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Submission of the

**Director of Investigation
and Research**

Competition Bureau

**To the Task Force on the
Future of the Canadian
Financial Services Sector**

November 1997

Canada



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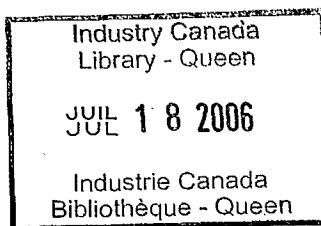
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Executive Summary

This submission is provided in response to the Discussion Paper issued by the Task Force on the Future of the Canadian Financial Services Sector (the "Task Force") on June 13 of this year. It represents the views of the Director of Investigation and Research (the "Director"), Competition Bureau (the "Bureau") with respect to the issues currently under review by the Task Force.

The central theme of the Bureau's submission is that the public policy objectives which underlie this review can best be achieved by relying upon competition and market forces to the maximum extent possible, rather than through continued or increased regulation. The Bureau recognizes that stability of the financial system is generally the paramount goal of financial market regulation and that stability may come at the expense of competition. In the Bureau's view, however, there are regulatory changes that can increase flexibility and facilitate competition without concurrently compromising the stability and solvency of the financial system.

In this regard, the Bureau supports the positions of the Task Force stated in sections 1.10 and 1.11 of the Discussion Paper concerning testing of regulations and the importance of competition. As the Task Force points out:

[w]here effective competition exists among the participants in a market, they are driven to perform in the interests of their customers; they are forced to be innovative and are motivated to provide good service at a favourable price.¹

The Bureau also concurs with the view expressed by the Task Force that where:

a policy objective is identified that justifies some degree of regulation . . . , care should be taken that the degree of governmental intervention in the marketplace . . . in furtherance of that objective does not exceed what is reasonably necessary to attain the objective.²

¹ Task Force on the Future of the Canadian Financial Services Sector, Discussion Paper, June 13, 1997, p. 6

² Task Force Discussion Paper, p. 5.

The submission begins with a summary of the Bureau's recommendations. This is followed with a discussion of the trends affecting the financial services sector in Canada. These trends include globalization, rapid changes in technology and disintermediation. It is apparent from studying these trends that there is no certainty in terms of how the various markets, institutions and products will evolve in response to changes in the marketplace. With this in mind, it is critical that a new regulatory framework affecting this sector is developed which is flexible, adaptive and, to the greatest extent possible, facilitates market driven outcomes rather than predetermined ones. This point is particularly relevant to the Task Force's discussion regarding possible holding company structures for financial institutions. In addition, the Bureau notes the increasing importance of international co-operation in the enforcement of financial services sector regulations and anti-trust laws in the face of the emerging globalization of the financial services markets.

The submission addresses the role of competition policy in this sector and provides an overview of Canadian competition law and institutions. The submission outlines various provisions of the *Competition Act* (the "Act") which are relevant to the financial services sector, including the civil matters reviewable before the Competition Tribunal relating to:

- mergers;
- refusal to deal;
- abuse of dominance;
- various forms of vertical restraints including tied selling

as well as the criminal provisions relating to:

- misleading advertising;
- resale price maintenance;
- predatory pricing;
- conspiracy; and
- agreements among federal financial institutions.

The Bureau has also noted the value of the preliminary work done by the Task Force with regards to criteria that should be used in assessing mergers involving institutions within the financial services sector. The submission recommends that the reviews of federally regulated financial institutions performed by the Minister of Finance, the Office of the Superintendent of Financial Institutions and the Director of Investigation and Research should be conducted simultaneously with, where possible,

an exchange of information necessary to facilitate an effective, efficient and timely review.

The submission provides a brief overview of the Bureau's approach in assessing mergers within the financial services sector. The importance of obtaining the necessary information to conduct timely and effective reviews of mergers that occur in this sector has prompted the Bureau to consider, in greater detail, how the Merger Enforcement Guidelines would be applied to a bank merger. The Bureau has developed a preliminary draft and will be consulting with members of the financial services sector community before finalizing the document.

The submission then considers the impact on competition of various policies and regulations in the financial services sector. As noted above, it is understood that maintaining financial sector stability may come at the expense of some competition policy goals. The balancing of these two important policy objectives requires careful scrutiny. The Bureau's experience in advocating competition and enforcing the *Act* in regulated sectors of the Canadian economy has led to the formulation of a number of competition principles that the Bureau encourages legislators and regulators to consider when dealing with industries in transition. These principles are included in the recommendations.

The submission examines a number of current regulations and policies affecting the sector from a competition policy perspective. In addition, a more detailed piece on tied selling is attached to the submission as Appendix I and a draft document, to be used for consultation purposes, which deals with the application of the Merger Enforcement Guidelines as applied to bank mergers is attached as Appendix II.

The conclusion of the submission reaffirms the Bureau's view of the importance of the work of the Task Force. The Bureau recognizes that while markets evolve over time and may not be immediately ready for open competition, a fair and equitable period of transition should take place in a way that maximizes the benefits of competition but which also ensures the continued viability of the sector.

Director of Investigation and Research
Competition Bureau
November, 1997

Summary of Recommendations

1. The Task Force should include in its final report the preliminary views it provided in the July 11, 1997, Report to the Secretary of State (International Financial Institutions) concerning the criteria the Government should take into account in reviewing particular transactions. [see page 1]
2. The regulatory framework affecting the financial services sector should be flexible, adaptive and, to the greatest extent possible, facilitate market driven outcomes rather than predetermined ones. [see page 4]
3. As markets within the financial services sector become more global in nature, it is important that actions be taken to ensure that international regulatory oversight and enforcement is consistent, co-operative and effective. [see page 11]
4. For greater transparency and predictability, the Task Force should recommend criteria to be employed by the Minister of Finance when evaluating mergers from a broader public policy perspective. [see page 33]
5. As regards proposed mergers involving federally regulated institutions:
 - i) To ensure a timely process, the preliminary reviews of a merger by the Minister of Finance, the Office of the Superintendent of Financial Institutions ("OSFI"), and the Director of Investigation and Research (the "Director") should be conducted simultaneously, each relying on their respective criteria when conducting their review.
 - ii) Subject to the confidentiality provisions set out in section 29 of the *Competition Act* and corresponding provisions affecting OSFI, there should be an open exchange of information between the three federal authorities where necessary, to facilitate the proper coordination of the reviews and the decision making process. (In the context of mergers involving financial institutions which are subject to provincial regulations, a similar exchange of information should take place involving the relevant provincial regulators).

iii) Once preliminary views have been determined, one of a number of scenarios result:

- a) If the Minister of Finance, OSFI and the Director conclude that there is no reason for blocking the merger, based on their respective review criteria, then the merger should be allowed to proceed;
- b) If the Minister concludes that the merger should be blocked, based on the Ministerial criteria for review, the Minister would then exercise the authority to block the transaction after having informed both OSFI and the Director. This early notification on the part of the Minister would avoid the unnecessary expenditure of time and resources that might be required by the Director and OSFI in completing their respective reviews and, if necessary, seeking remedies;
- c) If the Minister and OSFI conclude that there is no reason for blocking the merger, based on their respective review criteria, but the Director has determined that there is a competition related issue, the Minister of Finance would be informed of the Director's findings and the proposed course of action that the Director intends to pursue to resolve the matter. At this juncture, to save costs and time, it would be helpful if the Minister would provide both the Director and the parties to the merger with the assurance that there will not be the exercise of Ministerial override once the Director has committed to pursuing the competition remedy. [see page 34]

6. The overriding authority of the Minister of Finance to block the acquisition of a federal financial institution or to certify the acceptability of activities of financial institutions which may contravene the *Act*, is best exercised only in respect of non-competition issues. The Director, the Competition Tribunal and the courts are well equipped to evaluate and remedy competition issues as they may arise in the sector. [see page 36]

7. The Bureau's experience to date in both advocating competition and enforcing the *Act* in regulated sectors of the Canadian economy has allowed it to develop a number of competition principles that both legislators and regulators should consider when dealing with industries in transition. These principles are:
 - i) Direct regulation should be considered only when market forces are inadequate by themselves to achieve the desired policy objective;
 - ii) If direct regulation is required, the form of regulation that least distorts competition and efficiency in the affected markets should be chosen;
 - iii) Clear conditions should be established respecting the circumstances in which the regulator will exercise forbearance from regulation;
 - iv) When making changes to the regulatory environment of a sector of the economy, there is a need to assess the impact of the proposed changes on competition in the affected markets;
 - v) During the period of transition from regulation to competition, there is a need to ensure there is an effective and coordinated set of regulatory and competition law constraints against anti-competitive abuses; and,
 - vi) The ultimate goal of deregulation should be to bring choice regarding suppliers and product offerings down to the individual customer level.
[see page 36]
8. Should consideration be given to modifying ownership restrictions of banks, the impact of such modifications on competition should be taken into account.
[see page 39]
9. Applying the merger provisions of the Competition Act to mergers occurring within the financial services sector will prevent undue market power and achieve the same competition policy objective as the "big shall not buy big" policy. The merger provisions of the Competition Act could be the appropriate substitute for the "big shall not buy big" policy. [see page 40]
10. It is important that public policy scrutiny be applied to arguments that domestic mergers are the only alternative to coping with the pressures of global competition. By definition, mergers between competing banks reduce competition. [see page 41]

11. To the extent that strategies to expand access to foreign markets involve mergers of domestic institutions, regulators should consider the means by which to encourage foreign competition in domestic markets. [see page 41]
12. From a competition perspective and subject to prudential considerations, foreign banks should be allowed to establish branches in Canada. [see page 42]
13. While there may be other public policy arguments that can be advanced, strictly from a competition policy perspective, banks should be permitted to offer auto leasing and insurance products to their clients through their branch network. [see page 43]
14. While there may be other public policy arguments that can be advanced, strictly from a competition policy perspective, all financial institutions should be afforded the greatest flexibility in terms of the choice of financial products and services which they can offer consumers. [see page 43]
15. In order to foster competition and promote a level playing field among direct clearers and other financial institutions, access to the payments system should be provided to any institution which can demonstrate: (i) a justifiable need for using the system; (ii) the technical ability to participate in clearing; and (iii) an ability to meet the necessary capital and risk requirements. [see page 45]
16. Any changes to the *Canadian Payments Association Act, 1980* should guarantee finality of payment for alternative private clearing systems which emerge over time. This would promote competition between or among clearing systems. [see page 45]
17. No new restrictions should be introduced on the availability of pass through and sweep accounts. These accounts enhance economic efficiency by opening opportunities for providers of specialty financial services to take advantage of technological advancements without incurring substantial capital costs. If new restrictions on the use of pass through and/or sweep accounts should be required, they should be introduced without undermining ongoing efforts to improve the Canadian Payments System and they should ensure that the intent of the Interac Consent Order, issued by the Competition Tribunal, is also not being undermined. [see page 46]

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I - Introduction

1. This submission is provided in response to the Discussion Paper issued by the Task Force on the Future of the Canadian Financial Services Sector (the "Task Force") on June 13 of this year. It represents the views of the Director of Investigation and Research (the "Director"), Competition Bureau (the "Bureau") with respect to the issues currently under review by the Task Force.

2. In addition to enforcing the various provisions of the *Competition Act* (the "Act"), the Director has a statutory right, pursuant to sections 125 and 126, to intervene before federal regulatory boards, tribunals and other agencies to make presentations concerning competition. The Director also has an important policy role as advisor to the government on competition matters. As such, the Director has made frequent submissions to legislative committees. This affords the Director an opportunity to ensure that competitive factors are taken into consideration in the formulation of various policies.

3. The work of the Task Force to enhance competition in this sector is well founded, logical and achievable. Their recognition of the importance of competition as a means of ensuring the efficiency and effectiveness of this sector is an extremely positive and important step which hopefully will encourage the trend away from regulation towards reliance on competition principles. The effort of the Task Force in its July 11, 1997, Report to the Secretary of State (International Financial Institutions) to provide their preliminary views concerning the criteria the Government should take into account in reviewing particular transactions should also be applauded. Although the views are preliminary, their report represents a well-balanced attempt by the Task Force to respond to a request by the government on an extremely important issue. Despite the fact that the Task Force had very little time to consult on the issue, it provided some sound advice, particularly regarding the roles and responsibilities of the various entities currently mandated to assess mergers that occur within the sector. These preliminary views should no doubt be included in the Task Force's final report slated for September 1998.

Recommendation 1:

The Task Force should include in its final report the preliminary views it provided in the July 11, 1997, Report to the Secretary of State (International Financial Institutions)

concerning the criteria the Government should take into account in reviewing particular transactions.

4. It is the Director's view that as this sector continues to move away from direct regulation, and places greater reliance on market driven outcomes, the legislation and institutions which embody Canada's competition policy are well positioned to maintain and encourage competition within the markets that comprise the financial services sector.

II - Trends Affecting the Financial Services Sector

5. The financial services sector, like many other sectors of the Canadian economy, has been subject to a great deal of change in recent years. Globalization, rapid developments in technology and changing demographics have had, and will continue to have, a dramatic impact on both the structure and conduct of the sector.

6. Globalization, which can be defined as the convergence of geographically distinct markets into one global market, has redefined the geographic parameter of many of the wholesale financial services markets. This process of globalization creates both enhanced access to what were traditionally foreign markets but also increases the exposure of these domestic markets to increased foreign competition. The trend seems less developed within the retail financial services markets. However, as technology driven changes allow enhanced competition through such things as virtual banks, it is not unreasonable to assume that there will be increasing exposure to global competition in these other markets as well.

7. Technological changes in such areas as financial delivery systems are having a profound effect on the structure of the financial services sector. Financial institutions are scrambling to exploit a variety of emerging technologies without the benefit of knowing which system, or combination of systems, will ultimately prevail. This process is forcing traditional financial institutions to reconsider fundamental strategies involving their corporate structure, the products and services they provide and the markets they will serve.

8. Disintermediation is an evolving trend within the sector which, simply put, involves a shift away from the traditional reliance on banking services for loans

and deposits towards a more direct interaction between lenders and borrowers. The trend has both demand and supply elements.

9. On the demand side, changing demographics, complemented with more sophisticated consumers have prompted traditional depositors and borrowers to look to alternative financial services to replace bank deposit accounts and loans. The proliferation of mutual funds as a vehicle for investments is evidence of this trend. Corporations are increasingly bypassing banks and other lending institutions and going directly to capital markets to obtain lower cost financing.

10. On the supply side, banks have expanded their product offerings into brokering securities and mutual funds, complementing these product offerings with enhanced wealth management and investment advisory services. The proportion of bank revenues generated from these fee-based activities has been steadily increasing over the past few years. There has also been the emergence of securitizations which involve the packaging of outstanding credit owed to a company or a bank which are sold to large customers as an investment alternative. Securitizations enable corporations to more efficiently manage their balance sheets and banks to reduce loan balances.

11. Regulatory reform has also had a significant impact. In particular, the financial sector reforms of 1992 went a long way in dismantling the barriers that separated the remaining pillars of the financial sector (banks, trust companies and insurance companies)¹. The removal of most of the ownership restrictions among the pillars along with the broadening of the business powers of certain institutions has opened the door for more competitive and efficient markets within the financial services sector.

12. The significant changes which are affecting the financial services sector have precipitated the need for reviewing and modifying the regulatory framework which, as the Task Force has recognized, will require trade-offs between safety and soundness on the one hand and freedom of competition on the other hand.

13. One of the important lessons in studying the trends affecting this sector is that there is no certainty in terms of how the various markets, institutions and products

¹ Restrictions on ownership of the fourth pillar, securities dealers, were removed in 1986.

will evolve in response to changes in the marketplace. With this in mind, the following recommendation is critical:

Recommendation 2:

The regulatory framework affecting the financial services sector should be flexible, adaptive and, to the greatest extent possible, facilitate market driven outcomes rather than predetermined ones.

14. This point is relevant in the context of consideration of various models of holding company structures for regulated financial institutions. While recognizing the importance of prudential policy objectives, competitive markets generally provide the best mechanism for determining the most efficient organization of business activity. Preordained corporate structures which require additional regulatory oversight can create an environment that inhibits the ability of firms to organize themselves in the most efficient manner. It may also disadvantage these organizations if they must compete with others that are not subject to the same regulatory oversight.

III - The Role of Competition in the Canadian Financial Services Sector

15. In general, competition should act as the fundamental driving force of our economy. It is a better vehicle than regulation for creating the incentives for innovation, encouraging the development of new products, services and the methods of delivering them to consumers. Competitive market forces drive the prices of goods and services toward their relative costs of production. This minimizes the misallocation of resources in the economy which in turn enhances economic efficiency. In those sectors of the economy in which regulation restricts competition, it is essential to constantly re-assess the continuing need for, and the cost associated with, sector-specific regulation.

16. The importance of this sector to the Canadian economy is measured, not simply in terms of its direct contribution to the economic growth of the country,² but also in terms of its strategic importance in providing services and products essential for almost every other type of economic activity. The sector, through a wide range of functions, facilitates the flow of savings and investments and the accumulation of

² Statistics Canada estimates that this sector contributes approximately 8 per cent to GDP and directly employs half a million people. In a recent address to the Canadian Club, the CEO of the Royal Bank claimed that the 6 largest banks in Canada spent nearly \$6 billion in goods and services and paid more than \$5.5 billion in taxes in a one year period.

wealth in the economy. It arbitrates market prices for risk and time which are essential factors affecting commerce. Through the supply of financial intermediation services, borrowers and lenders are brought together, mitigating risk in the economy and facilitating the transfer of purchasing power between individuals, businesses and governments. Additionally, financial service providers collect, interpret and disseminate important information about a wide range of factors affecting the economy.

17. All of these activities promote an efficient and dynamic economy and it is therefore essential that such an important sector of our economy operates as efficiently as possible. It is in this regard that competition plays such an important role.

18. As a new regulatory framework evolves, and greater reliance is placed on market forces, it is important that our competition policy framework legislation and the institutions which surround it, are effective in dealing with any competition issues that may arise. The law and institutions which make up Canada's competition policy regime are well positioned to meet these challenges.

IV - Canadian Competition Law and Institutions

A - Institutional Features

19. Canadian competition law is embodied in the *Act*. The purpose of the *Act* as set out in the legislation is:

"to maintain and encourage competition in Canada in order to promote the efficiency and adaptability of the Canadian economy, in order to expand opportunities for Canadian participation in world markets while at the same time recognizing the role of foreign competition in Canada, in order to ensure that small and medium-sized enterprises have an equitable opportunity to participate in the Canadian economy and in order to provide consumers with competitive prices and product choices."³

20. The *Act* contains substantive criminal and non-criminal provisions to deal with a broad range of anti-competitive activities. As the statutory official responsible for its administration and enforcement, the Director has the responsibility of

³ The *Competition Act*, R.S.C 1985, c. 19(2nd Supp.), Part II section 1.1

undertaking investigations to determine whether a particular form of business conduct raises an issue under the *Act*.

21. For the Director to commence an inquiry under the *Act*, he must have reason to believe that an offence under the criminal provisions of the *Act* has been committed, or is about to be committed, or that grounds exist for the making of an order by the Competition Tribunal (the "Tribunal") in respect to any of the civil provisions of the *Act*. The *Act* gives the Director various powers, including search and seizure upon court order, which he may exercise when there are grounds to warrant doing so in the course of carrying out inquiries. The legislation requires that all inquiries under the *Act* be conducted in private.

22. Under the *Act*, the Director does not regulate business conduct, nor does he adjudicate competition related matters. In the case of the criminal provisions of the *Act*, which include conspiracies to lessen or prevent competition unduly, bid rigging, price maintenance, price discrimination, and predatory pricing, as well as misleading advertising and other deceptive marketing practices, the Director refers evidence which he has obtained to the Attorney General of Canada who is responsible for taking appropriate action before the courts. On conviction, the courts have the authority under the *Act* to impose fines, imprisonment, and prohibition orders. The *Act* also allows private parties to sue for damages resulting from conduct that is contrary to the criminal provisions of the *Act* or failure to comply with an order of the Competition Tribunal or a court.

