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STRATEGIC ALLIANCES UNDER THE *COMPETITION ACT*

Director of Investigation
and Research

Competition Act

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Information Bulletin

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Director's Preface

A growing number of firms have turned to strategic alliances as a means of improving their competitiveness in an age of increasing international competitive pressures, the globalization of markets, and generally decreasing trade barriers. Indeed, several have taken advantage of our compliance program to obtain advisory opinions from my office on proposed alliances. Nonetheless, uncertainty on the part of some business people regarding the legality of strategic alliances may increase the risk that opportunities to create alliances which are beneficial for the economy may not be pursued. To reduce this risk, I am issuing this policy statement which provides general guidance and clarifies my enforcement approach to strategic alliances under the *Competition Act* (the *Act*).

There are no specific provisions within the *Act* dealing exclusively with strategic alliances, which is not surprising when one considers the myriad of corporate forms which these arrangements have taken in the past and may take in the future. At their broadest, strategic alliances may encompass any form of inter-firm cooperative arrangement beyond contracts completed in the ordinary course of business. A far narrower interpretation might include only those alliances which are joint ventures or entail an equity investment and endorsement of a longer-term strategic plan. Various definitions have been used by others in an attempt to distinguish strategic alliances from alternative forms of inter-firm cooperation. While these definitions may be helpful for particular studies, they do little to assist in determining how the *Act* will apply to strategic alliances. Therefore, I have not adopted a set definition of a strategic alliance. My ultimate responsibility is the enforcement and administration of the *Act*, which is why this Bulletin is focused on the competitive effects of strategic alliances and not the form they may take.

The use by Canadian firms of strategic alliances to improve their competitiveness should generally lead to positive innovation and efficiency gains without accompanying negative effects on competition. As a result, these alliances are unlikely to raise competition issues. Indeed, it is the Bureau of Competition Policy's experience that most strategic alliances do not raise issues under the *Act*. However, alliances can take a variety of forms with varying impact in the marketplace and where they are likely to lead to anticompetitive effects, intended or otherwise, parties must be able to determine whether the *Act* is contravened. This Bulletin provides guidance on how the Director will review, and if necessary, seek to apply the *Act* to the few alliances which potentially lead to anticompetitive effects.

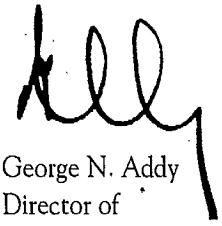
The Bulletin begins by briefly describing some of the types of inter-firm cooperative arrangements which have been characterized as strategic alliances. The remaining sections focus on the application of the *Act* and key elements of our compliance program. The *Act* contains certain provisions which do not involve any test of market power, and it is the Bureau's experience that most strategic alliances are less likely to raise any issues under these sections. As a result, the bulletin focuses on those provisions of the *Act* which involve a test of market power.

In conducting our analysis of a strategic alliance under the *Act*, we will examine whether an alliance is likely to maintain, create or enhance market power. Market power has been legally interpreted to be the ability of the parties to behave relatively independently of the market. Consistent with this legal interpretation, economists refer to market power of a seller as the ability to increase price above competitive levels (or reduce output, quality, choice, service, promotional activity, innovation or other significant dimensions of rivalry,

below competitive levels) for a sustained period of time. Thus, the reason that few strategic alliances raise issues under the *Act* is because the majority of them do not result in market power.

In the few situations where market power is maintained, created or enhanced by a strategic alliance, the examination involves an in-depth analysis of the nature of the alliance. An alliance may be reviewable under a number of the provisions of the *Act*, given the wide range of corporate activity which alliances may encompass. It has been our general experience that horizontal alliances involving competitors more often raise issues of market power than either vertical or conglomerate alliances, and consequently the focus of this Bulletin is on the provisions of the *Act* most applicable to horizontal alliances. Therefore, details on the legal tests which must be met under the provisions of the *Act* related to conspiracy, export consortia, specialization agreements, mergers, joint ventures and abuse of dominant position are given. Nine illustrative examples are also provided in Appendix 1.

While this information should assist business people in determining the application of the *Act* to a particular alliance, it is not possible for this document to answer all possible questions which might arise in an individual case. As a result, parties contemplating entering into a strategic alliance, particularly one which is likely to maintain, create or enhance market power, may wish to seek the Bureau of Competition Policy's advice through the Program of Advisory Opinions.



George N. Addy
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Competition Act

Highlights to Guide Firms Considering Strategic Alliances

- Most strategic alliances do not raise issues under the *Act*.
- Vertical and conglomerate alliances are less likely than horizontal alliances to raise issues under the *Act*.
- The few strategic alliances which may raise competition issues are more likely to involve those sections of the *Act* which involve a test of market power.
- Firms acting as sellers will hold market power when they have the ability to increase price above competitive levels (or reduce output, quality, choice, service, promotional activity, innovation or other significant dimensions of rivalry, below competitive levels) for a sustained period of time.
- In the few cases where an alliance may result in market power, caution should be exercised by the parties to ensure that their behaviour does not involve or give rise to either an undue lessening or prevention of competition under the criminal conspiracy provisions of the *Act*, or a substantial lessening or prevention of competition under the civil reviewable provisions.
- The greater the market power collectively held by the parties to an alliance, the more likely is behaviour which is potentially injurious to competition and the greater the likelihood of an inquiry under the conspiracy provisions of the *Act*.
- Where strategic alliances involve behaviour which would be particularly injurious to competition, such as agreements in respect of prices, output, marketing strategies or other areas important to rivalry, an inquiry under the conspiracy provisions of the *Act* may be initiated even if the market power held by the parties to the alliance is not so considerable.
- Alliances that involve the future acquisition of control will be reviewed under the civil merger provisions rather than the criminal conspiracy provisions of the *Act* unless there is a basis for believing that the acquisition of control is a sham.

Part 1
Introduction

In an age of increasing international competitive pressures, globalization of markets, and generally decreasing trade barriers, some companies may find it difficult to match the product and service offerings of their rivals. Certain firms have turned to cooperative arrangements, more generally referred to as strategic alliances, as a means to improve their competitiveness in these circumstances.

Canadian firms' use of strategic alliances to improve their competitiveness will often lead to positive innovation and efficiency gains without accompanying negative effects on competition. As a result, these alliances are unlikely to raise concerns among competition authorities. Indeed, it is the experience of the Bureau of Competition Policy (the Bureau) that most strategic alliances do not raise issues under the *Competition Act* (the *Act*)[1]. However, in circumstances where alliances are likely to lead to anticompetitive effects, intended or otherwise, the Bureau needs to be in a position to respond.

Uncertainty on the part of some business people regarding the position of the Director of Investigation and Research (the Director) on strategic alliances may increase the risk that alliances which are beneficial to the economy may be abandoned. In order to provide greater certainty and avoid a chilling effect on these transactions, the Director believes that, as part of the Bureau's Program of Compliance, it would be helpful to publish a policy statement to clarify the enforcement approach taken to inter-firm cooperative arrangements, be they called strategic alliances, joint ventures, or any other name.

Strategic alliances and other forms of inter-firm cooperation may take numerous forms and have varying impacts in markets. It is the Bureau's experience that the majority of strategic alliances are either neutral or procompetitive, often designed to take advantage of particular firms' competencies or to effect efficiencies which may lead to enhanced competitiveness in international markets. However, there may be instances where serious competition issues are raised in respect of strategic alliances.

This document provides general guidance on the status of strategic alliances under the *Act*. While this statement will address a number of key issues raised under the various sections of the *Act* which may potentially apply to such arrangements, particularly horizontal alliances, it cannot anticipate all questions that may arise in the marketplace. It is not a binding statement of how discretion will be exercised in a particular situation. Guidance regarding a specific situation may be requested from the Bureau through its Program of Advisory Opinions. This Bulletin is also not intended to bind or affect in any way the discretion of the Attorney General of Canada in the prosecution of matters under the *Act*. Nor is it intended to be a substitute for the advice of legal counsel. The approach outlined does not represent a substantive change in enforcement policy or a restatement of the law. Final interpretation of the law is the responsibility of the courts and the Competition Tribunal.

[1] "The *Act*" refers to the *Competition Act*, R.S.C., 1985, c. C-34, as am. R.S.C. 1985, c. 27 (1st Supp.), ss. 187, 198; R.S.C. 1985, c. 19 (2nd Supp.), Part II; R.S.C. 1985, c.34 (3rd Supp.), s. 8; R.S.C. 1985, c. 1 (4th Supp.), s. 11; R.S.C. 1985, c. 10 (4th Supp.), s. 18; S.C. 1990, c. 37 ss. 27-32, S.C. 1992, c.14, s.1.

