal, the Director will be able to challenge anti-competitive horizontal arrangements more easily than under the current criminal prohibition. Under the current provisions, the Director must prove, on a criminal burden of proof before an all-purpose criminal court, that the arrangement lessens competition "unduly". Under our proposal, the Director may successfully challenge a notified anti-competitive arrangement by proving, on a civil burden of proof before the Tribunal, that the arrangement substantially lessens competition.

Our proposal is also consistent with our understanding of the relative institutional competence of all-purpose criminal courts as compared to specialized tribunals. In the areas of monopolies and mergers, for example, Parliament has accepted that it is inappropriate to ask criminal courts to engage in a complicated rule-of reason or welfare analysis. Parliament specifically created the Competition Tribunal to engage in this form of evaluation.

When the Tribunal evaluates the extent to which a challenged arrangement lessens competition, we believe that it should undertake an enquiry along the lines of a rule-of-reason review. In particular, it would seem sensible to require the Tribunal to consider the provisions of Part V of the Act, which address trade associations, export agreements, sports leagues, professional bodies and other sub-classes of horizontal arrangements. These provisions now qualify the current subsection 45(1) criminal prohibition against horizontal arrangements. The provisions in Part V should be transferred to Part VIII of the Act to provide guidance

to the Tribunal when it undertakes rule-of-reason reviews of horizontal arrangements. We also believe the Tribunal should use this framework for evaluating joint research ventures,[18] strategic alliances, and specialization agreements.[19] In particular, it is not clear to us why specialization agreements should require special registration with the Tribunal as provided by the current Act.

Proposed Collateral Revisions to the Competition Act

We recommend that an efficiency defence be made part of the provisions for civil review of horizontal arrangements. This would be consistent with section 96 of the *Competition Act* (which provides such a defence in the case of mergers), and with article 85(3) of the *Treaty of Rome*. Moreover, such a defence would again place horizontal integration by ownership and horizontal integration by contract on a similar legal footing.[20] We acknowledge that the decision of the Canadian Competition Tribunal in *Canada (Director of Investigation and Research)* v. *Hillsdown Holdings (Canada) Ltd.*[21] has created considerable uncertainty as to whether the existing section 96 efficiency defence embodies a consumer welfare or a total welfare standard. We favour the latter standard.

We also believe that procedural innovations adopted in the 1986 amendments to the *Competition Act*, which created the new merger regime, should be adopted for horizontal arrangements, and indeed all reviewable practices, that follow the civil review route. In particular, the ability of the Director to seek and obtain an interim order from the Tribunal, immediately following notification of a horizontal arrangement to which he or she takes objection, is indispensable in the general framework that we have outlined. Substantial sanctions for breaches of either interim or final orders of the Tribunal are also essential to deter non-compliance. As well, advance-ruling certificates for mergers under section 102, consent orders under section 105 and interim orders under section 100 or section 104 seem equally appropriate in the case of reviewable practices, as do advisory opinions and undertakings, although advisory opinions and undertakings are not at present formally recognized in the Act, despite being common practices.

It is also important that parties not be exposed to multiple proceedings, by, for example, the Director initiating Tribunal review proceedings after an unsuccessful criminal prosecution, or (less realistically) the converse. Thus, an election provision like the combination of section 45.1, subsection 79(7) and section 98, which addresses this type of problem in the context of abuse of dominant position and mergers, would need to be included in the revisions.

Once the Bureau receives notification of an arrangement, the Director should be subject to a limitation period within which to file an application with the Tribunal if he or she objects to the arrangement. The German competition law, for example, imposes a limitation period of three months from the filing of the notification. Of course, this limitation period should not be binding on the Director if parties subsequently modify their arrangement. As well, any significant modification will vitiate the criminal immunity conferred by the initial notification unless the parties subsequently notify the Bureau of the modified arrangement.

We also propose two amendments to section 36 of the *Competition Act*, which governs private actions. First, section 36 should render unenforceable all arrangements which violate the criminal prohibition. Australia, New Zealand, the EC, the United Kingdom and Germany have similar provisions. Second, section 36 should preclude private civil actions for damages in respect of arrangements for which valid notifications have been filed under our proposed notification mechanism. There are three reasons why private actions should be precluded in those cases. First, if a notification has been filed before the arrangement has been implemented, it will be rare that third parties will be able to prove damages. Second, as a matter of relative institutional competence, we believe that the Competition Tribunal is better able to evaluate the welfare effects of these arrangements than civil courts. Third, if notification confers immediate immunity from private civil suits as well as criminal prosecutions, the incentives to notify will be further strengthened. This will further broaden the Director's information base, and will facilitate applications to the Tribunal in appropriate cases.