23. In the case of the non-criminal provisions of the *Act*, the most important of which are those dealing with mergers and abuses of dominant positions which prevent or lessen competition substantially, the Director has the exclusive authority to apply to the Competition Tribunal for remedial orders in situations where competition issues arise and cannot or will not be resolved by the parties involved. In establishing the Tribunal, Parliament intended that it have the capacity to deal with complex legal, economic, and business issues. The *Competition Tribunal Act* requires that all proceedings before the Tribunal shall be dealt with as informally and expeditiously as the circumstances permit. As a court of record, it is composed of up to four Federal Court judges, one of which is the chairperson, and lay members who typically have an economics or business background. The Tribunal's rules of practice and procedure provide for proceedings to be held in public and for the participation of intervenors whose interests may be affected by the proceedings. The Tribunal has the broad

discretion to issue orders to overcome the effects of anti-competitive behaviour and to restore competition in markets, including by the divestiture of assets or shares if the circumstances so warrant.

24. Tribunal decisions are subject to review by the appellate courts. The process set out under the *Competition Act* and the *Competition Tribunal Act* ensures that the parties have a transparent and impartial forum where they can present their arguments.⁴ Furthermore, the Tribunal greatly assists the development of competition policy by providing guidance in the form of jurisprudence. The Bureau has, since the enactment of the *Act* in 1986, developed and published guidelines and policies regarding the approach to enforcing the *Act*. Jurisprudence from the Tribunal and the courts serves to continually assess the Bureau's approach ensuring that it is both valid from a theoretical perspective and reflects a proper interpretation of the law.

B - Regulated Conduct

25. In order to deal with cases where competition law and regulation may conflict, the courts in Canada have developed a doctrine which has become known as the "regulated conduct defense." The case law developed under the regulated conduct defense was essentially concerned with the need to reconcile an apparent conflict between the public interest in free competition as expressed in the *Act*, and the public interest in promoting a particular regulated activity, as expressed in the statute authorizing its conduct.

26. The basis of the defense, which is really more of an exemption, is that specific activity which is authorized or carried out pursuant to a valid scheme of regulation, is exempt from the application of the *Act*. As such, the activity cannot be found to be in violation of the provisions of the *Act*.

C - Program of Compliance

27. The impact of the *Act* goes beyond the individual enforcement cases that are pursued. In most cases, businesses voluntarily design their business practices, or later alter these practices, to ensure that they comply with the *Act*, without the need for formal proceedings. Furthermore, voluntary compliance is actively encouraged and

⁴ There are provisions with the Competition Tribunal which allow for in-camera session where commercially sensitive information is discussed.

promoted by the Bureau. Prosecutions or applications to the Competition Tribunal are an essential adjunct to this approach where attempts to achieve voluntary compliance with the *Act* fail.

28. In order to assist businesses from coming into conflict with the *Act*, the Bureau offers businesses access to its Program of Advisory Opinions. Under this program, the Bureau assists members of the business community and their legal counsel by providing opinions on whether the adoption of certain business proposals would cause the initiation of an inquiry and by suggesting modifications which could be incorporated to avoid coming into conflict with the law. Businesses consulting the Director are not bound by his opinion and remain free to adopt practices that they are prepared to have tested before the courts or the Tribunal. The Director makes it clear that the opinion given is based on information provided by the parties and as such would be subject to review if there should be any change in the details of the proposed plan, its method of implementation or changes in the business environment.

29. At the same time, there is an ongoing review of the Director's policies to make sure all the tools on that continuum fit together and that we use the right tools for the task at hand. With the recent publication of the Corporate Compliance Bulletin (issued on June 30, 1997) we are encouraging business to adopt a more proactive compliance oriented approach. The idea is to prevent trouble before it starts and help businesses avoid future violations.

30. This approach does not mean more leniency for those who engage in serious anti-competitive behavior. In civil matters where reasonable solutions cannot be worked out by consent orders or other means, the matter will and should be taken to the Tribunal. In cases where there are egregious and serious violations of criminal provisions, it will be recommended to the Attorney General that it is prosecuted with the full rigour of the law. In this regard, the Director is continuing work on sentencing principles to ensure that recommendations on penalties to the Attorney General are based on a consistent and meaningful set of principles which can be applied to all cases.

31. In general, the Director has adopted an approach aimed at ensuring maximum conformity with the law. Conformity with the law involves a continuum that starts with education and goes up the scale from education to guidelines, advisory opinions, information contacts, voluntary codes, settlements, consent orders, charges, guilty pleas, fines up to imprisonment at the other end.

D - Strategic Alliances

32. The *Act* has the legislative breadth to deal with a variety of joint-corporate activities including mergers, joint ventures and strategic alliances. The *Act* does not contain specific provisions dealing exclusively with strategic alliances, which is not surprising given the myriad of forms which these arrangements have taken in the past and may take in the future. Nevertheless, the *Act* has the flexibility to prohibit or remedy any anti-competitive alliances, whatever form they may take, that create, maintain, or enhance market power.

33. Most strategic alliances will pose no competition issues because they do not maintain, create or enhance market power. Those which do, however, may be reviewable under a number of provisions of the *Act* that involve a test of market power, including the provisions relating to conspiracy, specialization agreements, mergers, joint ventures and abuse of dominant position. A consideration under some of these provisions, in particular the merger provisions, is whether the alliance is likely to result in gains in efficiency that are greater than, and will offset, the reduction in competition, and would not otherwise be realized. Thus, where strategic alliances do raise competition issues, the *Act* is well-equipped to deal with these on a balanced basis.

E - International Co-operation

34. The globalization of markets and the liberalization of barriers to trade have led to the emergence of international corporations which transcend national borders, and have presented new challenges to competition law and policy which are domestic in nature. As governmental barriers to trade have been reduced and eliminated, business activity has expanded to take advantage of new markets and customers, which in turn increases the likelihood of international cross-border anti-competitive activity. The challenge to competition law enforcers is to ensure that private anti-competitive practices are not allowed to negate the benefits of, or replace, the government-imposed barriers removed by trade liberalization.

35. The various competition policy regimes have responded to the challenge of globalization by improving upon the international cooperation and coordination mechanisms already in place.

36. Canada and the United States have been at the forefront in the development of new instruments of cooperation between competition authorities. Beginning with the Fulton-Rogers Agreement of 1959, the relationship between the enforcement agencies of our two countries has evolved significantly through a series of bilateral agreements. The 1995 *Canada-U.S. Agreement Regarding the Application of their Competition and Deceptive Marketing Practices Laws* provides the current framework for closer collaboration in the enforcement of our competition laws, in conjunction with Mutual Legal Assistance and Extradition treaties which are of significant value in investigating and prosecuting criminal cases which have a cross-border dimension.

37. The 1995 Agreement expands the ambit of previous cooperation to include deceptive marketing practices, as well as expressly allowing for "positive comity", which permits a country being affected by anti-competitive activity based in the other country to request enforcement action by that other country's agency, such as in the case of import cartels or the abuse of a dominant position.

38. Cooperation and coordination of competition policy enforcement is also facilitated by semi-annual meetings of senior officials from the relevant agencies to share experiences and discuss matters of current mutual interest. Perhaps just as important as the formal relationships are the regular inter-agency contacts to share information and discuss cases and broader developments in the competition field while honoring the confidentiality provisions in our respective statutes. Canada is now finalizing a cooperation agreement with the European Community which incorporates provisions similar to those of the 1995 Canada-U.S. Agreement.

39. Multilateral cooperative arrangements are also in place to facilitate enforcement cooperation. The 1995 *OECD Revised Recommendation Concerning Cooperation Between Member Countries on Anti-competitive Practices Affecting International Trade* is the latest in a series of non-binding agreements which provide for cooperation and consultation between member states. The OECD has proved, time and again, to be a very useful forum for the exchange of information about its members' competition laws and policies. The *North American Free Trade Agreement* ("NAFTA") incorporates obligations regarding competition in Chapter 15 and has similarly proved itself to be a useful medium for discussing competition policy concerns. Another multilateral arrangement on cooperation is the 1980 *UNCTAD Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices*.

40. The type of cooperation and coordination varies, but investigations may be assisted not only by the exchange of information to the extent permitted by confidentiality provisions, but also by joint or parallel investigations by the authorities of both countries. In the case of Canada and U.S., the Mutual Legal Assistance Treaty further provides for the use of compulsory investigative powers by one agency on behalf of another to seek information located in the requested country with respect to criminal matters.

41. However, with the exception of the 1995 Canada-U.S. Agreement and the NAFTA, the multilateral and bilateral arrangements now in place have a number of limitations. Most arrangements take the form of recommendations or "best-efforts" statements and thus fall far short of treaty obligations. There is no binding dispute adjudication and settlement procedures to discipline the behaviour of signatories in such areas as enforcing their own laws or in relation to extra-territorial application. Information sharing through these arrangements is restricted by the confidentiality provisions in each of our competition policy statutes. As well, the existing instruments provide no mechanism for designating a lead agency when two or more agencies are investigating the same merger or other competition matter. These limitations may be the subject of further cooperation initiatives.

42. Overall, the assistance provided by international cooperation has been invaluable to the conduct of cases by the Bureau. The efforts on the part of the international anti-trust community to enhance co-operation can serve as an example to other regulatory bodies responsible for elements of the financial services sector.

Recommendation 3:

As markets within the financial services sector become more global in nature, it is important that actions be taken to ensure that international regulatory oversight and enforcement is consistent, co-operative and effective.

F - Analytical Approach used in Competition Policy Analysis

43. In section 1.5 of the Discussion Paper, the Task Force asked for comments on the framework needed to analyze issues before the Task Force including a vision of the financial services sector.

44. The Bureau can offer one component of the framework the Task Force is seeking: the analytical approach used in competition policy analysis. In assessing the

state of competition in a market, the Bureau ascertains whether any firm in the market can exercise significant power over prices or the terms or conditions of sale other than by superior competitive performance. For example, an examination under the *Act* might consider whether the conduct in question would allow a firm or firms to impose a significant price increase in a substantial part of the relevant market for a period of two years or more. This ability of firms to profitably influence price⁵, quality, variety, service, advertising, innovation or other dimensions of competition in a market is referred to as "market power". In evaluating whether the conduct serves to maintain or enhance market power, the Bureau generally focuses on its impact on the price dimension of competition.

45. When competitive market forces discipline the conduct of all market participants such that no participant in the market has market power, the market is effectively competitive. This is a simple enough definition, but putting it into practice normally involves a detailed process that requires relevant, accurate and detailed information.

46. To assess the state of competition in markets, the Bureau begins by establishing the boundaries of the relevant product and geographic market. This is defined as the smallest group of products and geographic areas for which sellers, acting as a single firm (or hypothetical monopolist), could profitably impose a significant and non-transitory price increase. When determining the extent of a market, the Bureau considers the likely responses of buyers and competing suppliers.

47. For instance, if an attempt by this hypothetical monopolist to impose a significant and non-transitory price increase prompts buyers to switch purchases to other products in sufficient quantity to render the price increase unprofitable, then the Bureau would add the product that is the next best substitute⁶ to the relevant market. In essence, this approach seeks to define the relevant markets through identifying the actual and potential sources of competition that constrain the exercise of market power.

48. In determining whether a geographic area or product category constitutes a market, the Bureau examines various factors relating both to the willingness of

⁵ The assessment of the likely price effects of the conduct generally involves an assessment of its likely effect on output. Output and price may also be affected by anti-competitive effects on non-price dimensions of competition such as service, quality and choice.

⁶ The Bureau considers the "next best substitute" to be the product that would account for the largest percentage of the volume that would be lost by the hypothetical monopolist.

consumers to switch between products and suppliers and to the likelihood of entry occurring as a result of price increases. Direct evidence, in the form of statistical measures of cross-elasticities of demand and supply, is rarely available. As a result, other factors are used to provide indirect evidence of substitutability.

49. Evidence of substitutability that the Bureau may look at includes: the views, strategies and behaviour of buyers towards the product in question; any physical and technical characteristics of products that could limit their interchangeability; costs that customers might have to bear to switch between products or suppliers; or whether there are potential suppliers with facilities that could be easily adapted to producing the relevant product.

50. Having defined the relevant markets, the Bureau turns its attention to determining whether or not a supplier, or a group of suppliers, has the ability and incentive to significantly increase prices for a sustained period. The size of the company or companies under examination in relation to the relevant market is an important, but not determinative, consideration in this part of the analysis. The higher are both the market share of the relevant businesses and overall level of concentration in a market, the more likely it is that the Bureau will be concerned about the existence of market power.

51. However, high market share alone will not lead to a conclusion that market power exists. Rather, other factors mentioned in the *Act* and supported by the economic analysis of markets and competition must also be considered. These factors include, for example: the availability of substitutes that are acceptable to buyers; the barriers facing new competitors who wish to enter the relevant market; and the nature and extent of change and innovation in the relevant market.

52. Of these factors, barriers to entry may be particularly important to consider in assessing whether a business has or would have market power. Entry impediments exist to some extent in all markets. To determine their importance the Bureau tends to concentrate on the following questions:

- i) what must be done and what commitments must be made by potential competitors in order to enter on a scale that would be sufficient to eliminate a material price increase in the relevant market;

- ii) what factors are likely to delay entry, and are they collectively likely to prevent the scale of entry described above from occurring within two years; and,
- iii) are potential competitors likely to enter, given the commitments that must be made, the time required to become an effective competitor, the risks involved and the likely rewards.

53. From an economics perspective, the notion of commitment or sunkness embodied in these questions is particularly important to keep in mind. Costs of entry that are recoverable should not be considered as barriers to entry. Only those investments that must be sunk or committed to enter the market and cannot be recovered on exit should be viewed as actual barriers to entry. As the proportion of total entry costs accounted for by sunk costs increases, entry becomes less likely because of the greater risk and uncertainty.

54. Market power is not the Bureau's only concern when examining markets and business practices. Where the *Act* warrants it, the Bureau also considers whether the actions under consideration have efficiency or other pro-competitive advantages that outweigh their anti-competitive effects. The benefits that the Bureau takes into consideration in this part of its analysis are only those that involve a real resource cost to the economy. That is, it is not sufficient that there be a pecuniary gain to some market participants or customers. Rather, this gain must also be linked to a real economic benefit.

55. The overall analytical approach provides the basis for assessing a broad range of activities that are ongoing in the marketplace. With this approach in hand, there are various provisions set out in the *Act* designed to provide the legislative framework for addressing those activities that have a detrimental impact on competition.

G - Criminal Provisions

i - Misleading Advertising and Deceptive Marketing

56. The misleading advertising and deceptive marketing practices provisions, sections 52-60 of the *Act*, help to ensure no competitor gains or retains market share by deception. Representations made to the public which are false or misleading in a

material respect are prohibited. If the representation could influence a consumer to buy the product or service advertised, it is material. To determine whether an advertisement is misleading, the courts consider the "general impression" it conveys as well as its literal meaning.

57. Advertisers are often surprised to learn that it is not a valid defense that they did not intend to mislead their customers. The Crown only needs to prove that the effect of the advertisement was misleading. Common violations include:

- unsubstantiated performance and durability claims,
- misleading warranties, and
- misrepresentations as to regular price.

58. The *Act* applies to all representations to the public to promote the sale of products, regardless of form. Because of this, the misleading advertising and deceptive marketing provisions can apply to any misrepresentations that occur in the financial sector. This is especially important in today's marketplace because of the increasing number of venues being used to access the sector. Electronic commerce and the Internet have provided an increased opportunity for consumers to obtain information about financial products and services. However, it has also provided an alternative venue for misleading representations.

59. Misleading advertising can have serious economic consequences, especially when directed towards large audiences or when it takes place over a long period of time. It can harm both business competitors, who are engaging in honest promotional efforts, and consumers.

60. Penalties under the *Act* include fines, the amounts of which are at the discretion of the courts, and imprisonment for up to five years. Both companies and individuals can be charged. The highest fines imposed so far under the misleading advertising provisions are \$1 million against a company and \$500,000 against an individual; the longest jail term, one year.

ii - Price Maintenance

61. Business activities typically carried out by financial institutions are also affected by the price maintenance provision, found in section 61 of the *Act*. The purpose

of the price maintenance provision is to enable businesses to set their own prices on their products. By definition under section 2 of the *Act*, a product includes both an article and a service.

62. Section 61(1)(a) prohibits anyone who is engaged in a business from attempting, by way of an agreement, threat, promise or any like means, to influence upward, or to discourage the reduction of, the price at which any other person engaged in business in Canada supplies or offers to supply or advertises a product within Canada. It is also unlawful, under paragraph 61(1)(b), to refuse to supply a product to, or otherwise discriminate against, a person engaged in business in Canada because of that person's low pricing policy. Furthermore, under subsection 61(6), anyone who counsels another to engage in such refusals to supply may also be in violation of this provision.

63. With few exceptions, section 61 applies to all businesses and products. In particular, section 61 specifically states that it applies to businesses related to credit cards. As a result, credit card issuers may not prevent retailers from offering discounts to customers who pay with cash rather than with a credit card.

64. Section 5 of the *Act* states that section 61 does not apply to agreements or arrangements between or among securities dealers where the agreement or arrangement has a reasonable relationship to the underwriting of a specific security.

iii - Predatory Pricing

65. The predatory pricing provisions contained in section 50(1)(c) of the *Act* make it an offence to engage in a policy of selling products (which would include financial services) at unreasonably low prices, having the effect or tendency of substantially lessening competition or eliminating a competitor, or designed to have such effect.

66. Predatory pricing has proven to be a rare rather than a common occurrence in Canada. To help business people to distinguish between legitimate price competition and predatory conduct, the Bureau has published enforcement guidelines with respect to this section. These guidelines suggest that predatory pricing is not likely to occur unless the alleged predator has the ability to later recoup the losses incurred, or profits foregone, during the period of predation. Among the factors which the Bureau

considers, is the market power of the alleged predator, as well as barriers to entry into the industry.

67. Under the Bureau's enforcement guidelines, prices set at or above average total cost are not regarded as "unreasonably low" within the meaning of section 50(1)(c). Prices which are set between average total cost and average variable cost could, under the guidelines, be found to be "unreasonably low" under certain conditions. In the absence of very unusual circumstances, the Bureau would likely consider prices below average variable cost to be "unreasonably low". In any examination under this section, the Bureau would seek to determine whether the circumstances of the market were such that a firm's low pricing policy could inflict significant and lasting harm to the competitive process as opposed to simply having a negative effect on the profitability of one or more of its rivals.

68. When assessing the need for regulatory safeguards, the issue of predatory pricing or cross-subsidization should be considered from the perspective of protecting the competitive process. Competition legislation or other regulatory safeguards must not deter vigorous and otherwise beneficial price competition. In distinguishing between legitimate price competition and predatory conduct, it is important to determine whether the firm involved has sufficient market power to recoup the revenue lost in the course of pursuing a predatory pricing strategy. The market conditions necessary for a firm to successfully engage in a strategy of predatory pricing, particularly in markets not subject to regulation, are extremely rare. The experience in Canada and the United States in respect of predatory pricing bears this out.⁷

69. While the possibility of dominant firms' engaging in predatory pricing cannot be ignored, this concern must be weighed against imposing limitations on the ability of dominant firms to compete effectively. The most effective means to guard against instances of true predation is to remove any barriers to entry that may exist. The presence of effective competitors, or the threat of entry, ensures that pricing decisions are efficient.

⁷ In the period 1980 to 1990, the Bureau received some 550 complaints alleging an offence under the predatory pricing provisions. Of these complaints, only 23 resulted in formal inquiries under the *Competition Act*, four were referred to the Attorney General, and only three resulted in the laying of charges (one resulted in an acquittal, in a second case charges were withdrawn after the preliminary hearing, and the third case recently resulted in convictions). In the last fifteen years the US. Department of Justice pursued only one predatory pricing case and only 3% of private anti-trust actions in the US. involved predatory pricing as a primary allegation.

iv - Conspiracy

70. Agreements or arrangements made in relation to the supply of an article or service which lessen competition unduly are prohibited under section 45 of the *Act*. Section 45 is the most serious of the criminal provisions of the *Act*. On conviction, guilty parties are subject to imprisonment for up to five years or fines up to \$10 million or both.

71. Illegal agreements are most often proven by documentary or testimonial evidence of overt acts of the conspirators, such as memos, letters, meetings or telephone conversations. However, subsection 45(2.1) of the *Act* allows the court to infer the existence of an agreement from circumstantial evidence with or without direct evidence of communication among the parties. However, in all cases, the Crown has the burden of proving the existence of the agreement "beyond a reasonable doubt".