Part 2
Inter-Firm Cooperative Arrangements

Many firms are facing external pressures to become more innovative and efficient in order to remain competitive in domestic and foreign markets. These pressures include falling trade barriers; innovations which affect the types of products and services produced, the production process, or the organization of firms and institutions; and, consumer demands for better product and service quality, highly customized products and services, and greater product and service variety. These external pressures make up the forces of economic globalization and trade liberalization which are the dominant trends in commerce in the 1990s, especially in the North American, South-East Asian and European markets. The response of some firms to these pressures is to form strategic alliances.

The arrangements in which firms may become involved, in response to these pressures, may take numerous forms and have varying impacts in the market. In this section, there are descriptions of the more common forms of alliances and explanations of how their structure and behaviour may give rise to inquiry under the *Act*. This Bulletin does not offer a definition of strategic alliances, but instead relies upon several of the more common features of alliances. The lack of a definition does not affect the approach the Bureau will take in examining the competitive effects of a particular alliance.

Many strategic alliances are characterized by the continuing independence of the partners and, while generally established to jointly pursue medium to longer-term goals, they often have a set time frame and termination date. A common feature of some alliances is the acquisition of a minority, non-controlling investment by one of the parties in their alliance partner, together with some sort of undertaking to work on a cooperative basis in a particular area. In addition, these arrangements may provide for the exchange of property rights or technical assistance, but allow for the parties' independent pursuit of interests outside of the alliance. Typically, strategic alliances cover only a portion of the partners' total operations (e.g., research and development, promotional activity, or foreign sales). On the other hand, even the most informal strategic alliances differ from "one-shot" contracts because the partners make some attempt to align their longer-term interests. Hence, information sharing on technologies, products, processes, and/or customer needs is generally greater compared to more traditional contractual arrangements.

Alliances may also act as a mechanism for transferring the skills and relationships of employees within participating firms. These resources may be hard to acquire through normal market transactions. Many alliances involve something new, innovative and forward-looking: a new research and development program, new products, technologies and processes, or a new marketing strategy to be conducted jointly by the parties. The adjective "strategic" has a definite meaning here. It implies a concern with the longer-term, with investment rather than day-to-day operations, and with developing new markets rather than servicing existing ones.

Another distinguishing feature of strategic alliances is that they generally involve swaps, trades, or the barter of goods or services, rather than the exchange of goods and/or services for money. As is generally the case with barter, there must be a close alignment of interests for this to be beneficial, illustrating the complementary and reciprocal nature of the alliance partners' goals. Each party has something the other wants, involving either tangible or intangible assets (e.g., skills, knowledge, reputation or contacts). Strategic alliances, particularly those involving international partners, can also be designed to facilitate transfers of technology,

surmount non-tariff barriers to trade, and/or reduce the time needed to gain access to new markets where expertise on local market conditions is required.

In short, the major features of strategic alliances appear to be: the relative continuing independence of the parties in respect of those matters not covered by the alliance; a set (albeit longer-term) time frame; limited scope of the arrangement and greater flexibility of the parties compared to takeovers or acquisitions; and, reciprocity between the parties, as seen in the sharing of objectives, information and key assets. Whatever the form taken, the competition analysis of a particular strategic alliance will focus on its effects and likely effects, as well as the purpose for which the alliance is formed.

The Bureau will be particularly concerned with strategic alliances in cases where there is either a substantial or undue lessening or prevention of competition. In determining whether either of these thresholds is met, the Director seeks to determine whether the strategic alliance is likely to maintain, create or enhance market power. Market power may exist at either a selling or buying level. Market power of a seller is the ability to increase price above competitive levels (or reduce output, quality, choice, service, promotional activity, innovation or other significant dimensions of rivalry, below competitive levels) for a sustained period of time. The Director will also examine the nature of the strategic alliance to determine if competition is diminished and, if so, whether the *Act* applies and which of its provisions are the most relevant.

Part 3
Application of the *Competition Act*

3.1 General Remarks

A fundamental objective of the *Act*, as highlighted by its purpose clause, is to foster competition so that Canadian businesses become more efficient and are better able to adapt to changing markets both at home and abroad. In Canada, our small and geographically sparse markets have often resulted in firms that, though large relative to the domestic market, are small by world standards. In an age of increasing international competitive pressures, globalization of markets, and generally decreasing trade barriers, there is a continuing requirement for Canadian business to become more efficient. This is recognized both in Canada's competition legislation and in the Bureau's enforcement approach.

At the same time, a fundamental premise of the law is that firms independently operating in an unrestrained market system are best able to meet the constant pressure to innovate, improve and adjust to changing consumer demands and market conditions. This is the best means of allocating our economic resources. In an effort to balance these two principles, the *Act* principally seeks to prevent those business practices which unduly or substantially lessen or prevent competition and so diminish the efficiency and competitiveness of the Canadian economy. The *Act* also contains certain provisions which do not involve any test of market power. These include bid-rigging, certain types of agreements among federal financial institutions, price maintenance and consignment selling.

Strategic alliances may come to the Director's attention either through the parties to the alliance, a complaint, media reports or staff research. In each of these instances, Bureau staff carry out a preliminary examination and determine whether further action is warranted.[2] If, upon further examination, the Director believes on reasonable grounds that there has been a contravention of the criminal or civil reviewable provisions of the *Act* or of an outstanding order made under the *Act*, the Director is required to commence an inquiry.[3] All inquiries are conducted in private. Once an inquiry has begun, the Director has access to a number of investigative tools.

At any stage of an inquiry relating to the criminal provisions of the *Act*, the Director may refer a matter to the Attorney General. The Attorney General determines whether charges should be laid and conducts prosecutions or such action as the Attorney General may wish to take. In the case of an inquiry into a civil reviewable matter, the Director may apply to the Competition Tribunal for a remedial order.[4] The Tribunal may issue orders designed to remedy the effects of the conduct in question, but it cannot fine firms or take other punitive action. Private rights of civil action are also available to anyone who has suffered losses or damages as a result of a violation of the criminal provisions of the *Act* or contravention of an order issued under the *Act*.

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[2] For a complete description of the approach taken by the Director to promote and to ensure compliance with the provisions of the *Competition Act*, see the Director of Investigation and Research's *Program of Compliance*, Information Bulletin No. 3, (revised) March 1993.

[3] The Director is also obliged to commence an inquiry when the Minister of Industry so directs, or when six Canadian residents make an application in accordance with the *Act*. An inquiry may be discontinued at any stage if, in the Director's opinion, further inquiry is not justified. The Director is required to report in writing to the Minister when an inquiry is discontinued. If the inquiry was commenced as a result of a six-resident application, the Director must inform the applicants of the decision and the grounds for discontinuance. The Minister may, on the written request of the applicants or on his own motion, review the Director's decision and, if in his opinion the circumstances warrant, instruct the Director to make further inquiry.

[4] Note that the burden of proof required to obtain a conviction under the criminal provisions (proof beyond a reasonable doubt) is higher than that required for the Tribunal to conclude that grounds exist to make an order under the civil provisions (proof on a balance of probabilities).

3.2 Provisions Most Relevant to Strategic Alliances

There are no specific provisions within the *Act* dealing exclusively with strategic alliances. This is not surprising when one considers the myriad of forms which these arrangements may take. Many strategic alliances involve types of cooperation among firms which do not differ significantly from those effected in the past. Hence, the Bureau's analysis of these alliances will follow the analytical framework dictated by the applicable section of the *Act*. The fact that a relationship between two or more firms is called a strategic alliance does not in any material manner affect its legal status under the *Act*.

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*, given the wide range of corporate activity which strategic alliances may include. It is possible a particular alliance may be reviewed under the criminal conspiracy provisions of the *Act* or any of the civil provisions related to specialization agreements, joint ventures, abuse of dominant position or mergers. In addition, an alliance between vertically related firms may also be reviewed under the vertical restraint provisions of the *Act*, including tied selling, exclusive dealing, market restriction, or price maintenance,[5] depending upon the nature of the arrangement. It has been the Bureau's experience that horizontal arrangements involving competitors are more likely to raise competition issues than either vertical or conglomerate alliances. It is only in very limited circumstances that arrangements between firms which are either vertically related or are in different lines of operation (i.e., conglomerate alliances) are likely to be found to maintain, create or enhance market power.[6] In light of this, the focus of this document will be the provisions of the *Act* most applicable to horizontal alliances.