Finally, some transitional provision would also need to be made for arrangements already in place at the time of proclamation of the new legislative scheme. Perhaps parties could be given up to three months from proclamation to notify the Director in order to qualify for immunity from criminal liability.

Conclusion

The recent constitutional challenge[22] to the validity of the price-fixing provisions of the Canadian *Competition Act*, while ultimately unsuccessful, points to substantive deficiencies in the existing provisions and warrants a reconsideration of these provisions on policy rather than constitutional grounds. The current provisions attempt to categorize horizontal arrangements. Our comparative review demonstrates the elusiveness of a watertight distinction between pure price-fixing arrangements and potentially pro-competitive arrangements, and suggests little prospect of a tightly focused criminal prohibition. Yet a broadly-cast criminal prohibition that requires rule-of-reason review by courts will in many cases deter potentially pro-competitive behaviour as well as offend notions of criminal due process and relative institutional competence.

Our proposals instead envisage a two-track process for reviewing the legality of horizontal arrangements: a criminal law *per se* prohibition of price-fixing and a civil rule-of-reason review of other horizontal arrangements by the Competition Tribunal.

Despite our best efforts to confine the scope of the *per se* criminal prohibition to naked price-fixing, we recognize that in many instances our proposed prohibition will be over-broad. We seek to solve this problem not through further attempts at more precise substantive elaboration, but rather by creating incentives for parties to horizontal arrangements to self-select or channel themselves into the appropriate legal track. By providing automatic criminal and civil immunity to parties who have, in a timely fashion, notified the Bureau of their arrangements, only covert arrangements among competitors are likely to be left in the criminal law track. Horizontal arrangements which have been notified to the Bureau will be subject to civil rule-of-reason review administered by the Competition Tribunal at the instance of the Director. The

adoption of these proposals will retain criminal sanctions for those arrangements where they are most warranted, (i.e., covert arrangements), while providing the Director with a much more complete information set for reviewing other, potentially pro-competitive, horizontal arrangements.

Notes

[1] *R.* v. *Nova Scotia Pharmaceutical Society* (1991), 36 C.P.R. (3d) 173; *L'Association quebecoise des pharmaciens proprietaires* v. *Canada (A.G.)*, [1991] R.J.Q. 205 (Sup.Ct.); *Alex Couture Inc.* v. *Canada (A.G.)*, [1990] R.J.Q. 2668, rev'd [1991] R.J.Q. 2534.
[2] Presley Warner and Michael Trebilcock, "Rethinking Price-Fixing Law" (1993) 38 McGill L.J. 679.
[3] *R.* v. *Nova Scotia Pharmaceutical Society*, [1992] 2 S.C.R. 606; 93 D.L.R. (4th) 36 (hereinafter *PANS*).
[4] See William Baxter, "Substitutes and Complements, and the Contours of the Firm" in F. Mathewson, M. Trebilcock and M. Walker, eds., *The Law and Economics of Competition Policy* (Vancouver: Fraser Institute, 1990).
[5] *Northern Securities Co.* v. *United States*, 193 U.S. 197 at 411 (1904).
[6] See Director of Investigation and Research, *Guidelines on Strategic Alliances Under the Competition Act* (27 February 1995).
[7] Sections 47 and 49 of the *Competition Act.*
[8] See sections 4, 5, 6, 45(6), 86 and 95 of the *Competition Act.*
[9] See sections 45(3) and 45(4) of the *Competition Act*; see also dicta in *PANS*, *supra*, note 3.
[10] *Aetna Insurance et al.* v. *The Queen*, [1978] 1 S.C.R. 731.
[11] Warner and Trebilcock, *supra*, note 2.
[12] 441 U.S. 1 (1979).
[13] 568 U.S. 85 (1984).
[14] 457 U.S. 332 (1982).
[15] F.R. Warren-Boulton, "Implications of U.S. Experience with Horizontal Mergers and Takeovers for Canadian Competition Policy" in Mathewson, Trebilcock, and Walker *supra*, note 4 at 346.
[16] C.F. Rule, "Report from Official Washington: 60 Minutes with Charles F. Rule, Attorney-General, Antitrust Division" (Address to the American Bar Association, Section of Antitrust Law, 36th Annual Spring Meeting, 22-24 March 1988), (1988) 57 Antitrust L.J. 257 at 265.
[17] *PANS*, *supra*, note 3.
[18] *Competition Act*, section 95.
[19] *Ibid.*, section 86.
[20] See Baxter, *supra*, note 4.
[21] (1992), 41 C.P.R. (3d) 289 (Comp. Trib.).
[22] *PANS*, *supra*, note 3.

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