72. Similarity in prices, price movements and other key competitive variables may provide circumstantial evidence of collusion. However, under certain conditions, these phenomena might occur because of "conscious parallelism" rather than because of an agreement. Conscious parallelism refers to a situation where firms act in a similar fashion with respect to a key competitive element, such as price, because they each recognize that it is to their benefit to do so. For example, all of the firms in a market might charge identical prices because each knows that if it dropped its prices in an attempt to gain market share, each of the others would do the same, resulting in lower profits. Conscious parallelism is most likely to occur in concentrated industries that produce a homogeneous product under similar and slowly changing cost conditions. Without the element of an agreement, conscious parallel behaviour would not be an offence under section 45.

73. In a prosecution under section 45, the Crown is required to prove that the accused intended to, and did, enter into the agreement and that the accused knew, or should have known, as a reasonable business person, that the agreement, if carried into effect, would likely lessen competition unduly. This requirement provides for a broader assessment of the activity in question than merely rendering it a *per se* offence. In providing this breadth, the legislation does not prohibit those situations which have no anti-competitive effects.

74. The Crown does not have to prove that the conspiracy would likely eliminate, completely or virtually, competition in the market to which it relates. As indicated by the Supreme Court of Canada in *R. v. Pharmaceutical Association of Nova Scotia et. al.* ([1992] 2 S.C.R. 606), it is the combination of market power and some behaviour likely to injure competition that makes a lessening of competition undue and, thus, unlawful. The Bureau would be particularly concerned where the parties to an agreement collectively have more than 50% of the relevant market.

75. As regards financial institutions, section 5 states that section 45 does not apply to agreements or arrangements between or among securities dealers where the agreement or arrangement has a reasonable relationship to the underwriting of a specific security. In addition, section 45(7.1) states that section 45 does not apply in respect of an agreement or arrangement between federal financial institutions that is described in subsection 49(1) of the *Act*.

v - Agreements Among Federal Financial Institutions

76. Section 49(1) of the *Act* proscribes certain agreements among federal financial institutions. This is a *per se* offence, meaning that an undue lessening or prevention of competition is not an element of the offence, as it is for section 45. The injury to competition is "presumed" by the specific nature of the agreements which are proscribed. This means that there is no "competition test" as afforded in the civil provisions of the *Act* which would allow for a balancing of factors in assessing the competitive impact of the activity in question. In the absence of such a competition test, section 49(1) prohibits the specified conduct without regard to the presence of market power or the likelihood of injury to competition.

77. Agreements which could violate section 49 include those with respect to the rate of interest on deposits or loans; the amount of service charges; and the amount or kind of loan or service provided to a customer. Section 49(2) provides exceptions to section 49(1) in respect of specified classes of agreements, such as:

- agreements with respect to deposits, loans or other services provided to customers outside Canada;
- agreements applying only to dealings between federal financial institutions (i.e. not affecting customers);

- agreements with respect to services rendered by two or more federal financial institutions as regards to a customer of each of the institutions where the customer has knowledge of the agreement;
- agreements with respect to a bid for or purchase, sale or underwriting of securities by federal financial institutions;
- agreements with respect to the exchange of statistics and credit information;
- agreements with respect to the development and utilization of systems, forms, methods, procedures and standards;
- agreements with respect to the utilization of common facilities and joint research and development in connection therewith;
- agreements with respect to the restriction of advertising;
- agreements where the Minister of Finance has certified to the Director that he has requested or approved the agreement for the purpose of financial policy; and,
- agreements among affiliated financial institutions.

H - Civil Provisions

i - Refusal to Deal

78. The refusal to deal provision, section 75 of the *Act*, applies where a person is substantially affected or precluded from carrying on business due to his inability to obtain adequate supplies of a product from a supplier; the person is willing and able to meet the usual trade terms of the supplier; the product is in ample supply; and the inability to obtain supplies of the product results from insufficient competition. In such cases, the Tribunal may order that the person be supplied or recommend to the Minister of Finance a reduction in customs duties.

79. Someone who is refused supplies must pursue all other sources of supply. So long as other suppliers are willing to supply the would-be customer, the inability to obtain supply would not be considered to result from a lack of competition among suppliers. A replacement product that placed the person at a significant competitive disadvantage would not be considered a reasonable alternative.

80. There are no exemptions contained within the refusal to deal provision. Thus, participants in all parts of the financial services sector are subject to having their conduct examined in relation to this provision.

ii - Exclusive Dealing, Tied Selling and Market Restriction

81. Section 77 of the *Act* explicitly provides for the review of three types of vertical restraints: exclusive dealing, tied selling and market restriction. Given the importance to the Task Force of the issue of tied selling, the Bureau has included, as **Appendix I**, an explanation of how tied selling would be dealt with by the Bureau in the context of the financial services sector. It should be stressed that the *Act* does not prohibit these business practices and that they are not criminal offences under the *Act*. Rather, in certain instances, the Competition Tribunal can issue orders prohibiting or altering these practices.

82. In cases involving each of these vertical restraints, there are two broad elements that must be demonstrated before the Tribunal can issue an order. The first requirement is to demonstrate that the practice meets the definition describing the restraint that is set out in the *Act*. The second element is to demonstrate that the practice will have the required anti-competitive effect (the "competition test").

83. Exclusive dealing occurs when a supplier engages in a practice of requiring or inducing a purchaser to deal only or primarily in particular products. Tied selling occurs when a supplier engages in a practice of requiring a customer, as a condition of obtaining a product, to purchase any other product, or to refrain from dealing in other products of different brands. As with exclusive dealing, tied selling is also defined to occur when a supplier induces a customer to meet the stated conditions by offering to supply a product on more favourable terms. Market restriction is defined to occur when a supplier engages in a practice of restricting customers' operations to a defined geographic market.

84. The second element, the competition test, must then be demonstrated. In the case of either exclusive dealing or tied selling, the test requires that the practice be engaged in by a major supplier or be widespread in a market and that the practice be likely to impede entry or expansion of a firm, or sales of a product, in the market or have some other exclusionary effect, with the result that competition is or is likely to be lessened substantially. The competition test for market restriction is that the practice be

engaged in by a major supplier or is widespread in a market with the result that competition is or is likely to be lessened substantially. In the event that the Tribunal finds that these conditions are met, it may issue a remedial or prohibitive order.

85. Section 77(4) sets out certain conditions under which the Tribunal shall not make an order. With respect to the financial services sector, there is an exemption for tied selling when it is engaged in by a person in the business of lending money for the purpose of better securing loans made by him and is reasonably necessary for that purpose. Other exemptions are available when tied selling occurs as a result of a reasonable technological relationship or when exclusive dealing or market restriction occur for a reasonable period in order to facilitate entry of a new supplier or product. As well, any of these practices are exempt when confined to affiliated companies.

iii - Abuse of Dominance

86. Under the abuse of dominant position provisions of the *Act*, sections 78 and 79, the Competition Tribunal may issue an order when it finds that one or more firms substantially or completely control a class or species of business and have engaged in a practice of anti-competitive acts that has had, or is likely to have, the effect of preventing or lessening competition substantially in a market. The Tribunal may make an order prohibiting the persons from engaging in the practice and/or directing the persons to take such actions, including divestiture of assets or shares, as are reasonable and necessary to overcome the effects of the practice. To ensure that the law does not impede aggressive, pro-competitive behaviour, the Tribunal shall consider whether the practice is a result of superior competitive performance.

87. There are no exemptions in the abuse provisions that exclude participants in any part of the financial services sector from having their conduct examined as an abuse of a dominant position. In fact, in an application last year involving a joint abuse in the financial services sector, the Competition Tribunal issued a Consent Order concerning abuses by the charter members of the Interac Association of their dominant position in the provision of shared electronic network services in Canada.

88. The types of situations that would raise an issue under the abuse provisions of the *Act* would involve the use of market power by a dominant firm or firms so as to prevent or impede the entry or expansion of rivals. The abuse provisions are concerned with the types of anti-competitive acts that maintain or enhance market

power and include foreclosing the customers or suppliers of a competitor; the use of "fighting brands" for disciplinary or predatory purposes; squeezing the margins of non-integrated competitors; and use of long term, restrictive contracts to tie up customers.

89. There is a non-exhaustive list of anti-competitive acts set out in the abuse provisions, each of which includes consideration of the purposes or objects of the dominant firm in engaging in the act. Under the abuse provisions, the Director can examine any practices, including those covered under other sections of the *Act*, such as refusal to deal, tied selling, exclusive dealing or predatory pricing, whenever they constitute a practice of anti-competitive acts.

90. The size of a business, even one that dominates a particular market, is not, of itself, an issue under the *Act*. The dominant firm or firms must possess market power, for which a necessary but not sufficient condition is having significant market share. A market share of less than 35% in a particular product and geographic market would likely indicate that the firm does not have market power. Other relevant factors include the existence of barriers to entry such as tariffs or government regulations that limit competition; a lack of substitute products; an insufficient number of potential competitors, or a low level of innovation in the industry.

91. Joint conduct that lessens competition substantially may be addressed under the abuse of dominance provisions. The *Act* refers explicitly to situations in which "one or more persons" substantially or completely control a class or species of business. In joint abuse cases, unaffiliated firms may individually have less than a 35% market share, but collectively possess market power which they maintain or enhance through common actions. This could involve joint adoption of exclusionary practices including restrictive contracts, tying, refusal to supply or squeezing non-integrated rivals. It could also involve the reduction of competition within the dominant group, such as by using customer allocation practices. Although there is no jurisprudence on this point, the abuse section could apply to joint conduct outside the purview of the conspiracy provisions of the *Act*, such as behaviour approaching what is known as conscious parallelism.

iv - Mergers

92. Mergers and acquisitions are examined under the *Act* to determine whether they are likely to substantially lessen or prevent competition. The Director's

1991 Merger Enforcement Guidelines ("MEGs") set out the analytic framework that is employed by the Bureau to determine whether a merger is likely to substantially lessen or prevent competition in a market. Attached as **Appendix II** to this submission is a preliminary draft of a supplement to the MEGs that the Bureau intends to circulate to interested parties for consultation purposes. The purpose of this document is to set out how the Bureau proposes to apply the MEGs when assessing the competitive effects of a merger involving two or more banks.

93. This is the first time that the Bureau has released a document that describes how the MEGs would be applied to a specific industry sector. The Bureau feels that this is appropriate in light of the profile that this issue has gained as a result of the current review by the Task Force and the importance of this sector to the economy as a whole. It is also in keeping with the Bureau's desire to foster an open, transparent, and predictable approach to enforcement of the *Act*. It is not the Bureau's intent in this document to revisit the MEGs but rather to consult on the manner in which the MEGs will be applied to a merger in this sector. It is important to note that the approach outlined herein is predicated on the fact that the Bureau has not undertaken a major bank merger review and as such, our views are preliminary and subject to refinement and revision.

94. After it has been determined that a transaction constitutes a merger under the *Act*, the Bureau proceeds with an analysis to determine whether the merger is likely to have the effect of preventing or lessening competition substantially. The Bureau will consider whether a merger is likely to cause harm to consumers as the result of either the unilateral exercise of market power by the merging firms or the increased scope for interdependent behaviour among firms in the market. A merger allows firms to unilaterally exercise market power if the merger, by placing the pricing and supply of the products of the merging firms under common control, enhances the profitability and possibility of increasing prices and restricting supply (or limiting competition on some other dimension). A merger in a concentrated market can also increase the likelihood that firms, including firms that are not parties to the merger, will engage in interdependent behaviour that harms consumers. Interdependent behaviour can include implicit or explicit understandings among firms to profitably limit competition.

95. As explained below, if the analysis of the competitive effects of merger indicates that the merger will substantially lessen or prevent competition, the Bureau

considers whether the merger creates efficiencies which are likely to be greater than or offset this effect.

Definition of the Relevant Market

96. The first stage in the analysis is relevant market definition, which serves to identify the suppliers with which the merging parties compete and the geographic areas within which such competition takes place. At the market definition stage, the Bureau first determines whether there are geographic areas in which there is overlap between the product or service offerings of the merging parties. This is followed by the identification of all products and services to which consumers can turn in response to an increase in prices by the merging parties.

97. The definitions of "product" and "service" in this context are consistent with the purpose of assessing whether a merger is likely to result in an increase in the market power of the merging firms. Generally speaking, products that are similar may nevertheless be placed in separate product markets if consumers are unwilling to switch from one to the other in response to a change in relative prices.⁸ The broad category of loans, for instance, may include several products that are distinguished by their dollar value, terms, or collateral. Whether large-value loans are in the same product market as smaller loans, for example, depends on whether a significant number of borrowers are likely to switch from one to the other in response to an increase in the interest rate on smaller loans; if no such switching is likely to take place, then these two products will be placed in separate markets.⁹ Failure to identify whether small and larger loans are distinct in this way could yield misleading conclusions about the competitive effects of a merger. Such a failure to distinguish between small and large loans at the market definition stage could lead to the erroneous conclusion that suppliers of large loans constrain the pricing of suppliers of small loans when this is not the case. The analysis would therefore fail to identify a merger's enhancement of market power in the supply of small loans.

98. A similar analysis is conducted for other products to which borrowers could turn as an alternative to small loans. In evaluating whether these alternatives are close substitutes for small loans and therefore merit inclusion in the same relevant

⁸ The term "product" is defined as both articles and services.

⁹ Whether small loans are in the same market as large loans depends on many factors, including the ability of borrowers to substitute a bundle of small loans for a single large loan.

market, the Bureau asks whether borrowers will turn to these products in response to a small but significant, non-transitory price increase. The Bureau will seek and use any information that will assist in answering this question. Ideally, data on actual consumer switching in response to changes in relative prices would be used. However, this type of data is rarely available, and consequently the Bureau will generally use more indirect evidence of substitutability. The set of all products that are close substitutes to small loans would constitute a relevant product market.¹⁰

99. There is likely to be a large number of relevant product markets in a bank merger assessment. Differences in dollar value, terms, collateral, etc. among loans may imply that there are several product markets within the broader category of loans; similarly, deposits with differing characteristics may be placed in separate product markets. The many other products supplied by the banks will also be subject to the same analysis. Products supplied by non-bank deposit-taking institutions may also be included in relevant product markets, depending on whether these products are close substitutes to the products supplied by the banks.

100. A "cluster" of banking services may also constitute a relevant product market. A cluster would include a set of products and services that buyers tend to purchase from the same institution. A cluster is not necessarily sold as a bundle, but the price or availability of some components of the cluster may be more favourable for the buyer when purchased in conjunction with other products from the same institution. Such a cluster of banking products constitutes a relevant market when the individual components or a subset of components of the cluster are not collectively a close substitute for the cluster. This will be the case when consumers will not, in response to an increase in the price of a cluster, purchase the various components separately from different institutions. This may be because of the "transaction" costs associated with using a number of suppliers (for example the physical transportation costs, the time taken to make several applications) and economies of scope. If the cost to a supplier of providing the cluster is less than the sum of the costs of providing the components individually, the price a consumer pays for the elements purchased separately is likely to be higher than the price of the cluster.

¹⁰ The conceptual tool used to identify substitutes and define relevant markets is the "hypothetical monopolist" test. Using this test, a relevant market is the smallest group of products (which includes the products of the merging firms) such that a sole supplier of these products could profitably maintain a small but significant, non-transitory price increase. Significant in this context usually means 5%, and non-transitory means a price increase lasting at least one year.

101. Once product markets are defined, the Bureau's attention turns to delineating the geographic scope of the markets. The geographic market associated with a given relevant product market is determined by the geographic areas in which there are suppliers to which borrowers could turn in response to an increase in the price of products within the relevant product market. Geographic markets may be local, regional, national, or international, depending on the characteristics of the product and the nature of transactions. The characteristics that are likely to be important in determining the size of geographic banking markets are the value of transactions, the frequency of interaction between the supplier and the consumer, the nature of their interaction (for example, the need for personal contact between provider and consumer), and the cost of accessing more distant suppliers.

102. Consumers of certain types of banking services may be unable or unwilling to switch to suppliers outside of their local areas in response to an increase in the prices of these services in their own areas. In such cases, geographic markets are likely to be local, consisting of particular urban or metropolitan areas. This is most likely to be the case where transactions require frequent personal contact between the bank and the customer and monitoring of customers' activities. In such cases, geographic markets will be defined by reference to the cost of additional travel by both the service provider and the customer, and also by the time incurred in traveling. For other products, geographic markets may be much larger. This is likely to be the case for higher-value transactions.

Market Share Calculation and Thresholds

103. Once all product and geographic substitutes are identified, the Bureau determines the amount of new supply that is likely to be attracted to the market should prices of products in the relevant market rise by a small but significant amount. The Bureau will then calculate market shares of both current suppliers in the market and firms that can participate in the market through a supply response. The share of each firm is its total sales of output in the relevant market plus its potential supply response divided by the sum of total sales in the market plus the total of all firms' supply response. Market shares are calculated for each product and geographic area for which there is overlap between the merging parties.

104. At this stage, threshold tests are applied to assist in determining whether the merger is likely to result in a substantial lessening or prevention of competition in

the supply of any of the products of the merging parties. The Bureau is unlikely to be concerned that the merger will enhance the ability of the merging firms to unilaterally exercise market power if the sum of the pre-merger market shares of the merging parties in the relevant market is less than 35%. If the sum of the merging firms' market shares is below 35%, there are likely to be sufficient products and suppliers to which consumers can turn in response to an attempt by the merged entity to exercise market power by increasing prices post-merger. The Bureau will not be concerned that the merger will increase the likelihood that firms in the market will engage in interdependent behaviour in a way that harms consumers if the share of the market accounted for by the largest four suppliers in the market, post merger, is less than 65%. If the four-firm concentration level is below 65%, then coordination among firms in the market is likely to be too difficult to be of concern. If there is other information to suggest that competition is likely to be lessened substantially even though these thresholds are not surpassed, the Bureau will consider this information in its assessment.¹¹

105. The Bureau will not conclude that a merger is likely to substantially lessen or prevent competition in the supply of some product solely on the basis that the market shares or concentration level in the relevant market are above the threshold levels.¹² Rather, the Bureau will undertake an assessment of other competitive factors in order to determine the competitive effects of the merger. Particular emphasis is placed on market characteristics that make it more or less likely that the merger will enhance the ability of the merged entity to unilaterally exercise market power or increase the likelihood that firms will engage in interdependent behaviour.

106. The term "interdependent behaviour" refers to a set of actions undertaken by a group of firms that are profitable for each of them only in the absence of other

¹¹ When a merger creates a concern that unilateral market power will be exercised by the merging parties, the most important factors that would suggest that further investigation is warranted notwithstanding that the sum of the merging firms' market shares is less than 35% are those relating to the extent to which the products of the merging firms competed with each other pre-merger. For example, if the products in the market are differentiated and the products of the merging parties are the first and second choices for a large number of consumers, then there would likely be greater concern about the unilateral exercise of market power. If the concern is with the increased scope for interdependent behaviour and if market characteristics strongly suggest the possibility of reaching and enforcing an agreement among firms in the market, then notwithstanding the fact that the four-firm concentration ratio is less than 65%, the Bureau will continue to conduct its assessment.

¹² Section 93(2) of the Act directs that the Competition Tribunal cannot find that a merger lessens competition substantially based solely on evidence of market shares or concentration.

firms' retaliation for deviations from the understood actions¹³. This type of behaviour may include tacit or explicit understandings among firms on price, service levels, or any other dimension of competition. Reaching terms of understanding are likely to be easier when products and/or firms are homogeneous, and when important information about rival firms and market conditions is readily available. Relevant factors will include whether there are industry organizations that facilitate communications and dissemination of information among market participants. Important factors affecting the ability of firms to detect and punish deviations from an understanding include the transparency of the terms of market transactions and the stability of underlying costs. The existence of "maverick" firms may impede successful coordination.

Evaluative Criteria

107. The evaluative criteria listed in Section 93 are also used to determine the competitive effects of a merger on the supply of each product for which the market shares or concentration levels exceed the threshold levels.¹⁴ These criteria include the availability of acceptable substitutes, effective remaining competition, removal of a vigorous and effective competitor, and change and innovation. One of the critical section 93 factors concerns the likelihood that firms will enter the market within two years should prices increase in the relevant market (section 93(d)). In keeping with the purposes of merger assessment, only entry that is likely to discipline a post-merger price increase is relevant to this stage of the analysis. The lower the barriers to entry into the market, and the more likely that firms will enter in such a way as to discipline a post-merger price increase, the less likely it is that the merger will result in a substantial lessening of competition. In determining whether entry would discipline a post-merger price increase, the Bureau will consider the extent to which the costs of entering a market are sunk. The entry analysis in the context of a bank merger will also take into account the regulations that facilitate or hinder new entry, including restrictions on foreign bank entry and regulations with respect to business powers.

