COMMENT & ANALYSIS

CANADIAN BANK MEGA MERGERS REJECTED: WHAT HAPPENED?

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I. Introduction

On January 23, 1998, Royal Bank of Canada ("Royal") and Bank of Montreal ("BMO"), Canada's first and third largest banks based on the value of Canadian assets, sent a shock wave across the nation when they announced plans to merge. The news of this proposed merger of Royal and BMO was followed by the announcement some three months later, on April 17, 1998, that Canadian Imperial Bank of Commerce ("CIBC") and The Toronto-Dominion Bank ("TD"), Canada's second and fifth largest banks based on the value of Canadian assets, were also proposing to merge.

Some eight months later, on December 14, 1998, following an intensive review of the two mergers by several branches of government, the Canadian Minister of Finance announced that he would not permit the two proposed mergers involving four of Canada's "Big Five" banks to proceed, on the ground that they would not serve the best interests of Canadians. Key among the reasons cited by the Minister for prohibiting the proposed mergers were concerns that they would result in an unacceptable concentration of economic power in Canada among too few, very large banks and that the mergers would significantly reduce competition. In this latter regard, the Minister of Finance relied on detailed letters ("Merger Review Letters") sent to each of the merging banks outlining the findings of the Competition Bureau (the "Bureau"), the agency responsible for enforcing Canada's *Competition Act* (the "Act"), about the competitive effects of the proposed mergers. The Minister also cited the finding of the Superintendent of Financial Institutions to the effect that the large size of the merging banks would reduce the government's flexibility to address future potential prudential concerns as a ground for prohibiting the mergers.

Given that hundreds of bank mergers have been approved by U.S. and other antitrust authorities in the past few years, it may come as something of a surprise that the only two significant bank mergers proposed in Canada in several decades[2] were turned down on grounds which included competition law concerns, particularly when these mergers would have created merged entities many times smaller than the largest banks internationally.[3] The result reached in the Canadian context is best explained by reference to the relatively concentrated structure of Canada's banking system. Canada ranks as the

most highly concentrated banking sector in the world when concentration is measured as a function of the percentage of domestic banking assets controlled by the top three banks; and as the fourth most concentrated banking sector, after Switzerland, Australia and The Netherlands, if concentration is measured as a function of the percentage of domestic banking assets controlled by the top five banks.[4] Canada's largest banks are also among its largest firms in any sector and had the Royal/BMO merger been allowed to proceed, it would have been the largest merger in Canadian history.

The primary purpose of this paper is to analyse, and provide insight into, the findings of the Bureau in its review of the Royal/BMO and CIBC/TD merger proposals, as well as the review process which led to those findings. While the Royal/BMO and CIBC/TD mergers were unique cases in many respects, several aspects of the Bureau's analysis of these transactions are of interest and may be relevant to mergers in the financial sector[5] and in other sectors. In the first place, as has been noted by other commentators,[6] the concerns about market concentration and market share that were central to the Bureau's assessment of retail banking markets revealed a structural approach to merger review which is uncharacteristic for the Bureau and raises questions under section 92(2) of the Act, which prohibits the Competition Tribunal from issuing an order based on market share or concentration levels alone. A second area of interest, which also relates to the structural nature of the analysis, were concerns raised by the Bureau that the mergers would or might give rise to a substantial lessening of competition due to interdependent behaviour among the major Canadian banks. Finally, the reluctance of the Bureau to give much weight to dynamic industry developments, such as increasing reliance on electronic banking and decreased importance of branches, or the role of credit-scoring technology in expanding geographic markets for lending, is of interest since industry developments of this nature and their effects on competition present a common challenge for bank merger applicants and other merger applicants alike.

II. Background

(a) *Canadian Banking Industry Structure*

Canada's banking industry is highly concentrated by most measures and is led by a handful of widely-held domestic banks, known as Schedule I banks under the *Bank Act*.[7] Canada's "Big Five" domestic banks control approximately 81% of domestic banking assets in Canada.[8] While there are also in excess of 40 foreign bank subsidiaries operating in Canada, these entities are much smaller than the "Big Five" domestic banks and account for only about 10% of total assets held by the banking sector.[9] Foreign bank subsidiaries operating in Canada also tend to participate in only a limited range of activities as compared with domestic banks (e.g. MBNA Canada Bank operates a credit card business only) and only one foreign bank, Hongkong Bank of Canada, has a sizeable branch network. Non-bank financial institutions, including independent trust companies, credit unions, insurers, independent investment dealers and mutual fund

companies, compete in a broad range of areas with Canadian banks. All of Canada's domestic banks, many of its foreign banks and numerous non-bank competitors are members of the Interac national ATM and debit card payment network.

The range of activities carried on by Canada's domestic banks is very broad and a non-exhaustive list of such activities would include deposit-taking, lending to individuals, commercial and corporate lending, credit and debit card services, ATM services, transaction services, investment banking (including brokerage services, institutional debt and equity trading, merger and acquisition and other advisory services and the underwriting of debt and equity issues) and international banking (including transaction services such as foreign exchange and travellers cheques, risk coverage including letters of credit and guarantees, swaps, foreign exchange risk management and a variety of financing services for international clients). In recent years, the major Canadian domestic banks have acquired a number of Canada's largest investment banking firms and all but one of Canada's major trust companies, Canada Trust.[10]

One circumstance which may explain some of the difficulties which were later encountered by the banks is the fact that the Royal/BMO and CIBC/TD bank mergers were announced in the midst of an ongoing comprehensive federal government-initiated review of proposals for reform of the Canadian financial services sector. In December 1996, the Minister of Finance created a Task Force on the Future of the Canadian Financial Services Sector ("Financial Services Task Force") with a mandate to examine public policy issues affecting the Canadian financial services industry and to make recommendations to enhance the attainment of a number of public policy goals, including competitiveness, innovation, consumer benefit, technological advancement and employment. The mandate of the Financial Services Task Force also included a review of the regulatory policy applied to mergers involving large financial institutions. In this regard, it was generally understood that the Minister of Finance, who has the ultimate decision-making authority over such mergers, had adopted a regulatory policy prohibiting mergers between large financial institutions, known as the "big shall not buy big" policy. The Financial Services Task Force was given the mandate to consider the appropriateness of this regulatory policy. Given that this issue was under review, it was generally anticipated that no bank mergers would be announced prior to the release of the Financial Services Task Force's report.

When the proposed Royal/BMO and CIBC/TD merger transactions were announced in advance of the release of this report, the work of the Financial Services Task Force took on a greater significance and profile. When the Financial Services Task Force released its report in September 1998, it confirmed conclusions contained in the Task Force's earlier interim recommendations to the effect that each proposed merger transaction should be assessed on its own merits and that a "big shall not buy big" policy should not automatically apply. The Task Force also recommended criteria to be examined by the Minister in exercising his public interest discretion to approve a merger and recommended the establishment of a public interest review process for large bank mergers. Seemingly as a *quid pro quo* for recommending the elimination of the "big shall not buy big" policy, the report included numerous recommendations

aimed at fostering increased domestic competition from second-tier competitors such as credit unions, life insurance companies, mutual fund companies, securities dealers and foreign banks. Certain of the report's recommendations in this regard, relating to the demutualization of insurance companies and to a liberalised regime for foreign bank entry, were already on the policy agenda and have since been implemented.[11] Most recently, in a White Paper released on June 25, 1999 (the "White Paper"),[12] the Minister of Finance announced its intention to implement most of the recommendations of the Financial Services Task Force report, including the adoption of a public interest review process and public hearings for mergers among banks with equity in excess of $5 billion, as well as measures to increase the competitiveness of non-bank competitors in the core retail banking area (including measures to strengthen the credit union system and to provide access to the payments system for life insurance companies, securities dealers and money market mutual funds). The White Paper also proposes that in the future, large banks proposing to merge will have an opportunity to negotiate remedies in regard to any competition, prudential or public interest concerns with the Minister of Finance and the Minister of Finance will have the power to enforce these remedies by means of legally enforceable undertakings.

(b) *Bank Merger Review Process*

Mergers between banks in Canada are subject to concurrent review by three federal regulators. As outlined above, the ultimate decision over whether a bank merger is to be approved lies with the Minister of Finance. Under the *Bank Act*, the Minister has broad and largely unfettered public interest discretion whether or not to approve a merger between banks. The White Paper suggests that, in the future, the public interest review process will provide an important input to the Minister of Finance's decision, and will include an assessment of the impacts of a merger on the sources of financing for individual consumers and small and medium-sized enterprises, as well as on regional issues including bank closures, changes to service delivery, and on the impact of the merger on international competitiveness, employment and technology. However, at the time of the review of the Royal/BMO and CIBC/TD mergers, no criteria for the exercise by the Minister of his discretion had been enunciated.

The second regulator involved in bank merger activities is the Office of the Superintendent of Financial Institutions ("OSFI"), whose mandate it is to consider any prudential reasons why a bank merger should not be approved and to make recommendations to the Finance Minister in this regard.

Bank mergers are also subject to pre-merger notification and are reviewed from a substantive competition law perspective by the Commissioner of Competition ("Commissioner") (formerly the Director of Investigation and Research) under the Act. By virtue of section 92 of the Act, the Commissioner may challenge a merger by bringing an application before the Competition Tribunal (the "Tribunal") if the Commissioner considers that the merger would prevent or lessen competition substantially in any relevant market. However, pursuant to section 94 of the Act, the Tribunal has no power to make an order under section 92 in respect of a bank merger where the Minister of Finance has determined that such merger

is in the best interests of the financial system in Canada. As such, the Minister of Finance may override a decision by the Commissioner to challenge a bank merger and thus retains ultimate authority to approve a bank merger.

The general analytical framework applied by the Commissioner and by Bureau staff in determining whether a proposed merger may give rise to a substantial prevention or lessening of competition is set out in the Commissioner's *Merger Enforcement Guidelines* ("MEGs"). Given the singular economic significance of mergers among major Canadian banks, the Commissioner's 1997 submissions to the Financial Services Task Force included a draft document which described how the MEGs would be applied to bank mergers. This document was later finalized (in July, 1998) as *The Merger Enforcement Guidelines as Applied to a Bank Merger* (known as the "BMEGs").[13] The BMEGs focus on the specific application of the MEGs in the banking sector, particularly in the area of retail branch banking. The MEGs and the BMEGs consider both the unilateral effects of a merger and the extent to which a merger will facilitate interdependent behaviour among firms. Both documents provide that the Commissioner will generally not be concerned about the possibility of the merging parties being able unilaterally to exercise greater market power as a consequence of a merger, where the post-merger market share of the merged entity would be less than 35% (the "unilateral effects" or "safe harbour" threshold). Additionally, they state that the Commissioner generally will not be concerned about a merger on the basis that the interdependent exercise of market power by two or more firms in the relevant markets will be greater than in the absence of the merger where (i) the post-merger share accounted for by the four largest firms in the market would be less than 65%; and (ii) the post-merger market share of the merged entity would be less than 10% (the "interdependent effects" threshold). In this latter respect, the BMEGs contain a far more detailed explanation than do the MEGs of how competition might be lessened through interdependent behaviour, thus foreshadowing an issue that was to become an important element of the Bureau's findings in respect of the 1998 bank merger proposals.

Although the Minister of Finance is the ultimate decision-maker in terms of determining whether or not a bank merger proposal is to proceed, the focus of the applicants in the Royal/BMO and CIBC/TD merger cases was to a large degree on the Bureau process, as it was expected that the effects of the mergers on competition would be an important factor in the Minister's eventual decision. Shortly following the announcement of the Royal/ BMO merger on January 23, 1998, the Minister of Finance stated that he would not exercise his jurisdiction to rule on any proposed bank mergers until after consideration and consultation respecting the report of the Financial Services Task Force, which was scheduled for release (and was in fact released) in September 1998.[14] In practice, both the Commissioner under the Act and OSFI reported their findings to the Minister of Finance, who based his own decision on these findings as well as on his own investigation.

III. The Competition Bureau Decisions

No merger between any of Canada's largest banks has taken place for several decades. As a consequence, prior to the two merger proposals announced in 1998, no comparable bank mergers had been scrutinized under the merger review provisions of the Act, which were introduced only in 1986. Given the sheer size of the banks involved relative to Canada's small population, the concentrated nature of the Canadian banking industry, and the broad range of businesses carried on by Canadian banks, the competition law issues raised by the bank merger proposals were extremely complex. The proposed bank mergers were also fraught with difficulty from a process standpoint, since, in the absence of any prior experience with large bank mergers, the Bureau's approach in dealing with such mergers, including data requirements and market definition issues of necessity evolved in the course of the review. The uncertainty created by this lack of prior experience with significant bank mergers contrasts sharply with the experience of regulators in other jurisdictions where such mergers appear to have become in some respects relatively "routine". In the United States for example, the sheer number of mergers that have been reviewed and approved by U.S. regulators has permitted the development of a regulatory process which, although imperfect, permits applicants to approach a bank merger proposal with a reasonable degree of certainty and an understanding of the assessment criteria that will be applied.[15]

Before moving to a discussion of the Bureau's findings, it is worth underlining the overall scope and scale of the Bureau's review. Given that the businesses of the parties to the proposed mergers extended well beyond traditional commercial and retail banking to include investment banking, trust services, credit card services, mutual funds, securities custody, investment management, corporate banking, correspondent banking and many other services, the mergers presented enormous challenges to the Bureau's staff from a resource perspective. The Commissioner has indicated that his staff reviewed approximately 400,000 pages of documents in connection with the proposed mergers, and it has been reported that more than 100 individuals (Bureau staff, experts and others) were involved in the Bureau's bank merger review process. For the bank merger applicants, the Bureau process also presented a resource challenge as it involved the disclosure of voluminous documentation, the preparation of substantive legal and economic submissions respecting a broad range of business areas where the activities of the merging banks overlapped and simultaneous dealings with the Minister of Finance, OSFI and the numerous political committees and lobby groups which took an interest in the merger review process. The process was further complicated by the fact that two large transactions were being examined simultaneously and their competitive effects had to be measured both individually and cumulatively.

The Bureau's findings were outlined in two Merger Review Letters addressed to the chairmen of the respective merging banks which were released to the merging banks and to the Minister of Finance on December 11, 1998. Just three days later (most of the intervening time being a weekend), on December 14, 1998, the Minister of Finance released the Bureau's findings and those of OSFI to the public and announced his own decision to turn down the merger proposals.[16]

Applying the analytical framework contained in the MEGs as supplemented by the BMEGs, the Bureau concluded that the proposed bank mergers raised concerns in the retail banking, credit card services and investment banking areas. More specifically, it concluded that the proposed Royal/BMO transaction would or might give rise to a substantial lessening of competition in certain local markets for branch banking services to individuals and businesses, in certain provincial markets for mid-market lending, in the general purpose credit card network services market, in the market for primary merchant acquiring for small and medium-sized ("SME") merchants, in certain local markets for full-service brokerage services and in the national market for the underwriting of equity issues exceeding CDN$50 million. In the case of the CIBC/TD transaction, the Bureau concluded that a substantial lessening of competition would or might occur in certain local markets for branch banking services to individuals and businesses, in certain provincial markets for mid-market lending, in the Visa merchant acquiring market, in the market for primary merchant acquiring for SME merchants and in certain local markets for full-service brokerage services. The Bureau assessed the parties' efficiency claims in light of the statutory efficiencies defence contained in section 96 of the Act, but concluded that the magnitude of efficiencies that would result from the proposed bank mergers could not be accurately projected by the banks until after public interest concerns raised by the Minister of Finance were taken into account. The Commissioner's Merger Review Letters also outlined in general terms the sorts of measures that the banks might be expected to undertake in order to address competition concerns, but noted that the ultimate decision to allow or disapprove mergers rests with the Minister of Finance under the Bank Act. Given that the Minister of Finance released his decision to prohibit the proposed bank mergers only three days after the Bureau submitted its findings, there was no opportunity for the merging parties to propose remedial measures to address concerns which were identified.[17]

What follows is a review of the highlights of the Bureau's analysis in the three substantive business areas of concern, namely retail branch banking, credit cards and investment banking.