In most of the cases where an alliance results in market power and is subject to examination, it is the Bureau's expectation that following an examination of the nature of the alliance, the alliance usually will fall squarely within a single section of the *Act* and the Director will adhere to the analytical approach dictated by the relevant provision. However, given the broad range of activities which strategic alliances may encompass, it is possible that several sections of the *Act* may apply. Parliament has clearly contemplated that there can be an overlap between various provisions within the *Act*. While the possibility of review under several sections of the *Act* exists, since 1986 there have only been a handful of cases where the Director has initiated an inquiry under both the civil and criminal provisions of the *Act* for a particular fact situation. While an inquiry pursuant to either the abuse, conspiracy or merger provisions may be commenced concurrently, the *Act* limits prosecutions or applications to the Competition Tribunal for remedies to a single section on the basis of the same or substantially the same facts. In determining which provision is the most appropriate, an analytical framework is also implicitly determined — for example, either an undue lessening or prevention of competition test with no efficiency considerations in the case of a criminal conspiracy investigation, or a substantial lessening or prevention of competition test with an efficiency trade-off as would be the case in a reviewable merger investigation.

Generally, the Bureau will examine alliances that involve the future acquisition of control[7] as mergers, unless there is a basis for believing that the acquisition of control is a sham.[8] Where there is evidence of an agreement in violation of the conspiracy provisions arising from an alliance or discussions related to a prospective strategic alliance, the Director will launch

[5] The price maintenance provisions do not involve any test of market power.

[6] For a discussion of the circumstances when a vertical or conglomerate merger may raise competition concerns, see the Director of Investigation and Research's *Merger Enforcement Guidelines*, Information Bulletin No. 5, April 1991, at 41-43 .

[7] See the discussion below at 18-19 which describes the approach taken to "control" in the Director of Investigation and Research's *Merger Enforcement Guidelines*, *Ibid.*

[8] Competitively sensitive information exchanged by competitors during merger negotiations which do not ultimately lead to a merger could provide grounds for an examination under the conspiracy provisions. See the *Merger Enforcement Guidelines*, *Ibid.*, at 59 for a discussion of how to minimize this risk.

a criminal investigation. Factors which bear on this decision include evidence of an anticompetitive objective, intent or effect, covert or fraudulent behaviour, the nature of the evidence and whether there is a need for deterrence through criminal remedies. Finally, any acquisition of control through a strategic alliance, public or otherwise, cannot insulate the parties from initiation of an inquiry under the conspiracy provisions into past criminal conduct which occurred prior to the acquisition of control.

A fuller description of the relevant provisions of the *Act* is provided below to assist business people in determining a particular section's applicability. Although this document provides a summary of the major considerations, more detailed information is available from the Bureau on its enforcement approach to particular provisions.

3.2.1 Conspiracy Provisions

Strategic alliances between competitors involve agreements which may be reviewed by the Director under the criminal conspiracy provisions of the *Act* in certain circumstances. The Crown's burden of proof is the criminal standard of "beyond a reasonable doubt". Sanctions are severe in cases of conviction, with fines up to $10 million and imprisonment terms up to five years for individuals, reflecting the serious nature of the offence.

Substantively, section 45 of the *Act* prohibits parties from entering into an agreement which, *inter alia*, prevents or lessens competition unduly or is likely to do so. Several elements must be established in order for an offence to be found. First, the Crown must prove the existence of an agreement, with or without direct evidence. The *Act* provides for the finding of an agreement from circumstantial evidence, and in past judicial decisions exchanges of information have been used to infer the existence of an agreement in certain circumstances.[9] Second, the agreement is one whose likely effect is to prevent or lessen competition unduly.[10] Finally, the Crown must show *mens rea* or a "guilty mind". This involves establishing that the parties intended to enter into the agreement in question, were aware of its terms and intended to carry it out. It is also necessary to show that the parties intended to lessen competition unduly which can be satisfied by establishing that a reasonable business person, who can be presumed to be familiar with the business in which he or she engages, would or should have known that the likely effect of the agreement would be to unduly prevent or lessen competition.[11] The Supreme Court of Canada has noted that in most situations where it is shown that the agreement is likely to have an undue effect, the Crown could establish that this was the case.[12]

The Supreme Court has provided considerable guidance on the meaning of the element of undueness.[13] In addition to stating that an undue effect is one which is serious or of significance, the Court outlined a two-step approach which may be used to determine undueness. After determining the relevant product and geographic markets in which the parties operate, the first step is to determine whether the parties to the agreement have market power or will be likely to obtain it pursuant to the agreement. Consistent with other provisions of the *Act*, the Supreme Court has made it clear that market share, alone, is not sufficient to demonstrate market power. Other factors are also of importance, particularly the ease of entry.[14] The Supreme Court has noted that possessing only a moderate amount of market power may be sufficient to support a finding of undueness.[15]

In the second step the Court will evaluate the parties' behaviour to determine whether some behaviour likely

[9] See *R. v. Armco Canada Ltd.* (1974), 6 O.R. (2d) 521; 21 C.C.C. (2d) 129; 17 C.P.R. (2d) 211, and *R. v. Canadian General Electric Company Ltd.* (1976), 29 C.P.R. (2d) 1; 34 C.C.C. (2d) 489.

[10] It is possible that an offense may be established solely on the basis of evidence that the specific purpose or object of the agreement was to prevent or lessen competition unduly. However, the Bureau's enforcement approach has been to inquire into those agreements which are likely to have an anti-competitive impact in the market.

[11] *R. v. Nova Scotia Pharmaceutical Society* (1992), S.C.R. 606, 139 N.R., 43 C.P.R. (3d) 1, 10 C.R.R. 34 [hereinafter cited to SCR], at 611.

[12] *Ibid.*, at 660.

[13] *Ibid.*

[14] *Ibid.*, at 653.

[15] *Ibid.*, at 654.

to injure competition has occurred, or is likely to occur. Price fixing, restrictions on output or market sharing are almost always of competitive significance, and hence the Director will view such agreements as constituting injurious behaviour. Likewise, in cases where product quality, service, promotional activity or innovation are an important determinant of competitive rivalry such that an agreement in respect of one of these is likely to have a significant adverse effect on competition between the parties, the Director may view such agreements as providing grounds for inquiry where the parties possess market power.

The Supreme Court has stated that it is the combination of market power and injurious behaviour that makes a lessening of competition undue. In noting that many combinations are possible, the Court suggested that "a particularly injurious behaviour may . . . trigger liability even if market power is not so considerable".[16] It is the Director's position that the converse is also true, in that with a considerable amount of market power, a less injurious behaviour may trigger initiation of an inquiry under the *Act*.

Applying the above test to strategic alliances would involve the following determinations. First, have the parties to the alliance entered into an agreement? Second, does the alliance, or is it likely to, unduly lessen or prevent competition? Third, do the requisite elements of intent exist? In order to address the issue of undueness within the framework discussed by the Supreme Court, the Bureau will: (i) define the relevant product and geographic markets affected by the strategic alliance; (ii) determine whether the parties to the alliance possess market power in the defined relevant markets, or whether they are likely to obtain market power in these markets as a result of the alliance; (iii) assess what behaviour is specifically restricted or prescribed by the strategic alliance; and, (iv) determine if the alliance results in a combination of market power and behaviour injurious to competition which is serious or significant.

As the above discussion indicates, only those elements of a strategic alliance which represent a serious restraint of competition would be targeted by the conspiracy law. This means that many of the beneficial aspects of a strategic alliance may not be challenged. For example, where competitors develop technology sharing agreements and reciprocal patent licensing there may not be a serious adverse effect on competition, but where ancillary to these arrangements the parties begin to allocate markets between themselves or agree on prices, then this may run afoul of the conspiracy provisions. Unless the beneficial elements of the cooperative arrangement are tied to a broader conspiracy they will not be challenged by the Bureau.

In setting out the test of undueness the Supreme Court made it clear that the test focuses solely on the competitive effects, and not the efficiencies which may result from the agreement: "Considerations such as private gains by the parties to the agreement or counterbalancing efficiency gains to the public lie . . . outside of the inquiry under paragraph 32(1)(c) [now paragraph 45(1)(c)]. Competition is presumed by the *Act* to be in the public benefit."[17] Thus, parties, in considering whether to enter into strategic alliances, should realize that if an agreement unduly lessens or prevents competition, efficiencies provide no defence under section 45.

3.2.1.1 Defences and Exceptions

Not all agreements between competitors violate the conspiracy provisions, as the *Act* contains twelve specific defences. Among these, the following may be more likely to have application to strategic alliances — an agreement in respect of: the exchange of statistics; the definition of product standards; the size and shapes of product packaging; cooperation in research and development; restrictions on advertising or promotion; or, measures to protect the environment. There are also specific defences dealing with export consortia and specialization agreements, which are described in separate sections below.