108. The possibility of business failure and exit is another section 93 factor. When one of the merging parties is likely to fail should the merger not proceed, and

¹³ These punishments may take the form of low prices in the relevant market or in other markets.

¹⁴ The evaluative criteria listed in the MEGs include the following: views, strategies, behaviour and identity of buyers; trade views, strategy and behaviour; end use; physical and technical characteristics; consumer switching costs; and price relationships and relative price levels.

there is no competitively preferable alternative to the merger, the Bureau will not attempt to block the merger.

The Efficiency Exception

109. Upon completion of this stage of the analysis, the Bureau will have identified the set of products whose supply is likely to be adversely affected by the removal of competition as a result of the merger. If it has been determined that a substantial lessening or prevention of competition will result from the merger, the analysis then turns to an assessment of whether the merger is likely to result in cost savings which offset the negative economic impact arising from the merger.

110. Section 96 of the *Act* recognizes that some mergers may be both anti-competitive and efficiency enhancing. When a balancing of the anti-competitive effects and the efficiency gains from a merger demonstrates that the Canadian economy as a whole would benefit from the merger, section 96(1) explicitly resolves the conflict between the competition and efficiency goals in favour of efficiency. The underlying purpose of a competition analysis is to determine the overall economic effects of a merger; consequently, only those efficiencies that represent real savings in economic resources and those that would not likely be attained absent the merger will be weighed against the anti-competitive effects of the merger. In economic terms, the trade-off analysis seeks to identify the effect of the merger on total economic welfare. The onus of demonstrating any efficiencies rests with the merging parties.

Initial Threshold Tests

111. In analyzing the competitive effects of a bank merger, it would be difficult in practice and likely unnecessary for the Bureau to define markets associated with each product supplied by merging banks and with each location from which these products are supplied, and identify potential supply responses and evaluate the likelihood of entry into each of these markets. The fact that banks typically offer a vast number of products and services at a large number of locations implies that such an exercise would be extremely resource intensive and time-consuming, especially since markets for many products are likely to be local. In practice, the Bureau will attempt to apply an iterative approach which, although entirely consistent with the framework described in the MEGs, allows the Bureau to more quickly identify the products and geographic locations which are more likely to create concern with respect to the loss of competition.

112. The Bureau fully expects that there will be a number of mergers announced in the sector within a short timeframe should the current restrictions on bank ownership be removed. This will complicate the Bureau's analysis of the competitive environment in the industry and the appropriate approach to redressing any concerns that may arise. It is the Bureau's intention to assess each merger on its own merits and proceed on a first-in/first-out basis. Subsequent mergers will be assessed in light of the environment that would exist after the earlier mergers have been reviewed. The Bureau introduced, in early November, a cost recovery environment for certain services including premerger notification and advance ruling certificates. As part of this process, the Bureau also introduced service standards relating to the maximum turnaround times by which the parties can expect to receive the opinion of the Bureau. The Bureau has indicated three standards for merger review: fourteen days for non-complex transactions, ten weeks for complex transactions and five months for very complex transactions. Regardless of the number of transactions announced, any merger within this sector will at a minimum fall within the definition which the Bureau has established for a complex case.

113. In order to screen out products whose supply is unlikely to be affected by the merger, the Bureau will initially apply the market share and concentration threshold tests to a pre-defined set of product offerings and geographic locations. These sets of products and geographic locations do not necessarily constitute well-defined relevant markets, but rather are chosen to be narrower than the corresponding relevant markets are likely to be. That is, the product markets are likely to include more products and the geographic markets are likely to be larger than the pre-defined areas. For example, the Bureau may apply its threshold tests to loans from \$200,000 to \$500,000 in a particular Census Subdivision (CSD), but the relevant market may include both larger and smaller loans and adjacent CSD's.

114. Generally speaking, when the thresholds are not surpassed for several adjacent CSD's for a particular product, then the Bureau is unlikely to be concerned that competition will be lessened substantially for that product in those areas. For areas in which the thresholds are surpassed, the Bureau will use additional information to determine whether these areas are a part of larger geographic markets; if they are, and the thresholds are not surpassed in these markets, then the Bureau is unlikely to conduct further analysis with respect to these product areas. The products and areas

which survive this screening process will be subject to the full analysis, as described above.

115. The purpose of this initial test is to expedite the Bureau's analysis of a merger. The extent to which the initial test serves this purpose depends crucially upon the quality of the data that is made available to the Bureau and the promptness of its availability. In conducting previous Schedule II bank merger assessments, the Bureau has found that geographic markets for many products are local, and that loans and deposits of different dollar values and with other differing characteristics may constitute relevant product markets. In order to promptly assess a bank merger, therefore, the Bureau requires access to data disaggregated by branch for each bank, trust company, and other deposit-taking institutions, including that of non-merging parties.¹⁵ Furthermore, the data should be narrowly disaggregated by product.¹⁶

116. Given the importance of collecting and analyzing large amounts of detailed information during the course of reviewing a merger involving financial institutions, members of the financial services sector are encouraged to provide the Bureau with the information it requires in a timely fashion. To expedite any possible merger review, general industry information should be made available to the Bureau. At a minimum, this information, along with more specific relevant data, would be required at the time the Bureau is made aware of the proposed transaction.

V - Mergers of Federal Financial Institutions and the Role of Regulators

117. When financial institutions are involved in a merger, three federal authorities have the legislative mandate to review the transaction: the Minister of Finance, the Superintendent of Financial Institutions ("OSFI"), and the Director. Both OSFI and the Director have clear mandates for review based on prudential and competition considerations respectively. The Role of the Minister of Finance is based on much broader public interest considerations.

¹⁵ The Bureau will also use any available data regarding the supplies of non-deposit-taking institutions.

¹⁶ The Bureau is aware that data has been compiled regarding the supply, by branch, of the following products: personal loans; residential mortgages, non-residential mortgages, business loans for each of the following amounts: up to \$200,000; \$200,000 to \$500,000; \$500,000 to \$1 million; \$1 million to \$5 million; \$5 million and greater, personal chequable deposits, personal non-chequable deposits, personal term deposits (GIC's, Certificates of Deposit), non-personal chequable deposits, non-personal non-chequable deposits, and non-personal term deposits.

118. As noted earlier, the Director issued a set of Merger Enforcement Guidelines in March of 1991, which have proven to be very useful in terms of informing the business and legal community of the approach taken by the Bureau in assessing mergers.

Recommendation 4:

For greater transparency and predictability, the Task Force should recommend criteria to be employed by the Minister of Finance when evaluating mergers from a broader public policy perspective.

119. The various acts regarding federally regulated financial institutions such as the *Bank Act* and the *Trust and Loan Companies Act*, give the Minister of Finance the right to approve or disapprove of mergers, independent of the *Competition Act*. This creates the possibility that the Minister of Finance may not approve a merger which has been cleared by the Director or, in the alternative, may approve a merger which the Director feels should be modified or challenged before the Competition Tribunal.

120. In the latter case, under section 94 of the *Act*, the Tribunal shall not make an order if the Minister of Finance has issued a certificate to the Director that states that the proposed transaction is in the best interest of the financial system in Canada. The effect of this provision is to provide the Minister of Finance with a means of ensuring that a merger which the Director may otherwise challenge is allowed to proceed if, in the Minister's view, it is in the best interests of the financial system.

121. With this sort of multi-party review of mergers, it is important that the process is efficient, effective and timely. The institutions involved in mergers, the financial system as a whole and the public at large, cannot afford to sustain a prolonged term of uncertainty.

122. The Task Force has already provided its preliminary views in this regard.¹⁷ The Bureau agrees in principle with the Task Force recommendations regarding the approach that should be taken with respect to financial institution mergers. However, the review process could be performed in a more expedited fashion with a better clarification of the criteria used by the Minister of Finance and a better understanding of when and where the Minister would exercise the power to approve or

¹⁷ See the Report of the Task Force on the Future of the Canadian Financial Services Sector in Response to a request by the Secretary of State (International Financial Institutions) July 11, 1997.

disapprove of a proposed merger involving federally regulated financial institutions. The Task Force provides a starting point for assessing this merger review process:

"Once it is determined that a specific transaction should not be prohibited by the "big shall not buy big" rule, it should be assessed on its merits. Prior to consideration by the Minister, such transactions should be reviewed by the Director of the Competition Bureau in order to assess whether the merger results in a substantial lessening of competition and by the Superintendent [of Financial Institutions] to assess safety and soundness considerations. There is no reason why these reviews need be sequential in timing. They could proceed together.

Then the Minister, with the advice from the Superintendent, would consider the request for approval, applying criteria felt to be relevant to a determination of the public interest. For analytical purposes, we assume the Superintendent deals primarily with safety and soundness while the Minister deals with the public interest elements, although we recognize that in practice, there is no such sharp distinction between their areas of responsibility."¹⁸

123. The Task Force goes on to say that if the merger does not have anti-competitive considerations and does not involve difficulties from a safety and soundness standpoint, it ought ordinarily to be approved subject to other public policy considerations such as: international competitiveness of the financial system, benefits to consumers, employment and on the adoption of innovative technologies.

Recommendation 5

As regards proposed mergers involving federally regulated institutions:

- i) To ensure a timely process, the preliminary reviews of a merger by the Minister of Finance, the Office of the Superintendent of Financial Institutions ("OSFI"), and the Director of Investigation and Research (the "Director") should be conducted simultaneously, each relying on their respective criteria when conducting their review.**
- ii) Subject to the confidentiality provisions set out in section 29 of the *Competition Act* and corresponding provisions affecting OSFI, there should be an open exchange of information between the three federal**

¹⁸ Ibid. p. 5

authorities where necessary, to facilitate the proper coordination of the reviews and the decision making process. (In the context of mergers involving financial institutions which are subject to provincial regulations, a similar exchange of information should take place involving the relevant provincial regulators).

- iii) Once preliminary views have been determined, one of a number of scenarios result:
 - a) If the Minister of Finance, OSFI and the Director conclude that there is no reason for blocking the merger, based on their respective review criteria, then the merger should be allowed to proceed;
 - b) If the Minister concludes that the merger should be blocked, based on the Ministerial criteria for review, the Minister would then exercise the authority to block the transaction after having informed both OSFI and the Director. This early notification on the part of the Minister would avoid the unnecessary expenditure of time and resources that might be required by the Director and OSFI in completing their respective reviews and, if necessary, seeking remedies;
 - c) If the Minister and OSFI conclude that there is no reason for blocking the merger, based on their respective review criteria, but the Director has determined that there is a competition related issue, the Minister of Finance would be informed of the Director's findings and the proposed course of action that the Director intends to pursue to resolve the matter. At this juncture, to save costs and time, it would be helpful if the Minister would provide both the Director and the parties to the merger with the assurance that there will not be the exercise of Ministerial override once the Director has committed to pursuing the competition remedy.

124. The Bureau seeks to resolve issues with the parties to a merger through a "fix it first" approach requiring the parties to alter the transaction to satisfy the competition concerns prior to closing the merger. If this cannot be accommodated, an agreed resolution to the problem is taken to the competition Tribunal under the consent order process. Still a third option, where no resolution can be reached, is to contest the merger before the Competition Tribunal.

Recommendation 6:

The overriding authority of the Minister of Finance to block the acquisition of a federal financial institution or to certify the acceptability of activities of financial institutions which may contravene the *Act*, is best exercised only in respect of non-competition issues. The Director, the Competition Tribunal and the courts are well equipped to evaluate and remedy competition issues as they may arise in the sector.

VI - Current Regulations/Policies Affecting the Financial Services Sector

125. In its Discussion Paper, the Task Force provides a very good overview of the current regulations and policies affecting the structure of the Canadian financial services sector. Many of the policies are based on prudential and other non-competition policy objectives. It is not the intention nor the mandate of the Director to comment on the validity of these policy objectives but rather to assess their impact on competition in the financial sector and where appropriate, point out areas where regulatory reform should be considered.

126. While the stability of the financial system is recognized as the paramount goal of financial market regulation, it is also understood that maintaining stability may come at the expense of some competition policy goals. The balancing of these two important policy objectives requires careful scrutiny. Having said this, there are some regulatory changes which can increase the flexibility and competitiveness of the financial sector without compromising the stability and solvency of the financial system.

127. In view of the importance of competition to the efficiency of the financial services sector, there are some general points to be made regarding any changes to the financial services sector's regulatory framework, before discussing the specific proposed regulatory changes.

Recommendation 7:

The Bureau's experience to date in both advocating competition and enforcing the *Act* in regulated sectors of the Canadian economy has allowed it to develop a number of competition principles that both legislators and regulators should consider when dealing with industries in transition. These principles are:

- i) Direct regulation should be considered only when market forces are inadequate by themselves to achieve the desired policy objective;

- ii) If direct regulation is required, the form of regulation that least distorts competition and efficiency in the affected markets should be chosen;
- iii) Clear conditions should be established respecting the circumstances in which the regulator will exercise forbearance from regulation;
- iv) When making changes to the regulatory environment of a sector of the economy, there is a need to assess the impact of the proposed changes on competition in the affected markets;
- v) During the period of transition from regulation to competition, there is a need to ensure there is an effective and coordinated set of regulatory and competition law constraints against anti-competitive abuses; and,
- vi) The ultimate goal of deregulation should be to bring choice regarding suppliers and product offerings down to the individual customer level.

128. With these principles in mind, there are a number of observations to be made regarding current regulations and policies affecting the sector. As a general observation, rules and regulations which affect the structure of a sector by definition impact on the state of competition and on the ability of the sector to respond to competitive pressures.

129. The Bureau's experience with other sectors of the economy has continually demonstrated one important lesson: markets are not static. One has to look no further than our communications sector to appreciate this point. In recent years, this sector has and continues to experience significant changes as a consequence of being subjected to global competition, more demanding consumers and changing technologies. Regulations which impede the ability of companies to respond to these changes can have a very detrimental effect on the health of the sector. Often, the regulations which were designed to preserve the economic health of a sector have proved to be impediments to the necessary changes required to facilitate its continued growth and well being. It is therefore important, when reviewing the effects of regulation and policies affecting the state of competition, to also consider how they impact on the ability of the sector to respond to change.

A - Ownership Restrictions on Banks

130. The regulation that no more than 10 per cent of any class of shares of a Schedule I bank can be owned by a single investor, or by investors acting in concert, is not intended to address any competition issues affecting the financial services sector.

Rather, it can be ascribed to prudential concerns related to "self dealing" . A similar regulation applies to demutualized life insurance companies with assets over a certain amount.¹⁹ The social policy intent is to preclude an entity which has control over a Schedule I bank from redirecting activities and/or assets of the bank to pursue other corporate interests for fear that this may work to the detriment of the institution, potentially jeopardizing its economic well being. The impact that this regulation has on competition must be balanced with the desired intent of the regulation.

131. From a competition policy perspective, ownership restrictions may limit the competition for corporate control of these institutions. Normally, a problem with ineffective management of an institution can be dealt with through the exercise of power afforded a majority shareholder or alternatively through the acquisition of control, and subsequent disciplining, from an outsider. Without this market for corporate control, there is a greater reliance on competition between institutions to provide such a discipline.

132. Additionally, ownership restrictions may limit the options available to Schedule I banks (and demutualized insurance companies) to avail themselves of the competitive pressure of the global economy. There has been a great deal of discussion generated within the banking community regarding the need for consolidation through merger to effectively compete with large foreign banks in the emerging global markets. Putting aside, for the moment, the merits of these arguments, it is clear that the ownership restrictions preclude mergers with foreign banks and other corporate entities.²⁰

133. A related issue arises in the hypothetical situation where two institutions wish to amalgamate, but due to competition issues, are compelled to divest assets. Similar situations have occurred in the US and have been effectively dealt with through divestiture orders which prompt the merging banks to divest branches to third parties in markets where competition concerns have arisen. This divestiture is accommodated by the fact that there are third parties willing to purchase the branches. In Canada, the ownership restrictions may limit the ability to divest assets by restricting the number of suitable third party candidates.

¹⁹ As noted in the Discussion Paper, existing law does not clearly indicate what the certain amount will be or what "widely held" means.

²⁰ Mergers between Schedule I banks are restricted to amalgamations which require the approval of the Minister of Finance , OSFI and the shareholders of the amalgamating banks.

134. With regard to domestically owned Schedule II banks, any modification reducing the ownership restrictions, once they have reached \$750 million in assets, may induce new entrants into the sector. While this may raise prudential issues associated with concentration of ownership, it would provide for more competition in the market.

Recommendation 8:

Should consideration be given to modifying ownership restrictions of banks, the impact of such modifications on competition should be taken into account.

B - The "Big Shall Not Buy Big" Policy

136. While not enshrined in legislation, there has been a moratorium on large financial institutions merging or acquiring other large financial institutions through the prevailing policy that "big shall not buy big". There are no set definitions on what constitutes "large". Furthermore, the policy does not appear to be based on prudential grounds but rather as a means of restricting the level of corporate concentration in the marketplace. The explanatory notes that are publicly available concerning this criteria are in the policy paper that accompanied the release of the amendments to the *Trust and Loan Companies Act* in the Fall of 1990:

"Because of concerns about potential concentration in financial services markets, in considering whether to approve the purchase of a deposit-taking financial institution (a bank, a trust or loan company) by another deposit-taking institution where permitted under the legislation, the Minister of Finance would take into consideration the size of the target institution and the size of the acquiring institution. Similarly, the Minister would review relative sizes when considering whether to approve the purchase of a federal insurance company by another insurance company. In considering size, worldwide operations will be included.

When a financial institution considers making a purchase of another financial institution engaged in a different business, transactions involving large companies would not be automatically excluded.

As currently, the *Competition Act* will also apply to all takeovers and mergers of federal financial institutions."

137. The competition concerns about potential concentration resulting from mergers relate to the ability of the merged entity to unilaterally, or through interdependent behaviour with other competitors, exercise market power in markets which are effectively closed to competition through the existence of barriers to entry. Section 92 of *Act* affords the Director the legislative mandate to review mergers on a case by case basis. Such an approach gives the Director the flexibility to review each matter on its own merits. It is also clearly articulated in section 92(2) of the *Act* that the Competition Tribunal shall not find that a merger prevents or lessens competition substantially solely on the basis of evidence of concentration or market share. The basis for this section of the law is to ensure that a variety of factors are taken into consideration when assessing the competitive impact of a transaction. Section 93 of the *Act* sets out a series of such factors that should be taken into account.

138. In the absence of the "big shall not buy big" policy, the application of competition law to the review of mergers involving domestic financial institutions would apply together with the ultimate discretion that the Minister of Finance can exercise with respect to certifying mergers.

Recommendation 9:

Applying the merger provisions of the Competition Act to mergers occurring within the financial services sector will prevent undue market power and achieve the same competition policy objective as the "big shall not buy big" policy. The merger provisions of the Competition Act could be the appropriate substitute for the "big shall not buy big" policy.

C - Comments on the Merits of Domestic Bank Mergers

139. In discussing changes to the current regulations mentioned above, the Bureau is not endorsing or encouraging mergers between domestic banks to take place. Rather, the Bureau is encouraging the adoption of a regulatory regime that is consistent with those found in other sectors of the economy. Should there be competitive concerns emanating from a merger, the merger provisions of the *Act* are properly designed to address them.

140. It should be noted that while horizontal mergers such as those contemplated between Schedule I banks, may enhance their ability to compete in global markets, it would come at the expense of competition in those markets which are regional or local in terms of geographic scope. The concern under the *Act* is determining

whether this lessening or prevention of competition is substantial. Under the *Act*, the weighing of efficiency gains against a substantial lessening or prevention of competition associated with the merger requires careful scrutiny to determine whether the efficiencies claimed are *bona fide* and whether they are unique to the merger. Efficiencies which would likely be obtained through some less anti-competitive alternatives are normally not included in this weighing of these offsetting effects. Some of the examples, in this context, of less anti-competitive alternatives would include efficiencies which can be obtained unilaterally by one of the parties, joint ventures or a proposed alternative merger between one of the parties and a foreign firm.

Recommendation 10

It is important that public policy scrutiny be applied to arguments that domestic mergers are the only alternative to coping with the pressures of global competition. By definition, mergers between competing banks reduce competition.