(a) *Branch Banking Services*

(i) *Market Definition*

The BMEGs provide that the Bureau will not assume *a priori* that banking product markets should be delineated on the basis of particular "clusters" of products, and in this regard they appear to have moved more in the direction of adopting the analytical framework for product market definition which is applied by the U.S. Department of Justice, Antitrust Division and not that applied by the U.S. Federal Reserve Board. However, the BMEGs acknowledge that it might be appropriate to find a cluster market where individual components purchased separately are not a close substitute for a grouping of banking products for a significant number of customers. According to the BMEGs, the existence of a cluster market will be established when it is shown that consumers will not, in response to an increase in the price of a

banking product grouping, purchase the various components of such grouping separately from different financial institutions, due to the transaction costs of dealing with a number of suppliers, economies of scope and other factors.[18]

In the Royal/BMO and CIBC/TD merger cases, the Bureau did not define cluster product markets.[19] In the Commissioner's Merger Review Letters outlining the Bureau's findings, nine product-line specific markets for branch banking services were defined, as follows: (i) personal long-term investments; (ii) personal short-term savings; (iii) student loans; (iv) personal transaction accounts; (v) residential mortgages; (vi) personal loans/lines of credit; (vii) business term loans; (viii) business transaction accounts and related services; and (ix) operating loans.

The relevant geographic market was found to be regional in scope for mid-market loans between CDN$1 million to CDN$5 million. The Bureau used provincial boundaries to approximate these regional markets.

The Bureau found that the geographic markets for all of the other products at issue were local for customers of personal financial services and for SMEs.[20] In so doing, it rejected submissions to the effect that national pricing by the merging parties prevented any local exercise of market power and that technological innovations such as credit-scoring and electronic banking, which allow customers to be served from coast to coast regardless of the location of bank branches, had created a national banking market. The Bureau identified 137 local urban markets, which it constructed based on Statistics Canada census data for census metropolitan areas (areas with populations of more than 100,000 people) and census agglomerations (areas with populations of 10,000 to 100,000). The operations of Royal and BMO overlapped in 125 of these urban markets and the operations of CIBC and TD overlapped in 111 of these urban markets. In rural areas, the Bureau examined all areas where branches of the two merging banks were within 20 kilometres of each other (the number and methodology were revised on several occasions during the merger review process). The relevant geographic market was then defined by drawing circles with a 20-kilometre radius on a map around all such rural branches and calling the resulting areas (consisting of interlocking circles) the geographic market. The Bureau found that the operations of Royal and BMO overlapped in 99 local rural markets and that those of CIBC and TD overlapped in 68 local rural markets. The Bureau did not engage in a detailed exercise of assessing commuting patterns, local geography, advertising, the actual geographic draw area of a particular bank branch or other factors that would influence the size of the geographic market on a market-by-market basis as would normally be done in other merger review cases. Instead, the Bureau applied its 20 kilometre radius rule of thumb in all rural areas regardless of such other factors. A similarly inflexible approach appears to have been taken in regard to urban markets, using for this purpose census agglomerations and census metropolitan areas identified by Statistics Canada.

(ii) *Analysis of Competitive Effects*

The Bureau found that no detailed review of competitive effects was required for personal long-term investments, personal short-term savings, student loans or business term loans, either because the remaining competition was effective or because applicable thresholds (the unilateral and interdependent effects thresholds) were not exceeded. However, as regards the other banking markets in question, the Bureau concluded that both mergers would or might give rise to a substantial lessening of competition in a considerable number of local markets. Where the Bureau found that competition "may" or "might" be substantially lessened, it indicated that further review and analysis was required. However, in view of the fact that the Minister of Finance released his decision to prohibit the proposed bank mergers only three days after the Bureau released its findings, there was no opportunity or need for the Bureau to undertake such further analysis.

The BMEGs indicate that the Bureau will not conclude that a bank merger is likely to lessen or prevent competition substantially on the basis that market shares or concentration levels in the relevant markets exceed threshold levels.[21] This statement is consistent with section 92(2) of the Act, which directs that the Tribunal cannot find that a merger lessens or prevents competition substantially based solely on evidence of market shares or concentration. Despite this prohibition, it is obvious from the analyses contained in the Merger Review Letters that market share and market concentration data played a critical, if not decisive, role in the Bureau's review of mergers in the branch banking area.

The BMEGs contain an explicit emphasis on market share thresholds by proposing the use of an initial market share screen test to eliminate the need for further review of product offerings and geographic areas in respect of which a bank merger is unlikely to propose competition problems.[22] Such an initial screening test was considered necessary in the retail banking area given the large number of branches that each of the large national banks operate. For this purpose the BMEGs indicated that the market shares of the merging parties should be measured against the 35% unilateral effects threshold and 65%/10% interdependent effects thresholds using a pre-determined set of narrowly-defined product offerings and geographic areas. The markets where the initial screening thresholds are exceeded would be subject to a full competitive effects analysis while those which fall below such thresholds would be exempt from further scrutiny.[23]

The timing of the Royal/BMO and CIBC/TD mergers meant that the Bureau was not able to develop its screening tool or its pre-defined set of geographic markets and product offerings in advance of reviewing these transactions. However, in the course of the merger review process, it compiled a market share database using Canadian Bankers' Association ("CBA") data supplemented with information provided by other financial institutions and the Canadian Payments Association. Although the methodology used to construct the database was strongly disputed,[24] the Bureau's database played a critical role in that its findings were apparently applied both as an initial screen to eliminate markets where no competition

issue arose and in the context of the Bureau's analysis of competitive effects in the remaining markets which required further assessment. Applying its database as a screen, the Bureau found that the interdependent effects (65%/10%) threshold was exceeded in at least one of the relevant product markets in *all* 224 overlapping local markets in the case of the Royal/BMO merger and, again, in *all* 179 relevant overlapping local markets in regard to the CIBC/TD merger. As such, none of these geographic areas was completely exempted from further review. The screening test was presumably used to screen out the business lines which were ultimately excluded from review, namely personal long-term investments, personal short-term savings, student loans and business term loans, since one of the reasons cited for such exclusion was the fact that applicable market share thresholds were not exceeded.

Turning to the issue of competitive effects, the Bureau made market share determinative by adopting the view that, where the combined share of the merging banks in either personal or business transaction accounts[25] was 45% or greater, the proposed merger would result in a substantial lessening of competition and would require a remedy in such a market. In instances where the share of transaction accounts was between 35% and 45% or where the share of any of the other relevant product markets would exceed 35%, it concluded that further analysis of market conditions and any mitigating factors was required.

Applying these market share tests, the Bureau concluded that the proposed BMO/Royal transaction would result in a substantial lessening of competition in 104 of the 224 local markets in which these two banks compete, and *might* result in a substantial lessening of competition in a further 71 local markets. In the case of the CIBC/TD proposed merger, the Bureau found that it would give rise to a substantial lessening of competition in 36 of 179 local markets, and *might* result in a substantial lessening of competition in a further 53 local markets.

The use of market share as the principal factor in assessing whether the proposed bank mergers would create a substantial lessening of competition in local branch banking markets reflects a strongly structural approach to merger review and for that reason raises questions about the legal propriety of the Bureau's analysis in view of section 92(2) of the Act which prohibits the Tribunal from taking remedial action in regard to a merger on the basis of market share data alone. The Tribunal has acknowledged that market share and concentration data are relevant and may even provide *prima facie* evidence of a substantial lessening of competition *(Canada (Director of Investigation and Research) v. Hillsdown Holdings (Canada) Ltd.*[26]*);* however, it has never concluded that market shares in excess of a particular level were determinative in the absence of other market-specific competitive factors supporting that conclusion. The structural approach taken by the Bureau also appears to represent a significant departure from its typical approach to the merger review process, where market share and market structure are relevant but on their own are not decisive factors and where a market by market analysis of competitive factors (e.g. remaining competitors, barriers to entry, foreign competition, removal of a vigorous competitor and change and innovation) is undertaken. In the Royal/BMO and CIBC/TD merger cases, despite

having defined branch banking markets as local markets, the Bureau only took these qualitative factors into account on a national basis. This approach meant that local market realities were not reflected. For example, the failure to consider barriers to entry at the local level was significant since such barriers are low for existing Canadian financial institutions wishing to expand into new local geographic areas, even if expansion by such institutions was not considered to be significant on a national basis.

The structural approach taken by the Bureau was most likely motivated by expediency concerns given the number of individual product and geographic markets which were required to be considered in the two merger cases. It remains to be seen whether the structural approach taken by the Bureau in these cases will be applied in other retail (or non-retail) merger situations including, in particular, the recently announced Canada Trust/TD proposed merger and whether, if a similar approach were to be taken in such a case, proponents of the merger might be inclined to challenge such a position on the basis of section 92(2) of the Act.[27]

The Bureau also concluded that both mergers would give rise to a substantial lessening of competition in a number of provincial markets for mid-market lending.

(iii) *Interdependence Concerns*

In addition to its findings that the proposed bank mergers would give rise to a substantial lessening of competition based on the fact that certain unilateral effects thresholds were exceeded, the Bureau determined, again based largely on structural factors, that there was a risk that the transactions would give rise to a lessening of competition due to interdependent behaviour at both the national and local levels. While the Bureau initially raised interdependence concerns with respect to a broad range of areas of business overlap, the Bureau's findings with respect to interdependence, as recorded in the Commissioner's Merger Review Letters are largely limited to the retail branch banking area.

The theory of interdependence put forward by the Bureau in the bank merger cases was not one based on a supposition that the mergers would, through the removal of a competitor, facilitate future collusion in banking. Rather, it was based on the notion that, given high levels of industry concentration, a well as the existence of a number of factors which facilitate interdependent behaviour, including high barriers to entry, product homogeneity, the predictability of demand and costs, stable market shares, good information about pricing and customers and the degree of industry cooperation (e.g. in associations, joint ventures and networks), there was a likelihood that the proposed transactions would "increase the risk for reduced competitive vigour among the remaining major banks".[28] This application of interdependence theory finds its parallels to economic theories of non-cooperative oligopoly, which predicts the conduct of a small number of firms acting independently but aware of one another's existence. The approach taken by the Bureau in the Royal/BMO and CIBC/TD merger reviews departed from the model for interdependent behaviour put forward in the BMEGs, which turns on the notion of tacit collusion

and underlying factors tending to facilitate anti-competitive cooperation among competitors.

The Bureau's findings with respect to interdependence place constraints on the possibility that future bank mergers would receive competition law approval, since any such mergers would take place in a concentrated market and since many of the factors identified by the Bureau as facilitating interdependent behaviour will presumably continue to exist for the future. Moreover, this type of concern is not one which can very easily be addressed by divestitures or transaction restructuring. The reliance on a non-collusive model for interdependence also may have implications for mergers in other sectors, since many Canadian industries are relatively concentrated.

(iv) *Role of Industry Developments*

Technology and other industry developments are transforming the financial services environment in Canada as in other countries. In retail banking area, technology has had a number of industry effects. In the first place, the availability of electronic banking options, including the Interac ATM and debit card network, telephone banking, PC banking and Internet banking, have reduced the importance of the branch network and of local branch access for many types of personal and commercial financial services. These developments are, as a practical matter, expanding the geographic markets in which banks compete since the physical location of branches is no longer central at least for certain types of banking services. In the area of lending, the development of sophisticated credit-scoring technology has enabled remotely situated lenders — foreign (e.g. Wells Fargo) and domestic, bank and non-bank — to supply credit efficiently to personal and small business banking customers throughout Canada which again would favour an expansion of geographic markets. Technology has also created the possibility for new entrants to commence "branchless" bank operations. Canadian examples include ING Direct, a virtual bank owned by ING Bank of the Netherlands, and Citizens Bank of Canada, a virtual bank owned by Van City Credit Union. Most recently, Amex Bank of Canada announced its intention to offer deposit-taking services to Canadians without a branch network.[29] As such, technology facilitates entry even though it has not, as yet, removed barriers completely.[30] Additionally, the emergence of supermarket banking in Canada has lowered barriers for new entrants.[31]

In the Royal/BMO and CIBC/TD bank merger cases, the Bureau acknowledged the potential effects of technology and innovation on competition in the financial services industry. However, it concluded that technology had not transformed the industry to the point where a local branch presence ceased to be important and it had not substantially altered entry barriers for new competitors. In this latter regard, the Bureau applies a two-year time frame to the assessment of entry issues; i.e. it will consider a merged firm to be constrained by the likelihood of new entry only if such entry is likely to occur on a scale sufficient to ensure that a material price increase would not be sustainable in a substantial part of a relevant market within two years of the merger's consummation. The basis for this two-year time frame is found in the discussion of entry found in the MEGs and in the BMEGs. In the 1998 bank

merger cases, the Bureau also applied a two-year time frame to the assessment of the impact of technology and innovation generally, apart altogether from the issue of entry.

The Bureau's conclusions on the pace of technological change were largely based on quantitative data about the extent of use of new channels of distribution and the extent of penetration of new virtual bank competitors, as well as on predictions made by various experts on the growth of technology in the financial services sector. The essential conclusion of the Bureau was that these developments, while relevant, were too far off to constrain the behaviour of the two sets of merging banks. It also suggested that in some cases technology may increase barriers to entry, since customers expect new entrants to be able to offer new channels of distribution on the same basis as traditional banks which, taken to its extreme, would require new entrants to establish an ATM network to match that of the major banks. One of the challenges that will face applicants in any future merger of large banks will be to demonstrate that technology has evolved sufficiently beyond where it stood in 1998 to merit a reconsideration of this rather conservative view of technology adopted in the Royal/BMO and CIBC/TD merger cases.

(b) *Credit Card Services*

Credit card services are provided to two distinct sets of customers: merchants who wish to accept cards, and cardholders who wish to use cards to purchase goods and services. Suppliers who sell card acceptance and related services to merchants and who enable merchants to receive value for the goods and services that they sell are known as "merchant acquirers". Suppliers who issue credit cards to individuals and businesses to enable them to purchase goods and services are known as "card issuers".

In the Merger Review Letters outlining its findings in the Royal/BMO and CIBC/TD merger cases, the Bureau defined six relevant product markets in the credit card area, as follows: (1) general purpose credit (and charge)[32] card issuing to businesses; (2) general purpose credit (and charge) card issuing to individuals; (3) general purpose credit (and charge) card network services; (4) Visa merchant acquiring; (5) MasterCard merchant acquiring; and (6) primary merchant acquiring. On the basis of the Bureau's analysis of these markets, only the network services and acquiring markets raised competition law concerns (markets (3) through (6)).

(i) *General Purpose Credit Card Network Services*

The Bureau's discussion of the effects of the proposed mergers in the area of general purpose credit card network services raised a number of interesting and complex issues. The networks market was defined as the market in which different payment systems compete. In Canada, Visa is the largest network, followed by MasterCard, American Express and Diners Club/enRoute. According to the Bureau, MasterCard has competed vigorously with Visa in Canada by adopting more liberal membership rules than Visa and by setting lower interchange fees than Visa.

In Canada, card association rules prohibit banks from belonging to both the Visa and MasterCard associations, a situation known as "non-duality". Non-duality means that banks can provide issuing and acquiring services for one of the Visa or MasterCard brands only and that consumers and merchants who want to use or accept both cards must deal with two financial institutions to obtain them. By contrast, in the United States, banks may belong to both card associations and issue and acquire for both cards. On October 7, 1998, following a lengthy and well-publicized investigation, the U.S. Department of Justice brought an antitrust suit against Visa and MasterCard in the United States alleging, *inter alia*, that joint governance of the Visa and MasterCard card associations (which the DOJ terms "duality"[33]) has created disincentives for these associations to compete with each other and has reduced competition in the general purpose credit card network market in the United States. These proceedings, which are ongoing, have contributed to a climate of uncertainty around the legality of credit card duality under the antitrust laws, including in the merger context.[34]

The impact of the proposed mergers on the networks market was at issue only in the Royal/BMO merger since the CIBC/TD merger would have combined the credit card operations of two Visa members with no effect on inter-system competition. By contrast, the Royal/BMO merger would have combined a Visa issuer (Royal) and a MasterCard issuer (BMO) and raised squarely the issue of duality.[35] The Bureau did not, however, directly address the issue of duality in its findings in respect of the Royal/BMO merger. Rather, the Commissioner's Merger Review Letter in respect of the Royal/BMO merger examined the competitive effects of (1) a conversion of BMO's business to Visa, and (2) a conversion of Royal Bank's business to MasterCard. The letter concluded that the first of these alternatives would give rise to a substantial lessening of competition in the general purpose credit card networks market since, in the Bureau's view, it would undermine the effectiveness (and potentially lead to the demise) of the MasterCard network in Canada. By contrast, the Bureau concluded that a conversion to MasterCard would not give rise to a substantial lessening of competition in the networks market, although it might give rise to governance concerns within MasterCard.

Ironically, a case could be made for duality in Canada based on some of the very reasons relied upon by the Bureau in expressing its preference for a conversion to MasterCard. Specifically, if duality were to be permitted in Canada, it may be assumed that several, if not all, of the larger Visa issuers would also become MasterCard issuers. This would strengthen the historically weaker MasterCard network in Canada by providing it with expanded membership, and at this level would enhance competition between the Visa and MasterCard systems. Moreover, in such a dual environment, the two card associations would be forced to compete for the custom of their members on an ongoing basis, rather than viewing competition for members as a one-time act of recruiting a member at the outset.