[16] *Ibid.*, at 657.

[17] *Ibid.*, at 649-650.

It is important to note that these defences are not without limits. The *Act* makes it clear that what would not be acceptable under the basic conspiracy provisions will not be permitted to occur through activities related to these defences. As a result, if the strategic alliance is likely to lead to an undue lessening or prevention of competition in respect of prices, quantity or quality of production, markets or customers, or channels or methods of distribution, or if the alliance restricts anyone from entering into or expanding a business, the defence does not apply.

It is the Director's position that for a defence to be lost, it is not necessary that the agreement be directed explicitly at any of these fields, only that one of these dimensions of competition is likely to be lessened or prevented unduly as a result of the alliance. Consequently, a strategic alliance which may be directed primarily at research and development, but which is likely to have an undue effect on prices, for example, owing to an ancillary arrangement to jointly market and distribute the newly produced goods or services, may cause the Director to initiate an inquiry under the conspiracy provisions. At the same time, the beneficial features of the strategic alliance will not be subject to challenge by the Director unless they are seen as part of a broader conspiracy.

To date the courts have not considered a conspiracy case in which the defences and exceptions, under subsections 45(3) and 45(4) respectively, have been argued. Historically, the kind of cases brought before the courts under section 45 have generally been price-fixing or market sharing agreements. Furthermore, the Bureau has dealt with very few requests for advisory opinions in areas related to the defences. Nevertheless, the scope of the exceptions is relatively wide. This suggests that where the parties wish to avail themselves of a defence under subsection 45(3) for a strategic alliance that results in market power, caution would indicate that they may wish to strictly confine the agreement to the elements of the specific defence under subsection 45(3) in order to avoid straying into the fields listed in the exceptions in subsection 45(4). For example, firms possessing market power who enter into an agreement in respect of product packaging are advised not to extend the agreement to the marketing or promotion terms, particularly price, of the product. It should be emphasized however, that even if a party has lost the defence it had available under subsection 45(3), it would still be necessary to demonstrate in any prosecution under subsection 45(1) that the agreement unduly prevents or lessens competition.

3.2.1.2 Information Sharing

Strategic alliances often involve a considerable exchange of information between the parties. Such exchanges are generally constrained by the terms of the alliance and may not extend beyond the confines of the alliance agreement. The reasoning behind this is that it is not normally in the interest of any one alliance partner to risk losing a competitive advantage it may hold relative to its partners when these firms are its competitors. However, information sharing may also extend beyond the terms of the alliance agreement either between the alliance partners or to outside firms.

The exchange of information will not necessarily give rise to competition issues under the conspiracy provisions. Indeed, competitive markets function more efficiently when information is relatively free and openly available to market participants. At the same time, it is recognized that information exchanged among competitors who collectively possess market power may have serious adverse effects on competition, depending upon the nature and timing of the information exchange. Where markets are characterized by high levels of concentration, barriers to entry and relative stability, information exchanges in respect of sensitive commercial information may reduce uncertainty about rivals' competitive responses and so act to further temper rivalry. When the products involved are relatively homogeneous and firms compete across a limited number of competitive variables, the risk that such exchanges will have significant adverse effects on competition is further heightened. In light of this and the possible application of section 45, the parties to

a strategic alliance which results in market power must remain cognizant of the risks involved when information is exchanged either directly via the alliance, or indirectly via an industry or trade association, or other third party.

In order for information sharing among competitors to cause the Director to initiate an inquiry under section 45, the information exchange would have to satisfy all of the elements of the conspiracy provisions discussed above. Hence, it would be necessary to establish that either the information exchange itself constitutes an "agreement" between the parties, or that the information exchange is part of a broader agreement in violation of section 45. Second, the information exchange must be one which gives rise, or is likely to give rise, to an undue lessening or prevention of competition. Finally, the requisite elements of intent must be demonstrated. Depending upon the type of information to be shared, the exchange may qualify for one of the defences to section 45 provided none of the exceptions apply.

The Supreme Court's discussion of undueness makes it clear that without market power, an information exchange among strategic alliance partners will not be subject to section 45. Furthermore, where the information being exchanged among alliance partners is not likely to have a significant adverse effect on competitive rivalry or relates to matters that lack competitive significance, it is unlikely to constitute behaviour injurious to competition. As a result, it is only in circumstances where the parties to the information exchange collectively possess market power and are engaged in the type of information sharing which may adversely impact competitive rivalry in a serious or significant way that section 45 applies.

The risk of initiation of a formal inquiry under section 45 is also reduced when the alliance partners design the sharing of information between themselves in a manner which preserves the ability of the individual parties to determine "independently" what strategy, outside of the alliance, they will follow in the market. It is also advisable not to use the alliance as a means of "signaling" to competitors in the market what action the alliance partners wish their outside rivals to take or what action an individual member of the alliance wishes its partners to take in an area outside the scope of the alliance agreement.

The risk that an inquiry may be initiated in respect of information sharing increases with several factors. First, the greater the market power collectively held by the parties to the information exchange, the more likely it is that an information exchange in respect of any significant aspect of rivalry may adversely impact on competition. Second, when particularly sensitive information important to rivalry is shared, this may be more likely to be viewed as behaviour injurious to competition. In this regard, exchanging information in respect of current or future pricing, costs, trading terms, or marketing strategies significantly heightens the risk of inquiry by the Director.[18] Direct exchanges of sensitive commercial information between competitors are riskier than those made through an independent third party which holds the information in confidence, although care needs to also be taken when involving these or other third parties, particularly trade associations.[19] Firms should also be cautious in sharing the analyses or conclusions developed from the information exchange, in order to preserve their ability to act independently beyond the alliance. Similarly, the exchange of disaggregated data which allows for identification of an individual firm's plans is riskier than exchanges involving aggregated data. Third, any evidence of anticompetitive intent increases the likelihood that an inquiry may be initiated. Evidence of coercion on the part of one or more of the alliance partners to have another party act in a prescribed anticompetitive manner may lead to an inference of anticompetitive intent.

[18] The exchange of such information, particularly current or future pricing, may also raise issues under other provisions of the *Act*, including bid-rigging and price maintenance which do not involve any test of market power.

[19] Several prosecutions under the conspiracy provisions have involved trade associations. In *R. v. Armco* (1974), *supra* note 9, for example, a conspiracy conviction was obtained in a matter involving information exchanges and other activities made through an industry association.

3.2.2 Export Consortia Provisions

The importance of exports to the Canadian economy is recognized both in the purpose clause of the *Act* and in the export defence to the general conspiracy provisions. Subsection 45(5) of the *Act* provides a defence to an alleged conspiracy where the agreement relates only to the export of products from Canada.

However, like the earlier discussed defences, this is not absolute and hence the defence can be lost under certain circumstances. First, the defence applies to agreements that relate only to the export of products from Canada. Those agreements which may impact negatively on the Canadian market would therefore be subject to review by the Director under the general conspiracy provisions to determine, in particular, whether the parties to the agreement intended to lessen or prevent competition unduly in Canada.[20] Second, if the alliance in respect of exports is likely to reduce or limit the real value of the exported product, the defence is lost. Third, in cases where the export alliance restricts other firms from entering or expanding their business of exporting products from Canada, the defence is negated. Finally, the defence will be lost in the event that the alliance unduly prevents or lessens competition in the supply of services facilitating the export of the product from Canada.

A final consideration, which generally applies, but is particularly important in the case of export consortia, is the application of foreign competition laws. Canadian businesses need to recognize that the export defence under section 45 applies only to Canadian competition law, and provides no defence or exemption under the competition laws of foreign countries where the consortia hope to sell their products, to the extent that such laws apply.

3.2.3 Specialization Agreement Provisions

As noted above, the *Act* also allows an exemption from the conspiracy provisions for the use of specialization agreements among competing firms.[21] The provisions allow for a civil review of specialization agreements before the Competition Tribunal. In order for a strategic alliance to be reviewed under the specialization agreement provisions, it must meet certain conditions. Section 85 of the *Act* defines a specialization agreement as:

> "an agreement under which each party thereto agrees to discontinue producing an article or service that he is engaged in producing at the time the agreement is entered into on the condition that each other party to the agreement agrees to discontinue producing an article or service that he is engaged in producing at the time the agreement is entered into, and includes any such agreement under which the parties also agree to buy exclusively from each other the articles or services that are the subject of the agreement".[22]

Specialization agreements are meant to provide a means by which firms may benefit from efficiencies not available except through forms of inter-firm cooperation which adversely affect competition to some degree. The wording of the section indicates that it applies only to production which is in existence at the time that the agreement is entered into, and hence it does not apply to anticipated or future products.