141. Global competition not only involves expanded access to what were considered foreign markets, but also requires an enhanced presence of foreign competitors in the traditional domestic market.

Recommendation 11:

To the extent that strategies to expand access to foreign markets involve mergers of domestic institutions, regulators should consider the means by which to encourage foreign competition in domestic markets.

D - Entry by Foreign Banks

142. The conditions that were imposed on foreign banks when they were first allowed entry into Canada limited them to a secondary role in the market. The *Bank Act* imposed three specific limitations on foreign banks: an asset ceiling, restrictions on domestic branches and the subsidiary requirement. International trade agreements have eliminated the asset ceiling on foreign banks and the restrictions on the number of branches for U.S. and Mexican banks. Nevertheless, the subsidiary requirement still applies to all foreign banks and the restriction on branches continues to apply for banks from outside North America. The Bureau supports the current efforts by officials at the Department of Finance to explore legislative changes that would allow foreign banks to establish branches in Canada. While it is recognized that the removal of the subsidiary requirement would require new regulations to ensure the prudential operation of

foreign banks in Canada, this may be a means to encourage further entry if the regulations adopted offer a lower cost means of operation.

Recommendation 12:

From a competition perspective and subject to prudential considerations, foreign banks should be allowed to establish branches in Canada.

E - Business Powers

143. There is no competition policy rationale for the current regulations restricting banks from offering auto leasing and insurance products to their clients through their branch networks. Non-bank financial institutions should, subject to prudential or other public policy considerations, be afforded flexibility in terms of the choice of financial products and services which they are permitted to offer consumers. As in any industry, the greater the number of firms supplying, or able to supply a product, the broader is the array of price and quality choices available to consumers.

144. It is reasonable to expect that there will be certain efficiencies associated with bank entry into insurance sales and auto leasing. In particular, some economists, including Horstmann *et al*, have noted that due to the established relationship with their customers in the sale of banking products, banks have a cost advantage over insurance providers in certain parts of the insurance market.²¹ For example, a customer may wish to purchase real estate that requires a mortgage at a bank. When the customer applies for the mortgage, the bank recognizes (at no cost) that the customer is a potential candidate for mortgage insurance. The traditional insurance company, on the other hand, would have to incur a search cost i.e., through "cold" telephone calls, to identify such customers. In this sense, therefore, a bank represents a low cost provider in the market for mortgage insurance. Similar examples can be given for the sale of premium retirement savings products and term life insurance. The authors argue that, in a competitive market, these cost savings would be passed on to consumers through lower product prices. Therefore, bank entry into the insurance market should benefit consumers.

145. In support of their argument, Horstmann *et al* cite empirical evidence which suggests that, because of these transactional efficiencies, bank entry into the

²¹ I. Horstmann, G.F. Mathewson and N.C. Quigley, *The Evolution of Markets and Organization in Banking and Insurance*, (September, 1995).

insurance market has benefited consumers in other countries. For example, commission rates in Australia on bundled products have fallen by 50% in the last decade and, in addition, banks have been responsible for introducing innovations such as no-load single premium products. Similarly, in the UK and Europe there is evidence of banks offering lower prices to consumers for many standard products.

146. There have been concerns expressed that there is the potential for the deposit-taking institutions to derive significant competitive advantage in leasing and insurance from their activities in other markets. Critics claim that bank entry into insurance will drive insurance agents out of business. At the same time, the insurance industry argues that banks will not be able to provide customers with the level of service available from an agent. These statements seem somewhat contradictory. Ultimately the choice should be left to consumers. The market, rather than regulators will dictate those companies that can better meet consumers' demands.

147. Other arguments suggest that banks will buy a dominant market share through the acquisition of major insurance companies and use this position to give away services in a predatory fashion until such time that they have driven the competing insurance companies out of the market. However, for banks to successfully act in such a predatory fashion, it would require them to act in concert which would be a criminal offence under the *Act* that carries a fine of up to \$10 million. Such co-ordination would be necessary because predatory conduct requires the ability to control the market supply of the product that is discounted. Predation would also require significant and effective barriers to entry such that the predator(s) can recoup the losses incurred while predating. Ignoring for the moment the fact that it contravenes the law, without a guarantee that entry will be precluded at the onset, predation would be an irrational corporate strategy to adopt.

Recommendation 13:

While there may be other public policy arguments that can be advanced, strictly from a competition policy perspective, banks should be permitted to offer auto leasing and insurance products to their clients through their branch network.

Recommendation 14:

While there may be other public policy arguments that can be advanced, strictly from a competition policy perspective, all financial institutions should be afforded the greatest flexibility in terms of the choice of financial products and services which they can offer consumers.

F - The Review of the Payments System

148. As noted in the Task Force Discussion Paper, effective operation of the payments system is essential to the maintenance and continued health of Canada's financial system. In a sense, the payments system is the nerve centre of the Canadian financial sector. It is also a vital underpinning of the whole market economy. Identifying and implementing the most appropriate regulatory framework to govern the payments system and to ensure its efficient operation is therefore of critical importance.

149. The present review of the payments system undertaken by the Department of Finance with the assistance of its Payments System Advisory Committee will no doubt be a significant contribution to the work of the Task Force. The Bureau is following the work of the Advisory Committee and will provide views on its outcome to the Department of Finance with a copy to the Task Force. With this in mind, there are some preliminary comments that can be made in this submission.

150. Currently, the *Canadian Payments Association Act 1980* provides deposit-taking institutions with exclusive authority to offer settlement services in the country, backed up by the role of the Bank of Canada as a lender of last resort. The *Canadian Payments Association Act 1980* also confers legislative authority on the Canadian Payments Association ("CPA") to plan the evolution of the system.

151. In the Bureau's view, providing market-based incentives for the efficient evolution of the system to better manage risks and, where appropriate, implement new technologies, is a key challenge for policy makers. As well, specific authority should be considered for access to the system by non-deposit-taking institutions.

152. A conflict of interest may exist where members of the CPA have substantial powers for regulating and safeguarding the public interest with respect to their own activities. A specific problem raised with this institutional design is that the existing members may have an incentive to keep access to the system closed rather than to open it to new entrants.²²

²² Neil C. Quigley, *Public Policy and the Canadian Payments System: Risk, Regulation and Competition* (Paper for presentation to the Conference on Issues in the Reform of the Canadian Financial Services Industry (January 5, 1996).

153. Direct access to the payments system is increasingly seen as a necessary strategic tool for many institutions and as a source of competitive advantage in the marketing of a wide range of financial services. The Bureau's experience in the *Interac* Consent Order issued by the Competition Tribunal highlighted the importance of access to the payments system as a strategic factor affecting competition throughout the financial sector.²³

154. Currently, the *Canadian Payments Association Act 1980* reserves membership in the CPA for deposit-taking institutions. As the ongoing debate on access to the payments system has made clear, there is a growing concern that limiting access to the system to these institutions places other institutions such as insurance companies, mutual funds and securities dealers at a competitive disadvantage in the marketing of a growing array of services.

155. Every effort should be made to address whatever concerns that more open access for particular institutions might raise by putting in place regulation to tend to these concerns directly rather than regulation which broadly prevents the access of firms based on their type of business.

Recommendation 15:

In order to foster competition and promote a level playing field among direct clearers and other financial institutions, access to the payments system should be provided to any institution which can demonstrate: (i) a justifiable need for using the system; (ii) the technical ability to participate in clearing; and (iii) an ability to meet the necessary capital and risk requirements.

Recommendation 16:

Any changes to the *Canadian Payments Association Act, 1980* should guarantee finality of payment for alternative private clearing systems which emerge over time. This would promote competition between or among clearing systems.

156. A specific matter relating to access to the payments system that may come under scrutiny in the review of the payments system is the use of sweep or pass-through accounts. An ability to use such accounts was a key factor in negotiating the Consent Order issued by the Competition Tribunal pertaining to *Interac*. Accordingly, restrictions on the use of pass-through or sweep accounts have the potential to undermine certain of the remedies to competition concerns contained within the Order.

²³ See Reasons for Consent Order (June 20, 1996), Competition Tribunal document CT-95/02.

157. Outside of the context of the *Interac* Consent Order, pass-through and sweep accounts may, subject to safeguards which are commensurate with the risk they pose, allow a wider range of sellers of financial products access to the electronic banking system. In doing so, these accounts enhance economic efficiency by opening opportunities for providers of specialty financial services to take advantage of technological advancements without incurring substantial capital costs.

Recommendation 17:

No new restrictions should be introduced on the availability of pass through and sweep accounts. These accounts enhance economic efficiency by opening opportunities for providers of specialty financial services to take advantage of technological advancements without incurring substantial capital costs. If new restrictions on the use of pass through and/or sweep accounts should be required, they should be introduced without undermining ongoing efforts to improve the Canadian Payments System and they should ensure that the intent of the Interac Consent Order, issued by the Competition Tribunal, is also not being undermined.

158. The future evolution of the payments system involves technical issues that go beyond the expertise of the Bureau. Nonetheless, it has been widely noted that recent technological advances hold out the promise of major improvements in the design and operation of payment systems and their ability to manage risk. These advances include the possibility of real time gross settlement clearing mechanisms.²⁴ Arguably, such mechanisms would substantially reduce or eliminate the "systemic risk" which is inherent in the current system.²⁵

159. The key to timely and effective implementation of innovations in payment technologies will be to ensure that competitive market forces guide the evolution of the system.²⁶ This is best insured by ending the current monopoly on the provision of settlement services held by the CPA, and by eliminating the current restrictions on participating in the system. Innovations in payment systems should be driven through the competitive forces in providing clearing and settlement services rather than by directive planning from organizations such as the CPA.

²⁴ See D. Folkerts-Landau, "Systemic Financial Risk in Payment Systems," in International Monetary Fund, *Determinants and System Consequences of International Capital Flows* (Washington DC) March, 1991.

²⁵ Systemic risk occurs when "the failure of one participant to settle deprives other institutions of expected funds, and in turn prevents these institutions from settling. Thus, although a participant does no business directly with a failed institution, chains of obligation may make it suffer..." Folkerts-Landau *supra* note 24.

²⁶ E. Gerald Corrigan, "Perspectives on Payment System Risk Reduction," in David B. Humphrey, ed., *The U.S. Payment System: Efficiency, Risk and the Role of the Federal Reserve* (1990).

VII - Conclusion

160. The importance of the work of the Task Force on the Future of the Canadian Financial Services Sector cannot be overstated. Its contribution to the overall health and continued growth of the financial services sector will be enormous.

161. As the regulatory framework affecting this sector continues to evolve away from direct regulation with a greater reliance on the market, the Bureau's role in promoting competition within the sector will no doubt increase. It is therefore critical that the approach taken by the Bureau is well balanced and that the Director has the proper resources and legislation to cope with competition issues which may arise in the sector.

162. Our experience to date has demonstrated that as industries are deregulated, there are major transition issues. Markets evolve over time and may not be immediately ready for open competition. Normally a fair and equitable period of transition should take place in a way that maximizes the benefits of competition but which also ensures the continued viability of the industry. The amount of regulation should decrease as more of the industry is opened up to market forces. This constantly changing balance is an important, if difficult, task for the Director and regulators to maintain. However, it is recognized that pure competition principles may not always be realistic because of competing objectives (e.g. prudential considerations).

163. There is a responsibility on the part of regulators and the Director to ensure that their mandate and the legislation they enforce are both relevant and effective.

164. Finally, we live in the age of globalization and trade liberalization. Efforts must continue to not only promote international anti-trust enforcement but to ensure that there is greater international co-operation between all regulators responsible for the financial services sector.

Director of Investigation and Research
Competition Bureau
November 1997

Appendix I

Tied Selling: Background Information for the Task Force on the Future of the Canadian Financial Services Sector

Tied Selling Defined

1. A firm engages in tied selling when it makes the purchase of one or more goods or services conditional on the purchase of others. This can be accomplished either through making the tied selling an overt condition of purchase or through some form of inducement such as a lower price for the bundle of tied goods than the sum of the individual prices of the goods if purchased separately. The two most common types of tied sales are bundling and requirements tying: bundling (or package tie-in) occurs when a product is sold only on the condition that some specified number of units of some other product is purchased from the same supplier (for example, in order to purchase a unit of B from a supplier, a consumer must also purchase two units of A from the same supplier); with a requirements tie, consumers must make all of their purchases of product A from a firm if they wish to purchase product B from that firm.

Pro and Anti-Competitive forms of Tied Selling

2. Tied selling can be either anti-competitive or pro-competitive. Tying may be anti-competitive when it forecloses competitors who supply the tied product(s). Foreclosure leads to a reduction in the choice of suppliers of the tied goods. If the level of foreclosure is such that consumers are adversely affected either through higher prices, less variety, or both, then antitrust intervention is warranted. However, tying can also be pro-competitive if it allows suppliers to take advantage of economies of scope in production, sale, and distribution, or reduces transactions costs. The fact that many products that are supplied in competitive markets are commonly tied together suggests that pro-competitive rationales for tying are pervasive. The Competition Bureau (the Bureau) would therefore recommend against an outright ban on tying in any market, unless it is clear that the only motivation for a tie is to foreclose competition.

3. Examples of potentially pro-competitive instances of tied selling in financial markets involve the provision of various forms of credit, mortgages or loans. At some stage in the process of providing a customer with these products, the financial institution must incur the cost of assessing the credit worthiness of the customer. Once an institution has incurred this cost for the provision of one product, it need not incur it again to provide the same customer with other credit-related products. By bundling a group of such products together, the institution provides these services at a lower cost to the customer than if each product had to be purchased separately.

4. Given the existence of both pro-competitive and anti-competitive motivations, it is important that a proper analytical approach be adopted when assessing instances of tied selling. The rule of reason approach which is applied under the tied selling (section 77) and abuse of dominance provisions (section 79) of the *Competition Act* serves this purpose. Under this approach, the Bureau is afforded the analytical breadth to assess, on a case by case basis, the impact of tied selling on competition in the affected markets. In this way, the *Act* provides protection against anti-competitive tied selling while permitting pro-competitive or competitively neutral tying to continue.

Section 77 of the Act: Tied Selling

5. Section 77 of the *Act* explicitly provides for the review of three types of vertical restraints: tied selling, exclusive dealing, and market restriction. In cases involving each of these vertical restraints, there are two broad elements that must be demonstrated before the Tribunal can issue an order. The first requirement is to demonstrate that the practice meets the definition describing the restraint that is set out in the *Act*. The second element is to demonstrate that the practice will have the required anti-competitive effect (the "competition test").

6. Tied selling is defined in the *Act* as occurring when a supplier engages in a practice of requiring a customer, as a condition of obtaining a product, to purchase any other product, or to refrain from dealing in other products of different brands; or when a supplier induces a customer to meet these stated conditions by offering to supply a product on more favourable terms.

7. For the practice of tied selling to be considered anti-competitive under the *Act*, it must be demonstrated that competition is, or is likely to be, substantially

lessened. To meet this condition, the tied selling must be engaged in by a major supplier or be widespread in a market and is likely to impede entry or expansion of a firm, or sales of a product, in the market or have some other exclusionary effect. In the event that the Tribunal finds that these conditions are met, it may issue a remedial or prohibitive order.

8. Section 77(4) sets out certain conditions under which the Tribunal shall not make an order. With respect to the financial services sector, there is an exemption for tied selling when it is engaged in by a person in the business of lending money for the purpose of better securing loans made by him and is reasonably necessary for that purpose. Other exemptions are available when tied selling occurs as a result of a reasonable technological relationship or when exclusive dealing or market restriction occur for a reasonable period in order to facilitate entry of a new supplier or product. An example of a reasonable technological relationship in the financial services sector is the evolving "smart card" technology where it makes economic sense to load a smart card up with a variety of services which are convenient for the users and help defray the cost of the technology used in supplying the card. As well, any of the practices are exempt when confined to affiliated companies.

Section 79 of the Act: Abuse of Dominant Position

9. Under the abuse of dominant position provisions of the *Act*, (sections 78 and 79) the Competition Tribunal may issue an order when it finds that one or more firms substantially or completely control a class or species of business and have engaged in a practice of anti-competitive acts that has had, or is likely to have, the effect of preventing or lessening competition substantially in a market. Under the abuse of dominance provisions, one would argue that the practice of tied selling is an anti-competitive act that is foreclosing competition in the affected markets. The Tribunal may make an order prohibiting the persons from engaging in the practice and/or directing the persons to take such actions, including divestiture of assets or shares, as are reasonable and necessary to overcome the effects of the practice. To ensure that the law does not impede aggressive, pro-competitive behaviour, the Tribunal shall consider whether the practice is a result of superior competitive performance such as the sort of pro-competitive tied selling referred to earlier.

10. Although the *Act* stipulates that some form of exclusionary behaviour is necessary for a finding that competition has been lessened, the ultimate goal of the relevant provisions of the *Act* is to preserve the conditions that allow for competition rather than to simply protect competitors. Generally speaking, the protection of competitors is relevant only to the extent that the participation of these competitors in the market is necessary to keep prices at competitive levels. The sections of the *Act* dealing with tied selling are therefore aimed at protecting consumers from practices that would leave them with higher prices and less choice. Removal of competitors from a market may reduce competition and harm consumers, but this is not necessarily the case. Tying may reduce competition from suppliers of individual components of the set of tied products. However, when bundling reduces costs and there is sufficient remaining competition among suppliers of the tied products to ensure that these cost savings are passed on to consumers, a prohibition on tying would impose a cost to consumers in the form of higher prices. In these circumstances the Bureau would not seek an order from the Competition Tribunal to prevent tying.

Consumer Protection

11. The Bureau recognizes that there may be other consumer protection issues related to tied selling. For example, the perception by uninformed consumers that no choice exists as an alternative to a particular circumstance of tied selling can effectively restrict the options the consumer feels are available, thus allowing the supplier to exploit this ignorance by setting higher fees. Efforts that promote consumer education regarding the nature and choices of financial products can go a long way towards ensuring that this sort of uninformed decision making on the part of consumers is minimized.

12. If this misperception on the part of consumers has been created by misleading marketing practices by the financial institution, the matter can be addressed under the *Act*. The misleading advertising and deceptive marketing practices provisions, sections 52-60 of the *Act*, help to ensure no competitor gains or retains market share by deception. Representations made to the public which are false or misleading in a material respect are prohibited. If the representation could influence a consumer to buy the product or service advertised, it is material. To determine whether an advertisement is misleading, the courts consider the "general impression" it conveys, as well as its literal meaning.

13. Advertisers are often surprised to learn that it is not a valid defense that they did not intend to mislead their customers. The Crown need prove only that the effect of the advertisement was misleading. Common violations include:

- unsubstantiated performance and durability claims,
- misleading warranties, and
- misrepresentations as to regular price.

14. The *Competition Act* applies to all representations to the public to promote the sale of products, regardless of form. Because of this, the misleading advertising and deceptive marketing provisions can apply to any misrepresentations that occur in the financial services sector. This is especially important in today's marketplace because of the increasing number of venues being used to access the sector. Electronic commerce and the Internet have provided an increased opportunity for consumers to obtain information about financial products and services; however, it has also provided an alternative venue for misleading representations.

15. Misleading advertising can have serious economic consequences, especially when directed towards large audiences or when it takes place over a long period of time. It can harm both business competitors, who are engaging in honest promotional efforts, and consumers.

16. Penalties under the *Act* include fines, the amounts of which are at the discretion of the courts, and imprisonment for up to five years. Both companies and individuals can be charged. The highest fines imposed so far under the misleading advertising provisions are \$1 million against a company and \$500,000 against an individual; the longest jail term, one year.

Conclusion

17. In conclusion, the *Act* provides the Bureau with the legislative tools to address anti-competitive forms of tied selling while preserving those forms which are pro-competitive or competitively neutral. Given the fact that there are pro-competitive forms of tied selling, the Bureau strongly urges the Task Force to consider whether there are remedies to other non-competition consumer issues related to tied selling that fall short of an outright prohibition on the practice.