(ii) *Merchant Acquiring*

The concerns identified by the Bureau in the merchant acquiring area were largely driven by the market definitions it adopted. The Bureau determined, on the one hand, that MasterCard and Visa acquirers provide complementary products and compete in separate, single branded markets. It concluded that the CIBC/TD merger, which combined two of the larger Visa acquirers in Canada, would have created a dominant player in this market and would have led to a substantial lessening of competition in this market. By contrast, there was no overlap between the businesses of Royal and BMO at this level since Royal is exclusively a Visa acquirer and BMO is exclusively a MasterCard acquirer.

The finding that Visa and MasterCard acquiring markets were separate markets was premised in the non-dual nature of Canada's credit card industry. In this regard, the Bureau wrote:

"Most merchants need to be able to accept both Visa and MasterCard. Under the existing rules and policies of Visa and MasterCard, members may not acquire transactions of a competing card. Consequently, Visa merchant acquiring and MasterCard merchant acquiring constitute separate markets."[36]

Ironically, the finding that Visa and MasterCard are complements (i.e. they do not currently compete) under non-duality suggests that Visa and MasterCard might become competitive products were Canada to adopt credit card duality. If this is the case, duality could be seen as contributing to increased competition between Visa and MasterCard and therefore as enhancing competition in the general purpose credit card networks market defined by the Bureau.

The Bureau's analysis, however, did not stop with the conclusion that Visa and MasterCard acquirers do not compete. Rather, it went on to conclude that acquirers for all card brands compete in what it termed "primary merchant acquiring"; i.e. the provision of terminal services bundled with either Visa or MasterCard acquiring services, principally to SME customers. In Canada's non-dual acquiring environment, a merchant must contract with two acquirers in order to accept both Visa and MasterCard services, but transactions for both card brands (as well as transactions for other credit and charge card brands and debit cards) are processed over a single terminal placed in the merchant's location by the primary acquirer. The Bureau concluded that acquirers for both the MasterCard and Visa brands compete to establish the primary terminal relationship with the merchant. Initially, the Bureau expressed a view that primary acquiring markets were local markets tied to merchant relationships at the local branch level; however, it ultimately concluded that the use of centralized service centres and sales teams meant that the primary acquiring market was "in transition to the national level".

The Bureau found that both the Royal/BMO and CIBC/TD mergers might lead to a substantial lessening of competition in the primary acquiring market. This finding did not take into account the effects of a conversion of the Royal portfolio to MasterCard, which presumably would have led to significant merchant

attrition as many Royal merchants would already have an established MasterCard relationship with a third party and would presumably not readily transfer this relationship to the combined Royal/BMO. In both cases, the Bureau indicated that the primary merchant acquiring market required further detailed review before the Bureau could confirm if a substantial lessening of competition would result. The Bureau concluded, however, that a substantial lessening of competition would occur if both proposed bank mergers proceeded.[37]

(c) *Investment Banking Services*

A further business area which was considered as part of the Bureau's review of the overall bank mergers related to the investment banking operations of the parties as conducted their respective investment banking affiliates. In the case of the Royal/BMO merger, the respective affiliated investment banking operations were carried on principally by RBC Dominion Securities (in the case of Royal) and Nesbitt Burns (in the case of BMO). By most measures, those two firms ranked either first and second or first and third in the various categories of investment banking carried on by them. In the case of CIBC, the investment banking operations of that bank are carried on by CIBC Wood Gundy (the second or third leading investment banking firm in most categories) and TD Evergreen (which generally holds a lesser position in most of these market categories). In addition, each of the banks carries on discount retail brokerage operations separate from the full-service retail brokerage functions of these firms. In the case of Royal, that business is carried on under the name "Action Direct". BMO's discount brokerage business operates under the name "InvestorLine" The discount brokerage businesses of CIBC and TD operate under the names "CIBC Investor's Edge" and "TD Greenline", respectively. Of these discount brokerage operations, TD's Greenline is understood to be the market leader with the majority of that business. By comparison, the discount brokerage market shares of the other firms would each be under 15% with CIBC Investor's Edge share being less than 10%.

After an extensive examination of the respective securities businesses of the parties, ultimately the Bureau delineated some seven overlapping product markets, namely:

- Discount brokerage (execution of trades without advice)
- Debt underwriting
- Mergers and acquisitions advice
- Institutional equity trading
- Institutional debt trading
- Full-service brokerage (execution of trades with advice)
- Equity underwriting

In the case of the Royal/BMO merger, the Bureau concluded that the proposed merger did not raise competition concerns in regard to the discount brokerage, debt underwriting, mergers and acquisitions

advice, institutional equity trading or institutional debt trading markets. In these areas, there were considered to be sufficient competitive alternatives post-merger or the applicable thresholds were not exceeded. Competition issues, however, were identified in regard to full-service brokerage and equity underwritings. In the case of the CIBC/TD merger, again, full-service brokerage (advised trading) and discount brokerage were identified as giving rise to issues warranting in depth review.

The investment banking operations of the banks had not been the subject of any special comment in the BMEGs which, by implication, probably means that the Bureau does not consider this business to have the sort of special characteristics possessed by banks.

In the result, apparently using the same market share thresholds[38] which had been identified in regard to various banking and credit card services to separate problematic and possibly problematic business areas resulting from the two bank mergers, the Bureau found that in regard to full-service retail brokerage business, the Royal/BMO merger would result in a substantial lessening of competition in 39 of the 63 local markets in which Nesbitt Burns and RBC Dominion Securities compete and might result in a substantial lessening of competition in some 16 additional overlap markets. The latter areas were expressed to be subject to further investigation and review which had not been concluded at the time of delivery of the Merger Review Letters (December 11, 1998). In only eight other overlapping markets was it considered that no substantial lessening of competition would result from the merger.

In the case of the CIBC/TD merger, in only one local full-service brokerage market was it concluded that a substantial lessening of competition would likely occur as a result of the combination of CIBC Wood Gundy and TD Evergreen. In two further geographic markets, there was a possibility of such a substantial lessening of competition, which warranted further examination and consideration (which, again, had not been completed at the time of delivery of the Merger Review Letters). In some 19 additional overlap markets, the CIBC Wood Gundy/TD Evergreen merger was not seen as likely to give rise to a substantial lessening of competition.

As noted previously, the Bureau determined that the Royal/BMO merger (but not the CIBC/TD Merger) might give rise to problems in the national market for underwriting of equity issues exceeding CDN$50 million. Again, this was stated to be an area in which more a detailed review was required to be undertaken before it could be determined whether a substantial lessening of competition would result from the transaction. In this connection, the Royal/BMO Merger Review Letter mentions that the merging parties had a combined market share greater than 35% as determined using a market share measurement method that allocates full credit to the lead underwriter. Finally, in regard to the CIBC/TD merger, although a detailed investigation of the impact of that merger on the discount brokerage business was undertaken (in light of the fact that the post-merger market share which would be enjoyed by the merged firm would have been in excess of 45%, measured on a national basis for the discount brokerage as a whole) ultimately it was concluded that the merger would not result in a substantial

lessening of competition in that market.

(d) *Impact of the Mergers on the Full-Service Retail Brokerage Business*

The approach taken to assess the impact of the two mergers in the full-service retail brokerage area was essentially the same in each case. The Bureau differentiated full-service brokerage from discount brokerage on the basis that full-service brokerage includes securities advice, in addition to trading, whereas discount brokerage does not. In addition, a relatively wide spread in the pricing of the two types of services (which is even more exaggerated when the pricing of full-service brokerage is compared with that of online brokerage) served to reinforce the view that these are two distinct market segments which are not inter-competitive. This conclusion appears to have been reached notwithstanding the fact that virtually all of the non-full-service brokerage market share has been captured by the discount brokers at the expense of full-service firms and many users of discount or Internet or online brokerage services are known to supplement such service by obtaining required information and advice needed for securities trading from other sources. This practice is widely seen as part of a general disintermediation of services which are otherwise bundled by full-service brokers. Evidence presented concerning the general decline in full-service brokerage commission rates during the time when discount and online brokerage services have gained market share appears not to have influenced the Bureau to consider the two types of brokerage business to be in the same market for merger analysis purposes.

Although not mentioned in the Merger Review Letters, the Bureau's definition of a separate full-service retail brokerage market had the effect of excluding from consideration the competition provided to retail brokers by a whole host of other financial service providers such as financial planners, investment counsellors, portfolio managers and investment management firms who provide investment advice but do not themselves undertake securities trading, although they customarily arrange for such trading to be executed for them through other registered brokers, including, in particular, discount brokers. Also implicitly excluded were other investment products and services which do not involve the provision of securities trading execution services but nevertheless compete with full-service brokers in selling many of the same or similar products, namely: investment products and services available from banks, trust companies, pooled funds, credit unions, group plans, mutual fund direct sellers and insurance companies, all of which, in addition to providing such investment offerings, effectively also involve the provision of investment advice (at least in regard to the products and services offered). The justification for these exclusions in each case was that neither group could be considered competitors of full-service brokerage firms in that they did not provide both investment advice *and* securities trading execution. However, as mentioned below, given the manner in which the respective market shares of the full-service brokerage firms were calculated for this purpose, it may be questioned whether these were appropriate exclusions.

Turning now to the geographic dimensions of full-service brokerage markets, the Bureau concluded that these markets were local in scope. This appears to have been on the basis of their view that most

clients want local investment advice in a conveniently-located office close to where they live or work and the fact that all of the investment banks involved maintain branch offices throughout Canada. While not mentioned in the Merger Review Letters, it is understood that in delineating geographic markets for this purpose, the Bureau proceeded on the view that the relevant geographies in which full-service firms operate may be defined in terms of StatsCan statistical census metropolitan areas and census agglomerations. While such geographies are no doubt somewhat arbitrarily constructed, their choice might be justified on the basis of convenience and the lack of readily available alternatives for the collection of data. However, given the way in which the market shares within these territories were measured (which excluded from consideration the business activities within those markets of firms or businesses whose offices are located outside their boundaries), the potential defects in relying on such data (particularly where it appears market share appears to be the dominant factor in the Bureau's merger analysis applicable to this area of the banks' business), appear to be of considerable significance.

Having described the various relevant markets in this manner, the Bureau then developed market share measures for each of the firms based solely upon the "assets under administration" of the various full-service brokers with offices physically located in each such local market. This approach was justified on the basis that it is a standard used in the industry to measure market shares. However, the appropriateness of this measuring method may be questioned for a number of reasons. Firstly, it includes to a very large degree assets which are typically not traded on behalf of the client (for example, fixed income securities, mutual funds, registered plans, pooled funds and other managed assets, cash and cash equivalents). Given that the reason for excluding from consideration as competitors in the relevant market other providers of these types of financial investment products on the basis that they do not execute trades in such securities, it would seem to be inappropriate to measure the market shares of full-service brokerage firms on the basis of assets under administration. Assets under administration also do not reflect the true earning power of the firm which typically does not have any discretionary investment authority in regard to such assets. Given that the Bureau had defined the relevant product market as advised securities trading execution, assets under administration, which are idle in the sense that there are no transactions undertaken by the broker in regard to them and thus are not "under management", are effectively not in the relevant market. It was pointed out on behalf of the banks that if these "non-brokerage" assets (eg., mutual funds and other managed assets) are to be included for market share measurement purposes, then account should be taken for this purpose of other competitors who provide similar products and services. Alternatively, if such other competitors are not to be considered, then the focus should be on commissions earned by full-service brokerage in trading securities (services which these other financial service providers typically do not provide). In this connection, it was argued that equity commission revenues are a more appropriate basis of market share measurement where the market being measured for this purpose is advised securities trade execution services. It was further submitted that information concerning commission revenues derived from equity securities trading transactions are typically reported by virtually all of the investment dealer firms and undoubtedly maintained on a local branch office basis. It appears that the Bureau had not considered this alternative

approach and was unable to collect relevant information on this basis prior to the delivery of the Merger Review Letters. However, it is significant that, in this connection, the Commissioner stated:

"These conclusions are based in part on the market share levels as measured by assets under administration in local markets. The Bureau would be prepared to review these conclusions if information having a material impact becomes available at the local level which would indicate that the market shares, as calculated, significantly overstate the market position of bank-owned firms."[39]

Using provincially-available data for equity trading volumes of various securities dealers firms, it appears that, at least on average, the combined post-merger market shares of both mergers would be well within the overall safe harbour limit of 35%, in contrast to the conclusions reached by the Bureau on the basis of assets under administration where some 55 out of 63 overlap markets identified by the Bureau in the case of the Royal/BMO merger were found to have combined market shares of over 35%.

One of the other factors cited in the Merger Review Letters was the existence of barriers to entry (including the cost of training investment advisors, the institutional competitive advantage enjoyed by integrated full-service firms having full research capabilities as well as preferred access to significant quantities of underwritten product). In expressing the view that the elimination of a combination of the first and second largest full-service brokers would involve the removal of a vigorous and effective competitor, the principal statistic cited was the greater number of investment advisors at each of the two merging firms as compared to most of the other competitors. As well, statistics were cited to show that the merged firm, in the case of the Royal/BMO merger, would be larger, on the basis of assets under administration and the number of investment advisors, than any of the remaining competitors by a considerable margin.

(e) *Equity Underwriting*

It was only in regard to the Royal/BMO merger that competitive concerns were raised about the impact of the proposed merger on the equity underwriting market. This was not an issue in relation to the CIBC/TD merger. For this purpose, the Bureau delineated the relevant market for the underwriting of equity issues exceeding CDN$50 million to be national in scope. However, the market was defined solely in terms of *domestic* issues having an aggregate issue price of over CDN$50 million. In this regard, the banks pointed out that a consequence of this segmentation of the market would be to isolate the very issuers who typically have the alternative open to them of accessing the U.S. equity capital markets, which has the effect of providing competitive discipline on domestic market participants. More importantly, the Bureau's market share measurement methodology used in this case led, in the view of the banks, to a significant overstatement of their position. In this connection, the Bureau chose to apply the so-called "full credit to lead" method of determining market shares. Under the full credit to lead approach, 100% of an underwriting (on a dollar volume basis) is attributed to the lead-manager and

no value or credit is attributed to any other members of the underwriting syndicate notwithstanding that the overall share of the commission revenue derived from an underwritten transaction by the lead-manager typically will not exceed 50%. In addition, since larger transactions tend to have a greater number of syndicate team members with the result that the lead-manager's share of the overall commissions paid is less, this overstatement of the relative economic importance of the lead-manager's position is further exaggerated in the case of larger transactions.

The banks argued that a more appropriate measure would be to calculate their share of underwriting liabilities or overall revenues derived from underwriting transactions, including all special fees paid to the lead-manager.

The choice of market share measurement methodology was critical because dramatically different results are derived from the selection of one method as opposed to another. In the case of the Royal/BMO merger, the combined market share, using the full credit to lead approach, was in the range of 40% on a post-merger basis, but when determined in accordance with underwriting liability the combined share was only 30%.