To be exempt from the conspiracy provisions of the *Act*, the specialization agreement must be registered with the Competition Tribunal. In considering whether to register such an agreement, the Tribunal will examine the alliance to determine whether it is likely to bring

[20] In conducting such an analysis, the Bureau would consider the extent of foreign competition in defining the scope of the relevant geographic market which could extend well beyond Canada.

[21] The *Act* also provides an exemption from the exclusive dealing provisions for specialization agreements.

[22] *Competition Act*, *supra* note 1.

about gains in efficiency that will be greater than, and will offset, the effects of any prevention or lessening of competition that are likely to result. Further, it must be established that these efficiency gains would not be attainable if the specialization agreement was not implemented.

Thus, it is only where firms decide to discontinue existing production of a particular article or service in exchange for the same with a second firm that the specialization agreement provisions will apply. Many strategic alliances contemplate more than a simple exchange of existing production, requiring cooperation across a broader range of either existing or future activities. Where this is the case or where the parties do not wish to subject their alliance to a Tribunal review process, the exemption from the conspiracy provisions afforded through specialization agreements will not apply.

3.2.4 Merger Provisions[23]

It is also possible that a strategic alliance may be reviewable under the civil merger provisions given the frequency of equity investments in these arrangements and the broad definition given to mergers under the *Act*. Under section 91, a merger is defined to be the acquisition of control over, or significant interest in, a business or part thereof. With respect to corporations, control is defined to mean *de jure* control, and so requires a direct or indirect holding of more than 50% of the corporation's voting rights. In the case of "significant interest", it is the Director's position that this arises when one or more persons directly or indirectly acquire or establish the ability to materially influence the economic behaviour of the business, or part thereof. Hence, where it is found that one firm's decisions in respect of pricing, purchasing, distribution, marketing or investment are materially influenced by another firm, a significant interest may be deemed to have been acquired or established.

Given the wide range of ownership structures and various arrangements that can be implemented pre- and post-closing, the determination of whether a "significant interest" exists can only be made by considering the particular facts surrounding each alliance on a case by case basis. In advisory opinions in this area, consideration has been given to the collective influence of a number of factors including: equity ownership; board participation; shareholder agreements, management contracts and other contractual arrangements; roles of the parties, be they financier, supplier or competitor; access to commercially sensitive information; extent of collaboration; advisory role to be taken or other participation in day-to-day operations; long-term supply agreements; asset acquisition; or leases, subleases and rights to purchase assets. Ultimately, where the effect of the strategic alliance is to give one party the ability to materially influence the economic decisions of another, then the definition of a merger is likely satisfied .

When strategic alliances are examined as mergers, they will be reviewed following the analytical framework set out in the *Merger Enforcement Guidelines*. The applicable legal test is whether the merger prevents or lessens competition substantially or is likely to do so. The provisions of the *Act* are expressly formulated to reflect that mergers are recognized as a legitimate way for companies to grow and consolidate. Hence in analyzing any merger, markets are defined on an economic basis, with a focus on demand and supply responses. Market share or concentration, alone, cannot be used to challenge a merger. The *Act* also requires an assessment

[23] Where an alliance falls within the merger provisions, it may be subject to the notification provisions in Part IX of the *Act*. These provisions require persons who are proposing certain large acquisitions, amalgamations or combinations to notify the Director before completing the transaction and to supply certain information. In addition, persons who are planning a merger who wish to seek some assurance that the transaction they are proposing will not be challenged by the Director may apply for an Advance Ruling Certificate under section 102 of the *Act*. Issuance of an Advance Ruling Certificate also exempts parties from the requirement to comply with the prenotification provisions of the *Act*. For further information, see the Director of Investigation and Research's *Merger Enforcement Guidelines*, *supra* note 6.

of foreign competition, the availability of substitutes, whether one of the parties is failing, barriers to entry, the effectiveness of remaining competition, whether the merger removes a vigorous and effective competitor, change and innovation, and any other relevant factor. Finally, even if a merger is challenged by the Director and it is found to (likely) prevent or lessen competition substantially, the Competition Tribunal may allow the merger to proceed if it finds that it is also likely to result in gains in efficiency that are greater than, and will offset, the reduction in competition, and that these efficiency gains would not be attained if an order of the Tribunal were made.

3.2.5 Joint Venture Provisions

An exemption from the merger provisions may be made for strategic alliances which fall within the joint venture provisions. To be exempt from a Competition Tribunal order under the merger provisions, section 95 requires the joint venture to meet the following criteria:

- the joint venture cannot be structured as a corporation;
- the joint venture must be formed to undertake a specific project or a program of research and development, where it can be demonstrated that the project or program would not reasonably have taken place in the absence of the joint venture;
- no change of control over any party to the combination resulted or would result from the joint venture;
- the agreement is in writing, requires that one or more of the parties contribute assets, and governs a continuing relationship between the parties;
- the agreement entered into restricts the range of activities that may be carried on, and provides for termination on the completion of the project or program; and
- the combination does not prevent or lessen, or is not likely to prevent or lessen, competition except to the extent reasonably required to undertake and complete the project or program.

Given that section 95 only covers agreements related to a specific project or program of research and development, and hence does not cover the broader collaboration often witnessed in strategic alliances, the provision's application to strategic alliances may be somewhat limited.

3.2.6 Abuse of Dominant Position Provisions

In other situations, a strategic alliance may be reviewable under the abuse of dominant position provisions. Several conditions will need to apply in such a case. First, the parties to the alliance will have to collectively control a class or species of business. The wording of the section refers to substantial or complete control of a class or species of business by "one or more persons", and hence it contemplates situations where a group of firms, perhaps through a strategic alliance, holds substantial or complete control of the class or species of business. In its interpretation of the word "control", the Competition Tribunal has adopted the economic test of market power.[24] Hence, a "class or species of business" involves defining relevant product and geographic markets. Because control requires market power, market share alone is not determinative. Other factors, most notably conditions of entry, are equally important.

Simply finding a dominant position, however, is not enough. The section also requires that the parties involved in the strategic alliance be engaged in a practice of anticompetitive acts. A non-exhaustive list of anticompetitive acts is found in section 78. In its decisions to date, the Competition Tribunal has taken a broad view of what constitutes a practice of anticompetitive acts, allowing for consideration of any act, the intended effect of which is either "predatory, exclusionary or disciplinary".[25] While anticompetitive purpose

[24] *Canada (Director of Investigation and Research) v. NutraSweet Company*, (1991), 32 C.P.R. (3d) 1 (C.T.) at 28.
[25] *Ibid.*, at 34.

is a necessary ingredient in making this determination, the Competition Tribunal accepts that evidence related to the likely effect of the act itself can be used to establish purpose.[26]

Finally, the practice of anticompetitive acts will need to have led to, or be likely to lead to, a substantial lessening or prevention of competition. The likelihood that this may result from the anticompetitive acts can be assessed by reference to the level of competition in the relevant market in which the alleged anticompetitive acts occur and its likely level of competition in their absence.[27] In determining whether a practice is likely to prevent or lessen competition substantially, the Tribunal may consider whether the practice is the result of "superior competitive performance", as referenced in subsection 79(4).

[26] *Ibid.*, at 35-36.
[27] *Ibid.*, at 33.

Part 4
Public Education Program/Compliance

Compliance with the *Act* is the Director's overall objective. This is accomplished through a number of instruments and can best be achieved when business people have a sound understanding of the provisions of the *Act*. The Director places a great deal of emphasis on communications and education to foster a better understanding of the *Act* and its application, and has implemented an open-door, fix-it-first approach when dealing with the business community. In light of the various provisions which may apply to strategic alliances, parties may wish to approach the Bureau under the Program of Advisory Opinions to determine the *Act*'s applicability.

4.1 The Communications and Education Program

The Director and staff of the Bureau undertake speaking engagements on a variety of competition matters. Bureau staff often conduct seminars for businesses and associations on topics of particular interest to them, such as: the detection and prevention of bid-rigging when calling for tenders; the notification and review procedures for large mergers; and the preparation of promotional material that conforms to the misleading advertising provisions of the *Act*. Other issues addressed include the application of the *Act* to joint ventures, specialization agreements and other strategic arrangements contemplated to respond to the demands for structural adjustment in the economy. These sessions, while general in approach, often lead to further, more specific, consultation through the Program of Advisory Opinions. The general education and communications program of the Director is supplemented by advisory opinions and information contacts which are designed to facilitate compliance with the *Act* in particular situations.