Preliminary Draft For Consultation Purposes

Appendix II

The Merger Enforcement Guidelines as Applied to a Bank Merger

OVERVIEW

1. This appendix articulates the analytical framework used by the Competition Bureau (the "Bureau") when assessing the competitive effects of a merger, under the *Competition Act*, (the "Act") involving two or more Schedule I banks. The Bureau's general approach to assessing a merger is described in the Director's Merger Enforcement Guidelines (the "MEGs").¹ This is the first time that the Bureau has released a document that describes how the general guidelines would be applied to a specific industry sector. While the *Act* is a law of general application and the MEGs are intended to be applied across all business sectors, the Bureau believes that this precedent is appropriate for several reasons. The current policy debate with respect to bank mergers has raised the question of how the Bureau would apply the MEGs to a merger that involves a large number of products and services which are provided by many market participants across a large number of geographic markets. While this is not an entirely new challenge for the Bureau, it is likely that a merger in this sector would involve a larger number of products and geographic markets than the Bureau has reviewed previously. As well, the importance of this sector in the economy and to the general public has encouraged the Bureau to provide those involved in the current policy debate with a clearer view of the approach that the Bureau would likely follow when assessing a transaction involving two or more Schedule I banks. It is also in keeping with the Bureau's open, transparent, and predictable approach to enforcing the *Act*.

2. The approach that the Bureau intends to use in reviewing mergers in this sector is entirely consistent with the approach described in the MEGs. It is the Bureau's

¹ These Guidelines were issued by the Director of Investigation and Research in 1991.

intention in this appendix to provide a more practical and industry-specific tool for applying the MEGs than is found in the MEGs themselves. It is important to note that the approach outlined herein is predicated on the fact that the Bureau has not undertaken a major bank merger review and as such, our views are preliminary and subject to refinement and revision. -

3. In general, the main objective of the merger review process is to maintain and promote competition within the Canadian economy in order to provide consumers with a wide variety of high quality products that are competitively priced. More specifically, section 92 of the *Competition Act* states that the Competition Tribunal may order remedies when a merger prevents or lessens, or is likely to prevent or lessen, competition substantially. However, section 96 of the *Act* provides an efficiency exception: in general, if the anti-competitive effects of a merger are outweighed by the savings in economic resources that are likely to arise as a result of the merger, then the Competition Tribunal may not make an order under section 92.

4. A merger lessens or prevents competition substantially when it creates, enhances or preserves market power. Market power is the ability to profitably maintain prices, quality, and/or product variety for a significant period of time at levels that are less favourable to consumers than would obtain in a competitive markets. A merger can substantially lessen or prevent competition in two ways. First, a merger, by reducing the number of competitors in a market, can facilitate interdependent behaviour among firms, including firms that are not party to the merger. Interdependent behaviour refers to explicit or implicit understandings among firms in the market to jointly exercise market power or limit competition on price, quality, variety, or any other dimension.² In order to determine whether a merger is likely to increase the scope for interdependent behaviour, the Bureau will consider whether market conditions are conducive to reaching, monitoring, and enforcing such understandings.

5. A merger can also lessen or prevent competition substantially by enhancing the market power of the merging firms, even absent co-operation with other firms in the market. This is referred to as a unilateral exercise of market power. A merger allows firms to unilaterally exercise market power if the merger, by placing the

²This type of behaviour is distinct from co-operative behaviour that has the effect of increasing the efficiency with which firms supply their products. Banks have several such co-operative ventures, including the Interac network, and the Bureau recognizes that such ventures can benefit consumers.

pricing and supply of the products of the merging firms under common control, enhances the profitability of increasing prices and restricting supply (or limiting competition on some other dimension). When assessing whether a merger will promote the unilateral exercise of market power, the Bureau will consider various factors, most importantly the extent to which the merging firms exerted a competitive influence on each other prior to the merger, the remaining choices available to consumers, and the likelihood that lost competition will be replaced by supply responses by existing suppliers or by new entry into the market.

6. The Bureau's review of a merger begins with relevant market definition, which consists of determining the extent to which the merging parties supply substitute products and identifying all suppliers with which the merging parties compete. This market definition stage has both a product and geographic dimension. Banks provide a large number of products from many locations, and consequently there are likely to be many relevant markets in an assessment of a bank merger. Each relevant product market includes all products to which consumers can turn in response to a small but significant, non-transitory increase in the prices of the offerings of the merging parties, and/or a reduction in quality or variety of the product offerings of the merging firms.³

7. The geographic boundaries of the relevant market are determined in a similar manner: the geographic market includes all areas in which there are suppliers to which consumers can turn in response to an attempt by the merging firms to exercise market power. The size of a geographic market varies with the characteristics of a product, and different geographic markets may be associated with different products. For banking products, geographic markets are likely to be smaller the more important and frequent the interaction between the bank and the customer and the smaller the size of the transaction. Although the size of the geographic market associated with a product cannot be determined without a thorough consideration of the evidence, the Bureau expects the geographic scope of "retail" banking products, including various types of consumer loans, deposits, and loans to small business, are likely to be

³As discussed below in the section on Relevant Market Definition, the conceptual tool normally used by the Bureau to define the boundaries of relevant markets is the hypothetical monopolist test. When using this tool, the Bureau generally postulates a price increase by the merging parties, and asks whether consumers are likely to switch to other products in sufficient numbers to render such a price increase unprofitable, and therefore unlikely. In many cases, considering consumers' responses to price increases will be sufficient to determine whether a reduction in quality or variety is likely to be profitable. However, when the information gathered by the Bureau suggests that such a test may fail to identify an important dimension of competition, the test will be adjusted accordingly.

significantly more limited than the geographic scope of many "wholesale" banking markets. Past Bureau assessments of Schedule II bank mergers have concluded that many banking markets are likely to be local, encompassing only a small geographic area.⁴

8. The next stage in the analysis is the application of market share and concentration thresholds, which distinguish mergers that are unlikely to have anti-competitive consequences from mergers that require further analysis. Generally, mergers will not be challenged on the basis of concerns relating to the unilateral exercise of market power where the post-merger market share of the merging parties would be less than 35 per cent, and mergers will not be challenged on the basis of concerns relating to the interdependent exercise of market power where the share of the market accounted for by the largest four firms in the market post-merger would be less than 65 per cent or the merging parties would hold less than 10 per cent of the market.

9. In order to expedite the Bureau's review of a bank merger, an initial threshold test, based on pre-defined geographic markets and narrow product markets, is used to distinguish products and services that require further review from those that are unlikely to create a concern regarding a substantial lessening of competition. This initial threshold test is described in paragraphs 50 to 57. The products which "fail" the initial threshold tests are subjected to a complete market definition exercise, and a full competition impact analysis is performed on these products where appropriate.⁵

10. In the banking industry, as in other industries, any review of a merger has to consider recent trends in technology, regulation, and other factors that occur independently of a merger, but that are likely to have an impact on the competitive effects of a merger. These developments may, for example, result in the introduction of new savings and loan vehicles or new means of distribution, possibly by suppliers who are not currently market participants. The delineation of relevant markets and the calculation of market shares and concentration levels on the basis of existing products

⁴ Bank mergers examined by the Bureau include the following: Bank of Tokyo/Mitsubishi Bank; Republic National Bank of New York /Leumi Bank of Le Israel of Canada; Republic National Bank/Bank Hapoalim; Bank of Montreal/Banca Nazionale; and, Swiss Bank/Bunting Warberg. The Bureau has also assessed a number of transactions involving trust companies, including Canada Trust/National Trust, Co-operative Trust Company of Canada, and Trust la Laurentienne du Canada Inc./Trustco Pret et Revenu Inc.

⁵ More accurately, market shares and concentration threshold tests are applied to the relevant markets defined around the products that fail the initial threshold test, and the complete analysis is conducted for the markets in which the thresholds are surpassed.

and suppliers may therefore not accurately reflect the likely competitive effects of a merger. In evaluating the competitive significance of such changes in market conditions, the Bureau will consider whether these changes are likely, timely, and sufficient to offset any enhancement of market power that would otherwise arise because of the merger.

11. The remainder of this document is structured as follows. The next section discusses the definition of a "merger" as stated in section 91. This is followed by a description of the anti-competitive threshold for mergers, relevant product and geographic market definition, market share and concentration level calculation as well as the Bureau's initial threshold test, and the factors that are used to assess the potential that a merger will lessen or prevent competition substantially. The last section deals with the efficiency exception.

THE DEFINITION OF "MERGER"

12. Section 91 of the *Act* defines a merger as any transaction in which control over, or a significant interest in, the whole or a part of a business of another person is acquired or established. With respect to corporations, "control" is explicitly defined in section 2(4) of the *Act* to mean *de jure* control, i.e., a direct or indirect holding of more than 50 percent of the votes that may be cast to elect directors of the corporation, *and* which are sufficient to elect a majority of such directors. Although significant interest is not defined in the *Act*, the Bureau's position is that a "significant interest" in the whole or a part of a business is held when one or more persons have the ability to materially influence the economic behaviour (e.g., decisions relating to pricing, purchasing, distribution, marketing or investment) of that business or of a part of that business. Given the range of management and ownership structures which exist, a determination of whether a significant interest is likely to be acquired or established must be made on a case by case basis.

THE ANTI-COMPETITIVE THRESHOLD

13. Section 92(1) of the *Act* provides that the Tribunal may make an order in respect of a merger where it finds that the merger "prevents or lessens, or is likely to prevent or lessen, competition substantially". A prevention or lessening of competition can only result from a merger where the parties to the merger are, or would likely be,

able to exercise a greater degree of market power, unilaterally or interdependently with others, than if the merger did not proceed.

14. Market power refers to the ability of firms to profitably influence price, quality, variety, service, advertising, innovation or other dimensions of competition. The exercise of market power by a bank or banks could be manifested in numerous ways, including a reduction in interest rates on deposits or an increase in service fees, an increase in interest rates on loans, and an increase in the price of other services. An exercise of market power can also result in a lowering of product quality and a loss in the variety of available products. In all cases, the prices used in the analysis are actual transaction prices, rather than posted prices.

Lessening Competition

15. A merger among banks can **lessen** competition if it enables the merged entity to unilaterally raise price, or if it is likely to bring about a price increase as a result of increased scope for interdependent behaviour in the market. Interdependent behaviour includes an understanding among firms in the market to profitably increase price or to compete less vigorously. Competition can also be lessened if the merger allows firms to profitably lower quality or reduce variety.

Preventing Competition

16. Competition can also be **prevented** by conduct that is either unilateral or interdependent. Competition can be prevented as a result of unilateral behaviour where a merger enables a single firm to maintain higher prices than what would exist in absence of the merger, by hindering or impeding the development of increased competition. For example, the acquisition of an increasingly vigorous competitor in the market or of a potential entrant would likely impede the development of greater competition in the relevant market. Situations where a market leader pre-empts the acquisition of the acquiree by another competitor, or where a potential entrant acquires an existing business instead of establishing new facilities, can yield a similar result. Competition can also be prevented where a merger will inhibit the development of greater rivalry in a market already characterized by interdependent behaviour. This can occur, for example, as a result of the acquisition of a future entrant or of an increasingly vigorous incumbent in a highly stable market.

Substantiality

17. In assessing whether competition is likely to be prevented or lessened substantially, the Bureau generally evaluates the likely magnitude, scope and duration of any price increase or reduction in quality or variety that is anticipated to arise as a result of a merger. In general, a prevention or lessening of competition will be considered to be "substantial" where the price of the relevant product is likely to be materially greater, in a substantial part of the relevant market than it would be in the absence of the merger; and where this price, quality, or variety differential would not likely be eliminated within two years by new or increased competition from foreign or domestic sources. The Bureau is not confined to pricing measures and will consider any impact on quality, service, or variety, to the degree that competition is substantially lessened or prevented.

MARKET DEFINITION

18. The first stage in the Bureau's review of a merger involves defining the relevant market or markets in which the merging parties operate. Banks supply a large number of products, and the Bureau expects that in an assessment of a major bank merger, there will be many relevant markets. A relevant market, with both a product and a geographic dimension, is defined for each of the products of the merging banks. The Bureau normally defines relevant markets by reference to actual and potential sources of competition that constrain the exercise of market power. However, the vast number of products and services offered by banks, and the similarity in the inputs that are required to offer many of these products, would make it difficult to identify and measure the constraining effects of all potential suppliers in a timely manner. As a result, when analyzing a bank merger, relevant product markets are initially defined by actual sources of competition. The potential constraining influence of firms that can participate in the market through a supply response is considered subsequent to an initial market definition. The suppliers that will likely be added to the market within a year are included in market share calculations. This approach to merger assessment is consistent with the approach articulated in the MEGs, and departs from the MEGs approach only by considering supply substitution at a different stage in the analysis. It is also consistent with the current approach to mergers taken by the U.S. Department of Justice.⁶

⁶ Department of Justice and Federal Trade Commission Horizontal Merger Guidelines (April 2, 1992)

19. The main advantage of using this approach in a bank merger assessment is that it allows the Bureau to more quickly identify the markets in which there are likely to be concerns regarding market power arising from the merger. The market share and concentration thresholds will initially be applied to relevant markets defined with reference to demand substitution. Unless there is information to suggest otherwise, product and geographic markets for which the thresholds are not passed will be given no further consideration. For product and geographic markets where the thresholds are surpassed, the supply of output that is likely to be added to the market by firms not currently producing output in the market, but likely to do so within a year and without incurring significant start-up costs, will be calculated.⁷ Market shares and concentration levels will then be re-calculated. The potential constraining influence of competition from sellers who would not likely respond to the postulated price increase in the relevant market within the postulated period of time is considered subsequent to market share calculation, in connection with the assessment of future entry into the market.

20. In some circumstances, sellers with market power can identify and discriminate against certain buyers who would not likely switch to product or geographic substitutes available elsewhere within the relevant market, in response to a significant and nontransitory price increase. When such discrimination is feasible, it may be appropriate to define relevant markets that associate products with certain classes of buyers. For example, a bank may be able to profitably set higher interest rates for loans to smaller businesses than for similar loans to larger corporations, if the larger corporations have greater access to alternative sources of capital. Price discrimination in banking markets is facilitated by the exchange of information between buyers and sellers; lenders normally require that borrowers disclose certain information, relating to income, type of business, assets, etc. in order to assess risk before loans are approved. Lenders may use this type of information to distinguish borrowers who are likely to have access to many substitutes from those with few substitutes by charging higher loan rates for borrowers with higher risk or inelastic demands.⁸ In such cases, an assessment of the competitive effects of a merger would take into account the potential

⁷ The calculation of likely supply responses is discussed in paragraphs 47 to 49.

⁸ In certain limited circumstances, price discrimination may contravene section 50 (1) a of the *Competition Act*. The Bureau's enforcement policy with respect to price discrimination is articulated in the *Director's Price Discrimination Enforcement Guidelines*.

differential effects of the merger on various buyers by defining relevant markets with reference to the characteristics of buyers.

21. Relevant markets are normally defined through use of the "hypothetical monopolist" test. Under this test, a relevant market is the smallest group of products (which includes those of the merging firms) and the smallest geographic area such that a sole supplier of these products could profitably maintain a small but significant, non-transitory price increase over prices that would prevail absent the merger.⁹ The hypothetical monopolist test is applied to define both the product and geographic boundaries of the relevant market.

22. In general, the base price that is employed in postulating a significant and nontransitory price increase is whatever is ordinarily considered to be the price of the product. As the base price for loans and deposits, the Bureau will likely use the interest rate, or alternatively, the total interest paid on a loan or received for a deposit. The base price for deposits and loans may also include any relevant service fees. For other types of transactions where the banks provide some service (such as cash management, etc.) the base price will typically be the service fee.

The Product Dimension

General Approach

23. The purpose of defining relevant markets is to identify the suppliers with which the merging parties compete. Each relevant market includes all substitute products and services to which consumers can turn in response to a significant and non-transitory price increase on the part of merging banks.¹⁰ Generally speaking, products that are similar may nevertheless be placed in separate product markets if consumers are unwilling to switch from one to the other in response to a change in relative prices.¹¹

24. Banks generally supply products that fall into one of the following categories: deposits; loans; other services, such as cash management. Within each of these categories, there may be separate products or groups of products, differentiated in

⁹ Significant in this context usually means 5%, and non-transitory means a price increase lasting at least one year.

¹⁰ Or a decrease in interest rates in the case of deposits.

¹¹ The term "product" is defined in the *Act* to include both articles and services. Throughout the remainder of this document, the term product will be used to denote both a product and a service.

some relevant way from other products, that themselves constitute relevant markets. Whether or not such a subset of products constitutes a relevant market depends on whether consumers are willing to substitute towards other products in response to a significant and non-transitory increase in the prices of products in the subset.

25. Using the hypothetical monopolist test, a given set of products constitutes a relevant product market if a sole supplier of these products could profitably raise price by a small but significant amount. This is possible only if consumers would not switch a sufficient amount of demand to products outside the set to render the price increase unprofitable. The boundaries of the relevant product market therefore separate the products that are close substitutes for a given product of the merging banks from products that are not close substitutes. Products in the relevant market need not be supplied by banks or other deposit-taking institutions; what matters for the purposes of market definition is not the identity of the supplier, but the characteristics of the products and consumers' willingness to switch their consumption from one product to another in response to changes in relative prices.

26. As an example, loans that differ in their size, amortization, collateral, etc., may not be close enough substitutes to merit inclusion in the same relevant market. Two loans with different characteristics are considered to be demand substitutes only if borrowers will switch from one to the other in response to a significant increase in the interest rate charged on the first in sufficient numbers to render such an increase in the interest rate unprofitable. Thus even loans for different amounts may be in separate markets: a borrower will not necessarily substitute a \$10 million loan for a \$10,000 loan in response to an increase in the interest rate on the latter.¹²

27. Similarly, deposits that differ in their characteristics, such as size, maturity, and risk, may be in separate product markets. Deposits with different characteristics will be considered to be in the same relevant market if a sufficient number of depositors is likely to switch to other types of deposits in response to a significant decrease in the interest rate offered.

28. A "cluster" of banking services may also constitute a relevant product market. A cluster would include a set of products and services that buyers tend to

¹² This is not to say that an institution that supplies \$10 million loans cannot respond to a profit opportunity created by an increase in the interest rate on \$10,000 loans. The supply responses of firms not currently supplying the market are considered in paragraphs 47-49.

purchase from the same institution. A cluster is not necessarily sold as a bundle, but the price or availability of some components of the cluster may be more favourable for the buyer when purchased in conjunction with other products from the same institution. Such a cluster of banking products constitutes a relevant market when the individual components or a subset of components of the cluster are not collectively a close substitute for the cluster. This will be the case when consumers will not, in response to an increase in the price of a cluster, purchase the various components separately from different institutions. This may be because of the "transactions" costs associated with using a number of suppliers (physical transportation costs, the time taken to make several applications) and economies of scope. If the cost to a supplier of providing the cluster is less than the sum of the costs of providing the components individually, the price a consumer pays for the elements purchased separately is likely to be higher than the price of the cluster.¹³

29. In order to determine whether a cluster of products constitutes a relevant market, the Bureau will consider whether a significant number of customers purchase the bundle of products from a single institution. If so, then various other factors will be considered to determine whether the components of the cluster can be purchased individually in response to a significant non-transitory increase in the price of the cluster. These factors are discussed below, in paragraphs 31 and 32.

30. The following section summarizes the type of information that the Bureau will use to assess the nature and magnitude of likely demand responses to changes in prices.

Evaluative Criteria--Product Market Definition

31. When defining relevant product markets, the Bureau will consider the factors discussed in the MEGs, which are as follows: views, strategies, behaviour and identity of buyers; trade views, strategy and behaviour; end use of products; physical and technical characteristics of products; the costs incurred by buyers in switching from

¹³ The purchase of clusters is not necessarily caused by tied selling on the part of banks. Tied selling is prohibited, in certain circumstances, under the tied selling (section 77 (2)) and abuse of dominance (section 79) provisions of the *Competition Act*. The Bureau's enforcement policy with respect to tied selling can be found in Appendix I.

one product to another; and, the relationship between the price movements of products and differences in relative prices.¹⁴

32. With respect to whether a cluster of products constitute a relevant product market, the Bureau will consider, along with any other data, the following types of information:

- i) Any survey or industry data on consumers' propensity to purchase a number of products from a single institution;
- ii) Data on the number of products purchased per person and the number of products purchased from a given institution per person;
- iii) Any survey data on consumer preferences;
- iv) Data on the extent to which consumers have broken up their purchases of a cluster of products in response to relative price changes.

The Geographic Dimension

General Approach

33. Geographic markets for various types of banking services may be local, regional, national, or international. The size of the geographic market for a particular banking product depends on the characteristics of the product and the nature of the transaction. The characteristics that are likely to be important in determining the size of geographic banking markets are the size of the transaction, the frequency of interaction between the supplier and the consumer, the nature of their interaction (for example, the need for personal contact between provider and consumer), and the costs, in terms of time and transportation, of accessing more distant suppliers.