Given that the Commissioner did not conclude, even measuring market shares on the basis of full credit to lead, that the merger would *likely* bring about a substantial lessening of competition in the equity underwriting business in Canada but only that it *might* do so (the combined market shares calculated on this basis were referred to only as being over 35%), it is perhaps more useful to look at some of the other considerations cited by the Commissioner in his analysis of the equity underwriting market. Again, in regard to this market, it was concluded that barriers to entry were high. It was noted that fully integrated firms are best able to benefit from economies of scope available in the industry and that the ability to win lead positions is enhanced when a firm is active in trading securities in the institutional market. In order to be successful in that market, the firm requires top-ranked research capability across a broad range of industry sectors. Accordingly, institutional trading capability was cited as an important adjunct to successful equity underwriting as was retail distribution which, although less important than institutional sales, can constitute upwards of 30% of an initial distribution of an underwritten equity issue. In this connection, the banks presented evidence that it is unnecessary for parties seeking to participate in the underwriting of equity securities to have retail distribution capability as selling syndicates typically include a considerable number of dealers who have that capacity. It was also pointed out that, historically, institutional investors have taken steps following similar mergers to reallocate their business amongst the remaining competitors so as to ensure that the merged firm does not account for more than 15% of their total business. However, while recognizing that such a reallocation had occurred in the past, the Commissioner's Merger Review Letter expressed doubt that the same would occur following the proposed Royal/BMO merger:

"Previous transactions, however, did not result in a merged firm the size of a combined RBC Dominion

Securities and Nesbitt Burns. Consequently, we cannot assume that there will be a comparable attrition rate resulting from this transaction as the merging banks contend. The banks had argued that the erosion of their combined institutional equity trading business that was the inevitable result of their merger would lead to a correspondingly reduced capacity to receive assignments in regard to the underwriting of equity issues."[40]

A further interesting statement contained in the Commissioner's Merger Review Letter to the Chairmen of Royal and BMO was as follows:

"This suggests that the economic influence the larger firms are capable of exerting is not necessarily captured by the market share of individual firms. The industry is such that market power may occur at lower market share and concentration levels than would normally be of concern to the Bureau. In addition, although certain forms of cooperation are both necessary and legitimate in the industry, concerns about the ability of such a large firm to act independently of the market are enhanced. The interdependent nature of this industry compounds this concern. In particular, it may be difficult for issuers to exclude such a large firm from underwriting syndicates."[41]

The foregoing statement raises the spectre of interdependence which, as mentioned above, was an issue raised in connection with the Bureau's analysis of branch banking. In this connection, the Bureau's view of the world appears to have been influenced by the relative stability of underwriting discounts in equity underwriting transactions which tend to average around 4% and the fact that syndication arrangements are typically put into place among the dealers in connection with such underwritings (which is expressly permitted by section 5 of the Act). At the same time, the Bureau was quick to refute any suggestion that the merger would give rise to the likelihood of collusion in the industry. Rather, it seemed to suggest that the consolidation of the number of members in this business would further accentuate an already present trend towards interdependent behaviour by industry members. It is somewhat surprising that the Bureau should have inferred what appear to be fairly sinister connotations from the collaboration between firms in connection with equity underwritings which section 5 the Act explicitly permits. The point was also made that, in order for interdependence concerns to give rise to a competition law problem warranting intervention by the Commissioner, there would have to be a likelihood of a collusion on the part of industry competitors which was facilitated by the merger's reduction of the number of competitors in the industry. Evidence was cited to show that the market circumstances in this regard were not appropriate to give rise to an inference that a collusive arrangement was probable. The principal consideration in this regard was the fact, as evidenced from independent market studies, that syndicate leaders are typically selected to lead transactions, not because of the price they offer, but rather because of the quality of their institutional coverage.

(f) *Discount Brokerage Business*

The possibility of significant adverse competition consequences arising in the case of either merger in relation to the discount brokerage business was, as mentioned above, only seriously considered in regard to the CIBC/TD merger where TD Greenline is the acknowledged industry leader in this area. For this purpose, the discount brokerage market was considered to be national in scope and to include Internet or online brokerage business competitors. On a national basis, it was found that a combined Greenline and CIBC Investor's Edge operation would constitute over 45% of the overall discount brokerage market in Canada.

However, it was concluded that barriers to entry in this business were moderate as evidenced by some nine new entrants having established discount brokerage operations since 1990, apart altogether from non-bank-owned discount brokers offering Internet brokerage services. The Commissioner noted in the Merger Review Letter sent to the Royal and BMO chairmen that the rate of growth of this business segment had attracted new entrants. The Commissioner also concluded that, as a competitor, CIBC Investor's Edge was not particularly vigorous and had not been particularly successful in extending its influence outside its own limited CIBC customer base. It was further noted that Greenline's own significant market share had been declining over time as new entrants had come into the business.

As a consequence of these facts, the Commissioner concluded that the proposed CIBC/TD merger would not result in a substantial lessening of competition in the national market for discount brokerage services, notwithstanding the high (in excess of 45%) post-merger combined market share that the merged firm would enjoy.

IV. Conclusions

A number of general observations may be made about the outcome of the Royal/BMO and CIBC/TD merger cases. First, despite the recommendations of the Financial Services Task Force, it would appear that the "big shall not buy big" regulatory policy is still in effect, at least in the short term. In his statement to the press which accompanied the release of the Finance Minister's decisions on the bank merger proposals on December 14, 1998, the Minister indicated that his department's immediate priority is to focus on establishing an appropriate policy framework for the Canadian Financial Sector for the 21st Century. The Minister outlined the essential elements of such a framework, which include the implementation of the proposed foreign bank branching regime, the putting into place of a new review process to assess major bank proposals as well as the implementation of measures which will assist in achieving some more general goals such as jobs and economic growth, responding to the needs of consumers in small business, ensuring financial soundness, promoting competition by allowing for the entry of new domestic and international players, promoting technological innovation and allowing for strong Canadian institutions with a strong international presence. The Minister's statement went on

to provide that the government will not consider any merger among major banks until the new policy framework is in place. In this regard, the Minister stated:

> "[w]hereas the merger proponents wanted the mergers to be allowed in order to change the status quo, we believe the status quo must be changed before any merger can be considered."

This statement was made in direct response to earlier press statements made by the chairmen of the merging banks to the effect that the status quo was not an option.

The Department of Finance June 25, 1999 White Paper sets out the essential elements of the new financial services policy framework and, with the creation of a public interest review process, leaves the door open to a merger among Schedule I banks in future years. The question of whether future large bank merger proponents will be able to address any concerns raised as part of the public interest review process, which will be an overly political process, remains open.

It is therefore far from certain that any significant bank mergers will be approved in Canada in the near future.[42] This being said, however, it is likely that sector specific rationalizations and combinations involving the major banks will take place as these banks struggle to eliminate less profitable lines of business and lower the delivery costs associated with specific lines of business. There have been a number of banking industry joint ventures and line of business combinations in the past (eg., the Interac ATM and debit network and the Symcor cheque processing joint venture). Indeed, the new bank ownership rules introduced by the White Paper are aimed specifically at encouraging strategic alliances in the financial services sector, many of which will be subject to pre-merger notification and review.

From a competition law perspective, the results of the Royal/BMO and CIBC/TD merger review processes were somewhat discouraging. By virtue of the Minister of Finance's December 14, 1998 decision not to approve the mergers, there was no opportunity to test the conclusions reached by the Bureau, which were controversial in many respects, at the Tribunal. Among the most disturbing of the Bureau's findings were those respecting interdependence, since these suggest that the very structure of the Canadian banking industry may be such as to preclude any future significant transaction. Whether or not a future bank merger or mergers could go through without crossing interdependence threshold issues is an open question. It also remains to be seen whether the interdependence concerns raised in the bank merger cases will resurface in the competition law review of any proposed joint ventures or combinations involving any of the large Canadian banks. However, if the Commissioner's intent was to state that the very structure of the Canadian banking industry is itself the problem, then there will have to be significant changes within the industry before any approval for a bank merger from the Bureau could be obtained. From the perspective of many Canadian banks, such a view based on industry structure will preclude them from becoming internationally competitive.

Also, in the area of technological change and innovation, the reluctance of the Bureau to give weight to the technological developments that are transforming the industry will place a heavy burden on future merger applicants to demonstrate that technology has had tangible and measurable impacts on the financial sector. Only if such burden can be discharged is there any likelihood that the Bureau will abandon its local market approach to retail branch banking or give meaningful weight to new, branchless entrants into the Canadian market.

Three further observations are in order. The first is that, in retrospect, the timing of the proposed mergers which, if consummated, would have substantially changed the structure of the banking business, was a difficulty for the banks. The government-initiated review of policy options in the financial services sector was still very much a work in progress while the mergers were being considered. Secondly, the concurrence of two merger proposals coming forward at the same time and the great public attention directed to them arising out of the general public obsession with the perceived power of banks undoubtedly put greater pressure on the regulators to be on their guard to protect the public from their possible adverse consequences. Finally, the decision of the Commissioner, made early in the process, to defer consideration of possible remedial measures to address identified competition concerns until after the Minister had been apprised of such concerns and the Minister's almost precipitous action to reject both transactions before any such measures could be proposed or considered, effectively denied the banks of any opportunity to secure clearance on the basis of divestitures or other remedial action designed to resolve such concerns.

Notes

[1] Janet Bolton is an associate lawyer at Osler, Hoskin & Harcourt located in its Toronto office where she practices primarily in the competition law field. Tim Kennish is a partner of Osler, Hoskin & Harcourt located in its Toronto office where he practices primarily in the competition law field. Osler, Hoskin & Harcourt acted as counsel to Bank of Montreal in respect of its proposed merger with Royal Bank of Canada.

[2] The last merger involving any of Canada's "Big Five" banks occurred in 1961 when the Canadian Bank of Commerce and the Imperial Bank of Canada merged to form The Canadian Imperial Bank of Commerce. The most recent merger between widely-held domestic banks (called Schedule I banks under the *Bank Act*) occurred in 1988, when Canadian Western Bank was created through the merger of Bank of Alberta & Western and Pacific Bank of Canada. Canadian Western Bank is significantly smaller than Canada's Schedule I Banks and has 23 branch locations located in Western Canada.

[3] Based on December 31, 1997 financial statements, the Royal/BMO merger would have created a merged bank with CDN$350 billion (US$244.4 billion) in assets and the CIBC/TD merger would have created a merged bank with CDN$275 billion (US$192.1 billion) in assets in Canada. The joint press release issued by BMO and Royal on January 23, 1998 announcing their merger revealed that they would have ranked as 22nd in the world and 10th in North America in terms of market capitalization on a combined basis. The largest Canadian bank, Royal, was the 49th largest bank in the world ranked by size of assets, as of December 31, 1997: "Top 150 Banks Worldwide by Size of Assets", *The Banker* (July 1998).

[4] Task Force on the Future of the Canadian Financial Services Sector, *Report of the Task Force* (September 1998) at 113-114.

[5] The recently announced (August 16, 1999) proposed acquisition of Canada Trust by TD will provide a relatively early opportunity for both the Competition Bureau and the Minister of Finance to apply their experience in

the two prior bank mergers to a slightly smaller, but nevertheless significant financial sector merger.

[6] See, for example, M. Sanderson, "Bank Mega-Mergers: Current Enforcement Policy", paper presented at the ABA Section of Antitrust Law 47th Annual Spring Meeting (14 April 1999); J.W. Rowley and J.F. Clifford, "Canada says no to banking mega-mergers" (February/March 1999) *Global Competition Review* at 25. J. Bodrug & P. Crampton, "Structural Considerations Figure Prominently in Rejection of Canadian Bank Mergers" (February 1999) *Antitrust Report* at 50.

[7] Under the *Bank Act*, Schedule I Banks are required to be widely-held and no single shareholder is currently permitted to hold more than 10% of any class of shares of a Schedule I Bank. Schedule II Banks may be closely held by certain shareholders (widely-held Canadian financial institutions other than banks; eligible foreign banks or financial institutions; and any person for the first ten years of the bank's operations). The Minister of Finance has recently proposed changes that will raise the 10% limit to permit an investor to hold up to 20% a class of voting shares and 30% of a class of non-voting shares for widely-held banks with equity in excess of $5 billion. The new regime will also permit an investor to hold up to 65% of a medium-sized bank (equity between $1 billion and $5 billion) and 100% of a small bank (equity less than $1 billion: Department of Finance Canada, *Reforming Canada's Financial Services Sector: A Framework for the Future* (25 June 1999).

[8] Task Force on the Future of the Canadian Financial Services Sector, *Report of the Task Force* (September 1998) at 114.

[9] Task Force on the Future of the Canadian Financial Services Sector, *Report of the Task Force* (September 1998) at 99.

[10] As previously mentioned, TD has entered into an agreement with Imasco Limited, which controls Canada Trust, to purchase its interest in Canada Trust. That transaction is subject to obtaining regulatory clearance under the *Bank Act* and the Act.

[11] Legislation permitting the demutualization of life insurance companies is already in place and the process of conversion into stock companies of several high profile Canadian mutual life insurance companies is underway. Bill C-67, which amended the *Bank Act* permits foreign banks to operate directly through a branch of the parent foreign bank rather than through a separate domestic subsidiary in Canada and will thus create an increased possibility for entry and growth by foreign banks in Canada, came into force on June 30, 1999.

[12] *Supra*, note 6.

[13] A copy of the BMEGs may be found on the Bureau's web-site at http://strategis.ic.gc.ca

[14] Department of Finance Canada News Release, "Minister of Finance Comments on Proposed Bank Merger" (23 January 1998).

[15] In particular, the use of pre-defined markets developed by the Federal Reserve Board banks, the availability of data on a market-specific basis, and the use of concentration-based screening tests to screen out markets where concentration measures are not exceeded, have facilitated process issues in the United States. It is acknowledged that concurrent antitrust review by two regulators, the Federal Reserve Board (or the Office of the Controller of the Currency) and the Department of Justice, may complicate process issues.

[16] Copies of the Bureau's December 11, 1998 letters may be obtained on the Bureau's website at http://strategis.ic.gc.ca.

[17] As noted above, the review process for large mergers proposed in the Department of Finance White Paper dated June 25, 1999 will permit the negotiation and enforcement of remedial measures in the case of future large bank mergers.

[18] BMEGs, paras. 35 and 36.

[19] The business transactions account product market may, however, be seen as a cluster market, as it included transaction accounts and a number of related transaction services, e.g. night deposit and cash and coin services.

[20] The Bureau defined SME businesses as firms which borrow $1,000,000 or less, but looked separately at market share information for operating loans up to $200,000 and between $200,000 and $1,000,000.

[21] BMEGs, para. 59.

[22] Screening tests are also used in bank merger review cases in the United States by both the Department of

Justice and the Federal Reserve Board. The thresholds employed in the United States are expressed in terms of the effect of a merger on total market concentration, using the Herfindahl-Hirschman Index measure: see D.S. Neill, "U.S. Antitrust Considerations in Mergers and Acquisitions of Bank Holding Companies" (February 1999) *Antitrust Report* at 4.

[23] BMEGs paras 54-58.

[24] The CBA data contained a number of deficiencies. For example, the CBA database content was constructed based on returns made by financial institutions to the federal prudential regulator, OSFI, and the line items it contained were not necessarily reflective of relevant antitrust markets; items were reported by branch postal code rather than by customer postal code; certain loans and transactions were booked centrally through a single branch transit number thus overstating share for that branch and understating share for others.

Although the Bureau acknowledged that the CBA data on which the database was based was deficient in many respects, it took the position that the database it compiled was the best available in Canada at the time of the Bureau's merger review. The Bureau indicated that it would be willing to further discuss data reliability issues with the merging banks.

[25] The Bureau selected transaction account data as its market share because it is the core of the banking relationship for personal and business customers.

[26] (1992), 41 C.P.R. 3(d) 289 (Comp. Trib.).

[27] The Competition Bureau appears to have taken a similar approach in its recent assessment of the acquisition by Loblaw Companies Limited to Provigo Inc. and of certain assets of The Oshawa Group, a merger of food retailers. These local markets were categorized into "Green" (less than 35%) "Orange" (between 36% and 45%) and "Red" categories (greater than 45%) as part of the Bureau's assessment. See News Release, Competition Bureau "Divestitures key to resolving competition concerns in Loblaw transaction" (12 August 1999).

[28] See Commissioner's Merger Review Letters to the chairmen of Royal/BMO (pp. 19-20) and to CIBC/TD (pp 18-19).

[29] "Amex to test first savings account", *The Globe & Mail* (3 June 1999) at B1.

[30] For example, the activities of virtual banks are at present somewhat limited since customers must maintain a bank account at a traditional financial institution in order to access their funds.

[31] The Bureau in its Merger Review Letters viewed supermarket banking as a different delivery channel for traditional financial institutions rather than as a new mode of entry, and cited an existing joint venture between CIBC and one of Canada's major supermarket chains, Loblaws. On June 5, 1999, it was reported that Loblaws had obtained a trust company license which will permit it independently to offer retail financial services through its supermarkets: "Loblaws set to launch own trust company" *The Globe & Mail* (5 June 1999), p. B1. The Loblaws initiative demonstrates that supermarket banking can provide an effective means of new, independent entry.

[32] For the purposes of the Bureau's analysis, general purpose credit cards included both credit (e.g. Visa and MasterCard) and charge cards (eg. Diners Club/enRoute and American Express).

[33] The definition of duality employed by the DOJ, which ties duality to joint governance of the Visa and MasterCard card associations, is narrower than the industry definition, which explains duality as the ability to issue and/or acquire for both card brands.

[34] For example, it has been argued that the pending U.S. Department of Justice case may chill or delay mergers and acquisitions in the United States involving general purpose credit cards, and that at least one Request for Additional Information under the Hart-Scott-Rodino Act focussing on questions around duality has issued in connection with a credit card acquisition: see D.S. Neill, *supra*, note 21 at 32-33.

[35] A similar issue appears likely to arise in the proposed Canada Trust/TD merger as Canada Trust is a MasterCard member, while TD is a Visa member.