4.2 Advisory Opinions

The Director facilitates compliance by providing advisory opinions to those who wish to avoid coming into conflict with the *Act*. Under this program, company officials, lawyers, and others may request an opinion on whether the implementation of a proposed business plan or practice would comply with the *Act*. Opinions take into account previous jurisprudence, previous opinions and the stated policies of the Director, especially those set out in published Enforcement Guidelines. Under this program, the Director provides advisory opinions in relation to the specific set of facts presented by the parties. Hence, the degree of comfort provided by the Director in offering an opinion on a specific alliance will be directly proportional to the information the parties provide on the likely competitive effects of the alliance.

In providing an opinion, the Director neither regulates conduct nor pronounces on the legality of the proposal. Instead, the Director will indicate whether a proposal is likely to provide grounds to initiate an inquiry under the *Act*. The parties remain free to adopt or pursue a particular course of action notwithstanding a negative opinion from the Director with the understanding that they may, following investigation, be challenged by either a referral to the Attorney General for prosecution under the criminal provisions or an application filed with the Competition Tribunal under the reviewable provisions.

Advance Ruling Certificates are also available for parties to a proposed merger who wish assurance that it will not give rise to proceedings under the merger provisions of the *Act*.

Part 5
Conclusions

As is evident from the above, black and white issues are infrequent when applying the *Act* to strategic alliances which maintain, create or enhance market power. Therefore, parties who believe their alliance is likely to have this effect may wish to request an advisory opinion.

When dealing with strategic alliances, it is important to focus on their actual and likely competitive effects. This focus highlights the fact that most strategic alliances will not be an issue under the *Act*. This results, not from an argument about the *Act*'s application to these new forms of inter-firm cooperation, but rather from the fact that, in most cases, strategic alliances are unlikely to have as their purpose or effect the maintenance, creation or enhancement of market power. Where competition issues do arise, the *Act* is well-equipped to deal with these on a balanced basis.

Appendix 1
Illustrative Scenarios

The possibilities for different kinds of strategic alliances are virtually without limit. Strategic alliances can be found in most, if not all, industries and include firms of all sizes and descriptions. The motivations for entering into alliances also vary considerably, including research, efficiency, learning, market access, or anticompetitive ends. Finally, strategic alliances may be constructed in various corporate forms.

To assist business people in determining the status of various types of strategic alliances under the *Act*, nine illustrative scenarios are presented below, relating to conspiracy, information sharing, cooperative measures to meet environmental regulations, export consortia, specialization agreements, mergers, international alliances, abuse of dominance, and industry-wide alliances. These scenarios are presented in summary form and of necessity do not include an exhaustive factual background nor a lengthy discussion of the issues raised. They are meant only to highlight the likely analytical approach taken in each situation. While the principles and issues identified in these scenarios have general application to all industries and to the many forms which strategic alliances may take, parties may wish to approach the Bureau for more specific guidance in respect of a particular alliance.

Strategic Alliances Scenarios

(I) Conspiracy Example

All of the members at one trade level of an industry want to take joint action to rectify or "clean up" two principal concerns: discount levels have become "too high" and credit terms have become "too long". Because each of these "problems" represents a form of competitive inducement to the customers of the industry, no single firm is willing to discontinue the current practice unilaterally due to the risk of lost business. Hence, they argue that joint action is required, perhaps through an alliance of interests established by their trade association. It is agreed by the three largest members of the industry association that they will participate in an alliance to better align their long-term interests, particularly their marketing strategies. As part of this strategy, the parties agree to discount levels and credit terms. A couple of smaller firms engaged in importing remain outside of the agreement although neither is viewed as a significant rival by the alliance partners.

Discussion

Whether the firms' proposals will cause the Director to initiate an inquiry will depend upon whether the likely effect of the alliance is an undue prevention or lessening of competition. As noted earlier, the "undueness" concept essentially involves a measurement of the market power held by the parties to the agreement combined with behaviour injurious to competition. In this example, the alliance of interests to be established involves the largest and most significant members of the industry. There are few firms outside of the alliance, and they are not viewed as providing significant enough competition to disrupt the participating firms' efforts to align their marketing strategies. If it is also the case that new firms would find it difficult to profitably enter this industry on a timely basis then new entry is unlikely to discourage the implementation of the agreement. In such circumstances, the Director is likely to find that the parties to the alliance possess market power.

As a result, the proposed course of action would likely cause the Director to initiate an inquiry under the conspiracy provisions. Notwithstanding the fact that the firms do not want to fix the nominal prices of the products which they sell in competition with each other, they are agreeing with respect to factors (i.e., discount levels and credit terms) which do have a bearing on the ultimate transaction prices to be paid and costs to

be borne by their customers, with ensuing downstream price consequences. Hence, it is the Director's view that the behaviour of the firms would likely be injurious to competition.

(II) Information Sharing Example

A manufacturer of consumer appliances finds that it must become more efficient if it is to maintain its market position relative to its rivals in a increasingly competitive market. Impressive efficiency gains in warehousing and distribution have been realized by some firms outside of the appliance industry, which are being widely benchmarked by their own and other industries.[28] Following the example of others, the manufacturer seeks out a clothing retailer as a benchmark for distribution. The two firms enter into a contract pursuant to which the retailing company agrees to share confidential cost information with the manufacturer for a fee and subject to various non-disclosure provisions. The two firms also agree to work together to improve future warehousing and distribution techniques.

Encouraged by the benchmarking of the clothing retailer, the manufacturer seeks a wider strategic alliance with one of its competitors. Each firm would benchmark the other with respect to administration, warehousing and distribution.

The key lesson learned by the participants involved in the second benchmarking exercise is that neither firm can individually afford an information technology system but each needs to utilize such a system in order to remain competitive with the largest firms in the industry who are able to afford the system on their own. The two competitors enter into a further alliance whereby they jointly buy the information technology and share it as a common facility, but do not share competitively sensitive information through it. The sharing of information on their administration, warehousing and distribution costs ends with the acquisition of the information technology.

Discussion

In the first alliance involving benchmarking between the appliance manufacturer and the clothing retailer, there are no competition issues, given that the two firms do not compete with each other in their relevant markets. As the benchmarking exercise is shifted towards a horizontal competitor of the appliance manufacturer, however, there is a potential risk of exposure under the conspiracy provisions of the *Act*. The level of risk will depend upon the degree of collective market power held by the two manufacturers and upon what kind of information is shared, who shares it and the particular process whereby the information is compiled and disseminated.

In this example, it is unlikely that the participants in the second benchmarking exercise possess market power. While the benchmarking exercise includes two horizontal firms, it does not include the largest firms in the industry. Furthermore, the larger firms operating in the industry are able to afford the new technology and hence would appear to have a cost advantage over the benchmarking participants. This cost advantage presumably allows the larger firms to price in a more aggressive fashion compared to the benchmarking firms.

Under a different set of assumptions, the example could be constructed to give the parties to the second benchmarking exercise market power. In such a case, the benchmarking exercise could give rise to reduced uncertainty about the competitive reaction of rivals. Under these circumstances, a competition issue could arise even in cases where the information to be shared does not relate to future pricing, output, or marketing strategies. As the above example of sharing information technology is constructed, the parties jointly purchase information technology which is shared as a common facility without competitively sensitive information being exchanged. Hence, their behaviour is unlikely to be found to be injurious to competition.

[28] Benchmarking refers to comparisons made with other firms in order to highlight best practices and promote their adoption.

(III) Cooperative Measures To Meet Environmental Regulations Example

An industry faces strong pressures from its customers, the general public and the federal government to reduce the level of emissions in manufacturing. Each manufacturer is willing to comply with environmental targets but only if its competitors also comply. Concerned that laggards would enjoy a competitive cost advantage, no firm is willing to take the lead in spending the necessary funds to reduce its level of emissions. To remove this concern, the industry association signs a memorandum of understanding with the federal government pursuant to which its members will work together to voluntarily achieve target reductions of certain emissions.

The four largest firms, accounting for 80% of Canadian output, also agree to enter into a research alliance to develop new technologies for reducing emissions and to find substitutes to existing products which present an environmental hazard.

Discussion

Voluntary agreements by industry to comply with environmental standards set by government are an alternative to command-and-control type regulations. They are part of an international trend towards market-oriented policies and decreasing reliance on industry-specific government regulation. Voluntary environmental agreements may refer only to emissions and the unwanted by-products of production, or they may refer to the final products that are sold on the market themselves (e.g., the reduction or complete elimination of products that contain certain harmful substances).