34. Consumers of certain types of banking services may be unable or unwilling to switch to suppliers outside of their local areas in response to an increase in the prices of these services in their own areas. That is, for certain types of products, geographic markets may be local, comprising only a limited geographic area. This is most likely to be the case where transactions require frequent personal contact between the bank and the customer and monitoring of customers' activities. In such cases,

¹⁴ These are discussed more fully in section 3.2.2 of the MEGs.

geographic markets will be defined by reference to the cost of additional travel by both the service provider and the customer, and also by the time incurred in traveling.

35. For example, a small business owner may need to frequently be in personal contact with the issuer of a loan and the loan issuer may need to monitor the activities and assets of the borrower. Given the cost, including time cost, of dealing with more distant suppliers, the borrower may be unable or unwilling to turn to these more distant suppliers in response to a significant price increase in his own geographic area. In these circumstances, the geographic market may be local.

36. For other types of services, where personal contact is infrequent or unimportant, geographic markets may be larger than local areas. This is most likely to be the case when the value of a transaction is large relative to the costs of personal contact or monitoring. In general, when determining the scope of local markets, the Bureau will take into account factors such as transportation costs, time costs and the size of the transaction.¹⁵ These evaluative criteria are discussed below.

Evaluative Criteria--Geographic Market Definition

37. The most useful data for the purpose of defining geographic markets, especially local markets, is data on commuting patterns. Markets are usually local when frequent interaction between the customer and the bank (or other service provider) is required, and the value of the transaction is relatively small. This interaction need not take place close to the customer's place of residence, and may rather occur near the customer's place of work. Data that indicates the proportion of a population that commutes to some other area (typically an urban centre) to work, and may therefore be able to do their banking in this other area, is therefore very useful in defining markets.

38. For rural areas, from which there may be less commuting to urban centres, information about the location of nearby shopping areas or any other location that is visited frequently for non-banking purposes is useful, as is information about how often such trips are made. However, areas in which the destinations of interest are visited relatively infrequently, such as appliance stores and hospitals, may not be included in

¹⁵ What is important is the relative cost of personal contact. A firm needing a small loan may not be willing to travel regularly to make personal contact just to obtain a loan with a 1 percent lower lending rate. However for a larger size loan, the cost of this traveling may be worthwhile.

the relevant market since interaction with a bank may be more frequent than visits to such locations.

39. Other important information includes banks' current drawing areas, although these areas are more likely to define the inner bound of a market (that is, banks outside this drawing area may be close substitutes for some consumers within its bounds). This data can often be acquired through survey data.

40. In defining relevant geographic banking markets, the Bureau will also consider the following factors, as discussed in the MEGs:¹⁶ views, strategies, behaviour and identity of buyers; trade views, strategies, and behaviour; switching costs, transportation costs; local set-up costs; particular characteristics of the product; price relationships and relative price levels; shipment patterns, and; foreign competition.

CALCULATION OF MARKET SHARES AND CONCENTRATION LEVELS

41. Although information which demonstrates that market share or concentration will be high cannot provide a sufficient basis, in and of itself, to justify a conclusion that a merger is likely to prevent or lessen competition substantially, it is a necessary condition that must exist before such a finding can be made. Absent high post-merger concentration or market share, the effectiveness of remaining competition in the relevant markets is generally such as to be likely to constrain the merged entity from acquiring, increasing or maintaining market power by reason of the merger.

42. Accordingly, the Director generally will not be concerned that the merging parties will be able to unilaterally exercise greater market power upon merger, where the post-merger market share of the merged entity would be less than 35 percent in the market. Similarly, the Director generally will not challenge 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 of each market accounted for by the four largest firms in the market would be less than 65 percent, and

¹⁶ Merger Enforcement Guidelines, section 3.3.2.

- ii) the post-merger market share of the merged entity would be less than 10 percent.¹⁷

43. If the sum of the merging firms' pre-merger market shares is below 35%, there are likely to be sufficient products and suppliers to which consumers can turn in response to an attempt by the merged entity to exercise market power by increasing prices post-merger. If the four-firm concentration level is below 65%, then coordination among firms in the market is likely to be too difficult to be of concern. If there is other information to suggest that competition is likely to be lessened substantially even though these thresholds are not surpassed, the Bureau will consider this information in its assessment. These thresholds simply serve to identify mergers that are unlikely to have anti-competitive consequences from mergers that require a more detailed analysis, before any conclusions regarding likely competitive impact can be reached. In all cases, an assessment of market shares and concentration is only the starting point of the Bureau's analysis.

44. Market shares are calculated both for firms that currently produce output in the relevant market, and also for firms that can potentially participate in the relevant market through a supply response. The market shares of existing market participants can generally be measured in terms of dollar sales, unit sales, or production capacity. Where firms in markets in which products are undifferentiated have excess capacity, the proportion of the total market capacity that is accounted for by a firm's own total capacity may better reflect the firm's relative market position and competitive influence in the market than does the proportion of total output supplied by the firm.

45. Although the capacity of a bank or other financial institution to provide credit is partly determined by its access to deposits or other sources of funds, capacity can also be affected by the size of the delivery network, including the branch network, the availability of trained personnel who are familiar with the market or industry, and other factors. The Bureau will therefore not calculate market shares solely on the basis of access to loanable funds, since the market shares and concentration levels calculated on this basis are not likely to accurately reflect the competitive significance of market participants. Since data on volumes of actual sales (i.e. loans and deposits) is likely to

¹⁷ Given that the Bureau's definition of the market may differ from that of the parties, full information should be provided to the Bureau regarding the merger and its likely effect on competition, where either the anticipated four-firm concentration level (CR4), or the market share accounted for by the merged entity, is close to the above-described thresholds.

be more readily available than data on capacity to make various types of loans or offer various types of deposits, the market shares of market participants will therefore likely be calculated on the basis of actual sales volumes. Information that suggests that firms' shares of actual volumes do not accurately reflect their competitive significance in the market will be taken into account in the assessment of the potential anti-competitive effects of the merger.

46. With respect to firms that can participate in the market through a supply response, only the capacity that is likely to be diverted to producing output in the relevant market within one year will be included in market share calculations. The Bureau will not in general assume that an institution that does not supply the relevant products (or supplies a minimal quantity of these products) is likely to respond to an increase in the price of the relevant products by diverting capacity simply because it supplies similar products. For example, an institution that offers primarily large loans to large corporations will not be assumed to be able to easily switch to supplying smaller loans to small and medium-sized businesses. The profitable supply of different types of loans requires different types of activities (for example with respect to screening and monitoring), and an institution that is well adapted to supplying large loans may not be well adapted to supplying small loans, and may not be able to quickly supply such loans without expending considerable resources. The criteria used to assess whether a supply response is likely, and the likely magnitude of such a response, are discussed in the following section.

Firms That Can Participate in the Market Through a Supply Response

47. Firms that are likely to respond to a price increase in the relevant market quickly (generally within one year) are considered at the market share calculation stage, while firms that are likely to have an impact in the market after one year, but within two years after the merger, and whose entry requires considerable investment in assets, are considered in paragraphs 75 to 88, under Barriers to Entry.

48. In determining the potential competitive influence of a firm that may respond to a price increase through a supply response, the following factors will be considered:

- i) the cost of substituting production in the relevant market for current production ("switching costs");

- ii) whether, and to what extent, capacity is committed to the production of other products or services;
- iii) the profitability of using capacity in current production.

49. In general, the Bureau will determine whether a firm not currently supplying the relevant product can profitably respond to a small but significant (usually 5%) increase in the price of this product within one year. Only the volume of output that is likely to be supplied in the relevant market at this price will be included in market share calculations.

The Initial Threshold Test

50. In analyzing the competitive effects of a bank merger, it would be difficult in practice and likely unnecessary for the Bureau to define markets associated with each product supplied by merging banks and with each location from which these products are supplied, and identify potential supply responses and evaluate the likelihood of entry into each of these markets. The fact that banks typically offer a vast number of products and services at a large number of locations implies that such an exercise would be extremely resource intensive and time-consuming, especially since markets for many products are likely to be local. In practice, the Bureau will apply an iterative approach which, although entirely consistent with the framework described in the MEGs, allows the Bureau to more quickly identify the products and geographic locations which are likely to create concern with respect to the loss of competition.

51. The Bureau will begin its analysis by conducting an initial threshold test. The aim of this test is to "screen out" geographic areas for which a bank merger is unlikely to pose competition problems. The Bureau will apply the market share and concentration threshold tests, as outlined above, to a pre-defined set of product offerings and geographic areas. The pre-defined set of product offerings will depend partly on the availability of data,¹⁸ and since the focus of the initial threshold test is to screen out products and geographic areas from further analysis, the set of pre-defined product offerings will be narrower than the likely product markets that include these products.

¹⁸ The Bureau is currently exploring available data sources at the Bank of Canada, OFSI and The Canadian Bankers Association. The success of the initial threshold test will obviously depend on the quality of the available data. The Bureau hopes to obtain, preferably even before a bank merger, branch level data for a wide array of product offerings.

52. The set of pre-defined geographic areas will consist of Canadian census subdivisions which were defined by Statistics Canada for the purpose of the 1996 Census. Census subdivisions are essentially legally defined municipalities (as determined by provincial legislation), including large urban centers as well as small rural centers. By choosing census subdivisions (municipalities) as the pre-defined geographic areas, the Bureau will be focusing its analysis on geographic areas which are likely to be no larger than relevant geographic markets. At the same time, given the retail nature of many banking products, a single municipality is likely to represent a large part of the internal core of a relevant market; census subdivisions should provide good initial approximations of local geographic markets in most cases.

53. If the thresholds are not exceeded for a given pre-defined product offering and a pre-defined geographic area, the Bureau is unlikely to be concerned that competition in the supply of that product in that area will be lessened substantially. In the absence of information suggesting that the relevant geographic market is larger than the pre-defined geographic area, the Bureau will have no cause to conduct a further review of this product offering and geographic area.

54. If the thresholds are exceeded for a given pre-defined product offering and a pre-defined geographic area, the Bureau will use additional information, as described in connection with the evaluative criteria for geographic market definition (paragraphs 37 to 40) to determine whether this area is part of a larger geographic market. If it is, and the thresholds are not surpassed in this broader area, then the Bureau will have no cause to conduct a further review of this product and geographic area.

55. The Bureau will also identify certain census subdivisions in which there are unlikely to be competition problems due to their economic integration with other larger census subdivisions. For example, the Bureau will use 1996 Census commuting data to eliminate certain census subdivision from further review. More specifically, smaller census subdivision that satisfy the forward commuting flow rule of a larger census subdivision (census subdivisions for which at least 50% of the employed labour force living in the census subdivision work in and travel daily to the larger urban area) will be eliminated from further analysis if the thresholds were not exceeded in the larger census subdivision. This will be the case even if the thresholds were surpassed in the smaller census subdivision. In this instance, the competitive forces of the larger

census subdivision will represent a competitive check on competition in the smaller census subdivision.

56. Finally, the product and geographic areas which are not excluded by this screening process will be subject to the full analysis, as described above.

57. The number of pre-defined product offerings and pre-defined geographic areas that will be used in the initial threshold test are numerous. There will be approximately 6000 pre-defined geographic areas alone, and a multitude of threshold calculations will therefore be required. In order to make the initial threshold test analytically tractable, the Bureau will use a geographic mapping program developed by Statistics Canada. This program is capable of quickly matching the market shares of each financial institution for each pre-defined product offering within each pre-defined geographic area. The program will also apply the threshold calculations to each area and list the results in tabulated form.

THE POTENTIAL ANTI-COMPETITIVE EFFECTS OF MERGERS

58. The Bureau will not conclude that a merger is likely to substantially lessen competition in the supply of some product solely on the basis that the market shares or concentration level in the relevant markets are above the threshold levels.¹⁹ Rather, the Bureau will undertake an assessment of other competitive factors in order to determine the competitive effects of the merger. Each of the relevant markets in which either the unilateral effects threshold is exceeded (i.e. the sum of the pre-merger market shares of the merging parties is greater than 35%) or the interdependent behaviour thresholds are exceeded (the post-merger four firm concentration ratio would be greater than 65 % or the post-merger market share of the merged entity would be greater than 10%) will be subject to further analysis. The next section discusses the factors that make it more likely that a merger will result in a substantial lessening of competition through the unilateral exercise of market power by the merged entity post-merger. The following section discusses the factors that increase the likelihood that firms in the relevant market will engage in interdependent behaviour post-merger.

¹⁹ Section 93(2) of the *Act* directs that the Competition Tribunal cannot find that a merger lessens or prevents competition substantially based solely on evidence of market shares or concentration.

Lessening of Competition Through Unilateral Effects

59. A merger can enhance the ability of the merging firms to profitably raise price by placing the pricing and supply decisions of the merging parties under common control and creating an incentive to increase prices and restrict supply or limit any other dimension of competition. In a competitive market, where consumers can choose among many suppliers with similar products, a firm's incentive to increase price is limited by consumers diverting their purchases to substitute products in response to the price increase. When two firms in a market merge and one of the firms increases its price, some demand may be diverted to the firm's merger partner, thereby increasing the overall profitability of the price increase and thus increasing the incentive to increase price. A price increase is likely to be profitable when the merging firms account for a significant share of the market. In assessing a merger, the Bureau will consider whether the characteristics of the relevant market are conducive to such a post-merger price increase.

60. In some markets, firms are distinguished primarily by differences in their products, while in other markets, firms are distinguished by their capacities or costs. In differentiated product markets, a merger is more likely to enhance the ability of merging firms to exercise unilateral market power when a significant number of consumers view the product offerings of the merging parties to be their first and second choices. In these circumstances, a post-merger price increase is likely to be profitable because a price increase by one of the merging firms is likely to divert demand toward its partner. If, on the other hand, the merged firms' products are not first and second choices for a significant number of consumers, then a price increase by one of the merging parties may not be profitable, because demand will be diverted to other firms in the market.

61. In order to assess whether a merger among producers of differentiated products is likely to enhance the ability of the merged entity to unilaterally exercise market power, the Bureau will use any information which indicates whether the products of the merging firms are first and second choices for a significant number of consumers. Evidence of past consumer switching behaviour in response to changes in relative prices is particularly useful. The Bureau will also consider whether other firms in the market are likely to re-position their products to replace any competition lost as a result of the merger.

62. In markets in which firms are distinguished primarily by their capacities, a post-merger price increase may be profitable if the merger removes a competitor to which consumers would otherwise turn in response to the price increase. Such a price increase is unlikely to be profitable if other firms in the market are able to absorb the demand that is diverted from the merged entity. This is possible only if the remaining firms have sufficient capacity to absorb this demand, or if capacity can be expanded quickly and at low cost.

63. Capacity in the context of a bank merger is likely to be limited to some extent by access to funds for the purpose of lending, but it may also be limited by the availability of trained personnel with knowledge of the market and the availability of other inputs required to supply banking services.

Lessening of Competition Through Interdependent Behaviour

64. The term "interdependent behaviour", also known as coordinated behaviour, refers to conduct by a group of firms that are profitable for each of them only because of the accommodating co-operative conduct of the others. Such behaviour is more likely in markets in which firms can recognize and reach a co-operative understanding, monitor one another's behaviour, and respond to any deviations from the co-operating behaviour by others.²⁰ This type of behaviour may include tacit or explicit agreements on price, service levels, or any other dimension of competition.

65. A high level of concentration in the relevant market is a necessary, but not sufficient, condition for a determination that competition is likely to be lessened because of an increased probability of interdependent behaviour. An understanding among firms in a market to limit competition is easier and less costly to reach and enforce if the number of firms accounting for a large proportion of total market output is small. However, high concentration levels in themselves do not imply that a merger will increase the likelihood of the exercise of market power through interdependent behaviour. In addition to high levels of concentration, interdependent behaviour requires the ability to reach an understanding and to detect and deter deviations from the agreement.

66. Reaching terms of understanding is likely to be easier when products and/or firms are homogeneous, and when important information about rival firms and

²⁰ These punishments may take the form of low prices in the relevant market or in other markets.

market conditions is readily available. On the other hand, the complexity of products and differences in product offerings, and rapid and frequent product innovations, may make it more difficult to reach an understanding. The existence of industry organizations that facilitate communication and dissemination of information among market participants can also facilitate anti-competitive cooperation.

67. The following are important factors affecting the ability of firms to detect and successfully deter deviations from a co-operative understanding:

- Transparency of the terms of market transactions. When prices are transparent to market participants, deviations are more easily detected;
- Stability of underlying costs. When costs fluctuate, it may be difficult to determine whether a price change represents a deviation from an understanding or is rather a response to a change in cost conditions;
- Size and frequency of product sales. When sales occur in large discreet blocks and are relatively infrequent, then deviations from understandings are relatively more profitable and effective deterrence of deviation is more difficult;
- Multi-market exposure. When firms participate in multiple geographic or product markets, there are more opportunities to discourage firms from deviating from the co-operative understanding.

68. The Bureau will examine whether there is a history of market participants having engaged in interdependent behaviour in the past. The effect of "maverick" firms, who may impede successful coordination, will also be considered.

69. In previous assessments of bank mergers, the Bureau has found that geographic markets for some products are often local, but the participants in these markets are national or regional. When geographic markets are local, the concentration level threshold will be applied at the local level, but an assessment of ease with which a co-operative understanding can be reached and maintained will be undertaken at both the local level and the national level. If competition occurs locally, then a high level of concentration at the local level is necessary in order to facilitate interdependent behaviour. However, coordination can occur either among decision-makers in local markets or among decision-makers at the national or regional level: that is, senior

executives may have the ability to reach and sustain an agreement about prices in a particular local geographic market, even if concentration at the national level is low.

EVALUATIVE CRITERIA

70. Several of the section 93 factors play a major role at the market definition stage. However, once the relevant markets have been defined and market shares have been determined, it is important to assess these factors in relation to each of the relevant markets where the merged entity's market share exceeds the 35% threshold or the four-firm concentration level exceeds the 65 % threshold, to determine whether the merging parties can sustain price increases for more than two years.

Foreign Competition

71. The assessment of foreign competition (section 93(a)), particularly important in the context of the globalization of markets, involves a determination of the extent to which foreign products or foreign competitors provide or are likely to provide effective competition to the businesses of the merging parties. To determine the constraining influence of foreign competition, a number of factors are considered, including the extent to which the effectiveness of foreign competition is likely to be hindered or impeded by domestic ownership restrictions.

72. For example, current regulations restrict the entry of foreign banks by requiring that they establish bank subsidiaries rather than simply operate through branches within Canada. Other limitations on foreign competition include the restrictions on foreign banks to supply products requiring CDIC insurance. The 10% ownership rule also limits foreign entry, and while this rule is typically viewed as a constraining factor on domestic mergers, it also serves to restrict the ability of foreign companies to acquire a significant interest in Canadian financial institutions. Moreover, the extent to which foreign entry has been facilitated by technological change, particularly through the feasibility of electronic banking, is another factor considered in determining the constraining influence of foreign competition.

The Availability of Acceptable Substitutes

73. In addition to identifying which products compete with the products of the merging parties and therefore warrant inclusion in the relevant market or in market

share analysis, it is necessary to assess whether the supply of these products would likely increase or be made available within a two year period in response to an attempted exercise of market power (section 93(c)). In this regard, an assessment is made as to whether such sellers collectively have, or could easily add, sufficient additional capacity, whether it is likely that the total supply of acceptable substitutes in the market will in fact increase sufficiently, and whether based on qualitative factors buyers are likely to switch a sufficient quantity of their purchases to acceptable substitutes to ensure that a material price increase cannot be profitably maintained in the relevant market post-merger.

74. For example, although telephone banking services are available to most retail customers, other electronic banking services requiring a computer may not yet be readily available to many households and small businesses and may not necessarily have a sufficient constraining influence on a potential exercise of market power by merging banks. In addition, although the number of electronic-based transactions have increased substantially in the last decade and new products are continuously being introduced, customer acceptance may take longer than two years to have a sufficient constraining effect on the pricing of the merging parties.

Barriers to Entry

75. Section 93(d) draws attention to:

- i) "any barriers to entry into a market, including
- ii) tariff and non-tariff barriers to international trade,
- iii) interprovincial barriers to trade, and
- iv) regulatory control over entry and any effect of the merger or proposed merger on such barriers".