[36] Commissioner's Merger Review Letter to the chairmen of Royal and BMO, p. 26.

[37] The need to review both transactions concurrently also led the Bureau to base conclusions about one merger on assumptions about the other. For example, in the Merger Review Letter to CIBC and TD, the Commissioner outlined the Bureau's concerns about the dominance of a combined CIBC and TD in the Visa merchant acquiring

market and posited that, if as a result of the Royal/BMO merger Royal converted to MasterCard, CIBC and TD's dominance would be even greater.

[38] The Merger Review Letters do not refer to the 45% threshold in the investment banking context; rather, they state only that a substantial lessening of competition was likely to occur or might occur where the market shares possessed by the parties exceeded 35%.

[39] Merger Review Letter to Royal and BMO, p 33; Merger Review Letter to CIBC and TD, p. 31.

[40] Merger Review Letter to the Chairmen of Royal and BMO, p. 35.

[41] Merger Review Letter to the Chairmen of Royal and BMO, p. 35.

[42] The proposed Canada Trust/TD merger does not involve a combination of Schedule I banks, although Canada Trust is in 'absolute size' terms a significant financial industry competitor. Historically, acquisitions of even major trust companies by chartered banks have not encountered the same sort of difficulties in receiving regulatory clearance as the Royal/BMO and CIBC/TD mergers encountered.

EVALUATING CHALLENGES TO NON-PRICE VERTICAL RESTRAINTS

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1. Introduction

For years the courts and competition authorities in the United States and Canada have struggled with the question of whether vertical restraints should be *per se* legal or illegal, or subject to a rule of reason approach.[1] While competition law provisions covering vertical restraints stem from early concerns regarding their anti-competitive potential, economists have over the last 15 years established that vertical restraints frequently can be efficiency enhancing. Economists also have demonstrated that lawful vertical integration can (under certain conditions) duplicate the results of vertical restraints alleged by some to be anti-competitive. It makes little sense to prohibit vertical restraints with potentially efficiency or welfare enhancing effects if doing so will lead firms to adopt alternative business strategies that can achieve the same outcome, but at a higher cost to consumers and firms.

A review of the reported judicial and administrative tribunal decisions which have considered the legality of various non-price vertical restraints often reveals an absence of currently accepted economic rationale for conclusions that certain vertical restraints were anti-competitive. Many older cases drew little distinction between horizontal and vertical restraints. In others consideration of whether competition has been lessened substantially has been without the benefit of appropriate economic analysis.

In this paper, it is proposed that much of the difficulty in determining whether non-price vertical restraints are anti-competitive and unlawful could be addressed by adoption of a two part test:

(1) a logical and coherent economic theory should be presented that supports a conclusion that the vertical restraint will lessen competition under specified factual circumstances;

(2) formal proof should be presented that the specified factual circumstances exist in the subject case and competition has been substantially lessened as a result.

Given that the competition laws are used from time to time by businesses in an effort to obtain portions of their competitors' business by judicial fiat and to inhibit competition from rival firms, potentially welfare enhancing vertical restraints should not be presumed anti-competitive without proof justifying that conclusion.[2]

In the next section, we explain the need for an explicit two part test for anti-competitive and unlawful vertical restraints. An examination of some U.S. and Canadian cases in the light of current economic theory regarding vertical restraints illustrates the lack of economic logic in some decisions and the usefulness of the proposed test in forcing the parties to grapple with the relevant economic issues. The concluding section summarizes some common themes to the attacks on non-price vertical restraints in the cases examined and contains some concluding remarks.

2. A Two Part Test for Anti-Competitive Vertical Restraints

Since the late 1960's there has been a move in economics toward acceptance of the efficiency explanation for the majority of non-price vertical restraints. That was followed in law in the United States with the adoption of the rule of reason standard of analysis in the *Sylvania* case and subsequent court decisions.[3] In Canada in 1976 it was embodied in statute with the addition of the reviewable practices to the then *Combines Investigation Act*. However, some of the older case law, reliant on older economic theory, has not been expressly overruled or rejected in more recent cases. Given the role of precedent in legal decision making, that gives rise to potential for confusion.

Unfortunately neither the rule of reason in the United States nor the Competition Tribunal's interpretation of the reviewable practices in Canada provide a practical test to distinguish the claims with little or no merit from those which have substance. In order to succeed a complaint that a non-price vertical restraint is anti-competitive should have to pass a two part test:

(1) a logical and coherent economic theory should be presented that supports a conclusion that the vertical restraint will lessen competition under specified factual circumstances; and

(2) formal proof should be presented that the specified factual circumstances exist in the subject case and competition has been substantially lessened as a result.

The approach of requiring a complainant to prove adverse effects flowing from an alleged diminution of intrabrand competition which clearly outweigh any benefit which the restraint provides to the parties' ability to meet interbrand competition, fixes the onus where it clearly belongs — on the person claiming the restraint to have adverse anticompetitive effects.

We suggest that the proposed test captures the essence of the requirements which the U.S. courts have been applying *de facto* to vertical restraint cases since *Sylvania*. Defence summary judgment motions have succeeded where a plaintiff has failed to present a logical economic theory which could support its claims and evidence of the applicability of that theory to the facts of the case. In *Matsushita* the U.S. Supreme Court granted summary judgment dismissing an anti-trust claim where the plaintiff failed to present a theory of predatory pricing which made economic sense and where the plaintiff's evidence did

not reasonably tend to prove the theory.[4] This is consistent with our proposed test.

In Canada there has been no clear articulation of any test. In some cases the Commissioner of Competition (the "Commissioner") (formerly the Director of Investigation and Research (the "Director")) appears to have proceeded on the basis that it is only necessary to introduce evidence to meet the elements of the various reviewable practices and introduce an opinion from an economist that the respondent's conduct is anti-competitive (sometimes without any explanation of why that is so) in order to induce the Competition Tribunal to make an order prohibiting a practice or make some other direction. The Competition Tribunal seems to have fluctuated between checking off the elements without any analysis of the competitive effects (such as in the *Chrysler* and *Xerox* cases) and stating that a broader economic analysis is required (such as in the Tele-Direct case).[5]

There is benefit to society in articulation by the judicial and administrative tribunals of a clear test for proof of the anti-competitiveness of an impugned vertical restraint. Litigation over these issues can be costly and involve diversion of firm management from productive behaviour. Pro-competitive and productive behaviour should not be dissuaded by the threat of an uncertain result in the event the behaviour is challenged in litigation.

3. Applications of the Proposed Test

It is instructive to review a few representative vertical restraints cases in both the U.S. and Canada and consider how the decision might have been affected by the proposed test.

(a) Group Boycott Cases

In *Klor's Inc. v. Broadway-Hale Stores, Inc.*[6] Klor's Inc., a San Francisco department store, claimed that its competitor across the street, Broadway-Hale, and 10 national appliance manufacturers and their distributors had conspired to boycott Klor's (presumably as a result of some approach by Broadway-Hale). The defendants moved for summary dismissal of the claim, introducing evidence of little market power on the part of the defendants and that the manufacturers' products were sold by many other retailers in San Francisco. The Court dismissed the motion saying, if proved, the allegations constituted a *per se* offence under the *Sherman Act*.

The Court concluded that the group boycott of the plaintiff was anti-competitive. It applied no market power test, and there was no explanation of what motivated the manufacturers and their distributors to agree to the alleged boycott. The stated rationale for the decision was that a boycott deprived Klor's of a right to buy appliances in an open competitive market. The Court also seemed to see it as an effort to drive Klor's out of business. Why this would provide any benefit to the manufacturers and distributors is unexplained.

What is troubling about the case in the light of current economic knowledge is that no economic theory supporting the conclusion of anti-competitive behaviour was advanced. To the manufacturers and distributors both Klor's and Broadway-Hale's retail margins were a cost which increased the price paid for their products by consumers. It was in the manufacturers' and distributors' interests to keep those margins as low as possible, consistent with effective marketing of their products. On the reported facts of the case it is likely that it was a case of a retailer providing a higher level of service attempting to induce suppliers to choose between Broadway-Hale's higher service and higher margin retail operation and Klor's lower price and lower service alternative — the classic free rider complaint by the full service retailer.

Under our proposed test Klor's would have to present a logical and coherent economic theory of why the alleged boycotters' agreement to sell through one retailer, Broadway-Hale, rather than through both Broadway-Hale and Klor's was anti-competitive rather than efficiency enhancing. Second, Klor's would have to prove to the ordinary standard of proof that in fact the anti-competitive theory was what motivated the alleged boycotters.

In 1966 in *United States v. General Motors Corporation* the U.S. Supreme Court held General Motors and 3 of its dealer associations to have infringed s. 1 of the *Sherman Act* by engaging in collaborative action to cause dealers to stop dealing with discounters.[7] The Court noted that it was not a case of individual action by the manufacturer, but a joint collaborative action with the dealers to eliminate discounters.

The *General Motors* decision did not expressly analyze why General Motors was prepared to join the "conspiracy" of its dealers to boycott discounters. The decision was just over a year before the U.S. Supreme Court decided in *Schwinn* that unilateral vertical restraints were *per se* offences.[8] It is reasonable to infer that the Court in *General Motors* did not engage in a considered analysis of what motives General Motors would have had to cooperate with its authorized dealers to attempt to eliminate sales to discounters. The rationales might have varied from a desire to eliminate free riding type behaviour (more likely on the facts described in the judgment) to pressure from a dealer cartel (unlikely on the facts described in the judgment).

Like in the *Klor's* case, potentially efficiency enhancing activities were condemned as anti-competitive, not on the basis of a rational economic explanation, but apparently on the basis that it was behaviour engaged in by a group of economic actors. To General Motors the dealers' margins were a cost of vehicles sold to consumers at retail in competition with other auto manufacturers. General Motors had no rational incentive to increase its dealers' retail margins and thereby make its vehicles less competitive with other brands. It is more reasonable to surmise that the participation of General Motors was as a result of complaints by dealers of free riding behaviour than a desire by General Motors to increase

its dealers' profits for their own sake.

Under our test, on the facts recorded in the judgment, the claim probably would have been dismissed for failure to present a coherent and logical economic theory explaining why the efforts to eliminate discounters would lessen competition in the marketing of vehicles.[9] The second step of proving that the parties before the court engaged in the behaviour for the anti-competitive reasons posited by the economic theory would require successful completion of the first.

(b) Apple Computer

O.S.C. Corporation v. Apple Computer Inc. is more typical of the American approach since the articulation of the rule of reason in the *Sylvania* case.[10] Apple Computer Inc. marketed its computer products through a network of local retail outlets. Some of those dealers engaged in mail order sales. Apple decided to stop distributing its personal computers through dealers who engaged in mail order sales. Its position was that it wanted its computers distributed by retailers that offered sales support. It advised its dealers that they would be terminated if they engaged in mail order sales. The plaintiff, a dealer which had specialized in such sales, sued, alleging that the decision resulted from a conspiracy with dealers that had complained about price cutters such as the plaintiff and constituted a breach of s. 1 of the *Sherman Act*. The Ninth Circuit Court of Appeals refused to infer evidence of a conspiracy from complaints from the plaintiff's competitors followed by a decision of the manufacturer to terminate a noncomplying dealer. It also refused to find that elimination of a form of intrabrand competition by the mail order ban was anticompetitive under the rule of reason.

It is interesting to review the case in the context of the subsequent development of direct mail sales by personal computer manufacturers such as Dell. Apple chose to market its products with a high level of dealer product support and to eliminate the distribution channel of dealer mail order sales. To serve the demand of consumers who wanted the hardware without dealer product support, competitive manufacturers emerged and expanded.

Under our test the same result would have occurred. The only competitive impact which O.S.C. could actually prove (under step 2 of our test) was elimination of a form of intrabrand competition. However, it could advance no persuasive economic rationale as to why that would be anti-competitive where competitive alternatives were available. Although personal computer consumers who wanted an Apple brand personal computer without dealer sales and service support could not buy it without those attributes, interbrand competitors, such as Dell, took advantage of the demand for direct mail purchase (obviously at lower prices) to serve those consumers.

(c) Chrysler Canada

In 1989 in *Director of Investigation and Research v. Chrysler Canada Ltd.*[11] the complainant, Brunet, was a Canadian based exporter of Chrysler motor vehicle replacement parts outside of North America. Brunet purchased the parts from Chrysler Canada Ltd. and authorized Chrysler dealers in Canada. Chrysler Canada Ltd. implemented a policy under which it refused to sell parts to Brunet and it prohibited authorized dealers from selling parts to Brunet. The Director applied to the Canadian Competition Tribunal for an order requiring Chrysler Canada Ltd. to accept Brunet as a customer under s. 75 (refusal to deal) of the *Competition Act*. The Tribunal found that the Director had made out the elements necessary to justify an order requiring Chrysler Canada Ltd. to supply Brunet with Chrysler replacement parts.

The Competition Tribunal accepted the Director's argument that the starting point for the definition of the relevant product under the statute was Brunet's customers and the products they demanded. Brunet's customers wanted Chrysler replacement auto parts and those became the relevant product. Thus, when determining whether Brunet was unable to obtain adequate supplies of Chrysler auto parts because of insufficient competition, the Tribunal had no difficulty finding that, because Chrysler Canada Ltd. had created no competitors to itself in its distribution system, there was inadequate competition among suppliers in the market. When the product is defined as the branded goods of a manufacturer, it is hardly a surprise that it will not have competitors.[12]

Firms select the degree of competition in distribution of their products which the firms expect to maximize sales at the least cost. For some products, where the manufacturer desires maximum exposure to the consumer and requires minimum pre-sales or post-sales service by retailers (such as candy bars), the manufacturer may have an incentive to sell to a large number of outlets and encourage retail price competition among them to maximize sales and minimize retail margins. Other products which require significant pre-sales and/or post-sales service to market (such as large expensive earthmoving machines), may induce manufacturers to impose expensive service obligations on dealers, but also provide protection against free riding on the dealers' investments in that service. It would be inappropriate to expect the distribution system for the latter type of products to exhibit the characteristics of the perfectly competitive market of economic theory — (1) homogeneous products, (2) atomistic sellers, (3) atomistic buyers, (4) an absence of entry barriers, and (5) perfect information flow.

The Tribunal did not consider the competitive context in which Chrysler Canada and Brunet operated and the effect of its decision on competition generally. The Tribunal's analysis would allow retailers to dictate to suppliers the distribution structure which the supplier must employ. If it is the group of customers to which the retailer/distributor caters that defines the relevant product, and the willingness of consumers or users to substitute other brands of product is not considered in the relevant product determination, the supplier can be placed in the position of having to meet the demands of an unattractive and unauthorized retailer/distributor simply because he has found a group of customers who prefer the

supplier's brand products and chooses to deal in nothing else.[13]

Under the first part of our test the Tribunal would require the Director to present a lucid economic theory outlining how the alleged conduct of the respondent in refusing supply to a potential customer results from insufficient competition among the supplier and its competitors. Under the second, the Tribunal would examine whether the Director has proved the theory applicable to the conduct of the respondent. In the *Chrysler* case no serious consideration was given to the economic implications of defining the relevant product as the respondent's branded parts. There was no debate analogous to that in *Eastman Kodak Co. v. Image Technical Services, Inc.*[14] over the constraints imposed by interbrand competition in relation to prime products.

(d) Nielsen

Director of Investigation and Research v. D&B Companies of Canada Ltd.[15] (usually referred to as the *Nielsen* case) involved a challenge by the Director of Nielsen's system of exclusive contracts on the ground that they constituted an abuse of dominance under s.79 of the *Competition Act*. Nielsen's business under attack was its collection of sales data from cash register scanning equipment of grocers and related retailers, processing the data and selling the resulting sales data and analysis to product manufacturers for use in the manufacturers' marketing programs. Nielsen paid the retailers for the data, which cost the retailers little to provide. At the time of hearing by the Competition Tribunal Nielsen was the sole purchaser of scanner data from the major retailers in Canada and the sole source of the combined sales data to purchasing manufacturers. Nielsen entered into long term contracts with the retailers to supply the scanner data exclusively to Nielsen, and long term contracts with customers, all of which contracts provided significant incentives for exclusivity. Nielsen consciously arranged for staggered terms for those contracts so that at any point in time only a few retailers' contracts would be up for renewal.

The Director contended that the system of exclusive contracts created barriers to entry by any competitor to Nielsen because the competitor would not be able to obtain a sufficient share of the business to make entry profitable and consequently constituted market foreclosure. Manufacturers attached considerable significance to the fact that Nielsen's data was very complete because it encompassed sales by all major retailers.