This example falls within the defences to the conspiracy provisions outlined in the *Act*; namely, measures to protect the environment.[29] As a result, it will cause the Director to initiate an inquiry under the conspiracy provisions only if the exception to the defence applies. If the environmental agreement relates only to emissions and unwanted by-products of production, it is not likely to prevent or lessen competition unduly in respect of either prices, quantity or quality of production, markets or customers, channels or methods of distribution or restrict entry or expansion and as a result the defence will hold. Likewise, if the research alliance is not likely to result in any of the adverse effects contained in the exceptions above, it too will fall within the defence.

Alternatively, if the environmental goal requires a reduction or limitation upon final product output, as opposed to emissions, an issue could arise under the *Act* if the participants to the voluntary agreement collectively possess market power. Targets for reduced industry output or an agreement on levels of output could well amount to a market sharing agreement, behaviour which is captured under the exceptions in subsection 45(4). Where market power is present, such agreements would likely lead to an undue lessening or prevention of competition.

With all firms within the industry party to the voluntary agreement, it is likely that collectively they hold market power although this will depend upon barriers to entry. Having found that market power exists, information sharing in the course of discussions relating to the voluntary agreement that results in an agreement that adversely impacts on prices, market shares, quantity or quality of output, or industry capacity would likely cause the Director to initiate an inquiry under section 45.

In principle, there is less potential for anticompetitive actions to be taken if all of the affected groups — including key customers and suppliers — are adequately represented in the process. Both industry and government participants could obtain comfort if a voluntary environmental agreement incorporates a disclaimer to

[29] The research alliance could fall under either the defence related to measures to protect the environment or cooperation in research and development.

send a clear message that the government is not condoning or promoting any type of activity that would violate the *Act* or any other Canadian statute.[30]

In the case of the research alliance, a determination of whether the parties to the alliance hold market power will depend upon the degree of import competition and barriers to entry. If it is found that market power exists and that the information exchange extends beyond cooperation in research and development such that either prices, market shares, output or industry capacity are negatively affected, it is likely that the Director would initiate an inquiry under section 45.

(IV) Export Consortium Example

Canadian producers of certain resource processing equipment sell their output exclusively within the domestic market. They realize that there are opportunities in foreign markets but each firm lacks the knowledge of how to penetrate those markets. Individual firms also face strong pressure to minimize costs, making any individual firm reluctant to invest the time, money and managerial attention required to establish a position in export markets.

The Canadian producers form an export consortium, which would purchase the expertise that is necessary to penetrate foreign markets, coordinate and combine the output from different firms into large shipment units, negotiate favorable shipping rates for the combined shipments, and negotiate on behalf of the industry with foreign buyers. The firms involved would possess market power if they acted in concert in the domestic market owing to existing trade restrictions, but not necessarily in any of the foreign markets they seek to enter.

Discussion

The *Act* provides a defence to the conspiracy provisions where the agreement in question relates only to the export of products from Canada. In this example, the alliance falls within the defence and hence the Director would not initiate an inquiry in respect of the alliance. It is only in the event that participation in the consortium is used as a cover to unduly lessen or prevent competition in the domestic market that the conspiracy provisions may be violated. Alternatively, the defence may be lost if the consortium acts to reduce the real value of exports of the product from Canada. This could be the effect if potential exporters were denied membership in the consortium or denied supply of the product in order to preclude them from participating in the export market.

(V) Specialization Agreement Example

Two Canadian firms account for the entire domestic production of a type of manufacturing equipment. Each domestic firm has several manufacturing plants spread across the country to serve regional markets, and sells its products through sales agents who visit manufacturing plants. While imports have traditionally been minimal, the threat of more significant import competition has increased following a reduction of tariffs. This has forced the two firms to consider further rationalization of their plants in order to achieve available economies of scale. They decide to enter into a specialization agreement in which each firm will concentrate on producing only certain of the products while discontinuing production of certain others. All of the products currently being produced would continue to be produced by one firm or the other.

Under the agreement, each firm would continue to market a full line of products by virtue of an exclusive supply arrangement between themselves. Transaction prices between the firms would be determined over time by a cost-based formula set out in their agreement, but final prices to customers are to be set by each firm independently. The firms claim that entering into this specialization agreement will enable them to realize certain purchasing and production economies, and result also in transportation savings. Since they are currently direct competitors in the production and sale

[30] Government involvement would preclude conviction under the *Act* only when such conduct is specifically authorized and effectively regulated pursuant to valid legislation.

of the relevant products, they want to know if their negotiations to enter into a specialization agreement would cause the Director to oppose the registration of the agreement by the Competition Tribunal.

Discussion

The registration of a specialization agreement by the parties with the Competition Tribunal provides an exemption from the conspiracy and exclusive dealing provisions of the *Act* where the efficiency gains expected to result from the agreement outweigh any lessening or prevention of competition. In this example, the parties to the agreement account for all domestic output. A final conclusion on market power, and hence the likelihood of a lessening or prevention of competition, will depend on the degree of import competition and barriers to entry. The efficiency gains flowing from the agreement may be defined as, *inter alia*, economies of scale, better integrated production facilities, plant specialization, lower transportation costs, and improved services and distribution operations. Reduction in general overhead expenses may also result. If the agreement is likely to lead to any lessening or prevention of competition, these cost savings must be large enough to offset the adverse effects on competition. In assessing the extent to which competition is lessened, the continued independence of the parties in pricing or marketing their products would be an important consideration. Furthermore, the relevant efficiency gains included in the trade-off analysis are those which would not likely be attained if the specialization agreement was not implemented.

The specialization agreement exemption relates only to the registered agreement, and does not cover other activities which may go beyond the registered agreement. In addition, entering into a specialization agreement without first attempting to have it registered before the Tribunal would leave the parties open to a possible inquiry under the conspiracy provisions for which the efficiency aspects of their agreement would not be a defence. Section 45 does not contain any provision for assessing the merit or value of efficiency gains which may offset negative effects on competition. The sole issue reviewed by the Director under the conspiracy provisions would be the extent to which the agreement lessened or prevented competition unduly.

(VI) Merger Example

Two horizontal competitors produce high technology equipment. A large, foreign multinational (Firm A) acquires a 14.9% equity share in a Canadian firm (Firm B) and will place one person on the six person board of directors of Firm B. Firm B supplies Firm A with a component of the equipment they produce whose source of supply has been rapidly diminishing in recent years. The alliance involves: a long-term supply contract for this component between the two firms; Firm A will collaborate with Firm B in certain research, development and manufacturing activities related to the equipment but the two firms will operate independently with respect to manufacturing, distribution and sales activities; Firm A will act as an "industry advisor" to Firm B and as such will have access to confidential proprietary information on Firm B and will play a significant role in expanding, altering, and diversifying product development and technology and the marketing and distribution of Firm B's products.

Discussion

Under section 91, a merger is defined to be the acquisition of control over, or significant interest in, a business or part thereof. While there is not an acquisition of *de jure* control in this case, the Director is likely to find that the transaction constitutes the acquisition of a "significant interest" by Firm A in Firm B. In this case, the collective effect of the various arrangements entered into is to place Firm A in a position to materially influence the competitive behaviour of Firm B by virtue of its equity holding; participation on the acquired firm's board of directors; multiple roles of financier, supplier and competitor; long-term supply agreement; advisory role; access to commercially confidential information; and the likelihood that the arrangement significantly changes the economic behaviour of Firm B or ends vigorous, effective competition between the

partners. In order to determine whether the transaction is likely to give rise to a substantial lessening or prevention of competition it will require a full analysis following the *Merger Enforcement Guidelines*.

In general, a merger will be found to likely prevent or lessen competition substantially when the parties to the merger would be in a position to exercise a materially greater degree of market power in a substantial part of the relevant market for two years or more. In order to make this assessment, information in respect of market share or industry concentration must be augmented with an analysis of foreign competition, the availability of substitutes, whether one of the parties is failing, barriers to entry, the effectiveness of remaining competition, and any other relevant factor. Finally, even in the event that a merger is found to prevent or lessen competition substantially, the merger will not be prohibited when there are gains in efficiency sufficient to offset the anticompetitive effects and these efficiencies would not be attainable if an order against the merger were made by the Competition Tribunal.

(VII) International Alliance Example

A small Canadian company specializes in pharmaceutical research. The firm has patents on four promising compounds, but finds that in order to generate profits from the patents, it requires certain complementary resources, including: clinical research capability in terms of experienced personnel and the funds to finance it; production facilities capable of producing large volumes after the drug has been approved by the government; management of the government approval process which requires experienced personnel and significant financial resources; and marketing and sales capability. The company enters into a strategic alliance with a major multinational pharmaceutical manufacturer in order to acquire these resources for one of its most promising compounds. The agreement covers the obligations of each partner with respect to development and distribution of the new drugs, the manufacturer's "right of first negotiation" on new drugs that are developed from the compound, world-wide marketing rights, the sharing of confidential information, and the sharing of development costs and revenues. In order to minimize its dependence upon the manufacturer, the research firm makes similar agreements with different manufacturers for each of its other three compounds.