76. The section 93(d) stage of the Bureau's assessment is directed toward determining whether entry by potential competitors would likely occur on a sufficient scale in response to a material price increase or other change in the relevant market brought about by the merger, to ensure that such a price increase could not be sustained for more than two years.

77. In this assessment, consideration is given to any matter or combination of matters that would make entry on this scale within two years less likely or more difficult. This generally involves an examination of whether entry is likely to be delayed or hindered by the presence of absolute cost differences or the need to make investments that are not likely to be recovered if entry is unsuccessful. These latter investments are referred to as sunk costs.

78. When assessing whether entry is likely, the Bureau will give primary consideration to the profitability of entry. An analysis of the likelihood of entry therefore takes into account the barriers that must be overcome in order to enter the market, and the profit opportunities created by the merger. Since entry must be of sufficient scale to ensure that a material post-merger price increase could not be sustained for more than two years, the analysis of the likelihood of entry considers whether entry is profitable at prices that are below that level.²¹

79. The profitability, and therefore the likelihood, of sustainable entry at pre-merger prices depends primarily upon absolute cost disadvantages faced by the entrant, the degree to which start-up costs associated with entry are sunk, and the probability that entry will be successful. The Bureau will conduct an analysis of the likelihood of entry that is sufficient to prevent a post-merger price increase lasting for more than two years for each of the relevant markets in which it has been determined that, absent entry, competition would likely be lessened or prevented substantially as a result of the merger. When there are several such markets, as may be the case in a bank merger, the possibility that only entry into several product or geographic markets is viable will be considered. This may be the case if there are significant economies of scope that can be attained through the simultaneous offering of several different products or through simultaneous entry into several geographic markets.

80. In assessing the extent to which future entry into banking markets would likely occur, the Bureau's analysis generally commences with an assessment of the likelihood of entry by banks, other deposit-taking institutions, and any other potential suppliers that appear to have an entry advantage. For example, when product markets are local, the likelihood that banks and other institutions that supply the relevant product in other geographic markets, or similar products in the same geographic

²¹ Entry prior to the merger may not have been profitable because such entry would have reduced prices to below pre-merger levels.

market, will expand their supply of the relevant product in the relevant geographic market will be considered.

Absolute Cost Advantages

81. Incumbent firms can gain important cost advantages relative to potential entrants through a variety of sources. Sections 93(d)(i), (ii) and (iii) highlight three sources of cost advantage that can present potential entrants with considerable, and in some cases insurmountable, barriers to entry.²² The extent to which regulatory barriers to entry by foreign banks facilitate the exercise of market power in domestic markets is discussed in paragraphs 71 and 72.

82. Other potential sources of cost advantages include control over access to scarce resources and influence over access to membership in cooperative ventures, such as the payments system.

Sunk Costs

83. The term "sunk costs" refers to the proportion of the total costs incurred by a firm in entering a market which have continuing value if the firm stays in the market, but that are not recoverable upon exit from the market. New entrants into banking and other markets are often required to incur various start-up sunk costs, such as acquiring market information, making the entry decision, developing and testing product designs, installing equipment, engaging new personnel and setting up distribution systems. In addition, sunk costs may be incurred by potential entrants when making investments in market specific assets and in learning how to optimize the use of these assets (these investments may include training personnel and obtaining information about local market conditions), overcoming reputation-related advantages enjoyed by incumbent banks, and/or overcoming disadvantages presented by the strategic behaviour of incumbent banks.

84. In the case of local banking markets, sunk costs may be incurred in establishing distribution facilities required for making loans or offering deposits and other banking services, and in establishing or expanding specialized computer systems, etc. In assessing the likelihood of entry, the Bureau will take into account developments

²² These three sources are: i) tariff and non-tariff barriers to international trade; ii) interprovincial barriers to trade, and; iii) regulatory control over entry.

in technology that may reduce sunk costs by allowing for the profitable use of means of distribution that do not require a physical presence. However, in keeping with the purpose of entry analysis, such prospective changes must be likely and sufficient to prevent post-merger price increases. Where the available information suggests, for example, that a new entrant with a limited physical presence in the market is unlikely to gain acceptance by a significant number of consumers, such entry will not be considered to be sufficient to prevent a post-merger price increase.

85. In general, since entry decisions are typically made in an environment in which the probability of success is uncertain, the likelihood of significant future entry decreases as the proportion of total entry costs accounted for by sunk costs increases. The focus of the Bureau's assessment of sunk costs is upon whether the likely rewards of entry, the likely time required to become an effective competitor and the risk that entry will not ultimately be successful, taken together, justify making the sunk investments that would be required to undertake the entry initiative.

86. Information about commitments that must be made and the time required to become an effective competitor can often be obtained by examining past entry into the relevant market or other markets with similar characteristics. However, evidence of past entry will not, in itself, be taken to demonstrate that entry is likely to occur in the relevant market. Firms enter and leave markets for a number of reasons, and it will not be assumed that entry that may have occurred in response to changes in market conditions unrelated to the merger implies that entry sufficient to discipline a post-merger price increase will occur. The Bureau will generally conclude that a merger is not likely to prevent or lessen competition substantially where it can be established that in response to the merger or to the exercise of increased market power resulting from the merger, sufficient entry into the relevant market would occur to ensure that a material price increase would not likely be sustainable in a substantial part of the relevant market for more than two years.

87. Further background information about sunk costs is contained in Appendix I of the Director's Merger Enforcement Guidelines.

Time

88. An important aspect of the assessment of entry conditions involves determining the time that it would take for a potential competitor to respond to a

material price increase or other change in the market brought about by a merger, and to become an effective competitor in the relevant market. In general, the longer the period of time that would be required for potential competitors to become effective competitors, the less likely it is that incumbent firms will be deterred by the threat of future entry from exercising market power in the first place and the longer any market power that is exercised can be maintained. In the assessment of whether entry will likely occur within two years on a scale sufficient to ensure that a material price increase cannot be sustained beyond this period, account will be taken of whether the delay and losses that potential entrants can expect to encounter before this scale of sales is attained will likely increase the sunk costs, risk or uncertainty perceived to be associated with such entry, and thereby reduce the likelihood that this entry will occur.

Effective Remaining Competition

89. Effective remaining competition is a broad concept that refers to the collective constraining influence of all sources of competition in a market, including those afforded by individual competitors, as well as foreign competition, available and acceptable substitutes, new entry and innovation. In this regard, an assessment is made of the nature and extent of forms of rivalry such as discounting and other aggressive pricing strategies, innovative distribution and marketing methods, product and packaging innovation, and aggressive service offerings that have been evident in the relevant market(s) (section 93(e)). These and other forms of competition give rise to a competitive environment that contrasts sharply with markets where competitors accept stability or are content to follow attempts at price leadership or other initiatives of existing or aspiring market leaders. Furthermore, an assessment is made of how existing competitors will likely respond to a merger, particularly in relation to their vigor and effectiveness in the marketplace.

90. Where it is clear that the level of effective competition remaining in the relevant market is not likely to be reduced as a result of the merger, this alone will generally justify a conclusion not to challenge the merger on the basis that the merger will enhance the ability of the merging firms to unilaterally exercise market power. This is so whether the absolute level of effective competition in the market in question appears to be high or low.

Removal of a Vigorous and Effective Competitor

91. By assessing the competitive attributes of the acquired firm, more direct attention is drawn to what is likely to be lost as a result of the merger (section 93(f)). A wide variety of factors can indicate whether the acquiree, either large or small, is or has been a vigorous and effective competitor, including its level of innovation, its role in the marketplace as price leader or price follower, its use of discounting or other aggressive pricing strategies, its role as a disruptive force in a market that appears to be otherwise susceptible to interdependent behaviour, its role in providing unique service to the market, or in helping to ensure that similar benefits offered by other competitors are not reduced.

92. Although competition is prevented or lessened to some degree when a vigorous and effective firm is eliminated from the relevant market through a merger, in the Director's view, the removal of such a competitor is not generally sufficient, in and of itself, to warrant enforcement action under the *Act*. It must also be established that as a result of the removal prices will be materially higher than in absence of the merger; i.e., there must also be findings unfavorable to the merger in terms of other factors, in particular, effective remaining competition and future entry.

Change and Innovation

93. Although already incorporated to some extent in evaluating the impact of the other section 93 factors, an analysis of change and innovation is expanded to include general dynamic developments in products, distribution, service, sales, marketing, buyer preferences, firm structure, the regulatory environment and the economy as a whole (section 93(g)). The pressures imposed on remaining competitors in a market by the nature and extent of dynamic developments in any of these areas may be such as to ensure that a material price increase is unlikely to occur or will not be sustainable. Stage of market growth is also considered at this stage of the analysis.

94. Although traditional banking is characteristic of a mature industry, new developments in distribution and buyer sophistication have prompted changes to the way the financial sector operates. For instance, with the evolution of leasing and financing companies, disintermediation is displacing the traditional role of banks as the intermediary between the needs of lenders and borrowers. This and other trends are

critical elements in determining the ability of the merging parties to exercise market power.

95. When a merger is likely to enhance or facilitate the maintenance of existing market power, representations regarding how the merger may be likely to give rise to innovation-related synergies and other efficiencies will be considered pursuant to section 96.

Business Failure and Exit

96. Section 93(b) draws attention to the importance of assessing "whether the business, or a part of the business, of a party to the merger or proposed merger has failed or is likely to fail". The opening clause of section 93 makes it clear that this information is to be considered "in determining, for the purpose of section 92, whether or not a merger or proposed merger prevents or lessens, or is likely to prevent or lessen, competition substantially". The impact that a firm's exit can have in terms of matters other than competition are generally beyond the scope of the assessment contemplated by section 93(b).

97. Probable failure of a party to a merger is not sufficient to warrant a conclusion that the merger is not likely to prevent or lessen competition substantially. An assessment must be made of other options, such as whether acquisition of the failing firm by a third party, retrenchment by the failing firm, or liquidation, would likely result in a materially higher level of competition in the relevant market than if the merger proceeded. The Bureau also applies the same rationale as in a failing firm situation when analyzing situations where a firm wishes to exit a market for reasons other than failure, such as unsatisfactory profits, or a desire by a diversified firm to focus its efforts elsewhere. Similarly, these considerations are equally applicable to failure-related claims concerning a division or a wholly owned subsidiary of a larger enterprise.²³

98. At the same time, the Bureau recognizes that its analysis should not be blind to the unique circumstances that arise in a failing firm situation. The MEGs acknowledge that there are factors that serve to constrain the competitive implications

²³ However, in assessing submissions relating to the failure of a subsidiary or a division, particular attention will be paid to: transfer pricing within the larger enterprise, intra-corporate cost allocations, management fees, royalty fees, and other matters that may be particularly relevant in this context. These allocations will generally be assessed in relation to the values of equivalent arm's length transactions.

of a merger involving a failing firm. First, the loss of the competitive influence of a failing firm cannot be attributed to the acquisition of the firm if the firm would have exited the relevant market in any event. Second, the extent to which the acquisition of a failing firm can increase the market power of the acquiror is often reduced as the failure of the former becomes increasingly likely, and as its relative market position weakens. Third, the likelihood that any market power effects that will materialize subsequent to the merger can be avoided through such options as retrenchment or liquidation is typically reduced as the failure of the firm in question becomes increasingly likely.

99. The Bureau generally requires up to six weeks when full information has been made available to assess the extent to which a firm is likely to fail if the merger in question does not proceed. The time required to make this assessment will vary from case to case. Parties intending to invoke the failing firm rationale and/or anticipate that they may be required to undertake a search for a competitively preferable purchaser are encouraged to make their submissions/search as early as possible. As soon as the absence of a competitive preferable alternative is established, the assessment of the likely effects of the merger on competition becomes moot.

100. These time requirements may be a significant factor in the financial services market where delays may raise uncertainty about the deposits of customers. The Bureau has reviewed transactions in this sector where firms are in financial difficulty and it was able to complete its review within the time frames of the merging parties. However, the Bureau cannot always guarantee this outcome and it would encourage all parties who find themselves in these circumstances to approach the Bureau at the earliest opportunity. Firms may wish to consider consulting the Bureau at the same time as they advise OSFI of their status and the efforts they are making to resolve the problems. It will be important for the Bureau to be in consultation with the Minister of Finance in these situations since this is a possible scenario for the Minister to use the override authority set out in section 94 of the *Act* to allow a merger that the Bureau would otherwise challenge. In these circumstances, however, the Bureau may want an opportunity to make representations to the Minister on whether there are other competitively preferable options available to the proposed merger before such a certificate is issued.

Additional Evaluative Criteria

101. Finally, section 93(h) recognizes that other factors relevant to competition in markets that are or would be affected by a merger may also be assessed to determine the likelihood that a merger will result in a substantial lessening or prevention of competition. The likelihood that firms in a market will employ practices such as exclusive contracts, tied selling, and price discrimination, that may be harmful to competition will be considered at this stage.

THE EFFICIENCY EXCEPTION

102. Section 96 of the *Act* provides an efficiency exception to the provisions of section 92 of the *Act*. The Bureau recognizes that changes in regulations, developments in technology, and globalization will have implications for the structure of the financial services sector. It is expected that banks will respond to these and other changes through various forms of restructuring, including mergers. Notwithstanding the fact that a bank merger may substantially lessen or prevent competition, the Competition Tribunal may not make an order against the merger if, generally speaking, the merger will have a positive impact on the Canadian economy. When a balancing of the anti-competitive effects and the efficiency gains likely to result from a merger demonstrates that the Canadian economy as a whole would benefit from the merger, the Competition Bureau interprets section 96(1) as resolving the conflict between the competition and efficiency goals in favor of efficiency. However, the efficiencies must represent cost savings to the economy that would not be attained if the order that would be required to remedy the anti-competitive effect of the merger were made. Furthermore, the cost savings must represent real savings in economic resources, rather than private gains to the merging parties that result, for example, from an increase in bargaining power with suppliers.

103. The onus of demonstrating efficiencies rests with the merging parties. To facilitate expeditious assessment of the nature and magnitude of merger-related efficiencies, merging parties are encouraged to make their efficiency submissions to the Bureau at an early stage of its review of the transaction. It is not necessary to wait until a finding is made that the merger is likely to prevent or lessen competition substantially.

Efficiencies that Would Likely be Attained if an Order Were Made

104. Claimed efficiency gains are not considered in the trade-off against the likely anti-competitive effects of a merger where they would likely be attained if the order that would be required to remedy the anti-competitive effect of the merger were made. If any of the gains that are identified as being likely to be realized post-merger would also be likely to be attained through less anti-competitive means such as internal growth, a merger with a third party, a joint venture, a specialization agreement, or a licensing, lease or other contractual arrangement, if the order in question were made, then they are not appropriately considered to arise uniquely from the merger.

105. The order referred to is the proposed order requested in the Director's application, or such other order as the Tribunal may make. Where an application has not yet been made, parties can generally obtain from the Bureau a general description of the order, if any, that would likely be sought by the Director.²⁴

106. If the Bureau concludes that a bank merger lessens competition in certain local markets, the remedy sought in the Director's application may be divestiture of assets in these markets. In this case, any claimed efficiencies that would likely be attained even upon divestiture of these assets, or that portion of the total efficiencies that would still be attained, will not be considered in the trade-off analysis. The Bureau will also not consider any efficiencies that would likely be attained through some form of co-operation short of a merger. The Bureau recognizes that the nature of the financial services industry, in particular its "network" features, implies that cooperation among institutions often facilitates the efficient provision of products and services to consumers. Past instances of co-operation among banks, including the Interac network and Simcor, suggest that forms of cooperation short of a merger may, in some circumstances, be sufficient to attain the desired efficiencies while decreasing the potential that competition will be substantially lessened. In other circumstances, for example a merger that may facilitate entry into foreign markets, a joint venture with a foreign firm, a joint venture among domestic players solely for the purpose of operating in those foreign markets, or a merger/acquisition with a foreign player may be less anti-competitive. In the assessment of whether efficiencies that have been claimed would likely be attained through a merger with a third party or some other form of cooperation if the order were made, consideration will only be given to existing

²⁴ It is necessary to know the nature of the order because efficiencies are only considered in the section 96 balancing process if they "would not likely be attained if the order were made".

alternative merger proposals that are less anti-competitive and that can reasonably be expected to proceed if the order in respect of the first proposed merger is made. Efficiencies generally will not be excluded from the balancing process on the speculative basis that they *could* be attained through a merger with an unidentified third party.

Cost Savings that are Redistributive in Nature

107. Claimed efficiency gains are not considered where they would likely be brought about by reason only of a redistribution of income between two or more persons. For example, gains that are anticipated to arise as a result of increased bargaining leverage that enables the merged entity to extract wage concessions or discounts from suppliers that are not cost justified represent a mere redistribution of income to the merged entity from employees or the supplier, as the case may be. Such gains are not brought about by a saving in resources. This contrasts with the situation where the supplier is able to offer better terms as a result of the fact that larger orders from the merged entity will enable the supplier to attain economies of scale, reduce transaction costs or achieve other savings.

"Greater Than" and "Offset"

108. The words "greater than" are considered to signify that the efficiency gains must be more weighty than, more extensive than, or of larger magnitude than the anticompetitive effects that are likely to result from the merger. By comparison, the term "offset" is considered to suggest that the efficiency gains must neutralize, counterbalance or compensate for the likely anticompetitive effects of the merger.

109. The expressions "greater than" and "offset" are considered to each have qualitative and quantitative connotations. That is to say, the efficiency gains must be greater than the anticompetitive effects that are likely to result from the merger, in both a qualitative and quantitative sense; and the efficiency gains must offset these anticompetitive effects, in both a qualitative and quantitative sense. To be assessed in terms of "greater than", efficiency gains must be capable of being weighed in similar terms as all or some of the anticompetitive effects that will likely result from the merger. Efficiency gains and anticompetitive effects that cannot be weighed in similar terms will be evaluated in terms of whether the gains offset the anticompetitive effects. This evaluation can be subjective in nature and will ordinarily require the exercise of the

Director's discretion.²⁵ In short, efficiency gains and anticompetitive effects that can be measured in dollar or other similar terms are weighed to determine whether the "greater than" requirement is met; whereas efficiency gains and anticompetitive effects that cannot be balanced in such terms are compared to determine whether the "offset" requirement is met. Where all of the efficiency gains and anticompetitive effects can be measured in similar terms, and where the efficiency gains are "greater than" the anticompetitive effects, they will also be considered to "offset" the anticompetitive effects.

Anticompetitive "Effects"

110. Section 96(1) requires efficiency gains to be balanced against "the effects of any prevention or lessening of competition that will result or is likely to result from the merger or proposed merger". Where a merger results in a price increase, it brings about both a neutral redistribution effect²⁶ 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.

111. The calculation of the likely anticompetitive effects of mergers is generally very difficult to make. This is particularly so with respect to the measurement of losses related to a reduction in service, quality, variety, innovation and other non-price dimensions of competition. Insofar as such losses often cannot be quantified, they receive a weighting that is essentially qualitative in nature. In view of the difficulties associated with arriving at precise estimates of both the elasticity of market demand and the magnitude of the prevention or lessening of competition that is likely to be brought about by the merger, several trade-off assessments are generally performed over a range of price increases and market demand elasticities.

25. Accordingly, if part of the efficiencies likely to result from the merger include dynamic R&D efficiencies, (which cannot be measured in similar terms as any of the likely anticompetitive effects), and if part of the anticompetitive effects likely to result from the merger include a reduction in service, quality or variety, (which cannot be measured in terms that are similar to any of the likely efficiencies), the Director would exercise his discretion in assessing whether the R&D efficiencies would likely "offset" the effects of a reduction in service, quality or variety.

26. 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.

112. In calculating the magnitude of likely efficiency gains, cost savings are generally measured across the reduced level of output that will be required to bring about the anticipated material price increase. In estimating the extent of negative resource allocation effects of mergers, the Bureau includes the additional losses in total surplus that arise when market power is being exercised in the relevant market prior to the merger. Similar losses that arise as a result of foregone contribution to fixed costs (due to restricting levels of output) are also recognized.

113. Given that section 96(1) requires efficiencies to be balanced against the effects of "any" prevention or lessening of competition that will result from the merger, anticompetitive effects that are likely to arise in other markets affected by the merger are also considered in the trade-off analysis. However, anticompetitive effects in markets that are not targeted by the order sought generally will not be substantial in nature.

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