In this case the Director and the Tribunal both approached the issues in the manner prescribed by our test. The Director advanced a logical and coherent economic anti-competitive theory. It was alleged that Nielsen utilized the vertical restraints of the exclusive contracts to foreclose horizontal competitors to Nielsen from emerging. The Director then presented evidence to support the contention that Nielsen implemented the system for the alleged purpose of market foreclosure. The Tribunal analyzed extensively whether the evidence presented by the parties supported the Director's contention, examined the

behaviour of potential competitors and compared the Canadian market conditions to those prevailing in other countries. The Tribunal concluded that Nielsen's system of exclusive sales contracts did foreclose competition by other potential suppliers of scanner based sales data and constituted an abuse of dominance. An order was issued prohibiting Nielsen from enforcing the exclusivity portions of contracts with retailers and eliminating exclusivity terms in contracts with its customers.

In a recent article on the Nielsen case Michal Gal contends that the Competition Tribunal's orders were insufficient to restore competition to the marketplace because the retailers had an economic incentive to continue selling the scanner data exclusively to Nielsen even in the absence of contractual requirements to do so.[16] She noted that in the two years following the decision no competitive collator and seller of scanner based sales data entered the market in competition with Nielsen. In her view the Director should have added the retail suppliers of the scanner data as respondents to the application and orders should have been issued requiring them to supply the data on competitive terms to any prospective purchaser.

In our view her contention raises some interesting issues. In the absence of the exclusivity provisions in the contracts with retailer suppliers of scanning data and manufacturer purchasers there do not appear to have been entry barriers to another firm competing for that business. There may have been an additional constraint upon any market power Nielsen might have. The retailers who sold the scanner sales data to Nielsen for prices significantly in excess of their costs of provision of the data were receiving an economic rent from Nielsen. If Nielsen was to attempt to reduce payment of that rent, the retailers (which were relatively large and few in number) were free to approach the manufacturers and sell the data directly. In a sense Nielsen was simply a distribution channel through which the retailers sold the scanner based data to the manufacturers. If the cost of selling the scanner data back to the manufacturers through Nielsen was disproportionate to the value of the services provided, the manufacturers would have an incentive to obtain the data directly from the retailers.[17]

(e) Tele-Direct

The Canadian Competition Tribunal examined whether Tele-Direct's requirement that customers of advertising space in Tele-Direct's Yellow Pages telephone directories utilize Tele-Direct's advertising services was anti-competitive tied selling under s. 77 of the *Competition Act* in 1997 in *Director of Investigation and Research v. Tele-Direct (Publications) Inc.*[18] The Director argued that Tele-Direct was tying the sale of advertising services to the sale of advertising space in Yellow Pages directories. While Tele-Direct was the only significant seller of the space, there was competition between Tele-Direct's own sales force and advertising agents for the advertising design and placement for larger customers. Tele-Direct only would pay a sales commission to advertising agents where the advertising was placed in at least 8 "markets", which generally required the advertising to be in more than one province and reduced the number of commissionable accounts available to agents.

The Director argued that he was only obliged to prove a practice involving a major supplier, two products, tying and exclusion of competitors resulting in a substantial lessening of competition. He had no obligation to provide a plausible explanation of why or how the firm benefits from the tie. However, he did submit that Tele-Direct was leveraging its market power in the sale of advertising space in the directories into a market for advertising services through tying. The Director sought an order requiring Tele-Direct to make all customer accounts commissionable for advertising agents.

The Tribunal concluded that telephone directory space and telephone directory advertising services were two distinct products for large advertisers, which had been tied by Tele-Direct. It required Tele-Direct to pay agents commissions where the advertising was placed in at least 6 "markets". However, it concluded that there was no significant demand for separate advertising space and advertising services for smaller accounts (nor any interest by the advertising agents in servicing such customers) and that they were not distinct products for smaller customers.[19]

It would appear that the Director lost sight of the reason why the reviewable practices are lawful until the Tribunal concludes otherwise. They may and often do have pro-competitive effects. Although the Director may not have to explain how the firm under scrutiny benefits from the tie, he must show why the alleged practice substantially lessens competition. The reasons of the Tribunal do not indicate any effort by the Director to do that. An explanation of leveraging market power in one market into the other was presented, but there was no effort to prove that Tele-Direct was doing that or the adverse effects of that leveraging on consumers of either product. It would seem that whether the consumer purchased advertising services from either the direct sales force or the commissioned agent the price to the consumer was the same.

The effect of the decision was the same as the Tribunal's decision in *Chrysler* — it protected the competitor who complained, not the competitive process. Once again the product markets were defined as the product of the firm under scrutiny — Yellow Pages advertising services and space. Once again, it is little surprise that the firm had a high share of that market and that not paying commissions to agencies substantially lessened competition for its own business.

This approach to vertical restraints by the Director is very troubling. Instead of identifying and attacking vertical restraints where they are shown to have provable anti-competitive effects (such as facilitation of horizontal cartels or market foreclosure as done in the *Nielsen case*), the Director effectively was challenging major firms' distribution and sales policies on the ground that other firms would like a share of the major firms' business.

(f) Caterpillar

Certain distribution policies of Caterpillar Inc. were alleged to be tools of an anti-competitive vertical conspiracy between Caterpillar and its authorized dealers in *Ed Miller Sales & Rentals Ltd. v. Caterpillar Tractor Co.*[20] The plaintiff Miller was a western Canadian unauthorized reseller of Caterpillar machines and machine replacement parts. Miller acquired machines and parts from authorized dealers in the United States, Europe and Asia and sold them to consumers in western Canada. Miller claimed that the following Caterpillar policies were anticompetitive: (1) machine allocation policies which allegedly discriminated against brokers and resellers; (2) the restriction of price protection available to resellers; (3) the requirement that dealers selling a machine pay a 5% service fee to dealers responsible for warranty service on the machine; (4) the policy of setting different selling prices in various countries of the world and of charging selling dealers the price for the countries in which the machines were delivered; and (5) the policy of prohibiting authorized dealers from selling replacement parts to foreign parts resellers.

Despite all of these alleged anti-competitive practices the plaintiff managed to source about 1300 new machines from authorized dealers in Canada, the United States and Europe between 1972 and 1986. The Alberta Court of Queen's Bench dismissed the conspiracy claims. The court noted that the manufacturer had no economic incentive to combine with its authorized dealers to confer monopolistic market power on the dealers because dealer monopoly profits would result in the manufacturer losing sales to interbrand competitors. To the extent that Caterpillar's distribution policies made Caterpillar machines unnecessarily expensive to consumers in western Canada, consumers would be driven to purchase machines from interbrand competitors such as Komatsu and Deere. The policies under attack were examined one by one by the Court and none found to be anti-competitive.[21]

The test which we propose would achieve the same result. The plaintiff did not put forward a coherent economic theory to support its allegation that the policies claimed to be tools of the conspiracy were anti-competitive. During argument the plaintiff contended that they operated to foreclose alternative distribution channels such as the plaintiff and other unauthorized resellers. However, where a manufacturer selling products for which there is interbrand competition chooses to eliminate a particular distribution channel, it is likely because the manufacturer believes it to enhance its competitive position in relation to its interbrand competitors. To the extent that certain "inframarginal customers" lose their preferred means of acquiring the product, interbrand competitors probably will serve that preference if it is economic to do so.

In *Miller v. Caterpillar* the plaintiff would have failed the second part of our test as well because it failed to prove the policies under attack had any anti-competitive effect.[22]

4. Conclusion

An element common to many of the cases which have been used as illustrations of the proposed test is that they have involved an unauthorized competitor of authorized distributors who complained that the supplier and the authorized distributors were excluding the complainant from dealing in the supplier's products. Where the complainant has succeeded it appears that it avoided presentation of any logical and coherent economic theory to support its claim. The complainant presented allegations of unfairness and market definitions which made the respondent's products the relevant market for scrutiny. The complainant then contrasted the respondent's high market share in its products with the model of atomistic perfect competition of economic theory. Why the respondent should be expected to structure distribution of its own products in that fashion is never explained.

Since non-price vertical restraints often have efficiency enhancing effects, it is inappropriate to characterize such a restraint as anti-competitive without a logical and coherent economic theory to explain why that is so. A court or other tribunal which is adjudicating an allegation that a particular vertical restraint is anti-competitive should require the complainant to show that there is a rational and sound reason why the vertical restraint under attack lessens competition in the market in which the business which imposes that restraint operates (and not just within its own distribution system). A firm imposing an impugned restraint may have a substantial market share. However, where there is interbrand competition and there is sufficient consumer demand for supply of the product free of the restraint, presumably an interbrand competitor will supply the product free of the restraint if it is economically efficient to do so.

Adoption of the two part test presented in this paper will not eliminate all of the difficulty in adjudicating upon the pro-competitive or anti-competitive effect of non-price vertical restraints. However, it should require the parties to the adjudication to address the fundamental issues in an organized and logical fashion and thereby enable the adjudicating body to do the same.

Notes

* The views expressed in this paper are the authors' own and do not necessarily reflect the views of the Commissioner of Competition or the Competition Bureau.

1 Vertical restraints are restrictions which a firm at one stage of the production and distribution process imposes on the conduct of firms at another stage of the process. Non-price vertical restraints include exclusive dealing and territorial limitations or exclusivity.

2 Our proposed test is consistent with the views of Richard Schmalensee, "On the Use of Economic Models in Antitrust: The *Realemon* Case", 127 Univ. Of Penn. Law Rev. 994 (1979), who argued for the use of economic models in antitrust analysis. "If antitrust law is to be at least partially concerned with efficient resource use, any judgment, whether by court or commentator, that some action should be found unlawful or some relief imposed in any particular case must be based, at least partially, on some explicit or implicit model that predicts the effects of the action or relief considered. Unless economic efficiency is held to be of no importance, one can no more avoid the use of economic models in this context than one can avoid speaking prose."

3 *Continental T.V. Inc. v. GTE Sylvania Inc.* 433 U.S. 36, 97 S Ct. 2549, 53 L Ed 2d 568, (1977).

[4] *Matsushita Electric Industrial Co. Ltd. v. Zenith Radio Corp.* 475 U.S. 574; 106 S Ct. 1348; 89 L. Ed. 2d 538 (1986).

[5] *Director of Investigation and Research v. Chrysler Canada Ltd.* (1989), 27 C.P.R. (3d) 1 (Comp. Trib.); *Director of Investigation and Research v. Xerox Canada Inc.* (1990) 33 C.P.R. (3d) 83 (Comp. Trib.); *Director of Investigation and Research v. Tele-Direct (Publications) Inc.* (1997), 73 C.P.R. (3d) 1 (Comp. Trib.) It should be noted that both *Chrysler* and *Xerox* are s. 75 refusal to deal cases. Although insufficient competition among suppliers must be proved, there is no express substantial lessening of competition test in that provision.

[6] *Klor's Inc. v. Broadway-Hale Stores, Inc.*, 359 U.S. 207, 79 S Ct. 705 (1959). The ABA Section of Antitrust Law, *Antitrust Law Developments* (4th Edition) at p.100 treats *Klor's* as a case of horizontal agreement constituting a concerted refusal to deal. In our view it should be analyzed as a vertical restraint case. It does, after all, deal with the manufacturers' refusal to deal with a downstream firm.

[7] *United States v. General Motors Corporation*, 384 U.S. 127, 86 S Ct. 1321 (1966).

[8] *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365, 87 S Çt. 1856 (1967), In *Sylvania, supra* note 3, the U.S. Supreme Court reconsidered its decision in *Schwinn* and overruled it.

[9] The U.S. Supreme Court has not overturned either its decision in *Klor's* or its decision in *General Motors*. However, it has moved to limit the application of the group boycott doctrine: *Monsanto Co. v. Spray-rite Service Corp.* 465 U.S. 752, 104 S Ct. 1464, 79 L Ed 2d 775 (1984).

[10] *O.S.C. Corporation v. Apple Computer Inc.* 792 F.2d. 1464 (9th Cir. 1986).

[11] *Director of Investigation and Research v. Chrysler Canada Ltd, supra,* note 5.

[12] In analyzing whether there was insufficient competition with respect to the product of Chrysler auto parts, the Competition Tribunal could have considered how interbrand competition among automobile manufacturers may have constrained Chrysler's parts pricing. Such an analysis would take into account the real competitive situation faced by the supplier. Otherwise, even the manufacturers with minuscule sales levels and market power, such as those described in *Sylvania*, are subject to s. 75 orders because of "insufficient competition" in connection with their repair parts sales.

[13] The subsequent inquiry into the availability of the product elsewhere in the market and whether the product is unavailable due to insufficient competition becomes a tautology.

[14] *Eastman Kodak Co. v. Image Technical Services, Inc.* 504 U.S. 451, 112 S Ct. 2072, 119 L Ed. 2d 265 (1992).

[15] *Director of Investigation and Research v. D&B Companies Ltd.* (1995) 64 C.P.R. (3d) 216 (Comp. Trib.).

[16] Michal Gal, "The Nielsen Case: Was Competition Restored?", 29 Canadian Business Law Journal 17 (1997).

[17] Either the retailer suppliers or the manufacturer purchasers might have to process and collate the scanner sales data in order to make it useful to the manufacturers, but at some point it would be economic for the retailers and manufacturers to incur the costs of doing so to dispense with Nielsen's charges for its services.

[18] *Director of Investigation and Research v. Tele-Direct (Publications) Inc., supra,* at note 5.

[19] Tele-Direct's refusal to recognize or deal with advertising consultants who were paid by advertising customers from "savings" the consultants achieved for the customers also was attacked by the Director as an abuse of dominance. The refusal to deal with consultants was determined to be an abuse of dominance. Tele-Direct was directed to treat customers who used consultants no differently than those which did not and not to interfere with the relationship between the consultant and the advertiser.

[20] *Ed Miller Sales & Rentals Ltd. v. Caterpillar Tractor Co.*, [1994] 5 W.W.R. 473, 151 A.R. 1, 17 Alta. L.R. (3d) 251, 54 C.P.R. (3d) 251 (Alta. Q.B.). The plaintiff alleged a conspiracy to lessen competition unduly contrary to s.45 of the *Competition Act* and a common law conspiracy incorporating the reviewable practices of refusal to deal and market restriction as unlawful elements of the conspiracy.

[21] Although the trial court dismissed the conspiracy claim, it did find the defendant Caterpillar Tractor Co. to be liable to the plaintiff for the torts of: (1) interference in contractual relations between the plaintiff and one of Caterpillar's authorized dealers; and (2) unlawful interference in Miller's economic relations with the authorized dealer in relation to replacement parts. However, that was reversed on appeal and the entire claim of the plaintiff dismissed: *Ed Miller Sales & Rentals Ltd. V. Caterpillar Tractor Co.* [1996] 9 W.W.R. 449, 187 A.R. 81, 41 Alta. L.R. (3d) 217, 69 C.P.R. (3d) (Alta. C.A.).

[22] The writers participated in this case as counsel and expert economist for the defendant.

COMPETITION IN ELECTRONIC BANKING NETWORKS: REPLY TO RIVARD AND WARE

By: G. Frank Mathewson, University of Toronto and Charles River Associates and
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1. Introduction

In the summer 1997 edition of the *Record*, we ("MQ") published a paper about the impact of regulation on competition in the Canadian payments system.[1] In commenting on our paper, Brian Rivard and Roger Ware ("RW")[2] misinterpret our message as offering a critique of the Competition Bureau's case and Consent Order in the Interac case.[3] In this note we begin with a brief restatement of our views, pointing out how they differ from those that RW impute to us. More substantially, we consider the key issues where we have a different professional judgement about the potential for competition in a market such as that for shared electronic financial services ("SEFS"), and the impact of the regulatory environment on this market. Finally, we use the example of the competition within the New Zealand payments system to support our claim that in a deregulated environment competition within and across electronic funds networks can and will develop.

2. Setting the Record Straight

We claim that RW misinterpret our earlier message in two fundamental ways

- Our article was not intended to be a critique of either the Bureau's case or the *Interac* Consent Order. It was, however, intended to be a critique of the legislative framework associated with the payments system. We accept that the substantial lessening of competition arising from the actions of the charter members of Interac was a legitimate target for action by the Bureau, and that some increase in competition will be achieved as a result of the Consent Order. We argue that liberalizing membership in the payments system would produce still a lot more competition.