Discussion

It is possible to view this example as a strategic alliance which combines the core competence of each partner. The core competence of the small research firm is its ability to develop new compounds. The manufacturer's core competence (at least with respect to this particular compound) lies in the financial resources and knowledge required to shepherd new compounds through the regulatory approval process, manufacturing, marketing and distribution. The two firms may in fact be competitors in research but when the smaller company has produced a marketable compound, it is advantageous for both to combine their respective core competencies.

There are numerous firms participating in the market for drug research, production and sale world-wide. Small research companies may select their alliance partners from among a number of large, multinational pharmaceutical manufacturers and distributors, as illustrated in the example above. The opportunities to make alliances of this sort encourages smaller firms to enter into the research field in competition with the large multinationals. Given these factors, an alliance of this type would not likely maintain, create or enhance market power and as such would not raise an issue under the *Act*.

(VIII) Abuse Of Dominance Example

There is only one supplier of a chemical which is an essential ingredient in producing a new model of a consumer product. The chemical is used in many applications and is produced under patent, which will not expire for another ten years. The new consumer product enjoys a substantial price premium over the old models because of its unique features making it far more convenient to use. Two consumer product

manufacturers begin producing the new model, which quickly wins a 70% market share. The larger of these manufacturers, holding a 50% market share enters into a strategic alliance with the chemical supplier to replace existing production facilities for the chemical with a new plant. Pursuant to the alliance, the manufacturer offers financing for the new chemical plant and the supplier agrees to sell the chemical exclusively to the consumer product manufacturer. The manufacturer's competitor is then excluded from producing the new model because the alliance agreement has tied up the supply of the chemical. There are no other producers of a substitute for the chemical apparent on the horizon.

In response to repeated requests of the smaller manufacturer, the larger manufacturer agrees to supply the chemical to its competitor on a spot basis. While the smaller manufacturer gains access to the chemical, it finds its supply is sporadic and as a result it is unable to maintain its production levels at a cost-efficient level. In addition, the smaller manufacturer complains that the price which it is charged for the chemical greatly exceeds the price which the chemical supplier had previously charged, alleging that the larger manufacturer is attempting to squeeze its competitor's margins to reduce its ability to effectively compete and possibly force its exit. Even when the smaller manufacturer receives supply from the larger manufacturer, it finds that delivery is erratic, quality is not necessarily of the standard agreed to, and it is required to meet what it believes are unreasonable credit and payment terms. In response to its complaints, the larger manufacturer threatens to cut off supply entirely and to reinitiate an old-standing legal action against the smaller manufacturer in an unrelated area.

Discussion

In this example, the source of market power lies in the control of the chemical. By excluding competitors from reliable and independent access to an essential resource, the alliance may raise an issue under the abuse of dominance provisions of the *Act*. Among the nine anticompetitive act examples outlined in section 78 is the pre-emption of scarce facilities or resources required by a competitor for the operation of a business, with the object of withholding the facilities or resources from a market.

A number of factors make it likely that this agreement would cause the Director to initiate an inquiry under the abuse provisions. By pre-empting an essential input, the larger manufacturer effectively excludes its smaller competitor from producing, in a cost-effective manner, a model which has won 70% of the market for a product and thereby effectively controls the market for the new model of consumer product. The rapid gain in market share of the new model despite being sold at a substantial price premium indicates that the old models are not particularly close substitutes. Control in this case is achieved by an anticompetitive act, namely the pre-emption of an essential input through the strategic alliance with the chemical supplier.

Having gained this control, the manufacturer proceeds to engage in a number of anticompetitive acts which appear to be designed to exclude or discipline its smaller rival. These acts include the original exclusive supply agreement for the chemical and squeezing of its rival's margins through a number of actions designed to raise the rival's costs, including higher prices for the chemical, spot supply, erratic delivery schedules, poorer chemical quality, and unfavourable credit and payment terms. The threatened legal action might also be found to constitute an anticompetitive act if it is frivolous or otherwise without merit. Such control and the subsequent anticompetitive acts appear likely to lead to a substantial lessening of competition for the consumer product. As the example is constructed, there does not appear to be any efficiency enhancing aspect of the exclusive supply arrangement between the parties to the alliance or the other actions taken by the manufacturer against its smaller rival.

(IX) Industry-Wide Agreement Example

Canadian manufacturers of a wide range of branded products find themselves exposed to strong import competition as a result of falling barriers to trade and reduced transportation costs. They find that they are competitive with foreign producers on manufacturing costs, having recently modernized plants and rationalized capacity, but that their distribution system is highly uncompetitive. Foreign manufacturers have achieved distribution economies by selling through alternative retail formats such as warehouse stores and mass merchandisers, which enjoy economies of scale, low-cost location, and who have electronically linked their retail check-out scanners to the foreign manufacturers' factory floors.

The Canadian manufacturers wish to continue selling to the traditional retail chains because they are viewed as giving better support to the value of brand names than do alternative retail formats. However, they do not believe that distribution efficiencies could be achieved quickly enough to prevent a drastic loss of market share to foreign manufacturers on the basis of each individual retailer working one-on-one with each of its suppliers to establish electronic links and implement new logistics systems. As a result, the manufacturers seek an industry-wide commitment, involving both vertical and horizontal alliances, which would significantly accelerate improvements to the distribution process. Once the new system is in place, it will function purely as a vertical alliance between traditional retail chains, brokers and manufacturers.

Discussion

Although this example looks quite different from the cooperative measures to meet environmental regulations example and the information sharing example, above, the same principles regarding horizontal agreements and information sharing among firms which collectively possess market power apply. In this example, the horizontal feature of the alliance involves a significant amount of communication and cooperation between the domestic manufacturers. This will only cause the Director to initiate an inquiry under section 45 if the parties to the exchange possess market power. An important factor to consider in making this determination is the presence of strong import competition. If competition from the foreign-based manufacturers limits the domestic firms' ability to collectively raise price or lower output, quality, service, promotional activity or innovation then the Director is unlikely to initiate a formal inquiry.

If the parties are found to collectively possess market power, the Director's examination will turn to whether the contemplated arrangements are likely to constitute behaviour injurious to competition. The potential always exists when competitors meet around the same table, even for the purpose of implementing an essentially vertical arrangement, that discussions regarding competitive factors, such as pricing policy and the details of trade promotions will take place or that information exchanges may unduly lessen or prevent competition. If the arrangements entered into relate primarily to achieving cost-savings efficiencies along the vertical chain, they are unlikely to constitute injurious behaviour and hence unlikely to cause the Director to initiate a formal inquiry. The risk of a formal inquiry is increased, however, should the arrangements contemplate coordination among the horizontal manufacturers in respect of pricing, output, service or promotional activity.

This scenario is an example of competition, not only between individual firms, but between vertical systems. Such rivalry can be highly beneficial, resulting in lower costs, lower prices, a better selection of products and better service to consumers. Nonetheless, given the potential for widespread effects across the industry, particularly when the alliance entails agreements between all domestic horizontal competitors, firms contemplating such an arrangement may wish to approach the Bureau under its Program of Advisory Opinions. In responding to a request under the Program of Advisory Opinions, the Bureau would provide advice to assist the firms in achieving their aims without coming into conflict with the *Act*.

Appendix 2
How to Contact the Bureau of Competition Policy

(I) General Information

Anyone wishing to reach the Director or a member of the Bureau to obtain general information, make a complaint, or request an advisory opinion may contact the following office:

Complaints and Public Enquiries Centre
Bureau of Competition Policy
Industry Canada
50 Victoria Street
Hull, Québec
K1A 0C9

By telephone:
National Capital Region (819) 997-4282
Long distance (toll free) 1-800-348-5358
TDD service 1-800-642-3844

By fax: (819) 997-0324

(II) Mergers

Anyone wishing to obtain information concerning the application of the merger provisions of the *Act*, including those relating to notification of proposed transactions, may contact the Mergers Branch directly at the address below:

Mergers Branch
Bureau of Competition Policy
Industry Canada
50 Victoria Street, 19th Floor
Hull, Québec
K1A 0C9

By telephone: (819) 953-7092
By fax: (819) 953-6169

The Bureau recommends that notification filings be hand-delivered.