- RW summarize our argument as being "...that Interac was the wrong target for a competition policy intervention, and that the correct target is the CPA" (the Canadian Payments Association).[4] In our original paper we say that in issuing the consent order "...the Tribunal recognized that .... (c) the prohibition on non-deposit taking institutions participating in the clearing mechanism of Interac is a matter that the CPA has the power to regulate; and (d) the lawful actions of the CPA could not be challenged by the Tribunal".[5] So we support the MacKay Task Force[6] in its view that legislators have to address the competition problems created by the Canadian Payments Association Act (the "CPA Act"), but we understand that the Consent Order negotiated by the Bureau could not address legislative issues.

3. Competition Within and Between Networks

RW explain the impact of the focus of the Consent Order on promoting intrasystem competition in the market for SEFS. The members of Interac had market power through their joint ownership of Interac (the shared electronic network services "required to enable network participants ... to provide the final product"[7]) and their ownership of proprietary bank machines ("ATMs") and point-of-sale ("POS") terminals. The members of Interac also engaged in anti-competitive practices that restricted intrasystem competition through barriers to entry and limitations on competition between members. We accept that the Bureau had to address this substantial lessening of competition from the dominance and practices of the Interac members. Our focus, however, was on two distinct issues:

(1) Why were the members of Interac so successful in establishing dominance and co-operation to enforce rules and practices that were anti-competitive?

(2) Why have competing systems not emerged in response to the inefficient practices of Interac?

We think that the legislative framework provided by the CPA Act contributes in a material way to reducing competitive vigor in this market because it promotes co-operation between the major deposit-taking institutions and provides them with a convenient mechanism to limit intersystem and intrasystem competition.

4. Joint Venture Stability and the Framework for Co-Operation

RW claim that "...it is quite erroneous to argue, as MQ have, that a change in the framework and regulations of the CPA to allow broader CPA access to financial service providers would have been *sufficient* to restore competition in the markets identified by the Director in the Interac case".[8] To support this claim, RW use examples of past actions by the members of Interac that had the effect of lessening competition, and claim that these actions would have continued.

We accept that breaches of competition policy may occur in a wide variety of market environments but we do not accept that the past actions of the members of Interac are necessarily a guide to the way in which they would act in a deregulated market. In contrast to Interac, deregulation enhances the channels through which competition may occur. The CPA Act imposes on the Canadian payments system a common-user framework that requires standardization and compatibility, reducing the scope for the development of alternative network technologies and thus the potential for competition. If a much wider base of types of institutions could be linked directly to the payments system, for example, then each current member of Interac could face an incentive to break with the existing Interac agreement to establish or join a competing system.

RW claim that "...without the *Interac* Consent Order the chartered members of Interac would have likely established restrictive eligibility criteria to preclude unwanted participants from accessing the Interac Network. The only recourse of these institutions would have been to attempt to join together with other excluded institutions to start their own electronic funds network, requiring a large scale investment in terminals".[9] We maintain that this investment need not be prohibitive. Consider institutions currently excluded from the payments system but included under deregulation. If these formerly excluded institutions could viably form competing terminal networks then charter members of Interac could find it in their individual self-interest to sign co-operative agreements with competing networks to link their own terminal to those of these entrants. Our point is that the current payments regulations do not permit such an option.

To be clear about this, consider the following. Suppose that deregulation of the payments system permits coalitions of insurers and mutual funds to have access to the payments system. These coalitions could then offer debit cards to their clients. Debit cards would permit these clients to withdraw funds held in money market investments managed by these companies. The coalitions would need to create a system to facilitate electronic clearing and settlement of the corresponding transactions. For example, these clients would have the option to use their debit cards to purchase goods and services from merchants provided the merchants could verify the accounts and acceptance of the transactions by the institutions issuing the debit cards. The choice for the merchant is twofold, to have either two terminals, one for the system used by the merchant's bank and the other for the new system, or one terminal with the system used by the merchant's bank connected via a gateway to the new system.

Efficiency would be served if the two systems (that of the incumbents and the entrants) were interconnected. Would the merchant's bank or the system where it is a member have an incentive to establish an interconnection arrangement with the new system? Denying access might in the short run reduce the value of the new card and serve to forestall competition. But if the new network proved sustainable, then it would be in the interests of the merchant's bank to facilitate interconnection so that it could increase its revenue by accepting a larger number of transactions. Since it is likely that the corresponding transaction charges would be larger than the marginal cost of facilitating the interconnection, interconnecting would be a profit-maximizing strategy for the merchant's bank. At the same time, an interconnection agreement would enhance the viability of the new system even if it did not have a large network of terminals of its own.

The existence of a second network offers choice to consumers and promotes competition even in the presence of interconnection, since fees and service levels can vary. The equilibrium number of networks will depend on the efficient size of networks but there is no *a priori* reason to believe that this number is one. The equilibrium number of networks supported, for example in Canada, is an empirical issue. The issue becomes real and not hypothetical if in the presence of open competition amongst networks and equal access to the payments mechanism, several networks can survive. We pursue below the facts in the context of New Zealand, a country with a population base approximately 15% that of Canada's.

5. Economies of Scope

RW downplay the importance of economies of scope. We, however, think that they are important in this market. One reason is the observation that the firms who issue cards facilitating electronic access to funds and the firms that own ATMs or POS terminals usually combine these with some linked activity. That activity need not be a financial service. For example, retail stores who own the POS terminals or ATMs located in their stores are selling cash convenience with the goods and services in their outlets, an economy of scope. A second reason is that economies of scope appear in the emergence of competing networks. In our original paper and above, we use the example of a clearing system initiated by insurer/ mutual fund coalitions where debit cards and cash withdrawal are combined with investment accounts, pension plans and insurance. Other examples include telecommunications and data / messaging companies. Insurers and mutual funds possess the "deposit" base to make issuing feasible but direct entry of these transactions into the clearing and settlement system is not possible given the rules of the CPA.

6. Is the Existing Network of ATM's an Essential Facility?

RW discuss at length the question of essential facilities. They agree with our conclusion that the messaging system of Interac is not an essential facility, but claim that we have missed the point.

> "The barrier to entry, or essential input that is economically infeasible to duplicate, is different for potential issuers and potential acquirers. For issuers it is the installed network of terminals, plus some access to the settlement system for transactions. For potential new acquirers, such as retailers, the essential input is access to the installed base of Interac cardholders together, again, with access to a settlement system. Each of these would be difficult or prohibitively expensive to duplicate by new entrants in order to create a competing network."[10]

We do not see the existing facility as a barrier to entry. The economic feasibility of duplicating a network of terminals does not appear to us relevant to the question of whether entrants will have to bear costs that incumbents did not have to bear. Neither do we understand the simultaneous claim that RW appear to advance that the existing network of ABM terminals cannot be duplicated in a cost-effective manner and that large scale new entry will occur as a result of the implementation of the Consent Order.

Whatever the potential for new entry given the existing definition of "deposits", our belief is that the potential for competition and for entry would be greatly enhanced if

(1) the funds managed by mutual funds and life insurance companies were accessible through Interac or similar networks, and

(2) mutual funds and insurers could both issue cards and purchase terminals that provided for

direct clearing and settlement through the payments system.

Our point is that whatever the economic feasibility of duplication, legislative restrictions that prohibit transactions on those funds held by mutual funds and insurers from entering directly into the clearing and settlement system run by the CPA make it impossible for these institutions to establish a competing network. If an existing network such as that associated with Interac chooses not to deal with these new entrants on reasonable terms, the terms of the CPA Act ensure that they face no threat of competitive bypass through the establishment of an independent network linked directly to the payments system.

7. An Example: Deregulation and Competition in the New Zealand Payments System

Since the mid-1980s, the financial system of New Zealand (including the payment system) has been the least regulated in any industrialized country. No specific legislation or regulatory requirements govern the payments system in New Zealand. The operation of individual networks is governed only by the conditions agreed between the participants and the application of commercial law / competition policy. The central bank, the Reserve Bank of New Zealand, is not involved in the management of the payments system except through its role as the operator of the settlement accounts and the Austraclear settlement system. The Reserve Bank is on record as indicating that even though only registered banks operate settlement accounts at this time, an account would be provided to any institution that was able to demonstrate the need and the technological capacity to operate it.[11] The market for traditional deposit-taking institutions is therefore fully contestable.

With respect to retail payments instruments, non-bank institutions may enter into commercial arrangements to issue credit, electronic funds transfer at the point of sale ("EFTPOS"), or ATM cards by having these cleared and settled by institutions that are direct participants in clearing and settlement.[12] A range of institutions that are not registered banks issue different types of payment instruments under such commercial arrangements, and these enter directly into the payments system for clearing and settlement.

Despite the small size of the New Zealand financial system, there are six different messaging systems providing for payment instruments to be electronically processed, three of which communicate directly with the software operating the settlement accounts at the Reserve Bank of New Zealand (Figure 1). Four of the messaging systems are owned and operated by joint ventures:[13]

- Interchange and Settlement Limited ("ISL"),
- Kiwi Inter-bank Transfer System ("KITS"),
- Electronic Transaction Services Limited ("ETSL"), and
- Same-Day Cleared Payments ("SCP") – a new system not fully implemented at present.

In addition there are two proprietary systems:

- Austraclear (operated by the Reserve Bank), and
- ANZ (operated by ANZ Banking Group).

Of particular importance for our claim is that ETSL and the ANZ operated system compete directly in the processing of EFTPOS and electronic credit card transactions. ANZ operates a competing system to gain greater strategic flexibility than could be obtained by operating a switch in ETSL, but competition has ensured that both systems take the cards of all major issuers. In other words, there is an interconnection contract between the two systems that facilitates cards issued by members of ETSL being used at ANZ terminals. In practice, all of the ANZ, ETSL and ISL systems are capable of competing for business across the whole of the retail electronic payments sector if their owners perceive profits from doing so. In addition, we note that each system uses the services of competing communications and data processing services to process transactions, the dominant players being Telecom New Zealand Limited and EDS Limited.

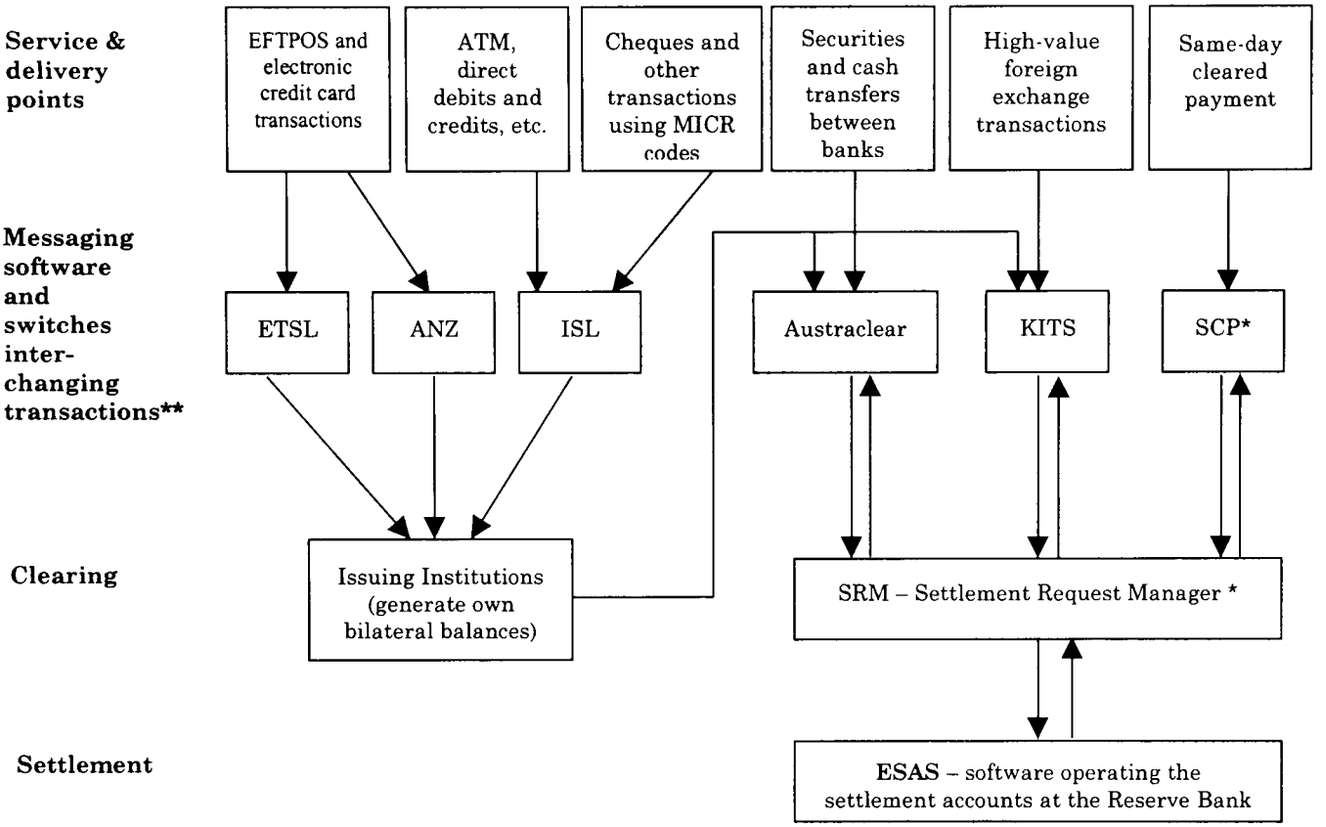
The New Zealand experience supports the claim that in a deregulated environment both intersystem and intrasystem competition will be present, and that economies of scope will result in the participation of firms from outside the financial sector.

8. Conclusion

By mistakenly interpreting our article as a critique of the actions of the Bureau in Interac, RW criticize views that we do not hold. The message of our original paper is this: in Interac the Bureau addressed some particular anti-competitive practices, but was unable to address the competition problems that arise throughout the payments system as a result of the CPA Act. Our view is that the CPA Act creates barriers to entry (for non-deposit-taking institutions) and encourages bank co-operation. Both limit the scope for competition and facilitate the creation and abuse of dominant positions.

RW do highlight different views between us on competition issues in this market. Based on the New Zealand evidence, we believe that positive network externalities and essential facilities are not a promising basis to justify public policy that relies on intrasystem over intersystem competition. Where payment system rules are more liberal, both intrasystem and intersystem competition exist. In the future, the potential for entry by non-deposit-taking firms is likely to be important in maintaining the viability of competition between networks. Public policy rules that promote co-operation within single joint ventures should be removed. Competition between networks and joint venture instability will be a positive outcome of this liberalization.

Figure 1: The New Zealand Interchange Payments System in 1998



* Managed by Interchange and Settlement Limited (ISL)

** Various data processing companies provide these companies with services at this stage, in order to get transaction information to the banks.

Notes

1 G.F. Mathewson and N.C. Quigley, "What's Essential, What's Prudential, What Can Competition Provide?" (1997) 18:2 Can. Comp. Rec. 11.

2 B. Rivard and R. Ware, "*Interac*, Essential Facilities and Access to Electronic Funds Networks: A Comment on Mathewson and Quigley," (1997-1998) 18:4 Can. Comp. Rec. 12.

3 Director of Investigation and Research v. Bank of Montreal (1996) CT-95/2 (Comp. Trials) (hereinafter "*Interac*").

4 *Supra*, note 2 at 17.

5 *Supra*, note 1 at 20.

6 Task Force on the Future of the Canadian Financial Services Sector, *Report of the Task Force*, Department of Finance, Government of Canada, September 1998.

7 *Supra*, note 2 at 16.

8 *Supra*, note 2 at 12.

9 *Supra*, note 2 at 14.

10 *Supra*, note 2 at 17.

11 New Zealand provides registered bank status to institutions who meet international capital adequacy standards and certain disclosure requirements, but it is not necessary to be a registered bank to undertake the business of banking.

12 The following material on the New Zealand payment system draws heavily on L.T. Evans and N.C. Quigley (1998) "Common Elements in the Telecommunications, Electricity and Payments Markets", mimeo, New Zealand Institute for the Study of Competition and Regulation, Wellington, New Zealand.

13 The composition of ownership in each joint venture is unique.

THE STATE OF EFFICIENCIES IN CANADIAN MERGER POLICY

By: Michael Trebilcock and
Ralph A. Winter*

Introduction

Commentators have often claimed that Canada's competition legislation is among the most economically sophisticated in the world. In large part, this claim is based on the explicit recognition given to efficiency as an overall criterion in the *Competition Act* (the "Act") (section 1.1) and as a specific criterion in the treatment of mergers. Section 96 of the Act prohibits the Competition Tribunal from making an order against a merger if the proposed merger would bring about gains in efficiency that are greater than, and would offset, any prevention or lessening of competition, provided that these gains would not likely be attained without the merger. A merger involving a substantial lessening of competition that would otherwise indicate a remedy or prohibition under section 92 of the Act may be permitted under section 96.

Unfortunately, application of section 96 and the entire role of efficiencies in merger review has become disturbingly uncertain. The uncertainty lies in the interpretation of the tradeoff implied in the section between the anticompetitive effects of a merger and the efficiencies, such as cost savings, arising from the merger.

In the view of some observers, including most economists, the appropriate standard for balancing anticompetitive effects and efficiencies is the total surplus standard. Under this standard, a merger would survive scrutiny provided that the merger increases the total surplus of market participants. Surplus to shareholders is measured by profits and surplus to consumers is measured by the value they attach to products over the prices that they pay for the products. Under this approach, the anticompetitive effect of a merger is measured by deadweight loss: the loss in consumer surplus from higher prices that is not offset by an increase in profits. (In a market where each consumer buys at most one unit, the deadweight loss can be thought of as the surplus over competitive prices lost by consumers priced out of the market.) Transfers from consumers to firms, i.e. to shareholders, do not count as a loss. Since most loss in consumer surplus is a transfer to shareholders, the deadweight loss resulting from a price increase is typically quite small. Even a modest savings in costs as a result of a merger can offset the effects of a price increase under the total surplus standard.

In *obiter* in the *Hillsdown* case, the Tribunal questioned the total surplus standard interpretation of section 96:

> "If only allocative inefficiency or the deadweight loss to the Canadian economy was intended by Parliament to be weighed in the balance then one would

> have thought that the section would have been drafted to specifically so provide. The interpretation which both the Director and the respondents put on s. 96 requires a reading down of the phrase "effects of substantial lessening of" so that it does not include the transfers from consumers to producers which will generally be the largest effect of the substantial lessening."[1]

The Tribunal's *obiter* in *Hillsdown* was criticized by some economic commentators for creating uncertainty in the welfare standards that are to be employed in assessing a tradeoff between efficiencies and lessening of competition in merger review.[2] Following *Hillsdown*, the case law provides no firm direction in the interpretation of section 96.

A practicing lawyer would reasonably turn to the Competition Bureau for guidance on efficiency-balancing criteria. Merger review by the Bureau is the most important hurdle in practice; only three mergers have been challenged before the Tribunal under the 1986 Act. Bureau statements, however, reveal a bewildering range of positions:

(1) The total surplus standard as expressed in section 5 of the Merger Enforcement Guidelines ("MEGs"):

> "Where a merger results in a price increase, it brings about both a neutral redistribution effect* and a negative resource allocation effect on the sum of producer and consumer surplus (total surplus) within Canada. The efficiency gains described above are balanced against the latter effect, i.e., the deadweight loss to the Canadian economy." [footnote: * "When a dollar is transferred from a buyer to a seller, it cannot be determined *a priori* who is more deserving, or in whose hands it has a greater value."][3]

Following Hillsdown, Howard Wetston, then Director of Investigation and Research at the Bureau, stated that he was "of the view that, from an enforcement perspective, it is preferable not to depart at this time from the approach adopted in the Merger Enforcement Guidelines".[4]

(2) A statement by the Commissioner of Competition in his address to the Canadian Bar Association in September 1999 that the following was one of two "fundamental principles" argued by the Bureau in the proposed merger of Superior Propane and ICG Propane: "no merger to monopoly could ever, by definition, bring about gains in efficiency that offset the effects of the merger on competition."[5]

(3) A detailed if somewhat abstract explanation of the Bureau's position on efficiencies after Hillsdown offered by Gwillym Allen, in a speech at a conference on May 3 of last year, and currently published on the Bureau's web site. In cases where a merger creates a substantial lessening of competition but would pass under the total surplus standard, the Bureau "feels that it is more appropriate for the Competition Tribunal to determine whether the merger

increases aggregate welfare or not."[6]

(4) A two-stage test described by Mr. Allen even more recently (by seven weeks) than his May speech.[7] Under the first stage of this test, if all buyers are similar and the quantity purchased of the product is independent or almost independent of income, then the total surplus criterion will be used by the Bureau. Under the second stage (which applies if the criteria in the first stage fail), the Bureau seeks to determine whether the transfers arising from the merger can be considered neutral.

This article provides a critical evaluation of the positions taken by the Competition Bureau.

The Competition Commissioner's Statement and the Economics of Merger to Monopoly

We first focus on the recent statement by the Commissioner of Competition that no merger to monopoly can entail offsetting efficiencies. What does the Commissioner mean by a "merger to monopoly"? To the layperson or undergraduate economics student, "monopoly" refers to a firm that sells free of any competitive discipline a product with no substitutes. A monopoly so-defined is fictional. Every product has some alternatives, if only because a consumer can keep the "cash" to purchase other commodities and services. Market power is a matter of degree, so a "monopoly" is not categorically defined. An alternative interpretation of "merger to monopoly" is a merger that would leave a single firm producing in the relevant market, where relevant market is defined as in the MEGs: "Conceptually, a relevant market for merger analysis under the Act is defined in terms of the smallest group of products and smallest geographic area in relation to which sellers, if acting as a single firm (a 'hypothetical monopolist') that was the only seller of those products in that area, could profitably impose and sustain a significant and nontransitory price increase above levels that would likely exist in the absence of the merger."[8] The following meanings are attached to the words significant and nontransitory: "In most contexts, the Bureau considers a five percent price increase to be significant, and a one year period to be nontransitory."[9] This is the only meaningful interpretation of "merger to monopoly" in the Commissioner's statement. The interpretation is natural in any case because the Bureau, which the Commissioner heads, produced the guidelines.

Under the Bureau's hypothetical monopolist test, products sold by two merging firms constitute a market if the merging firms, in the absence of a change in their unit costs, could profitably raise prices by five percent. This yields the following. Whatever the actual cost savings and resulting price effects, a merger is a "merger to monopoly" if the merging firms *would have* raised price by five percent with unchanged costs. This meaning of merger to monopoly, which is reasonably attributed to the Commissioner, is important because it applies to a much broader range of circumstances than might appear to be the case for someone inexperienced in competition policy.

The impact of a merger on prices requires some elaboration. To the extent that the merger entails

a reduction in competition, prices tend to increase. To the extent that marginal costs fall because of efficiencies, prices will decline: a profit-maximizing firm always marks up price over cost in proportion to the inverse elasticity of demand faced by the firm.[10] Unless demand is completely price insensitive (up to some price level), a firm will always respond to falling marginal cost by dropping price.[11] The optimal price is affected by cost, as well as the elasticity of demand.

Even a merger to monopoly can lead to price decreases. In the case of linear demand and per unit costs that are invariant to quantity (to take a simple and commonly invoked example) a firm will pass on to consumers 50 cents of each dollar of savings in per unit cost. If a firm experiences a drop in per unit cost of 10 percent, consumers can expect a price decrease of five percent, relative to the price at the original cost level. In the case of a merger to monopoly that would have involved a price increase of five percent if costs had not changed, a cost saving of greater than 10 percent is enough to lead to a price decline.

Such a merger involves a lessening of competition, since two competitors are merged into one, as well as an increase in price-cost margins. "Lessening of competition" in the Act cannot be measured by price, since price is affected by both lessening of competition and efficiencies, which the Act recognizes as distinct. Efficiencies are balanced against anticompetitive effects; the dominance of efficiencies does not as a matter of language deny the possibility of anticompetitive effects.

The Commissioner's statement that efficiencies can never offset a merger to monopoly means that even a merger to monopoly that leads to price decreases would be challenged by the Bureau. As a matter of economics, this is problematic. A merger that leads to price decreases yields positive benefits to both shareholders and consumers. All parties affected by the merger may benefit, yet according to the Commissioner the merger would be challenged.[12]

The Competition Commissioner's Statement and the Law

We turn now from the economics to the law. Is the Commissioner's statement consistent with Canadian law? The Commissioner's statement that efficiency effects cannot possibly offset a merger to monopoly contradicts section 92(2), which states that the Tribunal shall not find that a merger substantially lessens competition solely on the basis of market share or concentration. Section 92(2) contains no exception for the case of a combined market share of 100 (monopoly). Similarly, section 96 addressing efficiencies contains no exception for merger to monopoly, nor could it without being self-contradictory.

The Commissioner's statement also contradicts an important principle in competition policy, that the competitive discipline imposed on a firm depends not just on market share but on the potential for entry into the market and, as the Tribunal noted in *Hillsdown*, on competition from substitution to products outside any precisely defined market.

Furthermore, the standard implied by the Commissioner's statement is even more restrictive than the

U.S. price test.[13] Canada, with a small open economy and generally a lower scale of production in most industries, has never had a more restrictive competition policy than the U.S. It is also inconsistent with the *obiter* in *Hillsdown* which would permit a merger to monopoly provided that the cost savings from the merger offset both the deadweight loss and the transfer of consumer surplus to producers.

Finally, the Commissioner's statement is directly contrary to the Bureau's official position in the MEGs that it will assess gains in producer surplus and gains in consumer surplus with equal weight.

The Competition Bureau's May 1999 Position

We turn next to the position (3 in our list) taken by the Bureau in a May 1999 speech by Gwillym Allen. In practice, obtaining approval of a merger at the level of Bureau review is the key step in meeting legal requirements: merger review at the level of the Tribunal is so cumbersome that only three contested mergers have been brought to the Tribunal.[14] The Bureau's position that it will bring to the Tribunal any cases for which a successful efficiency defense requires acceptance of the total surplus standard has, for many and perhaps most cases, the same effect as rejecting the standard.

The Competition Bureau's June 1999 Position

The final position is the two-stage test proposed by the Bureau. The full description of this test is as follows:

> "Stage 1:
>
> In stage 1, the Bureau examines the case evidence to ascertain whether total surplus can be used to effect the 'greater than' and 'offset' tradeoff. For example, if it is determined that:
>
> - Our Buyers facing the same price have approximately equivalent expenditure shares on the relevant product;
> - Buyers' expenditures on the relevant product [are] virtually independent of [their] total expenditure[s]; and,
> - Buyers are similar across relevant geographic markets
>
> then it may be reasonable to use total surplus to determine whether the cost savings are 'greater than' and 'offset' the anti-competitive losses. However, if the evidence does not suggest that all anti-competitive effects are comparable in similar terms as the efficiency gains, then the Bureau would move to stage 2 to complete its trade-off analysis.
>
> Stage 2:
>
> At stage 2, the Bureau seeks to determine whether the efficiency gains arising from the merger 'offset' the anti-competitive effects. Hence, at this stage the Bureau seeks to determine whether the transfers arising from the merger, for example, can be considered neutral according to applied welfare economics. In other words, the Bureau would attempt to determine whether the anti-competitive effects include adverse distributional effects. For example, the Bureau would likely consider evidence

on:

- the importance of the income effect associated with the merger;
- existing government taxes/subsidies programs;
- cross-relevant market transfers; and,
- differences in buyer purchasing patterns

to make this determination."[15]

The logic of this two-stage test is unclear. Suppose that a merger satisfies the conditions of the first stage of the test. The first condition in this stage is that "expenditure shares" on the product — which means expenditure as a ratio of total expenditure on all goods, or wealth[16] — be similar across buyers. The second is that buyers' expenditures on the relevant product be "virtually independent of their total expenditure". The second condition may mean that as we move across consumers, expenditures on the product do not vary with buyers' total expenditure. Under this interpretation, however, the first condition and the second condition logically imply that all buyers have the same total expenditure (or wealth).[17] This is not a meaningful condition for merger analysis. A second interpretation of expenditures "virtually independent of total expenditure" is that if any particular buyer's wealth changed, the buyer's expenditure would not change. Logically, however, this means that if both conditions of Stage 1 were satisfied in a particular market, a moderate redistribution of wealth among buyers would render the conditions violated.[18] That is, two markets that differed only in the distribution of wealth among particular buyers would lead to different merger review decisions. Why this is a sensible outcome of a merger test is unclear.

Significantly, the first stage of the test (which, if passed, is sufficient for the Bureau to approve the merger) contains no direct reference to transfers between buyers and shareholders of the merging firms. One would think that if the Bureau is departing from a total surplus standard, it would be to incorporate distributive justice concerns with respect to the transfers involved between shareholders of merging firms and buyers of the merging firms' products: a transfer from buyers to shareholders in the market for low-income housing could be judged differently than the same transfer in the market for Mercedes automobiles, for example. In the first stage of the test, however, the Bureau accepts the total surplus standard only if the merger is in a market for neither of these types of goods (luxury goods or goods consumed by low-income individuals). The expenditure on the product must be independent of wealth.

In the second stage of the test, the Bureau broadens the investigation to consider evidence on whether the transfers involved in the merger include adverse distribution effects. At this stage, one might suppose that the Bureau brings into consideration the wealth of the average buyer, as in the housing versus Mercedes example. If so (and the position is not entirely clear from the text) this represents a marked departure from the total surplus standard adopted in the MEGs.

The premise of the total surplus test is that wealth redistribution is best left for government instruments such as taxation and social insurance or welfare systems that are designed for that purpose, and through which redistribution is more directly observed or monitored by the voters to whom government is

responsible than redistribution through government regulation. The Bureau's apparent position that they will decide which wealth transfers are acceptable and which are not risks incorporating into the merger review process greater politics and lobbying by special interest groups. (Do we want the Bureau to become another Department of Human Resources?)

Conclusion

Uncertainty in the role of efficiency analysis in merger review resulted initially from the *Hillsdown* decision, rather than statements by the Competition Bureau. The Bureau's recent statements have not clarified the issue, however. A resolution of the contradictions and ambiguities in the Bureau's thinking on the role of efficiencies in merger review would add credibility to the claim that Canada's competition laws are among the most economically sophisticated in the world.

Notes

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1 *Canada (Director of Investigation and Research)* v. *Hillsdown Holdings (Canada) Ltd.*, (1992) 41 C.P.R. (3d) 289 at 337, hereinafter referred to as "*Hillsdown*"

2 Donald McFetridge, "Merger Enforcement under the *Competition Act* after Ten Years," Review of Industrial Organization, Vol. 13, Nos.1-2 (April 1998) at 25-56, provides an assessment of the various interpretations that can be placed on the implications of the *Hillsdown* decision for the role of efficiencies in merger review.

3 Merger Enforcement Guidelines, Competition Bureau, at 49.

4 Howard Wetston, "Developments and Emerging Challenges in Canadian Competition Law," Speech at the Fordham Corporate Law Institute, New York, October 22, 1992, at 9.

5 Konrad von Finckenstein, Speaking Notes for an address to the Canadian Bar Association, September, 1999, published at http://strategis.ic.gc.ca/SSG/ct01616e.html (date accessed: February 7, 2000).

6 Gwillym Allen, speech to conference attendees at "Meet the Competition Bureau", Toronto, May 3, 1999, published at http://strategis.ic.gc.ca/SSG/ct01548e.html (date accessed: February 7, 2000), at 5.

7 Gwillym Allen, Speaking Notes for a Speech on "The Enforcement of the Efficiency Exception in Canadian Merger Cases," June 25, 1999, published at http://strategis.ic.gc.ca/SSG/ct01566e.html (date accessed: February 7, 2000).

8 *Supra*, note 3, at 7.

9 *Ibid.* at ii. The U.S. 1992 Merger Guidelines, section 1, contain essentially the same definition.

10 That is, $(P-mc)/P = 1/e$, where P is the price of a product; mc is the marginal cost of producing the product; and e is the elasticity of demand, defined as the percent change in quantity in response to a one percent change in price.

11 An example of a demand that is completely price insensitive up to some price level is the demand for a medicine that is essential but for which a substitute is available at a high cost. (Quinine was at one time produced by a cartel from natural sources at lower cost than via a synthetic production method. The quinine cartel faced a demand that was price insensitive up to the cost of the synthetic drug.)

12 Competitors may be harmed by the increased efficiency of their rival, but the purpose of competition policy is not to protect firms against increasingly efficient rivals.

13 It is generally understood that under current U.S. antitrust law, efficiencies must be sufficiently strong to lead to a price decrease in order to justify an otherwise anticompetitive merger.

[14] See Neil Campbell, Hudson Janisch and Michael Trebilcock, "Rethinking the Role of the Competition Tribunal," (1997) 76 Canadian Bar Review 297.

[15] *Supra,* note 7.

[16] We ignore saving on the part of consumers, to keep matters simpler.

[17] Two buyers can have the same expenditure share of wealth and the same expenditure in dollars only if their wealth levels are the same. (Throughout, we equate total expenditures to wealth, ignoring for simplicity the option of saving.)

[18] Suppose that expenditure shares are initially equal (condition 1). If there is a redistribution of wealth then expenditure levels won't change (condition 2) which means that expenditure shares must change. The first condition would be violated after the wealth redistribution.